

Standing up to scrutiny: BEPS country-by-country reporting

At first glance, the country-by-country reporting required under the Organisation for Economic Co-operation and Development's (OECD) Base Erosion and Profit Shifting (BEPS) Action Plan would appear to be relatively risk- and trouble-free. Yet despite being brief, the reporting template opens up a minefield of definitional challenges and requirements for hard-to-source information. Moreover, the way the results could be interpreted means that companies that are paying their 'fair share' of tax could still find themselves at risk of challenge and audit.

As we outline in this briefing, effective management of country-by-country reporting is therefore going to require a new way of looking at transfer pricing and a more systematic approach to justification and documentation, along with possible restructuring within the business. And with the regime starting in January 2016, and the first reports due from the end of 2017, the time to begin preparing is now.

The OECD sees enhanced transparency and inter-government information sharing as a crucial bulwark in its efforts to eliminate the gaps and mismatches in international tax rules.

There are three elements to the resulting reporting requirements. The first is a group-wide master file, which includes transfer pricing policies and transactional information. The second is a local file, focusing on the transfer pricing in each location. The third is a standardised country-by-country (CbC) report, which sets out the amount of tax being paid and accrued in each jurisdiction alongside the corresponding revenues, profits and other key financial information. The information in the CbC report would be sourced and evaluated on an entity-by-entity basis. What would go into the CbC reports is now fairly clear (Figure 1 overleaf sets out the main headings), though how the information in the master and local files would be shared between tax authorities is still to be finalised.



Figure 1: What goes into the country-by-country report?

Revenues (from related and unrelated party transactions)	Profit (loss) before income tax	Income tax paid (on cash basis)	Income tax accrued – current year
Stated capital	Accumulated earnings	Number of employees	Tangible assets (excluding cash and equivalents)

Source: OECD BEPS Project Guidance on Transfer Pricing Documentation and Country-by-Country Reporting ACTION 13, September 2014

When are the reports required?

The OECD wants filing to begin for fiscal years starting on or after 1 January 2016. This would mean that the first reports would be needed at the end of 2017. However, the OECD recognises that some jurisdictions may want more time to make the necessary adjustments to the law. Front runners such as the UK are introducing enabling legislation now.

While the US has sometimes been slow in adopting global tax initiatives, the US Treasury announced recently that it too intends to bring in CbC reporting with effect from 2016.

Brian Shea, Grant Thornton United States

Who is in and who is exempt?

Only groups with an annual revenue in the immediately preceding fiscal year of more than €750 million (or near equivalent in domestic currency) would need to file the CbC report. While the filings would therefore cover around 90% of global corporate revenues, the OECD believes that 85-90% of multinational enterprises (MNEs) would be exempt.¹

By our reckoning, however, a lot of mid-size companies would still be included. The net for what constitutes a permanent establishment for tax reporting purposes will also be cast wide in future. Even a field agent seeking out sales leads could be seen as a permanent establishment, for example. Similarly, some of the operations that have been explicitly excluded from tax filing under a number of current tax treaties, such as certain forms of warehousing, could also be included.

¹ OECD BEPS Project Action 13: Guidance on the Implementation of Transfer Pricing Documentation and Country-by-Country Reporting, 2015

Figure 2: A model template for the country-by-country report
Overview of allocation of income, taxes and business activities by tax jurisdiction

Name of the MNE group: Fiscal year concerned									
Tax jurisdiction	Revenues			Profit (Loss) before income tax	Income tax paid (on cash basis)	Income tax accrued – current year	Stated capital	Accumulated earnings	Number of employees
	Unrelated party	Related party	Total						

Source: Guidance on transfer pricing documentation and country-by-country reporting – OECD 2014

What is CbC reporting intended to achieve?

The CbC reports aren't meant to be detailed tax returns. Rather they are designed to be a risk assessment tool for tax authorities, giving them a brief overview of money made and tax paid from which they can judge which companies to follow up for further review and audit. While tax authorities can share the information, it would remain confidential. And looking at the guide reporting template (see Figure 2), this would seem like a reasonably straightforward compliance exercise.

Completing the templates is more difficult than most initially envisage. We've hosted client workshops in which even seasoned tax professionals from large companies have struggled within the many grey areas over what should and shouldn't go in.

