Country-by-Country Reporting: Potential Audit and Legislative Risks For MNEs

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Reprinted from Tax Notes Int’l, March 24, 2014, p. 1127
The OECD’s action plan on base erosion and profit shifting, released in July 2013, included a mandate to improve transfer pricing guidelines. The OECD guidelines, adopted in 1995, are nebulous enough that many member countries have adopted their own documentation rules, creating expensive compliance burdens and a minefield of unique jurisdictional rules for transfer pricing groups at multinationals and for their advisers, while leaving auditors with often inadequate data.1 To address this, the action plan calls for a requirement that multinational enterprises “provide all relevant governments with needed information on their global allocation of the income, economic activity and taxes paid among countries according to a common template.”

Accordingly, the OECD released a discussion draft with uniform reporting requirements on January 30.2 The discussion draft proposes a reporting template to provide key financial and operational metrics in all countries under whose laws a multinational enterprise operates. The template would require reporting of items such as revenue, tangible assets, and payroll.

Reaction from practitioners has centered on compliance or reporting issues, rather than the template’s potential impact on tax audits. During a February 13 PricewaterhouseCoopers webcast on the draft, nearly half of all polled respondents cited the cost of compliance as their primary concern, followed closely by maintaining confidentiality of the reporting data.3 But beyond the initial questions about what the incremental cost of compliance will be, and how MNEs will meet these burdens, are questions about the impact of providing the data to tax authorities. The discussion draft and the action plan take for granted that the data will be useful to auditors in identifying abuse. But once the data are made available to local country auditors, how will they use them?

Lost in Translation

An initial concern for MNEs is the standard of accounting used to report the data in the proposed template. From a local country auditor perspective, the most useful data would, arguably, be reported according to familiar local statutory accounting rules. That is, the country-by-country (CbC) template received by an auditor in India would reflect the value of all amounts (and across all other jurisdictions) according to Indian

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2Id.
statutory accounting principles. A Brazilian auditor would see the data for all jurisdictions adjusted to reflect Brazilian statutory accounting principles, and so on. The two-tier approach the OECD proposes in its draft may result in local country rules that require the new CbC data as well as the existing transfer pricing documentation. If the existing requirements were reported according to local country statutory accounting principles, the CbC template would supplement those data nicely, as the data in each would be comparable.

Obviously, the compliance costs of that scheme make it a non-starter, and this is not what the discussion draft proposes. Instead, the discussion draft requires the MNE take a “bottom-up” approach, reporting the data in each jurisdiction according to that jurisdiction’s statutory accounting rules. Under this method, the resulting master file is reported according to as many versions of generally accepted accounting principles as there are countries in which the MNE operates. Followers of the process of global international financial reporting standards convergence will note that even “adoption” of IFRS by two countries does not necessarily mean the resulting accounting standards are the same.

A note in the discussion draft provides for an alternate election, leaving reporting “under consistent accounting principles and translated on a consistent basis to a single currency” up to the reporting entity, without elaboration. Taken at face value (for a U.S. MNE), this suggests an available election to allocate U.S. GAAP consolidated values to the component entities or countries in the template. From a compliance cost perspective, this is likely the most efficient option, as MNEs will already have consolidating financial systems in place to meet existing reporting requirements and containing much of the requested data. It also improves the comparability of component entity data considerably as the data will, at least, be presented under one set of accounting principles. While preferable in concept, this method is alluded to only briefly in the discussion draft, without further detail about how that reporting scheme would function. Would this method, for example, require legal entity reporting on a U.S. GAAP basis, or would “management” accounting at each entity suffice? Further, even in final form, these reporting concepts will remain proposals for changes to the local country’s adoption and practice.

De Facto Formulary Apportionment?

Some commentators have suggested that the arm’s-length standard for transfer pricing has failed to deliver a fair apportionment between jurisdictions and advocate replacing it with some version of formulary apportionment. U.S. state tax practitioners will recognize the limitations of this strategy immediately. A formulary apportionment system that eliminates double taxation and allocates income according to economic activity requires uniformity, and the U.S. Supreme Court has recognized this is not the case in U.S. states, despite extensive reform efforts.

Nevertheless, other commentators have noted the similarity between the OECD’s emerging positions on entity, the MNE would not have liquidated and merged the target, but the combined business would continue to be managed as a single enterprise. The management accounts in this example would reflect the combined business and discount the importance of separate GAAP-compliant pro forma financial statements for each legal entity.


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transfer pricing and formulary apportionment, and they have suggested that it signals a shift toward apportionment principles.9 Considered in this light, the CbC template appears to contain the data necessary to apportion income using metrics similar to the U.S. multistate system, namely property values, payroll and headcount, and sales revenue. While a direct move toward formulary apportionment is not a component of the OECD’s action plan, equally important is what the effect of its latest step — the CbC template — will be. Including apportionmentlike data in the CbC template seems to suggest its legitimacy, in spite of the OECD’s stated preference for the arm’s-length standard, as a tool for determining the appropriate jurisdictional allocation of profit. Will the behavior of tax authorities change in response to these data?

Consider, for example, an auditor’s review of the manufacturing subsidiary of an MNE. The entity has typically collected nominal margins on the production of merchandise for distribution to sales affiliates in other jurisdictions. Under the arm’s-length standard, this was supportable; development of intellectual property occurred elsewhere in the organization, and no strategic or other high-value functions were performed at this location. Despite a supportable transfer price, a local country auditor will now receive a CbC template showing:

- a high proportion of total headcount and/or payroll located in the manufacturing jurisdiction;
- a high proportion of total enterprise tangible asset balances; and
- a tax return reflecting relatively low allocation of the total enterprise’s profit.

Will the manufacturing country auditor, armed with apportionmentlike data notionally supporting greater profit allocation to the manufacturer, use these data in support of a deficiency notice? In the longer term, will these jurisdictions adopt antiabuse provisions using these data to bring taxable income in line with “economic activity”?

The former would require a relatively aggressive auditor position and derogation of the arm’s-length standard. But, in fact, some evidence suggests this auditor behavior is already occurring, driven by rhetoric surrounding the OECD project. On January 30, at the Pacific Rim Tax Institute Conference, Michael Danilack, deputy commissioner (international), IRS Large Business and International Division, cited that rhetoric as the driver behind international tax-auditor positions that are not in line with established rules.10 Danilack said he had seen cases come to competent authority, in fact, in which the other government cites primarily BEPS concepts in support of its agent.

Some evidence suggesting antiabuse apportionment-based provisions will override the arm’s-length standard in some situations has appeared as well. In October 2012, the U.N. released its Practical Manual on Transfer Pricing for Developing Countries, which included a chapter that specifically discusses China transfer pricing issues. The China chapter suggests formulary apportionment may be appropriate when a significant share of headcount and tangible assets are present in-country, metrics that may now be reported annually as a matter of course via the CbC template. The required annual provision of these metrics is likely to reinforce the view that apportionment is appropriate, particularly if a significant inbound shift of taxable profits would follow.

As a result, what may be more concerning than how MNEs will comply with new CbC reporting requirements is how the newly disclosed data might be used by local country auditors and, potentially, as drivers of new antiabuse provisions. For now, the arm’s-length standard remains the chosen profit allocation method by the OECD and continues to be the international standard. However, from a planning and audit perspective, the trend toward associating profit with formulary metrics is critical to keep in mind — a trend that is only advanced by the BEPS project’s transfer pricing discussion draft.
