Country-by-Country Reporting and the International Allocation of Taxing Rights

In this article, the author examines the OECD/BEPS country-by-country reporting (CbCR) requirements and the disconnect between CbCR data and the arm’s length principle, discusses the potential benefits and costs of country-by-country data, and concludes by considering the possible implications of CbCR for the international allocation of taxing rights.

1. Introduction

In this article, I discuss the OECD country-by-country reporting (CbCR) requirements, the disconnect between CbCR and current tax policy, the potential benefits and costs of CbCR (including misinterpretations of the data), and what all of this might mean for the international allocation of taxing rights. The CbCR requirement is included in the OECD’s Base Erosion and Profit Shifting (BEPS) Action 13. It requires certain multinational enterprises (MNEs) to file a report of their income and economic activities aggregated by country. The items required are related-party revenues, unrelated-party revenues, pre-tax profit or loss, cash income tax paid, income taxes accrued, stated capital, accumulated earnings, number of employees and tangible assets. The first period for which reporting has been (or will be) completed is for fiscal years beginning on or after 1 January 2016. Currently, 108 countries are in the BEPS Inclusive Framework and all having agreed to implement the four BEPS minimum standards, including Action 13.

I am an empiricist. Thus, this paper was difficult to write because there are no data to examine with respect to the OECD’s CbCR requirement. To mitigate this empty feeling, I spoke to tax executives I have met over the years, people that work or have worked in the US government in various ways related to the OECD’s BEPS Project, and tax consultants about their experiences and expectations. Certainly, such discussions do not fall under careful survey procedures or rigorous, large sample evidence. However, hopefully the insights from the conversations shed light on some issues regarding CbCR prior to examining actual data.

First, I provide an overview of the intent of, and conditions surrounding, CbCR. Second, I discuss the disconnect between the CbCR data and the arm’s length principle upon which taxation and transfer pricing are based. It is not clear that CbCR data are the right data to answer any questions regarding whether transfer prices are set appropriately.

Third, I discuss the potential benefits and costs of the data. The potential stated benefits include more transparency for tax authorities to identify areas to examine further and upon which to focus scarce resources. Another benefit might be found in a potential behavioural response on the part of companies to curb income shifting once they have to disclose activities and income on a country-by-country (CbC) basis. The costs include compliance costs, future costs of controversy, potential misdirection of resources or misuse of data by tax authorities, and increased uncertainty for MNEs. The initial compliance costs are high because the data were not generally gathered by companies prior to CbCR. However, the more significant costs may lie in future controversies that arise as jurisdictions attempt to claim that more income is taxable in their jurisdiction based upon some measure of underlying activity. It is clear that MNEs are quite worried about the significant costs such attempts might create, both in terms of time and explicit litigation costs. It is not clear that governments (the US government at least) are prepared for such future controversies if MNEs’ fears are realized.

Fourth, I discuss possible misinterpretations of CbCR data. The potential for misinterpretation is high for...
various reasons and, thus, caution must be used when evaluating the data.

Finally, I discuss possible implications for the international allocation of taxing rights. It is important to recognize that (1) CbCR is only one part of one of the BEPS Actions; and (2) the BEPS Project is really just one of many factors in the global efforts to identify and mitigate corporate income shifting. Thus, how much of a consequence CbCR itself will have on the allocation of taxing rights (or on MNE behaviour) is impossible to predict ex ante and, indeed, will be difficult to test ex post. However, it seems that CbCR will potentially contribute to increased conflicts between countries or even constitute a step towards the abolishment of the arm’s length principle for an international tax system more based on source, destination or formulary apportionment. My immediate opinion is not about whether this is the right direction, but rather that, while in flux, MNEs might be caught in the middle and be subject to excessive costs and uncertainty.

2. CbCR: Intent and Conditions

The overriding intent of CbCR is to provide tax administrations with information to conduct high-level transfer pricing risk assessments and to ensure that taxpayers give significant consideration to transfer pricing requirements. A general theme that is often expressed is that CbCR will enhance transparency for tax administrations, especially those that currently do not have access to high-quality information. The BEPS Project was not “…directly aimed at changing the existing international standards and the allocation of taxing rights on cross-border income.”

There are many conditions and constraints on the use of CbC reports and the information contained therein. At present, all three tiers of the Action 13 transfer pricing documentation are to be held confidentially within the tax administrations. In the United States, the tax form for filing this information is Form 8975, Country-by-Country Report, and accompanying Schedule A, Tax Jurisdiction and Constituent Entity Information. Thus, the information is covered by the normal confidentiality conditions of tax returns in the United States under Internal Revenue Code Section 6103.

The information in the CbC report is not to be used as a substitute for detailed transfer pricing analyses by tax authorities. The OECD clearly states, repeatedly, that the information in the CbC report does not on its own constitute conclusive evidence that transfer prices are inappropriate and that jurisdictions are not to propose transfer pricing adjustments based on a global formulary apportionment of income. Jurisdictions are to commit to using the data appropriately, and to commit that, if adjustments are proposed based on CbC data, the jurisdiction’s competent authority will promptly concede the adjustment. In

addition, a consequence of violating the confidentiality condition is the exclusion from future CbC information exchanges. Essentially, the CbC reports are to be confidential data used by tax authorities as a basis for further questioning about transfer pricing issues, not as a sole basis for making audit adjustments.

