A Tale of Two Continents: It was the BEPS of times...

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In April, Robert Stack, the U.S. Department of the Treasury's deputy assistant secretary for international tax affairs, shocked the transfer pricing community by stating that U.S. country-by-country (CbC) reporting regulations (at that time in draft) were expected to be finalized by June 30, 2016. The Treasury has exceeded this aggressive deadline, and on June 29 (24 hours early!) final regulations were released. U.S. multinational enterprises (MNEs) meeting the annual revenue threshold of $850 million will now be required to file U.S. CbC reports for tax years beginning on or after July 1, 2016. The astonishingly rapid progression from draft regulations issued in December 2015 to final regulations in June 2016 has come to the great surprise of many in the transfer pricing industry, particularly considering that prior estimates (and indeed initial draft regulations) indicated the earliest introduction was to be 2017. This article outlines the impact of the introduction of CbC into U.S. regulations, and details essential steps that in-house tax teams should be taking now to prepare for the mandatory CbC filing requirements.

Background

As has been well documented, CbC reporting was first proposed by the Organization for Economic Co-operation and Development (OECD) as part of its base erosion and profit shifting (BEPS) initiative. Having been adopted across the globe (although occasionally with differences in reporting threshold), CbC reporting seeks to capture commercial, financial and functional information in three tables to be prepared by MNEs and submitted annually to tax authorities along with their tax returns. The information requested on the forms includes:

- Revenue by territory (for all territories an MNE operates in);
- Employees by territory; and
- Key activities of each entity within an MNE group.

While the information to be presented in CbC tables is objectively straightforward, decisions regarding how to aggregate and state the information soon present numerous issues for MNEs. For example, the presentation of “stateless” income (particularly when considering partnership income), the interpretation and location of “hybrid” entities, the level of consolidation adopted by an MNE and thus what constitutes a “group” for CbC purposes, etc., are not simple or straightforward issues to address. These are issues that will vary among MNEs filing CbC reports, and may ultimately end up varying across countries as they implement their own versions of CbC reporting.

Despite a rather muted reaction to the BEPS initiative generally, the U.S. Treasury has seen the benefit of mandatory CbC reporting, and indeed in December 2015 this willingness translated into draft CbC regulations. While the U.S. regulations generally follow the OECD guidelines, minor discrepancies do exist. For example, in relation to the reporting of location of employees, the OECD relies upon an employer's tax residence as a proxy for employee location, while the U.S. requires a determination of the location where employees perform the majority of their activities.

Mind the Gap

Conventional wisdom is that with respect to the implementation of new IRS rules, the later the better. This is not necessarily the case with CbC reporting. Many countries adopted and implemented CbC reporting before the U.S. did, and thus they have adopted earlier effective dates than the U.S. has. These differences in effective dates potentially create a “gap year” in reporting between when an MNE’s first report is due in the U.S. versus elsewhere. And, unlike the carefree gap year taken by many high school graduates before they go off to college, this gap year can be a real headache for an MNE that finds itself in one.

Specifically, with an effective date of July 1, 2016 for U.S. CbC reporting, there are two groups of U.S.-based MNEs. First, there are those with tax years beginning between July 1 and December 31. For these MNEs, the first U.S. CbC report will be due with the tax return filed for the fiscal year beginning between July 1 and December 31, 2016. The second group consists of U.S.-based MNEs whose tax years begin between January 1 and June 30. These companies are not required to file their first U.S. CbC report until they file their tax return for the following year — the year beginning between January 1 and June 30, 2017.

It is this second group of U.S.-based MNEs that will fall into the CbC reporting gap caused by different effective dates in different countries. Assuming that the U.S. MNE also operates in a jurisdiction that has introduced CbC regulation or legislation (e.g., most developed nations in Europe), it is likely that the tax authority of that jurisdiction will require a CbC report to be produced for a tax year earlier than the U.S. will require.

Apart from the fact that the delayed effective date in the U.S. will have no practical benefit for many MNEs, there is also the issue of *where* a “gap” MNE should file its first CbC report. Initially, the IRS stated that it would not accept CbC filings from U.S. companies before they were required. At the same time, several other (non-U.S.) jurisdictions have introduced the concept of “surrogate filings,” whereby a CbC report can be filed to a surrogate tax authority under certain circumstances. This would allow a U.S. MNE that does not have to file a U.S. CbC report (in the year before it is required by the U.S.) to still meet its foreign CbC reporting obligations. There are still unresolved issues with this option, however, including whether CbC reports provided in this manner would benefit from the confidentiality protections of the U.S. treaty network. Because of this general uncertainty, the U.S. Treasury is expected to imminently release further guidance on this issue, and potentially allow MNEs to file in the U.S. for this gap year, even though there would be no legal obligation to do so.

