Bloomberg Tax

Tax Management
International Journal™

Reproduced with permission from Tax Management International Journal, 47 TM International Journal 23, 1/12/18. Copyright © 2018 by The Bureau of National Affairs, Inc. (800-372-1033) http://www.bna.com

# Country-by-Country Reports: New OECD Handbook Guides Countries and Taxpayers in Risk Assessment Best Practices

*By Barbara J. Mantegani*[*]

As taxpayers around the globe begin filing country-by-country reports based on the notorious CbCR template developed in Action Item 13 of the Base Erosion and Profit Shifting project, and countries prepare to exchange their 2016 reports, the big question is "What next?" Will countries that get the CbCR just start running numbers and issuing audit adjustments, as taxpayers have feared since the CbCR template was first released? Will the IRS establish new audit "campaigns" around the information it receives in the CbCR? At the end of the day, what impact will the CbCR information have on a country's audit procedures and audit adjustments?

The Organization for Economic Cooperation and Development, led by the work of the Canada Revenue Agency, begins to answer that question with a thorough, thoughtful country-by-country reporting handbook ("the Handbook")[1] reiterating that the onus is now on the tax administrations to make effective "and appropriate" use of the information contained in the CbCR.

[*] Barbara J. Mantegani is a principal at Mantegani Tax PLLC in McLean, Va., www.mantegani-tax.com.

[1] OECD, *Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment* (OECD, Paris 2017), www.oecd.org/tax/beps/country-by-country-reporting-handbook-on-effective-tax-risk-assessment.pdf.

The Handbook is a practical guide to both tax authorities and taxpayers, in that it:

- explores the framework of tax risk assessment used by tax authorities in several of the countries that participated in the BEPS project;
- identifies tax risk indicators that can be detected specifically by using a CbCR;
- identifies challenges to the effective use of CbCR information in tax risk assessment;
- identifies other information sources that might be used in conjunction with the CbCR to perform tax risk assessment; and
- includes a comprehensive example that demonstrates how the information from a CbCR might properly be used as part of a country's tax risk assessment framework.

The Handbook shows that CbCR can be an important tool for tax authorities, for the identification of transfer pricing and other BEPS-related risk, when used alongside other information the tax authority holds, or as the basis for further inquiries. It also raises cautions about the risk that "simplistic and misleading conclusions" may be drawn if the CbCR is used in isolation, but expresses the hope that it will provide "valuable support to countries introducing CbC Reporting and using the information they receive." The Handbook will be updated periodically so that tax authorities in all countries can benefit from each other's experiences, and taxpayers can be apprised as audit practices develop and change.

The Handbook identifies three broad scenarios that can suggest the existence of transfer pricing risk:

1) Where a group has recurring transactions with related parties that have the potential to erode a jurisdiction's tax base over time, e.g., where there are large intragroup payments that can be hard to


© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

value — such as interest, service fees, management fees, and royalties;

2) Where a company has undergone a major business restructuring or has transferred valuable income-producing assets, leading to one-off transactions; and

3) Where a group does not have effective tax governance processes in place to manage the pricing of related-party transactions on an ongoing basis.

Of those three scenarios, the CbCR contains data that can assist tax authorities in risk assessment for the first two (i.e., the recurring hard-to-value transactions and the one-off transactions) with the other elements of transfer pricing documentation (i.e., master file, local file, transfer pricing questionnaires, and the like), providing information relevant to determining risk factors arising from an entity's tax controls and governance processes (or lack thereof).

## THE ROLE OF TAX RISK ASSESSMENT IN TAX ADMINISTRATION

Tax risk assessment is a key element of modern tax administration, in that it allows tax authorities to identify factors which, if present in a taxpayer's profile, suggest either an increased or a reduced risk of noncompliance with the country's tax laws. Tax authorities continue to grapple with limited resources, and while much tax risk assessment continues to have a manual element, tax authorities increasingly look at incorporating automated methods for risk assessment into their audit processes. Automated risk assessment tools can be used to identify both higher risk taxpayers and higher risk arrangements, which can then be flagged for further review regardless of the taxpayer's overall risk profile.

With the addition of the CbCR to the list of transfer pricing documentation that taxpayers must submit with their tax returns, tax authorities now have information provided in a format (primarily numerical data — e.g., revenues (allocated between related party and unrelated party), value of assets, tax amounts, number of employees) that lends itself to the development of formulas and algorithms that can be used to compare the taxpayer's results across countries and size and type of affiliates. Requiring taxpayers to list all constituent entities in each jurisdiction and identify the functions of each entity allows tax authorities to do apples-to-apples comparisons of the financial and tax results between and among countries with similar functional profiles.