3. A Disconnect

There is a clear and well-acknowledged disconnect with CbCR: taxation and transfer pricing rules are not based on formulary apportionment or otherwise directly based on where economic activity occurs - the tax rules work on an arm’s length principle. Thus, although MNEs are required to apply the arm’s length principle in their planning and in computing their taxes, they will be evaluated, at least to some extent, based on their CbCR, which is not about arm’s length prices but a global reporting of income and activity. Indeed, consistent with the existence of a disconnect, David Ernick, a principal at PwC and former associate international tax counsel at the US Treasury Department, stated that:

“[t]he focus has since shifted to an MNE providing high-level information on its global value chain and allocation of income, economic activity, and taxes paid among countries that generally will be unrelated to the specific transfer pricing arrangement.”

In addition, as already discussed, the OECD has attempted to put boundaries and constraints on the use of the data. Whether these hold, however, is an open question. If tax authorities rely too strongly on the CbC data to initiate investigations of transfer pricing arrangements, the investigations may not be well founded. Thus, it is possible that, instead of making tax audits more efficient, the data (and the disconnect from the arm’s length principle) could lead to Type I errors (false positives in identifying income shifting).

6. There are many other issues with respect to the protection of the data and potential lack of confidentiality resulting from the lack of treaty arrangements between some countries and the timing of the CbC reports (among other issues). These are beyond the scope of this article.
8. At the conference, a suggestion was made to include an example of an MNE with a tax haven, legal transfer pricing arrangements and CbC data that might be misleading. Such an example/case study can be found in an article by Bill Brennan entitled “BEPS Country-by-Country Reporting: The Practical Impact for Corporate Tax Departments.” I refer the interested reader to that article, but briefly the case is as follows.

A US MNE has many subsidiaries and operations around the world. The company has a Swiss affiliate with which it enters into an intercompany licence agreement that grants the Swiss affiliate rights to patents and an intercompany R&D agreement whereby the US company performs R&D activities for the Swiss affiliate. The Swiss affiliate enters into intercompany licence agreements and intercompany sales agreements with other affiliates as well. The end result is that the Swiss affiliate earns a substantial amount of profit from the European operations. It is likely in this example that the information regarding the income earned by the Swiss affiliate will be available to many tax authorities where it was not before. (The Swiss entity would not be disclosed for financial reporting probably because the Swiss affiliate only has intercompany accounts, which are eliminated for financial accounting purposes.) However, it is also possible that in this case that the transfer pricing arrangements are consistent with the arm’s length principle and the profit is being properly reported in the Swiss affiliate under current residence-based tax systems. However, many other jurisdictions may try to assess tax on the MNE and reallocate profits based on the CbC report. I discuss

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5. It is likely that some level of aggregate data by sector, size, etc. will be publicly available via Statistics of Income reports consistent with the release of other aggregate tax return data in the United States. This would be CbC reports of US resident MNEs only. The OECD may publish multiple countries’ aggregated anonymized reports.

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4. Potential Benefits

There are several potential benefits from CbCR. First, the three-tier approach for transfer pricing documentation (Master File, Local File, CbC report) will force companies to articulate their transfer pricing strategies and company structure to tax authorities which should enlighten the tax authorities about the overall company business, operations, and strategy.

Second, CbCR will certainly increase the amount of disclosure available to tax authorities about the location of the economic activities of MNEs. While the United States has high-quality information because it requires form 5471 Information Return of U.S. Persons with Respect to Certain Foreign Corporations and form 5472 Information Return of a 25% Foreign-Owned U.S. Corporation or a Foreign Corporation Engaged in a U.S. Trade or Business (although these forms do not require exactly the same information as the CbC report), many countries do not have similar filing requirements and have much less information on MNEs than the does United States.

CbC data are not even available for publicly traded companies, except at a very high level. I examined Microsoft Corporation’s and Alphabet Inc.’s forms 10-K for the first fiscal year starting on or after 1 January 2016. What did I observe? I could see the names of the most highly paid executives of both companies, and with some quick Internet searches was able to deduce that all are located in the United States (five are disclosed for Microsoft, seven for Alphabet). I could also see that sales, which for financial reporting purposes for these two companies are disclosed based on the location of the third-party customer, are disclosed as being 50% US for Microsoft and disclosed as being 47% US for Alphabet. Also, pre-tax financial income for Microsoft is reported as being 1.96% US and for Alphabet is being almost 50% US. Microsoft also reports that 57% of its assets are in the United States. Thus, for publicly traded companies, it is possible to see some information about where economic activity occurs and where income is reported - at a minimum, between their home country and all other countries. However, among “all other countries” that are aggregated as “foreign” or “international,” almost no information is available.9 So, certainly, the CbC reports will provide more information about the location of MNEs’ activities and reported income.

