

Performing a BEPS Diagnostic — The CbC Report as a Tool for Taxpayers

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In this article, the authors discuss how taxpayers can use draft country-by-country reports to identify potential BEPS issues.

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In July 2013 the OECD and G-20 countries released a 15-point action plan to address base erosion and profit shifting by multinational enterprises.¹ Action 13 of the plan called for a reexamination of transfer pricing documentation. More specifically, it called for the development of:

transparency for tax administrations, taking into consideration the compliance cost for business.

The rules to be developed will include a require-

¹One of the main concerns is the economic notion that higher assumed financial risks (by contract) should lead to higher financial returns, even without meaningful change in business operations. The BEPS report says that the financial returns of a business entity (that has contractually assumed financial risk without the ability to control and/or finance those risks) should be reallocated to the party or parties that have those abilities.

ment that MNEs provide all relevant governments with needed information on their global allocation of income, economic activity, and taxes paid among countries according to a common template.

On October 5, 2015, the OECD issued its final report on action 13. The report contains a complete rewrite of Chapter V of the OECD transfer pricing guidelines, which addresses documentation. The new Chapter V provides that countries should adopt a standardized approach to transfer pricing documentation — a three-tiered structure consisting of the following:

- A *master file* containing standardized information relevant to all MNE group members (the master file generally includes a disclosure of the group's organizational structure, a description of the business and a brief functional analysis, a description of intangible and financing arrangements, the consolidated financial statements of the group, and a list of existing tax rulings and advance pricing arrangements).
- A *local file* referring specifically to material transactions by the local taxpayer.
- A *country-by-country report* containing information about the global allocation of the MNE's income and taxes, as well as specific indicators of the location of economic activity within the MNE group. The CbC report also requires a listing of all constituent entities for which financial information is reported, including the tax jurisdiction of incorporation (if different from the tax jurisdiction of residence), as well as the nature of the main business activities carried out by that constituent entity.

Annex III to Chapter V contains the model template for the CbC report.² The final report on action 13 recommended that MNEs be required to file their first CbC report for the 2016 tax year. In response to the final action 13 report, on December 23, 2015, the U.S. Treasury issued proposed regulations (REG-109822-15) that require annual CbC reporting by U.S. persons that are the ultimate parent entity of the MNE group. According to the preamble to the proposed regulations, Treasury determined that it was appropriate to use the OECD's model template as a guide for U.S. CbC reporting. On June 30, 2016, the proposed regulations were issued in final form (T.D. 9773).

As we previously reported, the proposed regulations created a "gap year" concern for U.S. MNEs.³ Specifically, because the United States did not require the filing of CbC reports for 2016, U.S. MNEs were potentially required to make a secondary filing of their CbC reports for the 2016 tax year in the jurisdictions of one or more of their subsidiaries. That left many U.S. MNEs scrambling to find suitable countries other than the United States to make a so-called surrogate parent filing. On January 19, 2017, the IRS issued Rev. Proc. 2017-23, 2017-7 IRB 1, allowing U.S. MNEs to voluntarily file a CbC report in the United States for 2016. It is expected that, in accordance with OECD guidance issued on June 30, 2016, other jurisdictions will consider a voluntary filing of the 2016 CbC reporting in the United States (a "parent surrogate filing") to relieve U.S. MNEs from the local filing obligations.

Outside of the United States, the number of countries implementing CbC reporting is increasing. To date, CbC reporting obligations for the 2016 tax year have been implemented in Belgium, the Netherlands, Luxembourg, Ireland, Austria, Denmark, Australia, Brazil, Mexico, Canada, and China, among others.⁴

²Annex IV to Chapter V also contains a CbC reporting implementation package, which includes:

- model legislation that can be used by countries to require the ultimate parent entity of an MNE group to file the CbC report in its jurisdiction of residence, including backup filing requirements; and
- three model competent authority agreements that are to be used to facilitate implementation of the exchange of CbC reports.

³See Lewis J. Greenwald and Lucas Giardelli, "The Final U.S. CbC Reporting Regs: Has the Gap Been Filled?" *Tax Notes Int'l*, Oct. 24, 2016, p. 409.