## WAYS TO USE CbCR TO DETECT INDICATORS OF TAX RISK

Inherent in the process of identifying tax risk is the need to compare two or more pieces of data; for example, comparing an entity's results for similar activities in different jurisdictions or regions, or comparing an entity's results with the results of a ''typical'' taxpayer in the same industry or sector, or comparing an entity's results in a particular jurisdiction over a period of years. It is expected that in addition to the usual ratios applied in a typical transfer pricing analysis such as operating profit or average mark-up on costs, tax authorities will also perform data analysis using more complex algorithms considering different attributes of entities in specific industries.

The Handbook notes that, particularly in the early years of using CbCR data to identify tax risk, tax authorities will need to be flexible in their approaches and algorithms, which are likely to change over time as the tax authorities gain experience with the document. One particular area of concern is the use of ''text mining'' of the information in Table 3, and the ''other'' column of Table 2, to search for specific words or phrases that may be indicators of an increased or reduced level of tax risk. Since the first reports are just being filed, it will take some time for tax authorities to analyze how taxpayers use CbCR Table 3, what additional information they provide, and how that information is presented. The Handbook includes the suggestion that tax authorities perhaps provide taxpayers with additional guidance on how to complete Table 3, including the recommendation of some standard disclosures to identify known common false positives.

The Handbook then identifies 19 specific tax risk factors that could be derived from the information included in the CbCR, which tax authorities could use, either alone or in combination with other factors, to measure potential transfer pricing risk for a particular entity in its jurisdiction:

1. The group has a footprint in a particular jurisdiction.

2. The group's activities in a jurisdiction are limited to those that pose less risk.

3. There is a high value or high proportion of related-party revenues in a particular jurisdiction.

4. The results in a jurisdiction deviate from those of potential comparables.

5. The results in a jurisdiction do not reflect market trends.

6. There are jurisdictions with significant profits but little substantial activity.

7. There are jurisdictions with significant profits but low levels of tax accrued.

8. There are jurisdictions with significant activities but low levels of profit (or losses).


© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

9. The group has activities in jurisdictions that pose a BEPS risk.

10. The group has mobile activities located in jurisdictions where the group pays a lower rate or level of tax.

11. There have been changes in the group's structure, including the location of assets.

12. IP is separated from related activities within the group.

13. The group has marketing entities located in jurisdictions outside of its key markets.

14. The group has procurement entities located in jurisdictions outside its key manufacturing locations.

15. Income tax paid is consistently lower than income tax accrued.

16. The group includes dual resident entities.

17. The group includes entities with no tax residence.

18. The group discloses stateless revenues in Table 1.

19. Information in the group's CbCR does not correspond with information previously provided by a constituent entity.[2]

For each risk factor, the Handbook provides a more detailed explanation of how the factor might flag increased risk, and a cautionary (to tax authorities) paragraph noting the non-tax reasons that could impact, for example, having a high proportion of related-party revenues in a particular jurisdiction.

Many of the factors — such as identifying jurisdictions with significant profits but little substantial activity or low levels of tax accrued, or with results that deviate from potential comparables — are relatively easy to calculate based on the financial data in Table 1. Table 2 provides the functional details that can surface risk factors such as having marketing entities located outside the company's key markets, procurement entities located outside the key manufacturing jurisdictions, or mobile activities located in jurisdictions with lower rates of tax. If a multinational entity has one or more of those factors present in its corporate structure, Table 3 provides the MNE an opportunity to explain and mitigate the risk factors before an auditor identifies them for further investigation.

## EXAMPLE OF THE USE OF A CbCR FOR TAX RISK ASSESSMENT

In addition to the discussion regarding the role of tax risk assessment in tax administration set out in Chapter 2 and the risk factors explained in Chapter 4, Annex 3 of the Handbook presents an extensive example of a hypothetical MNE group headquartered in Europe, with affiliates around the globe. This example provides a practical roadmap to taxpayers looking for ways to mitigate their transfer pricing tax risk, and gives rise to potential "best practices" that taxpayers could employ to achieve such risk mitigation; the final section of this article identifies a number of such best practices.

In the example, the hypothetical MNE SA — resident in Europe, with entities in 26 jurisdictions across the globe — has submitted CbCRs for both 2016 and 2017. As described in the example, the initial risk assessment involves four steps:

1. An initial review of Table 1 and Table 2 of the CbCRs "in its raw form."

2. Identification of changes in the tables between 2016 and 2017.

3. Calculation of "key ratios," as identified in the Handbook, using data from Table 1 for both 2016 and 2017. These ratios include profit margin by country, revenue (or profit) per unit of economic activity (e.g., number of employees or tangible assets, pre-tax return on equity, and post-tax return on equity).