Other possible benefits include (1) potentially greater understanding on the part of the companies themselves; and (2) potential behavioural responses on the part of companies. The standard view of a corporation is that US MNEs’ concerns about such situations in this article. (Note that the Brennan article also discusses data and reporting issues for the case.)

9. Even though some companies offer a little more in the way of disclosure, it is still not country-by-country. If any country represents a material portion (often 10%), it should be separately disclosed. For example, Amazon Inc. discloses Japan, Germany and UK revenues separately. Apple Inc.’s disclosures include Greater China, Europe, Americas and Japan. In addition, some companies disclose other items with some jurisdiction information. Finally, exhibit 21 required by the Securities and Exchange Commission requires a listing of material subsidiaries and their jurisdiction but does not include any disclosure of income or activities.

managers have all the inside information and report some required and selected amount of information to outsiders. However, the literature also documents cases where managers seem to learn about the inner workings of their company when changes in accounting standards or disclosures are required.10 Thus, requiring companies to articulate their transfer pricing strategies and the location of their economic activities may bring to light issues upon which management had not previously focused.

The CbC disclosures to the tax authorities could yield a behavioural response, especially in the current time period of global attention on, and disdain for, corporate tax avoidance. Indeed, Robert Stack, former Deputy Assistant Secretary of International Affairs in President Obama’s administrations, said, “I think the effect of country-by-country [reporting] will be that companies are not going to want to show profits in low or no tax jurisdictions anymore.”11 Some companies I talked with said they knew of some companies that had already altered their organizational structure in some way as a result of the CbCR requirement.

There is academic literature on corporate responses to mandatory public disclosure.12 In terms of studies on private disclosures to tax authorities, the list is much smaller and not exactly on point.13 But it does seem increasingly the case that firms are concerned about some notion of tax risk, that they are worried about their reputation with respect to tax issues, and that most certainly they want to avoid any possibility of financial accounting restatements or earnings charges with respect to past tax positions.14 Moreover, recent survey evidence concerning

13. E. Towery, Untended consequences of linking tax return disclosures to financial reporting for income taxes: Evidence from Schedule UTP, 201 226 The Acc. Rev. 92 (3) (2017) finds evidence consistent with firms not changing their tax reporting after being required to report a new schedule to the IRS about uncertain tax positions (however, she finds that financial reporting of the amount does change). Z. Bozanic et al. IRS Attention, 79-114 of Acc. Rev. 35 (2017) also find that firms change public disclosures when required private disclosures to the IRS change.
14. M. Hasegawa et al., The Effect of Public Disclosure on Reportable Taxable Income: Evidence from Individuals and Corporations in Japan, 571-608 Nat. Tax J. 6 (2013) do not find evidence of tax avoidance behaviour changing when a system of tax disclosure was repealed in Japan. When tax information is required to be publicly disclosed, different results are obtained. For example, S. Gupta et al., The effect of mandatory financial statement disclosures of tax uncertainty on tax reporting and collections: The case of FIN 48 and multistate tax avoidance, 203-229 of Am. Taxn. Ass. 36 (2014) provide evidence that state tax avoidance declined after financial statement disclosures were required about uncertain tax benefits.
the impacts of the BEPS Project (and other concurrent issues) suggests that corporate managements have, at least to some extent, changed behaviour in response.\textsuperscript{15} Thus, a behavioural response is possible in which companies either alter where taxable income is reported to be more in line with where economic activity occurs, or they move economic activity to be located in jurisdictions where they want to report income.\textsuperscript{16}

5. Potential Costs and Concerns of MNEs (And Another Disconnect)

There are also several possible costs of CbCR. First, the compliance costs of gathering CbC data are potentially high. CbC data would not necessarily, or even typically, be maintained by MNEs prior to CbCR.\textsuperscript{17} Indeed, in the document “OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” (July 2017), the OECD provides arguments as to why the countries that have agreed to the BEPS Project agreed to continue with the arm’s length principle and not move to global formulary apportionment (pages 39–43). Some of these same arguments seemingly could be applied to CbCR. For example, paragraph 1.27 states that:

[c]ontrary to the assertions of its advocates, global formulary apportionment may in fact present intolerable compliance costs and data requirements because information would have to be gathered about the entire MNE group and presented in each jurisdiction.\textsuperscript{18}

Paragraph 1.28 goes on to state that “[d]ifficulties would arise in determining the sales of each member and in the valuation of assets…”.

The CbC data required by the OECD are not trivial for many MNEs to gather - their systems are just not designed to easily extract the required data by country.\textsuperscript{19} Further...

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\textsuperscript{16} Note that companies could alter real activities, not just stop income shifting. This may or may not be a “benefit” depending on one’s view, but is a possible outcome in addition to changing income shifting behaviour. This may not work out in current tax havens’ favour as it might seem would be the case at first glance. It has to be considered whether the recent tax law changes in the United States turn out to be more business friendly in practice. Such changes interacted with the increasing pressure and tax risk exposure in other jurisdictions around the world may lead US multinationals to shift real activity back to the United States and report more income in the United States. In addition, again, the other BEPS Actions (e.g. Actions 8–10) will potentially have effects as well.