⁴Many countries that have implemented CbC reporting for the 2016 tax year have also introduced notification requirements. In such cases, a resident company needs to notify the local tax authorities of the identity and the residence of the group company that will be filing the CbC report. For example, Austria, Ireland, and Denmark have introduced notification requirements that must be complied with by the end of 2016. In other countries, such as Belgium, Luxembourg, and the Netherlands, the notification deadline was extended into 2017.

The following information is required by the model CbC reporting template for each constituent entity of the group:

- the jurisdiction in which the constituent entity is a resident for tax purposes;⁵
- the jurisdiction in which the constituent entity is organized or incorporated (if different from the tax jurisdiction of residence);
- the tax identification number, if any, used for the constituent entity by the tax administration of the entity's tax jurisdiction of residence; and
- the constituent entity's main business activity or activities.

The CbC reporting template also requires specific financial and employee information for each tax jurisdiction in which at least one constituent entity is resident (to be reported on an aggregate basis, per tax jurisdiction)⁶:

- revenue⁷ generated from transactions with other constituent entities;
- revenue not generated from transactions with other constituent entities;
- profit or loss before income tax;
- total income tax paid on a cash basis to all tax jurisdictions, and any taxes withheld on payments received by the constituent entities;
- total accrued tax expense recorded on taxable profits or losses, reflecting only operations in the relevant annual accounting period and excluding deferred taxes or provisions for uncertain tax liabilities;
- stated capital of all constituent entities, except that the stated capital of a permanent establishment must be reported by the legal entity of which it is a PE unless there is a defined capital requirement in the PE jurisdiction for regulatory purposes;

⁵A business entity is considered resident in a tax jurisdiction if, under the laws of that jurisdiction, the entity is liable to tax in that jurisdiction based on its place of management or organization, or other similar criteria. However, a business entity will not be considered resident in a tax jurisdiction if it is liable to tax there solely on income from sources, or capital situated, within that jurisdiction. See Treas. reg. section 1.6038-4(b)(8). The final regulations also provide rules for determining the tax jurisdiction of a business entity that is resident in more than one jurisdiction or that is a PE.

⁶This information must also be provided, in the aggregate, for any constituent entity or entities that have no tax jurisdiction of residence.

⁷For this purpose, the term "revenue" includes all revenue, including from sales of inventory and property, services, royalties, interest, and premiums. It does not include payments received from other constituent entities that are treated as dividends in the payer's tax jurisdiction of residence. See Treas. reg. section 1.6038-4(d)(3)(ii).

- total accumulated earnings, except that accumulated earnings of a PE must be reported by the legal entity of which it is a PE;
- total number of employees on a full-time equivalent basis⁸ in the relevant tax jurisdiction; and
- net book value of tangible assets other than cash or cash equivalents.

All of these amounts must be based on “applicable financial statements, books, and records maintained for the constituent entity, or the records used for tax reporting purposes.”⁹

With the first CbC reports due shortly, and with taxing authorities exchanging CbC reports with a view to identifying MNEs’ BEPS exposures, taxpayers may want to already draft their first CbC report to identify BEPS exposures and to already develop possible alternatives or improvements to their structures. In other words, taxpayers may want to already draft CbC reports as a way of performing a BEPS diagnostic.

Here, by way of example, we take a relatively common intellectual property planning structure for U.S. MNEs and identify its BEPS exposures by completing its first CbC report.

L Corp: Irish IP HoldCo Structure

L Corp, a U.S. publicly traded corporation, produces and sells widgets. For the tax year ended December 31, 2016, L Corp had revenues, pretax income, a provision for taxes, and an effective tax rate as shown in Table 1.