4. Calculation of changes in the ratios between 2016 and 2017.[3]

The outcomes of these steps are then considered by the tax authority to identify possible tax risks, and alternative explanations for the various risk indicators. In the example, MNE SA has operations in 11 countries in Europe, six countries in the Americas and nine countries in the Asia-Pacific region, and has operating companies (i.e., those engaged in sales or manufacturing) in 21 of those jurisdictions. The group has several holding companies: an IP Hold Co and a services Hold Co in Europe, a finance and captive insurance Hold Co in the Americas, and a finance Hold Co in Asia-Pacific.

### Variances in Functions and Profits

The example first analyzes the company's returns on its sales and manufacturing activity, and compares profit margins by region, noting that affiliates in Europe and the Americas have similar ranges of returns (10–14% and 9–11%), but those in most Asia-Pacific countries earn much lower profits (3–5%). The exceptions to the low profits in the Asia-Pacific are opera-

[2] *Id.* at ¶40.

[3] *Id.* at ¶121.


© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

tions in countries U and Z, where they earn 95% of their revenues from related parties, and incur significantly lower effective tax rates than those found in other jurisdictions in the region.

After noting that there are ''a number of reasons'' why similar activities performed in different regions might result in different levels of profit (e.g., differences in production costs or market penetration), the fact that affiliates in Countries U and Z have significantly higher profit margins than the other entities in the region could flag a possible tax risk, particularly as those affiliates are in low-tax countries and perform functions (procurement in Country U and marketing and distribution in Country Z) that arguably are typically performed within the sales and manufacturing operation.

Comparing the returns achieved in the Asia-Pacific region between 2016 and 2017, revenues of the sales and manufacturing entities increased between 15 and 55%, while profits increased by between 2 and 9%. On the other hand, Country U revenues increased by 23% and profits by 29%, and Country Z revenues increased by 9% and profits by 15%.

The example concludes that tax authorities in the Asia-Pacific region with sales and manufacturing activities ''may request further information on the activities of the entities in Countries U and Z and on the pricing of intragroup payments to these entities.'' In other words, the CbCR gives a tax authority a way to analyze the financial results in its country and compare with other, similar countries, and also to countries where both the profits and the functional profile differ in ways that could be tax motivated.

## Variances in Corporate Structure

Changes in corporate structure can also be red flags, or at least create an area for further inquiry. In the example, Table 2 for 2016 includes two IP holding companies, one resident in Country K and one resident in Country Q. Table 2 for the 2017 CbCR does not include the Country Q IP holding company. In addition, from 2016 to 2017 the Country K total revenues increased by 44%, profit before tax increased by 106%, and accrued income tax for the current year increased by 52%. As a result, the profit margin for Country K increased from 10% to 14%, while the effective tax rate decreased from 21% to 16%.

As noted in the example, these arguably anomalous results would likely trigger additional questions by Country K. particularly regarding whether the IP held by the former affiliate in Country Q had been transferred to Country K. The tax authorities in Country Q might also raise questions regarding the disposition of the IP holding company, particularly regarding any IP that might have been transferred to Country K as part of the transaction.

## Variances Between Revenues and Profits, and Effective Tax Rate

The example includes in its facts a holding company in Country I that increased its revenues before tax by 313% between 2016 and 2017 and its profit before tax by 44%. Therefore, the group's profit margin in Country I decreased from 11% to 4%, which is significantly lower than the average profit margin for the European region.

In another hypothetical, in Asia-Pacific Country T, the group has a holding company, a group finance company, and a group services company. In 2016, the overall profit margin in Country T was 16% and the effective tax rate was 13%. In 2017, profit margins increased to 33% while the effective tax rate was only 5% — that is, there was a significant increase in revenues and profits during the year, but only a modest increase in the amount of tax incurred.

Finally, the hypothetical notes that the MNE has activities in Country C (Europe), Country N (the Americas) and Countries T, U, and Z (Asia-Pacific), which have the highest total revenues by employee and by tangible assets; the highest profit before tax by employee and by tangible assets; the highest pre-tax and post-tax return on equity (with the exception of Country C); the highest profit margins (with the exception of Country K, which holds the group IP in 2017); the lowest effective tax rates; and receive most of their revenue from related parties.

These results, calculated from the information in Tables 1 and 2, would likely give rise to additional inquiries by tax authorities in all of the jurisdictions regarding the group's policies and pricing of intragroup payments.

# TAX AUTHORITY BEST PRACTICES

The handbook includes specific recommendations, described as ''core characteristics'' of effective and efficient tax risk management, that are general best practices to be applied not only to CbCR analysis, but all facets of a tax authority's audit function. The Handbook recommends:

- Tax risk assessment tools should operate objectively, even where the algorithms are designed to detect risk in certain sectors or to target specific arrangements.
- Officials involved in tax risk assessment must be adequately trained and experienced in key areas.
- Risk assessment tools should be used to select and de-select taxpayers for audit or further in-


© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

quiry, and not be used as a substitute for such activity, i.e., for the purposes of directly making adjustments or assessing taxes.