\textsuperscript{17} Also, even if some data are maintained on a country-by-country basis internally, the definitions of the items are often not the same as the definitions required by the OECD.

\textsuperscript{18} As stated earlier, financial accounting standard setters and financial accounting reports usually do not report data by country. There are required disclosures for the accounting for income tax and now recommended disclosures for cash holdings for some US companies. These disclosures are not country-by-country but rather US versus foreign. Some proposals were made by the Financial Accounting Standards Board (FASB) to move to some level of reporting by material country for items in the income tax note to the financial statements. See FASB’s Minutes of the 11 February 2015 Board Meeting. However, these were not final, required standards as at the time of writing this article, would not entail the same detail and computations as the OECD CbC requirements (and they are just the pre-tax income and the tax accounts), and will likely change following the US Tax Act in 2017.

\textsuperscript{19} In discussions with tax consultants, they gave ranges of a few hundred thousand dollars to well into the millions. The costs would be especially high for companies that invested in systems and system upgrades. They added that compliance costs to create the Master File and Local File are very significant as well.

\textsuperscript{20} The notion that many companies would not have the data without considerable effort is further supported in B. Brennan, \textit{BEPS Country-by-Country Reporting: The Practical Impact for Corporate Tax Departments}, 430–438 The Tax Adviser (2015). Brennan was the chief tax officer of Vertex, Inc. when he wrote the article. In the article, he conveys that, after his 33 years working in corporate tax departments, he thought it would be “rare” for corporations to have the necessary data in ready form from their systems because the financial reporting systems are not maintained on a legal entity basis, among other reasons. Brennan also details many other reporting, system and data reconciliation issues in his article.

\textsuperscript{21} One particular item of uncertainty is with respect to surrogate filing when the United States does not have an agreement in place. Who do they send the report to and how do they send it?

\textsuperscript{22} In light of the difficulty in gathering the data and the unfamiliarity with the data, some people I talked to - both at companies and in the government - suggested the first year or two of data should just be considered something in the spirit of “practice CbCR” because they predict so many problems.

\textsuperscript{23} Some companies described this as “death by a thousand cuts” and that it will be an educational process whereby MNEs have to educate some tax authorities.
controversy, the government personnel at the same time seemed to think the United States is ready, has its “eyes wide open,” and is prepared (or in the process of becoming prepared). In addition, I heard comments such as “CbC information won’t even be useful” and that refraining such tax assessments by foreign governments will be easily accomplished. The view of US MNEs is quite different. As already discussed, MNEs expect that some foreign jurisdictions will attempt to (incorrectly) levy tax or, at a minimum, ask for a lot more information (possibly via blast information requests based on the CbC reports). If true, such actions will take time on the part of MNEs to deal with, some will be deemed “too small” to fight and, overall, such actions will be very costly for the companies. Thus, MNEs seem to expect the future controversy to be much greater than the government expects. My sense is that this is leading MNEs to feel somewhat vulnerable because they expect to receive insufficient protection from the US government as a result.

In addition, most companies also fully expect the data to somehow enter the public domain either through hacking of systems or leaks (an issue I return to subsequently). If the data enter the public domain, the expected public relations costs for large (especially consumer-oriented) MNEs could be high, even if their transfer pricing arrangements are free of any tax deficiencies. Thus, while most companies do not expect outright tax costs due to actual problems in their transfer pricing arrangements, they do expect high controversy costs, some tax payment costs just to settle the disputes where they must, and potentially high public relations costs. The MNEs I talked to do not think that the US government and the OECD are fully recognizing the extent to which this will (might) occur.

6. Omissions, Limitations and Possible Misinterpretations of the Data

6.1. Introductory remarks

Notwithstanding the issue that CbC data are not directly useful in transfer pricing arrangements/decisions, there are other issues with the data. These can be viewed, on one hand, as problems with the data, but, on the other, as opportunities for focused training or for improvement when CbCR is evaluated in 2020.

First, there are some seemingly obvious omissions. The CbCR requirements are that companies report the following items aggregated by country: related-party revenues, unrelated-party revenues, pre-tax profit or loss, cash income tax paid, income taxes accrued, stated capital, accumulated earnings, number of employees, and tangible assets. What is missing are items like intangible assets (e.g. patents and trademarks), debt and intercompany interest and royalty payments. When trying to identify income-shifting activities, these missing items may be the important ones to know.24

Second, there are also numerous ways in which the CbC data may be misinterpreted when just trying to decipher where economic activities occur. For example, the data can be reported from different underlying sources (e.g. financial accounting data and statutory reports) across companies and across countries, thus compromising comparability. Next, I discuss a few more detailed avenues for misinterpretation of the data. I note that some of the issues I outline have been previously highlighted by the OECD and others.

