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Fenny Lei
San Jose State University

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Country by Country Reporting Under BEPS

By: Fenny Lei, *MST Student*

Background

In the aftermath of sweeping and devastating destruction of World War II across Europe, the Organisation for European Economic Co-operation (“OEEC”) was formed in 1948 to manage distribution of post-war aid under the Marshall Plan and encourage economic collaboration through expansion of intra-European trade, improved labor conditions and studies of multilateral transactions. The OEEC, headquartered in Paris, started with 18 participating European countries and then expanded to include countries outside of Europe, evolving into the current, continuously expanding Organisation for Economic Cooperation and Development (“OECD”) in 1961.¹ Currently, the OECD has 35 Member countries and five key non-Member partners,² bringing together countries that account for 80% of world trade and investment, affording it a unique position in shaping global economic policies.³ While the OECD has no legal jurisdiction in its participating countries, its main decision-making body is composed of representatives from member countries, thus providing a centralized forum for discussion and dissemination of policy changes. Typically, the OECD monitors developing economic controversies in its member countries and other nonmember countries, pinpoints areas deserving further data collection and analysis and publishes the findings with guidance after multilateral discussion and peer review. The guidance can result in formal agreements and implementation by countries, bringing about binding policy changes such as policies against bribery. This paper focuses on the base erosion and profit shifting (“BEPS”) Action Plans published by the OECD, particularly newly required transfer pricing documentation.

An Introduction to BEPS

As global economies march towards more interdependence, leading to high-volume, multi-jurisdictional transactions, international tax complexities and issues have surfaced, specifically BEPS. Simply put, BEPS is a tax-motivated scheme of shifting income of multinational enterprises (“MNEs”) from high tax jurisdictions to lower tax jurisdictions, through aggressive tax planning – with an emphasis on strategic transfer pricing. However, not all transfer pricing is purely tax-motivated as it is required in many ordinary transactions of MNEs, resulting in difficulty measuring BEPS quantitatively. Predominantly, researchers focus on mathematical modeling of the relationship between the income of MNE affiliates and various related factors including tax rate differences between the parent and affiliate. If BEPS is present, then the income of MNE affiliate should increase as the MNE parent tax rate increases due to income shifting from parent to affiliate and vice versa. A meta-regression analysis study conducted by Heckemeyer and Overesch concluded a semi-elastic relationship of pre-tax profit to tax of 0.8, which translates into a 1% tax differential between the lower tax jurisdiction affiliate and higher tax jurisdiction parent that would result in a 0.8% increase in the MNE's profit.⁴ There is little doubt BEPS exist, but the scale is largely in question. According to the OECD, BEPS is conservatively estimated to be responsible for annual tax revenue loss of 100 billion USD to 240 billion USD for governments globally, a significant loss for most countries, but especially for developing countries due to their higher reliance on corporate income tax revenue.⁵

¹ Organisation for European Economic Co-operation. *The OECD*. (n.p., n.d.) Retrieved Jan 15, 2017, from <http://www.oecd.org/general/organisationforeuropeaneconomicco-operation.htm>

² OECD Website, Retrieved on May 8, 2017 at: <http://www.oecd.org/about/membersandpartners/>

³ The OCED (2011). *Better Policies for Better Lives, The OECD at 50 and Beyond*, page 10. Retrieved Jan 15, 2017, from <http://www.oecd.org/about/47747755.pdf>

⁴ Heckemeyer, Jost H.; Overesch, Michael (2013): Multinationals' profit response to tax differentials: Effect size and shifting channels, ZEW Discussion Papers, No. 13-045. Available at: <http://nbn-resolving.de/urn:nbn:de:bsz:180-madoc-340498>

⁵ The OECD (2016). *Background Brief Inclusive Framework for BEPS Implementation*. Retrieved Jan 15, 2017 from <https://www.oecd.org/tax/background-brief-inclusive-framework-for-beps-implementation.pdf>

Moreover, MNEs like Starbucks, Google, Amazon, and Apple have recently been making headlines due to their astoundingly low effective tax rate on foreign income, subsequently causing public outcry at home and abroad and resulting in BEPS gaining unprecedented political importance. As BEPS became a political priority for many of its members, the OECD strived to implement a framework to combat BEPS and align tax more accurately with the jurisdiction of value-creating economic activities. As a result, the OECD published its final comprehensive BEPS package in 2015 complete with 15 Action Plans, addressing issues of the digital economy, transfer pricing documentation, BEPS analysis and more.⁶ In addition, the BEPS package also includes four new minimum standards: stop MNEs from tax treaty shopping for more favorable tax treatments, increase transparency for tax authorities through country by country (“CbC”) reporting, improve dispute resolution and implement peer review process on harmful tax practices.