- Risk assessment processes should be dynamic and responsive to feedback from within the tax authority, and be subject to continuous improvement, to reduce the number of false positives and to address emerging risk areas.
- A tax authority's risk assessment strategy should combine different tools and take into account different aspects of the group's risk profile, and evolve over time to reduce opportunities for higher risk taxpayers to develop strategies to avoid detection.
- Tax authorities must have proper governance processes in place to ensure that the risk assessment function is properly monitored, and that a complete audit trail is available in the event of future inquiries.
- Tax risk assessment processes should be part of a tax authority's overall risk management framework, and should to the extent possible be aligned with the principles and guidelines for risk management and risk assessment established by the International Organization for Standardization (ISO).[4]

## TAXPAYER BEST PRACTICES

While the Handbook is written as a guide to tax authorities, it can also be read to provide taxpayers with several best practices regarding the preparation and filing of their CbCRs. As with any type of tax reporting, the CbCR can be prepared in a way that mitigates the risk of an audit, or that makes the taxpayer a prime target for a tax authority's questions. After carefully reviewing the Handbook the following items emerge as best practices for taxpayers that do not want their CbCR to become a red flag for one or more transfer pricing audits:

- To the extent possible, centralize the creation of the CbCR rather than allow individual entities to incorporate their information. This will increase the chances that the overall picture of the MNE that emerges from the CbCR is coherent and consistent.
- Test the standard ratios — e.g., profit before tax, revenue per employee, effective tax rate, etc. — before filing, to identify any countries or entities where adjustments might need to be made either in the financial statements (before books close) or on the tax return (after books close, in countries that allow such filing positions).
- Prepare explanations for anomalies in the data, and include them in Table 3, with specific references to the countries and entities involved.
- Pay close attention to acquisitions and dispositions and the impact of such events on the results reported in the CbCR. Where a business restructuring leads to results that might on their face seem anomalous, an explanation for those results should be provided.
- Document tax governance policies and processes, and where needed reference such policies in Table 3.
- Where high-risk transactions are present, consider taking steps to mitigate such risk by restructuring or repricing.
- When the CbCR is complete, request a review by a third party (either in house or external) who has extensive knowledge of the company but did not participate in any way in the preparation of the report. This review should help surface any data anomalies that might have been missed during the CbCR's preparation.
- For public companies in particular, provide the CbCR to the investor relations and finance departments for their assessment of any exposures (e.g., reputational risk) that could result if the data in the CbCR were to become public. At this point, while countries that have added CbCR to their transfer pricing compliance documents appear to agree that such documents should remain confidential, there is no guarantee that this will remain the status quo. Therefore, the reports should be "reality tested" by people outside the tax department.

## CONCLUSION

The BEPS project in many ways represents a turning point in international tax compliance, with a focus on transparency and on increased enforcement of the vast, many times inconsistent, tax laws applicable to MNEs, as countries grapple with how to reduce or eliminate base erosion and profit shifting by taxpayers with a presence in their country.

The Country-by-Country Report that emerged as a product of Action Item 13 and has been incorporated into the tax reporting of virtually every member of the OECD and the G20, is expected to have a significant, direct impact on how tax authorities enforce their transfer pricing and other international tax provisions,

[4] ISO 31000:2009 — *Risk Management*; www.iso.org/standard/43170.html.


© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600

and how MNEs structure their businesses. Also, as noted above, it is possible, if not likely, that CbCRs in some countries will be subject to public disclosure. The United Kingdom now requires companies with substantial U.K. business activity to post their tax strategies on their websites, and the U.K. tax authority recently announced that it will ''consider the case'' for making CbCR publicly available.[5] It is not a stretch to think that other countries could follow that lead and publish the CbCRs that are filed directly with them.[6] Thus, taxpayers need to keep in mind when preparing the CbCR that it could be read by a wide variety of audiences, and keep such audiences in mind while drafting it.

Although the first CbCRs will be filed by the end of 2017, it will be three or four years before we will be able to measure the impact of such reports. The programs and initiatives developed by tax authorities are likely to change as they gain more experience with the reports, and with the ways that they can lead to the more efficient and accurate identification and assessment of tax risk. Both taxpayers and tax authorities are in for an interesting few years.

---

[5] *See U.K. to Revisit Public Global Tax Reports for Large Companies*, DTR Int'l Breaking News (Dec. 14, 2017).

[6] Reports exchanged through a bilateral or multilateral agreement between countries presumably would be protected by the treaty confidentiality provisions, but this would not be true for reports filed directly with a tax authority.



© 2018 Tax Management Inc., a subsidiary of The Bureau of National Affairs, Inc.
ISSN 0090-4600