6.2. Potential sources of double counting

6.2.1. No eliminations

In general, when financial accounting data are used as the underlying source, the data will be reported at an aggregate level and not a consolidated level. What this means is that intercompany transactions will not be eliminated. Thus, a sale from a parent company to a subsidiary for ultimate sale to a third party will show revenue in the data for both the parent company and the subsidiary. Intercompany interest payments, royalty payments, etc. will similarly not be eliminated. As a result, the potential for double counting is quite high. One company I talked to mentioned that it had to work through how to check the number at a high level: was it reasonable? Aggregated data are not the type of data companies are familiar with and may lead to errors on the part of the companies. In addition, clearly it will appear as if there is a lot more revenue on a global basis than actually exists and, thus, tax authorities from around the world may be overly zealous in auditing the companies as a result. There are reasons to want the reporting to be on an aggregate basis, but the conceptual point that there will be a lot of double counting needs to be remembered when evaluating the data.

6.2.2. “Stateless income”

Another source of double counting will be in the row for “stateless income.” Entities that do not have a tax jurisdiction of residence are to be aggregated and reported in a separate row of the CbC report labelled “stateless” for the jurisdiction. A significant portion of the income shown in this row, however, will not, in fact, be stateless and will be double counted in the CbC report. For example, a business entity treated as a partnership in the jurisdiction in which it is organized will have no tax jurisdiction of residence if it does not own or create a permanent establishment in that or another tax jurisdiction. Because it technically does not have a tax jurisdiction of residence, the activity for these entities is to be reported in the “stateless” row of the report. However, each owner of the partnership will report its share of the revenue and profit in the information for the tax jurisdiction of its residence (whether or not the income is subject to tax for that partner). Users of the data will need to be very aware of this issue; the stateless income line will be overstated.

24 I recognize that the Master File and Local File include some discussion of the intangibles in the context of the business (see the Appendix). I am not arguing to include or exclude this information from the CbC report. Rather, this is another example of the part-way nature of the CbC report – i.e. part way to formulary apportionment and only part of the information.

25 There is an exception to this in recent guidance from the OECD.
6.3. Issues when comparing measures year to year

6.3.1. Introductory remarks

Suggestions for how to use the data in the OECD documentation often involves year-over-year comparisons of data and ratios. Such analysis is common in, for example, financial statement analysis, but at times such analysis is problematic and not reliable. For example, in some cases, long-run measures may be more appropriate to avoid year-over-year volatility due to underlying economic changes. In other cases, a more detailed view may be needed for assessment.

6.3.2. Business combinations

Under most financial reporting rules, when two companies combine (i.e. a merger or acquisition), the acquirer records the acquisition at the purchase price in the year of the acquisition. Thus, the acquiring company’s balance sheet (e.g. assets and liabilities) will increase due to the combination. Prior years are not restated. In addition, income for the two entities will be combined after the acquisition date. Thus, a direct comparison (pre-acquisition to post-acquisition) will not be useful and could lead to incorrect inferences.

6.3.3. Accounting standard changes

If the underlying data are financial accounting data, it is important to recognize that accounting standards change over time. For example, in 2005, many countries around the world adopted International Financial Reporting Standards (IFRS) and their reporting could have changed significantly at that time. Two significant changes in the US Generally Accepted Accounting Principles (GAAP) becoming effective right now are Revenue Recognition (ASC Topic 606) and Accounting for Leases (ASC Topic 842). The new revenue recognition standard will significantly change the way in which revenue is recognized for some companies (especially those with multiple element contracts and deferred revenue), at times accelerating revenue relative to the previous accounting standards and at times resulting in potential double counting over time for contracts in place when the new standard is adopted. The change to the lease accounting rules in the US GAAP will result in a significant amount of assets and liabilities being brought “on balance sheet”, whereas previously they were “off balance sheet”. A detailed discussion of each of these issues is beyond the scope of this article, but the point is that, as accounting standards change over time, and as a result, if the CbC data are reported based on financial accounting data, the reported data in the CbC reports will potentially be different year to year due to these standard changes. Thus, an understanding of the accounting changes and the implications for the reported numbers will be required before a proper evaluation of the data in year-to-year comparisons can be completed.

6.4. Financial accounting versus tax reporting

6.4.1. Introductory remarks

It is well known but important to recall that in many countries the financial accounting rules (US GAAP, IFRS or other local GAAP) are different from tax reporting rules. In general, each item of revenue and expense can be accounted for differently for tax purposes versus financial reporting purposes. These differences can be large, as discussed in various previous published works. In addition, there are other important issues, two of which I will discuss subsequently.

6.4.2. Consolidation rules and related issues

Financial accounting and tax rules often account for ownership of another company differently. For US financial accounting purposes (and under most accounting standards), the entities included in the MNE group, and the extent to which they are included, are determined by the level of control. If the investment is considered passive (i.e. ownership of less than 20%), there is no inclusion of the investee’s income in the investor company’s financial statements. Rather, if the security has a readily available market price and is liquid, the parent will include the change in market value of the security in its financial statements. If the investor company has some level of influence but not majority control (20%-50% ownership), the investee company is accounted for using what is known as the equity method of accounting, where the proportionate share of the investee’s income is included in the investor’s financial statements. Finally, for financial accounting purposes, the companies will be consolidated if the investor company has control (generally, more than 50% ownership). For tax purposes, these rules are often quite different. In the United States, for example, consolidation is an option if ownership is greater than 80% and there is no mark-to-market or equity method of accounting. Thus, the entities that are combined for tax purposes are different than those combined for financial accounting purposes. The definition of a ‘group’ for tax purposes is based on what is, or would be, the financial accounting group.