	FY 2016
Revenues	\$200
Pre-tax income	\$50
Provision for taxes	\$20 (35% federal, 5% state and local)
Worldwide effective tax rate	40%

Approximately 40 percent of L Corp’s revenues were from non-U.S. sources, and that percentage is ex-

⁸The number of employees on a full-time basis may be reported as of the end of the accounting period, on the basis of average employment levels for the annual accounting period, or on any other reasonable basis consistently applied across tax jurisdictions and from year to year. Independent contractors participating in the ordinary operating activities of a constituent entity may be reported as employees of that entity. *See* Treas. reg. section 1.6038-4(d)(3)(iii).

⁹Treas. reg. section 1.6038-4(e)(2).

Table 2. Irish IP HoldCo Structure

	FY 2016
Revenues	\$200
Pre-tax income	\$50 (\$30 U.S. + \$20 foreign)
Provision for taxes	\$14.20 (\$11.70 U.S. + \$2.50 foreign)
Worldwide effective tax rate	28.4%

pected to grow significantly. Also, L Corp is considering putting additional resources and infrastructure in Europe to support its growing international operations.

In light of those considerations, L Corp forms an Irish subsidiary (“L Ireland”). L Corp licenses the non-U.S. rights to its IP to L Ireland and, at the same time, L Corp and L Ireland enter into a cost-sharing arrangement to jointly develop the future enhancements to the L technology. L Ireland hires two administrative types for the office and enters into a contract manufacturing agreement with a third party in Ireland whereunder the third-party contract manufacturer agrees to produce product for L Ireland. Finally, regarding the sale of product to end-users, L Ireland forms subsidiaries in various jurisdictions to act as commissionnaires¹⁰ on its behalf. (See Figure 1.)

Under Irish tax law, L Ireland’s income (that is, the non-U.S. revenue of the MNE) is subject to a 12.5 percent corporate tax rate for active business income. L Ireland’s sales do not create current U.S. tax under subpart F because:

- there are no related sales by virtue of the fact that the commissionnaires do not take title to the product; and
- in any event, L Ireland should benefit from the “manufacturing exception” to subpart F/foreign base company sales income by virtue of its agreement with the Irish third-party contract manufacturer.

¹⁰A commissionnaire sells product to customers in its own name. The principal (here, L Ireland) is contractually bound to the commissionnaire to deliver the goods to the customer and the commissionnaire is contractually bound to the principal to remit the purchase price. The commissionnaire never takes title to the product. Commissionnaires have been used by U.S. multinational corporations for decades to avoid related-party sales/currently taxable subpart F income. However, under BEPS action 7, the use of commissionnaires has come under attack. “It is clear that in many cases commissionnaire arrangements and similar strategies were put in place primarily in order to erode the taxable base of the state where sales took place.” “Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 — 2015 Final Report,” section A-15.