CbC Reporting Overview:

Transfer pricing documentation requirements are diverse depending on the local jurisdiction with some requiring annual reporting or contemporaneous documentation, making compliance and risk assessment difficult. Action Plan 13 proposes a standardized three tier documentation process for transfer pricing:⁷

1. Master file, to provide global tax authorities with an overview of the international business operation and transfer pricing policies.
2. Local file, to provide local tax authorities with details of transfer pricing transactions including information on participants, accounting of the transactions and substantiating documentation related to each transaction.
3. CbC reporting, to provide identification of entities, operating activity, the amount of revenue, income tax accrued and paid, the number of employees, stated capital, retained earnings and tangible assets in an annual report for each pertinent tax jurisdiction.

Together these three documents paint a more standardized, comprehensive picture of transfer pricing activities and aid tax authorities in utilizing effective risk assessment tools to stop the tax-motivated shifting of income activities. Keep in mind the OECD can only issue guidance, standards, and models from which member countries can potentially implement, but are not legally required to follow in detail. Each jurisdiction may end up with slightly different reporting forms and requirements.

IRS CbC Reporting Guidelines:

The IRS first issued Proposed Reg. 109822-15 in 2015 addressing CbC reporting guidelines pertinent to U.S. based MNEs and then followed up with a slightly modified final regulation §1.6038-4 as part of T.D. 9773 in 2016 after incorporating some feedback.⁸ To maintain consistency, the IRS attempted to minimize the deviation of its CbC reporting guidelines from the OECD model, especially regarding filing obligations and reporting information. Recently, the IRS also released draft Form 8975, the official form for CbC reporting.⁹

Filing Obligations:

The CbC reporting is by far the most detailed report required out of the three tiers, but not all U.S. MNEs are required to prepare it. A filing U.S. MNE is:

⁶ The OECD (2016). Explanatory Statement - 2015 Final Reports. *OECD/G20 Base Erosion and Profit Shifting Project*. Retrieved Jan 15, 2017, from <http://www.oecd.org/ctp/beps-explanatory-statement-2015.pdf>

⁷ The OECD (2016). Transfer Pricing Documentation and Country-by-Country Reporting, Action 13 - 2015 Final Report. *OECD/G20 Base Erosion and Profit Shifting Project*. Retrieved Jan 15, 2017, from <https://www.oecd.org/ctp/transfer-pricing/beps-action-13-country-by-country-reporting-implementation-package.pdf>

⁸ Treas. Reg. §1.6038-4

⁹ See: <https://www.irs.gov/pub/irs-dft/f8975--dft.pdf>

1. Headed by an ultimate parent entity that indirectly or directly owns a group of business entities required to report as a consolidated group under U.S. GAAP or required to do so if equities in the ultimate parent entity are publicly traded on U.S. stock exchange. The ultimate parent entity also must not be owned directly or indirectly by another entity insofar as required to report under such entity using consolidated accounting under U.S. GAAP. Exception: the ultimate parent entity may assign a controlled U.S. business entity, defined in Section 6038(e), as surrogate parent entity to file on behalf subject to all the same requirements as if the report is filed by the ultimate parent entity.
2. One or more business entities must be liable for taxes levied in another tax jurisdiction outside of U.S. (country or territory with fiscal autonomy including U.S. territories) through incorporation, business operation or permanent establishment. In the context of this regulation, a business entity is:
 - a. Any separate business entity recognized for federal tax purposes, not including trusts defined under Treas. Reg. Section 301.7701-4,
 - b. Any grantor trust owned in whole or in part by individuals under IRC Section 671,
 - c. Disregarded entities under Treas. Reg. Section 301.7701-3,
 - d. Any business entity defined as a permanent establishment under tax convention, subject to tax in outside jurisdictions or treated as separate entity by owner's jurisdiction.
3. Reporting a total annual revenue of equal to or more than 850 million USD in the prior reporting period.