27. Note also that there will be a greater mixture of measurements in the balance sheet. The assets purchased will be recorded in the balance sheet at the purchase price, whereas self-developed assets of the acquirer may not be in the balance sheet at all and older tangible assets will be in the balance sheet at historical cost (less depreciation where applicable).
6.4.3. Revenue allocation and income allocation

It is also well known but important to recognize that sales are often sourced to a different location for financial reporting purposes relative to tax purposes. For financial accounting purposes, revenues can be disclosed using one of several methods, but are often disclosed by where the third-party customer is located.\(^31\) For example, Alphabet Inc. states that the allocation of revenue is “determined based on the billing addresses of our customers,” while Microsoft Corporation states that revenue is classified by “…the major geographic areas in which our customers are located.” However, some of the sales that MNEs disclose as tendered to foreign customers may be included in the US tax return.\(^32\) Thus, the CbC sales amounts will often be based on financial accounting revenue allocations, and it is important to recognize that where financial accounting allocates the sale does not necessarily correlate with where the sale was correctly recorded for tax purposes. This means that, even absent any income shifting, the location of the sale can vary wildly based on the differences in the rules.

6.5. Overall

The foregoing enumerates important issues with the data in a CbC report. Misunderstanding of the limitations and details of the data could lead to misuse of the data. In other words, the data could lead to many false positives in attempts to identify income shifting. Such issues will be unnecessarily costly for MNEs (and tax authorities). Furthermore, such issues are extremely important to remember when considering whether public disclosure of these data is appropriate.\(^33\) For example, the press (and some academics) would likely be attracted to a story or study about large amounts of stateless income for large, multinational corporations, but in many cases that income will not really be stateless. The details of the data will be hard for outsiders to understand.

7. International Allocation of Taxing Rights

Will the BEPS Project, and in particular CbCR, affect the international allocation of taxing rights? A data-supported answer, of course, cannot be provided because the requirement is so new. However, it seems that despite the OECD’s stated claims that the BEPS Project is not meant to directly alter the allocation of taxing rights, it almost undoubtedly will.

Again, it is important to note that the BEPS Project is not all that is occurring. Even before the BEPS Project (and still now), some countries were pushing for changes in taxing rights around the world. Indeed, this was, in some sense and in part, a motivation for a central organization like the OECD to take the lead, build consensus, and attempt to prevent many nations from taking unilateral actions. However, once the CbCR data are available, it might provide data which some countries will use to push for more direct changes. In other words, the train is rolling and it will be hard to stop. For example, at the International Taxation Conference in Mumbai, India, in December 2016, Akhilesh Ranjan, India’s Chief Commissioner of Income Tax said that developing countries would not be satisfied with the OECD BEPS Project’s recommendations for long because source-based issues were still not addressed.\(^34\) There is a lot at stake for the BRIC countries (and others) and it is likely that they will ask for more. In addition, other developments signal increasing pressure on existing policies (and on the BEPS Project); examples include Australia’s and the United Kingdom’s diverted profit taxes and the efforts of the European Commission to negate tax agreements of European nations and multinational corporations (e.g. the case against Apple Inc. and others). Thus, the CbCR data (and the BEPS Project in general) could lead to more conflicts between countries.\(^35\) In addition, CbCR may be a step (maybe one of many?) towards a different global tax regime – the abandonment of the arm’s length principle in favour of source or destination-based taxation (or formulaic apportionment).

In the interim periods before the final effects are settled, MNEs are likely to be caught in the middle and subject to a great deal of costs and uncertainty. It seems that all the parties do not have the same expectations with respect to

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31. ASC 280 Segment Reporting (formerly in Statement of Financial Accounting Standards No. 131). The other options are, for example, the location of the selling subsidiary or the location of the asset that generated the sale. The company should (but does not always) disclose how it is allocating revenue. In contrast to the allocation of revenue, the pre-tax financial accounting earnings are allocated to US and Foreign in the income tax note to the financial statements based on the domicile of the legal entity in which the earnings are reported per SEC Reg. S-X, Rule 4-08(h).
32. For example, if they are export sales or if they are foreign base company sales included in US taxable income via Subpart F. Details of these issues are beyond the scope of this article and may change following the tax law changes in the United States in 2017.
33. There has been and is a push to make some type of CbC reports public by the European Union and some suspicion that the reports filed to be compliant with OECD Action 13 will be made public somehow (e.g. leaked to the press or hacked). It is tempting to think that more information must be better, but caution must be exercised. Regulators for financial accounting information and disclosure often face this decision – how much disclosure is appropriate? For example, Mary Jo White, former SEC Chair, stated in a 2013 speech that “[w]hen disclosure gets to be ‘too much’ or strays from its core purpose, it could lead to what some have called ‘information overload’ — a phenomenon in which ever-increasing amounts of disclosure make it difficult for an investor to wade through the volume of information she receives to ferret out the information that is most relevant.”\(^{\text{supra}}\). At a minimum, more disclosure must be corrected. However, once the CbC data are available, it might provide data which some countries will use to push for more direct changes. In other words, the train is rolling and it will be hard to stop. For example, at the International Taxation Conference in Mumbai, India, in December 2016, Akhilesh Ranjan, India’s Chief Commissioner of Income Tax said that developing countries would not be satisfied with the OECD BEPS Project’s recommendations for long because source-based issues were still not addressed.\(^{\text{supra}}\) There is a lot at stake for the BRIC countries (and others) and it is likely that they will ask for more. In addition, other developments signal increasing pressure on existing policies (and on the BEPS Project); examples include Australia’s and the United Kingdom’s diverted profit taxes and the efforts of the European Commission to negate tax agreements of European nations and multinational corporations (e.g. the case against Apple Inc. and others). Thus, the CbCR data (and the BEPS Project in general) could lead to more conflicts between countries.\(^{\text{supra}}\) In addition, CbCR may be a step (maybe one of many?) towards a different global tax regime – the abandonment of the arm’s length principle in favour of source or destination-based taxation (or formulaic apportionment).
35. Id. Herzfeld calls such conflicts “tax wars.”
8. Conclusions