Figure 1. Irish IP HoldCo Structure

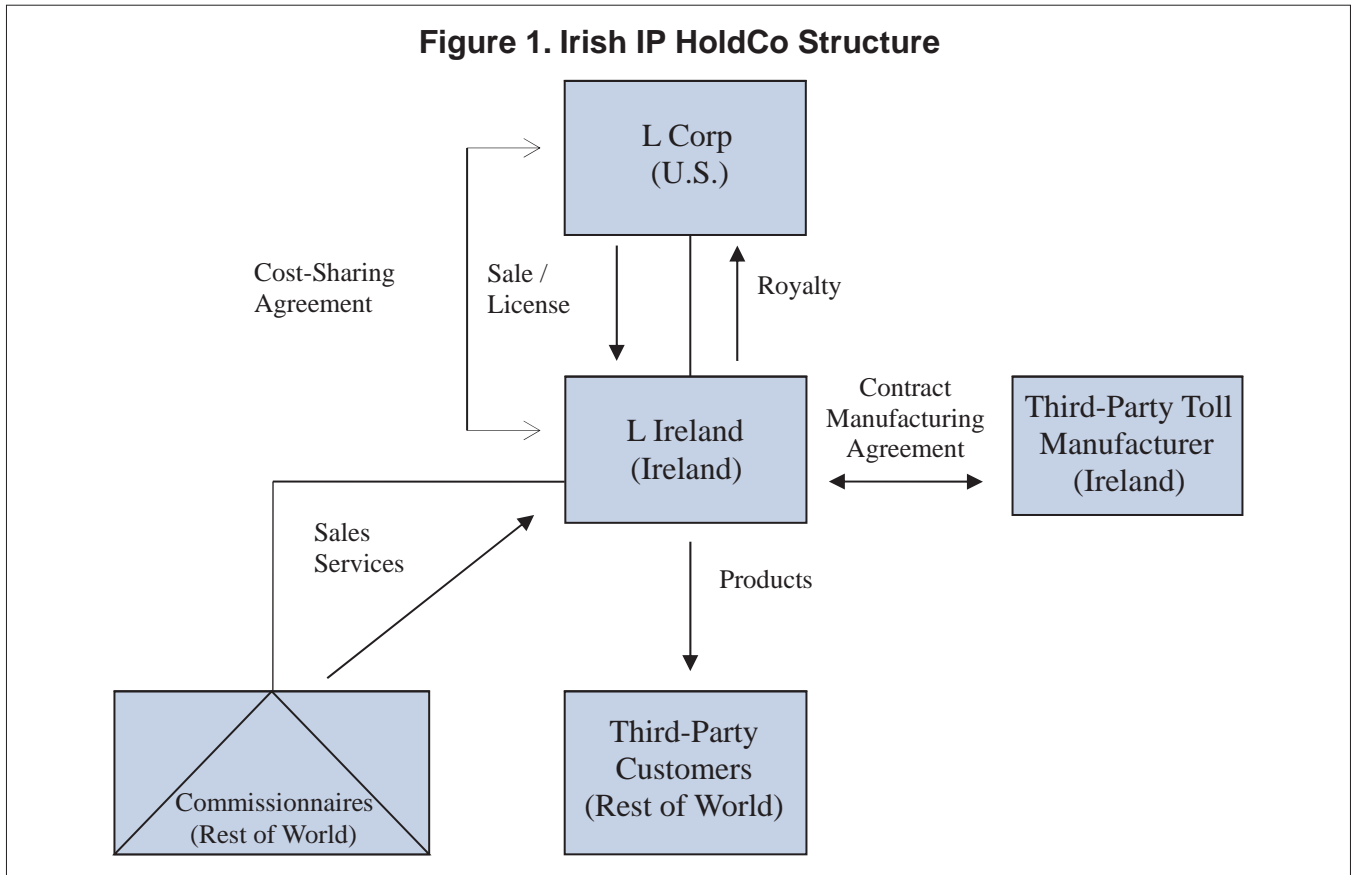


Table 3. Name of the MNE Group: L Corporation and Affiliates
 Fiscal Year Concerned: 2020
 Currency Used: USD (in thousands)

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	Tangible Assets Other Than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							
United States	12,000	500	12,500	5,000	1,750	1,750	1,000	15,000	300	5,000
Ireland	15,000	0	15,000	5,800	725	725	10	30,000	2	50
Germany	0	200	200	40	12	12	10	3.5	1	10
Japan	0	120	120	24	7.6	7.6	10	2	1	5

Also, there is no need to provide U.S. taxes on L Ireland’s earnings if those earnings are indefinitely re-invested outside of the United States (under APB 23). As such, by adopting the Irish IP HoldCo structure, L Corp reduced its worldwide effective tax rate from 40 percent to 28.4 percent, calculated as shown in Table 2.

All of that said, with the adoption of the Irish HoldCo structure, has L Corp created BEPS exposures? A review of a draft CbC report may help make this assessment. (See tables 3 and 4.)

As we see, the L Corp group has only two employees and limited assets in Ireland, the jurisdiction where it realizes most of its profit.