Wendy Nicholls, Grant Thornton United Kingdom

Concerns over how to populate the reports

So why is CbC reporting generating a growing amount of concern? The first challenge is that a lot of the information is hard to source or evaluate. While detailed data in areas such as headcount are typically available at divisional level as that is how most companies are managed, many firms will find it difficult to break this down to the entity level required under CbC reporting. Particular challenges centre on intangible assets, the use of which may be spread over multiple entities. The difficulties of collating the information are compounded by definitional anomalies such as whether particular types of contract staff should be included.

What this means is that CbC reporting will be a much more demanding exercise than the template forms would suggest. While larger businesses generally have the necessary people and systems in place, many of their mid-size counterparts will need to develop the required capabilities from scratch.

Risk of misinterpretation

CbC reporting also opens up new risks. In particular, a local tax authority could compare the headcount to the amount of tax a company is paying in their jurisdiction and conclude that they are missing out on their rightful share of the overall tax take.

While CbC reporting may not be incorporated as a part of Indian transfer pricing rules, tax authorities in India are likely to embrace this initiative as it could give them a handle to gather more information about the operations/value chain of MNEs operating in India and possibly assert a bigger share of tax pie.

Arun Chhabra, Grant Thornton India

Some operations may indeed lack the people and value generation that would constitute substance and the reports would highlight this. Some restructuring or relocation would be necessary in such cases to avoid tax challenge and audit.

Tax authorities are likely to compare tax paid against headcounts in their jurisdictions as a quick rule of thumb from which to pursue possible follow-up investigations.

Per Hedrén, Grant Thornton Sweden

In many cases we see, there are quite legitimate reasons why the headcount may be at variance from the substance and hence tax paid. For example, a dozen designers or IT programmers in one country may generate more value than hundreds of people assembling or packing the resulting products in another location. Unfortunately, tax authorities may simply divide the tax take by the headcount and come to a different conclusion.

The Chinese tax authority has responded positively to CbC reporting requirements, arguing that clearer information of the contribution and profit level of Chinese companies in their global supply chain would improve the evaluation of companies' transfer pricing risks. The revised version of 'Implementing Measures for Special Tax Adjustment (Trial)', China's 'reference manual' on transfer pricing, is expected to be released by the end of 2015 and is very likely to cover the core elements of CbC reporting requirements.

Richard Bao, Grant Thornton China

The CbC reports may thus generate multiple audits in the initial years, especially if tax authorities use this new data as part of aggressive ‘fishing expeditions’. Based on current practice, moreover, some tax authorities might call for what could be highly detailed follow-up information in weeks and even days. The risks are compounded by the fact that while we will now have multinational reporting, there is no comparable multinational mechanism to settle disputes.

Putting your business on a sound footing

So how can you prepare your business for the risks and extra work arising from CbC reporting?

1. Gap analysis

The first step would be to complete the template as a dry run and then use this as the basis for a gap analysis of what information is needed, what you have at hand and what more you need to source. A lot of the extra work will centre on allocation to particular entities. It’s also important to look at what will be in the scope of the reporting (eg what operations or what contingent staff to include or exclude).

2. Assess how your tax arrangements will come across

The next step is look at how the tax you pay compares to headcounts and returns on the template form. Then assess whether there are apparent anomalies that could attract attention and possible investigation.

3. Prepare robust justification

It’s important to ensure that tax allocations are substantiated by appropriate justification and supporting documentation, especially in areas that might attract attention from tax authorities as a result of the CbC disclosures.

As part of the need for more robust substantiation, we’re likely to see a new approach to the benchmarking of transfer pricing. This will look beyond what is justifiable at a transactional level to consider what is reasonable at a business-wide macro level. As this is likely to be a new departure, you will need to develop the benchmarking capabilities to carry out such evaluations and provide the supporting documentation.

4. Begin restructuring in good time

The complexities of entity reporting are likely to provide a fresh catalyst for the rationalisation of multiple entities.

Substance can't be changed overnight and therefore you will need to start planning now to make sure that any necessary movements in people, operations and tax location are achieved in time.

Chaid Dali-Ali, Grant Thornton France

Some restructuring of permanent establishments and associated transfer pricing arrangements may also be worth considering to avoid intensive audits and increases in tax demands under the new regime. Key areas of focus for restructuring are likely to include IT and research and development. In some cases, more far-reaching head office and operational restructuring may be needed to demonstrate real substance.