Regardless of whether a U.S.-based MNE falls into the gap or not, all U.S. MNEs falling above the $850-million revenue threshold will ultimately share the practical burden of deciding *how* to complete the three deceptively simple CbC forms. (Note that the U.S. has not yet released its form, and while we expect that it will generally conform to the OECD template, and indeed earlier drafts of the regulations demonstrated that it would, there is no promise that it will be identical.)

While the information on the OECD's CbC reports appears to be straightforward, the implications of coordinating accounting and management reporting systems across each of an MNE’s territories to produce consistent information is a potentially significant undertaking. Below is a brief discussion of the current status of CbC within the European Union, and steps that each affected MNE should be taking now to avoid panic when the reports become due, either in the U.S. or in a foreign territory.

EU CbC Reporting

The EU is currently discussing introducing EU-wide legislation compelling any group with operations in the EU (either via PE or entity) to file additional, modified CbC reports. Two fundamental differences exist between the proposals being discussed at the EU level on one hand, and the OECD and U.S. CbC reporting requirements on the other hand.

- First, EU CbC reports may be publically reported, while the U.S. has stated it will retain the confidentiality of any CbC reports it receives. In some drafts of the legislation being discussed at the EU level, the CbC reports may be made public. Considering that the level of information to be reported at the EU level is likely to be very similar to that required by the U.S., essentially U.S. groups with EU operations will now have to consider the PR implications of their CbC information becoming public. Further, the U.S. Treasury has also stated it will not exchange CbC information with any territories making their CbC filings public. The implications of this EU proposal may therefore make for an interesting dynamic on implementation and global coordination.
- Second, certain stakeholders within the EU legislative process are considering a much lower revenue threshold for CbC reporting, potentially as low as 40 million euros. While this is naturally a much more aggressive position than that taken by individual member states, and indeed lower than the OECD recommendations and U.S. regulations, the 40-million euro proposal is gaining traction in European discussions, particularly in the wake of the recent Panama scandal.

While the EU proposals are yet to be finalized, they add a further wrinkle to the increasingly global nature and complexity of CbC reporting requirements.

What Should I Be Doing?

Considering the newly mandated CbC reporting, multinationals should be preparing now for their first CbC filing, whenever it is due and whichever territory ends up receiving the information. To prepare, multinationals should:

- **Perform a trial run.** The easiest way to assess the ability of your systems to produce consistent information at the required level of consolidation is to try. Perform a trial run, attempting to create the information required in the format required based on FY15 data (if available). This would rapidly demonstrate whether changes need to be made to allow the "real" data of 2016 to be presented as required. This will be particularly important if there are any partnerships within your corporate structure, as these often present the most challenging requirements in presenting the data in a CbC report.
- **Keep humans involved.** While many areas of information required by CbC reports will be sourced from either management or statutory accounts, numerous data points within Tables 1 and 2 (the pure data reporting tables) as well as Table 3 (the explanatory table) will require discretion. This could include deciding exactly where employees are based (if, for example, they travel, or are employed in a territory outside of their home country), what the categorization of each entity is, or deciding whether joint-venture entities must be reported. Human involvement will be imperative in each data point within the CbC report, and nowhere more so than the qualitative statements in Table 3.
- **Decide on a presentation strategy.** There are numerous areas within the CbC tables where an element of discretion is possible, none more so than Table 3. Table 3 allows for an MNE to provide qualitative explanations for any potentially risk-highlighting territory information. Should, for example, your IP owner generate high profits at a low tax rate while your sales entities generate low profits at a high tax rate, the IRS (or surrogate filing nation) could use this as leverage to instigate an audit. Table 3 exists to highlight commercial rationale for a tax strategy, and should be thoughtfully prepared to support your tax profile.
- **Decide on a filing strategy.** Should your U.S. MNE fall into the gap of commencing its 2016 tax year between January and June, yet operating in a territory that has implemented mandatory CbC filing for tax years starting January 1, 2016, a decision needs to be made as to where and how to file. Unless the U.S. Treasury provides clear-cut guidance on this issue, spending time to consider which territory gets to see your CbC information in 2016 remains an all-important decision.

Alvarez & Marsal Taxand Says:

CbC has become a harsh reality for U.S. MNEs. Regardless of when the first filing is due in the U.S., for every U.S. MNE with revenues above the $850-million threshold, filing a CbC report is now a mandatory annual task. Despite the rapid progression of regulations in the U.S., there is still time for MNEs to adopt measures ensuring that when the time comes to produce the CbC reports, the relevant information systems are able to generate the information required, and any qualitative story is ready to be told.

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