**Table 4. Name of the MNE Group: L Corporation and Affiliates
Fiscal Year Concerned: 2020**

Tax Jurisdiction	Constituent Entities Resident in the Tax Jurisdiction	Tax Jurisdiction of Organization or Incorporation if Different From Tax Jurisdiction of Residence	Main Business Activity(ies)														
			Research and Development	Holding or Managing Intellectual Property	Purchasing or Procurement	Manufacturing or Production	Sales, Market, or Distribution	Administrative, Management of Support Services	Provision of Services to Unrelated Parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding Shares or Other Equity Instruments	Dormant	Other		
United States	L Corporation		X	X		X	X										
Ireland	L Ireland		X	X		X	X										
Germany	L Germany GmbH						X										
Japan	L Japan GK						X										

Figure 2. Irish IP HoldCo Structure — Adjusted

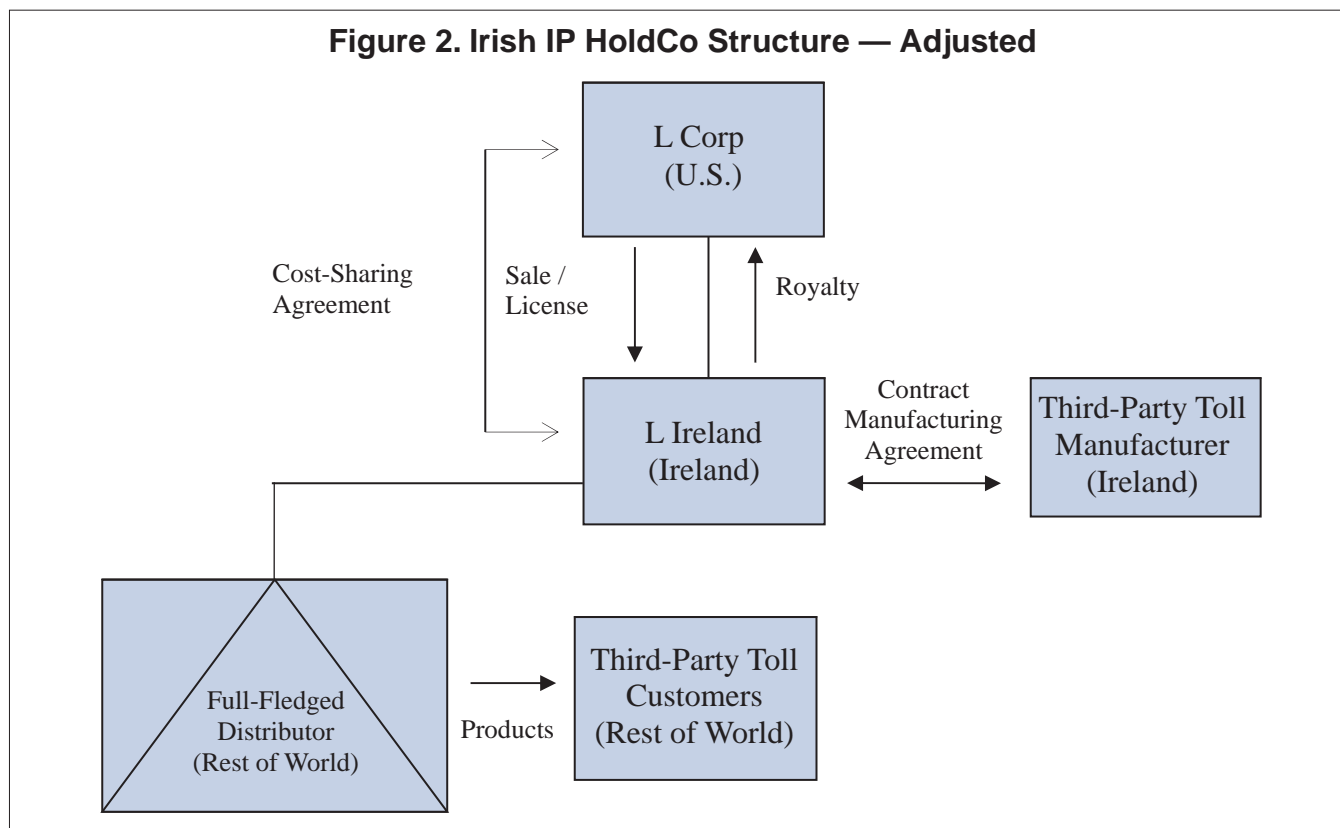


Table 5. Name of the MNE Group: L Corporation and Affiliates
Fiscal Year Concerned: 2020
Currency Used: USD (in thousands)