Another way to frame what I have outlined is by asking two questions often asked in academic workshops (especially in those workshops that do not go very well): “What is the question we are trying to answer” with CbC reports and “can the data answer the intended question?” MNEs are taxed using arm’s length transfer pricing principles. However, CbCR will require them to gather and report data based on where the underlying economic activity is located. There is clearly a disconnect between the CbC data and the arm’s length principle transfer pricing rules. CbC data will not provide direct information about whether an arm’s length price was employed. Requiring CbCR while taxing using the arm’s length principle will potentially lead to a great deal of uncertainty and exposure to tax claims for MNEs. It is as if they are in some type of mezzanine state, in limbo, or in some type of half-way house. This puts MNEs in a vulnerable position that will likely be quite costly in terms of future tax controversy – for MNEs and their home countries. The OECD recognizes the disconnect, but whether the constraints and conditions for use of the information will be regarded is an open question.

There are many ways in which CbC data can be misinterpreted and misunderstood. I have outlined a few of the issues. A great deal of training and probably some ongoing improvements (including the planned review in 2020) regarding the data required to be reported will be needed. The information should certainly not even be considered for public release until the issues are largely resolved (and micro-data quite possibly should never be released to the public).36

Finally, as outlined throughout the article, CbCR could have or contribute to several outcomes: (1) less income shifting (or more movement of real activities) by multinational enterprises; (2) more data for tax authorities, leading to potentially more or potentially less efficient transfer pricing audits; (3) more attempts to claim taxing rights to an MNE’s income by governments; (4) increased conflicts between countries; and/or (5) a step away from arm’s length pricing to a different policy based on destination, source or formulary apportionment. Furthermore, tax reform in the United States and other countries could interact with or counter the BEPS Actions to change the landscape dramatically and yield other outcomes.

I would normally close by saying that I look forward to future research on these issues as the data becomes available. While I do look forward to such research, I also want to add a bit of caution. As I have noted throughout, there are many things going on around the world with respect to taxes and combating income shifting and other tax avoidance behaviours - for example, all 15 of the BEPS Actions, the EU cases against Apple Inc. and other MNEs, unilateral laws, such as the diverted profits taxes of the United Kingdom and Australia, seemingly increasing press attention on corporate tax avoidance, the Tax Cuts and Jobs Act of 2017 in the United States and other events. Thus, isolating the economic effect of one policy, such as CbCR, will be difficult. Testing the effects of almost any regulation is notoriously fraught with problems, such as endogeneity and confounding factors, and this instance will be no different. Governments, the OECD and eventually researchers will need to exercise caution and use creativity (e.g. staggered implementations if they exist, size cut-offs, such as the EUR 750 rule in the CbCR, other cross-sectional variations or other methods, such as surveys) to gather data and conduct reliable tests.

9. Appendix: High-Level Overview of CbCR

The OECD’s Base Erosion and Profit Shifting Project includes 15 Actions, one of which is Action 13 Transfer Pricing and Country-by-Country Reporting.37 Action 13 develops a three-tiered approach to transfer pricing documentation: (1) a Master File; (2) a Local File; and (3) a Country-by-Country Report. The Master File and Local File are to be delivered by MNEs directly to local tax administrations. CbC reports should be filed in the jurisdictions of tax residence of the parent entity and shared among jurisdictions through automatic exchange agreements via mechanisms such as treaties, tax information exchange agreements (TIEAs) or the Convention of Mutual Administrative Assistance in Tax Matters.