Conclusion: Keeping control

CbC reporting is a major undertaking, both in completing the templates and in providing the substantiation needed to justify how your tax payments are allocated at a macro level.

And the demands may get tougher, both as part of CbC reporting and related moves in particular jurisdictions. With regard to CbC, the areas covered in the reports will be reviewed in 2020 and there have already been calls for extensions into areas such as royalties and service fees. Local developments include the European Commission's launch of consultations on a new inter-state 'tax transparency package', along with a review of the pros and cons of requiring public disclosure.²

The burden of preparation and justification is likely to weigh heaviest on mid-size businesses, who face a tough task in developing the necessary documentation and benchmarking capabilities.

While preparing fully now may be a time-consuming and expensive exercise, it puts you in greater control over your tax affairs by making it easier to demonstrate that your company is paying its share. Not doing so could leave you open to multiple audits, and the even bigger costs and risks that double taxation would present.

² European Commission media release, 18 March 2015 and 'Proposal for a Council Directive amending Directive 2011/16/EU as regards mandatory automatic exchange of information in the field of taxation' (http://ec.europa.eu/taxation_customs/resources/documents/taxation/company_tax/transparency/com_2015_135_en.pdf)

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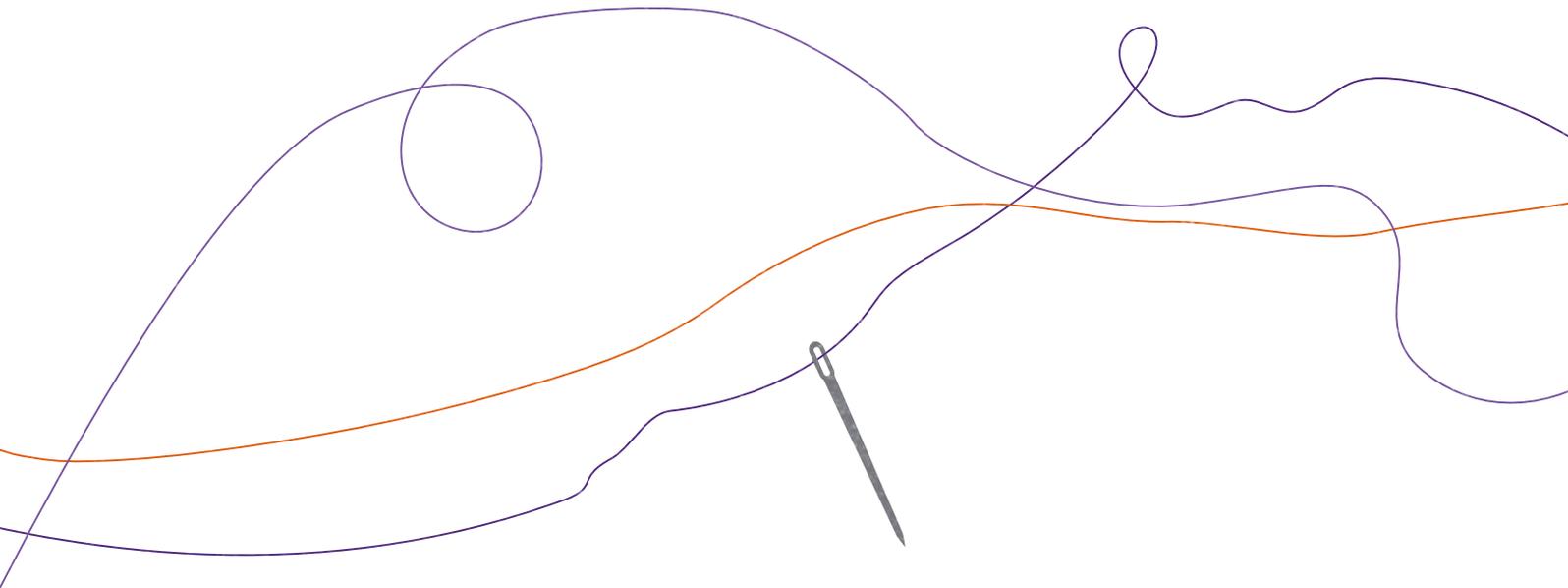
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