If the U.S. MNE group fulfills all of the above criteria, then the filing obligation applies to U.S. MNE ultimate parent entities whose first day of taxable year begins on or after June 30, 2016 and it is responsible for reporting information on all its business entities for applicable reporting periods on Form 8975 no later than the due date of federal income tax return including extensions, barring any exceptions. However, some constituent business entities may be subject to an earlier applicability date in its local jurisdiction. According to the OECD guidelines, a business entity residing in another jurisdiction different from its ultimate parent entity has an obligation to file in that jurisdiction in accordance with local CbC reporting regulations if its ultimate parent entity does not file CbC reports in its jurisdiction of residence. To address this issue, the IRS released Revenue Procedure 2017-23 outlining filing options and procedures for ultimate parent entities with multi-jurisdictional business entities subject to an earlier local CbC reporting applicability date beginning on or after Jan. 1, 2016.¹⁰ Those qualifying ultimate parent entities may file an amended income tax return with Form 8975 attachment beginning on September 1, 2017, and the filing date must be within 12 months of the end of the taxable year including the early reporting period.

Reporting Information:

The ultimate parent entity must report the following administrative and financial information on each of its business entities:

1. Identify the tax residence and incorporation jurisdiction, legal name of entity, main business activities and tax ID assigned by the local tax authority.
2. Revenues generated from business entities transacted both within and outside of the U.S. MNE group, profit/loss before income taxes, taxes paid, withheld, or accrued, stated capital, net book value of tangible assets, and total accumulated earnings. Deferred tax and provisions do not need to be reported if they fall outside of the reporting fiscal year.

¹⁰ I.R.B. 2017-7 (Jan. 19, 2017)

3. The number of full-time or full-time equivalent employees at the end of accounting period. The scope of full-time employees includes independent contractors participating in the ordinary course of business of the business entity and traveling workers, but traveling workers are attributed to the tax jurisdiction of their original business entity of employment and not the tax jurisdiction where work is performed. When reporting, the ultimate parent entity should use applicable financial statements, books, and records of the business entity and other documentation used for regulatory or internal control purposes to furnish information required. However, it is not responsible for reconciling CbC reported information to consolidated financial statements or tax returns. In Action Plan 13, the OECD describes Multilateral Competent Authority Agreements in the context of automatically exchanging CbC reporting information under defined scope, timing, procedures, and safeguards. Similar to OECD guidelines, U.S. CbC reporting information will be shared via an automatic exchange through competent authority arrangements with other jurisdictions through information on possible bilateral and multilateral automatic exchange arrangements.

Implications:

Compliance with BEPS reporting will be challenging because MNEs must prepare CbC reports in each pertinent jurisdiction in accordance with local requirements which can become cumbersome if the MNE has a large network of foreign business entities. Consequently, more resources need to be allocated to data management, training, and personnel recruitment to maintain compliance with various jurisdictional regulatory changes. Moreover, CbC reporting allows tax authorities unprecedented access to global tax data, putting MNEs under more scrutiny.

Conclusion:

Implementation of BEPS Action Plans is rapidly becoming a reality for many countries. As of now, 44 countries have signed the CbC's [Multilateral Competent Authority Agreement on the Exchange of CbC Reports](#) ("MCAA"), agreeing to participate in an automatic exchange of CbC reports amongst themselves.¹¹ Interestingly, the U.S. is not one of the signatories; instead opting to forge its own automatic exchange channels through bilateral competent agreements and tax treaties with other jurisdictions. As more jurisdictions integrate CbC reporting legislatively, each jurisdiction will most likely deploy CbC reporting standards differently, so it is imperative to monitor the jurisdiction of MNE clients' business entities and respective jurisdictional CbC regulations to ensure compliance.

¹¹ The OECD (2017). *Signatories of The Multilateral Competent Authority Agreement on the Exchange of Country by Country Reports (CbC MCAA) and Signing Dates*. Retrieved Jan 19, 2017 from <https://www.oecd.org/tax/beps/CbC-MCAA-Signatories.pdf>