I will briefly explain the first two documentation requirements. The Master File is required to report high-level information about global business operations and transfer pricing policies of an MNE. This file is not meant to include a lot of details, but rather a “blueprint” including (a) the MNE’s organizational structure; (b) a description of the MNE’s businesses; (c) the MNE’s intangibles; (d) intercompany financial activities; and (e) financial and tax positions. The Local File is to include more detailed information relating to specific intercompany transactions, for example relevant financial information (e.g. intra-group payments and receipts broken down by tax jurisdiction) regarding the specific transactions, copies of 36. Note that I am not against release of more data about taxation generally. Indeed, I proposed additional disclosure in 2003 involving a more detailed reconciliation from tax expense to taxes paid for US versus foreign locations. See Hanlon, supra n. 30. However, the CbC reports are going to have a lot of data that are ripe for potential misuse and misunderstanding. At a minimum, a several year trial period with the data as confidential is necessary.

37. The other actions are as follows: Action 1 – Addressing the Tax Challenges of the Digital Economy; Action 2 – Neutralising the Effects of Hybrid Mismatch Arrangements; Action 3 – Effective Controlled Foreign Company (CFC) Rules; Action 4 – Interest Deductions; Action 5 – Countering Harmful Tax Practices More Effectively. Taking into Account Transparency and Substance; Action 6 – Preventing the Granting of Treaty Benefits Inappropriate Circumstances; Action 7 – Preventing the Artificial Avoidance of Permanent Establishment Status; Action 8 -10 – Aligning Transfer Pricing Outcomes with Value Creation; Action 11 – Measuring and Monitoring BEPS; Action 12 – Mandatory Disclosure Rules; Action 13 – Making Dispute Resolution Mechanisms more Effective; and Action 15 – Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS. (See Interim Reports, Comments, and Final Drafts at http://www.oecd.org/tax/beps/beps-actions.htm.) CbCR is one of the four minimum standards contained in the 15 Actions.

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material intercompany agreements, a comparability analysis, a discussion of the selection and application of the most appropriate transfer pricing method, and relevant existing unilateral and bi/multilateral APAs and other tax rulings. In addition, the Local File should include a description of the management structure of the local entity, local organizational chart, descriptions of individuals and their locations to whom local management reports. Finally, the Local File should include a detailed description of the business and strategy of the local entity, including whether the local entity has been involved in or affected by business restructurings or intangibles transfers, as well as a listing of key competitors.

The third tier is the Country-by-Country Report, the primary focus of this article. The CbC report is required each year for MNE groups with consolidated group revenue in the immediately preceding fiscal year of EUR 750 million or more.38 In general, there are no other exceptions (e.g. for industry, public vs private, or organizational form) from the CbCR requirement.39 The MNE group is essentially the ultimate parent company of the group and its constituent entities, where a constituent entity is an entity that is included in the group’s consolidated financial statements or would be included if the company were required to prepare such financial statements.40

There are three tables to the CbC report that are to be filed each year:41 Table 1 is a tabular template that requires a listing of each tax jurisdiction of the MNE and an aggregate allocation to each jurisdiction of (1) revenues (unrelated party and related party); (2) profit or loss before income tax; (3) cash income taxes paid; (4) income tax accrued (current year); (5) stated capital; (6) accumulated earnings; (7) number of employees; and (8) tangible assets (other than cash and cash equivalents).42 The data for reporting may be obtained from one of several sources, but the MNE should consistently use the same sources of data year to year. The data may be obtained from financial accounting data (consolidating data, not consolidated data – meaning before eliminations), separate entity statutory financial statements, regulatory financial statements, or internal management accounts. The MNE should provide a description of the sources of data used and explain any changes year to year.

Table 2 is a tabular template for MNEs to list constituent entities included in each tax jurisdiction. Thus, the table requires a the listing of (1) each tax jurisdiction of the MNE; (2) each constituent entity resident in each tax jurisdiction; (3) the jurisdiction of organization or incorporation of each listed constituent entity (if different than the jurisdiction of residence); and (4) the main business activity of each constituent entity. Table 3 is for additional information where the MNE may provide an open-ended text description of any other information they consider necessary. CbC reports must be filed with the tax authority in the parent company’s residence jurisdiction within 12 months after the end of the fiscal year and the deadline for exchanging the report is 15 months after the end of the fiscal year (18 months in the first year).43

38. The OECD states that this rule should exclude 85%-90% of global MNE groups from the requirement. A quick pull from Compustat reveals that the revenue rule would mean that roughly 48% of the publicly listed US multinational corporations with available data would be required to file the CbC report.
39. Except for international transportation or transportation on inland waterways covered by treaty provisions.
40. It also includes entities that are excluded from consolidated financial reporting based on size or materiality, as well as any permanent establishment of any separate business unit of the MNE group if these permanent establishments have separate financial statements.
41. In the United States, the tax form for filing this information is Form 8975, Country-by-Country Report, and accompanying Schedule A, Tax Jurisdiction and Constituent Entity Information.
42. OECD Action 13 defines a tax jurisdiction as a State as well as a non-State jurisdiction which has fiscal autonomy. The list of jurisdictions should include all jurisdictions in which constituent entities of the MNE group are resident for tax purposes. Action 13 states that a separate line should be included for all constituent entities in the MNE groups deemed not to be resident in any tax jurisdiction for tax purposes.
43. There are exceptions where other entities in the group may file and other avenues of filing. These are beyond the scope of this article.