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	Tangible Assets Other Than Cash and Cash Equivalents
	Unrelated Party	Related Party	Total							
United States	12,000	500	12,500	5,000	1,750	1,750	1,000	15,000	300	5,000
Ireland	15,000	0	15,000	5,800	725	725	10	30,000	15	500
Germany	1,575	0	1,575	78,7	23.6	23.6	10	17.5	5	10
Japan	1,130	0	1,130	56.5	18	18	10	10	3	5

Table 6. Name of the MNE Group: L Corporation and Affiliates
Fiscal Year Concerned: 2020

Tax Jurisdiction	Constituent Entities Resident in the Tax Jurisdiction	Tax Jurisdiction of Organization or Incorporation if Different From Tax Jurisdiction of Residence	Main Business Activity(ies)													
			Research and Development	Holding or Managing Intellectual Property	Purchasing or Procurement	Manufacturing or Production	Sales, Market, or Distribution	Administrative, Management of Support Services	Provision of Services to Unrelated Parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding Shares or Other Equity Instruments	Dormant	Other	
United States	L Corporation		X	X		X	X									
Ireland	L Ireland		X	X		X	X									
Germany	L Germany GmbH						X									
Japan	L Japan GK						X									

Also, by virtue of using commissionnaires in Germany and Japan, very little in the way of income taxes is paid in those jurisdictions, where the headcount and assets are also very low.

These indicators may raise BEPS concerns by the various taxing authorities. As such, proactive adjustments to the structure should be considered.

Proactive Adjustments

First, a decision is made to increase L Ireland’s in-country substance (“boots on the ground”) by moving a portion of the U.S. research and development group to Ireland. This raises the number of L Ireland’s employees from two to 15, and results in an increase to L Ireland’s tangible assets.

Second, with the use of commissionnaires under attack, L Corp converts the German and Japanese commissionnaires to full-fledged buy/sell distributors; that is, the German and Japanese subsidiaries take title to the product (thus, assuming the inventory risk that the product will not sell) and then sell the product to third-party end-users in their country of incorporation (thus, assuming the accounts receivable risk that the customer(s) will not pay). (See Figure 2.)

These adjustments to L Corp's Irish IP HoldCo structure (adding R&D employees in Ireland and converting the commissionnaires to full-fledged buy/sell distributors) will result in a relatively modest increase in L Corp's worldwide effective tax rate. In turn, the proposed adjustments result in a more robust CbC report that now shows a level of revenue, tax, employees, and assets in each of Ireland, Japan, and Germany that is less likely to attract the attention of a tax authority reviewing the CbC report. (See tables 5 and 6.)¹¹

¹¹It is important to understand that BEPS exposure is more a continuum than a binary (with one being total compliance and 10 being total noncompliance). No one adjustment will totally eliminate a company's BEPS exposure; no single adjustment will flip the switch from "noncompliance" to "compliance." But there are meaningful modifications that can be made to reduce the magnitude of that exposure, which will move the company closer to 1.

This article has focused on two types of possible adjustments (R&D and commissionnaires). Another important focus of BEPS is the question of whether a controlled corporation, such as L Ireland, can exercise meaningful and specifically defined control over IP and other risks to which it is contractually subject to so as to justify its earning more than a substantially risk-free profit. That question will be the subject of a separate article.

Conclusion

As noted above, with the first CbC reports due shortly, and with taxing authorities exchanging CbC reports with a view to identifying MNEs' BEPS exposures, taxpayers may want to already draft their first CbC report to identify their BEPS exposures and to already develop possible alternatives or improvements to their structure. In other words, taxpayers may want to already draft CbC reports as a way of performing a BEPS diagnostic.

Here, by conducting a BEPS diagnostic, we found BEPS exposures in L Corp's Irish IP HoldCo structure. Adding additional headcount in Ireland and converting the commissionnaires into full-fledged buy/sell distributors should go a long way in mitigating those exposures and allowing L Corp to file more robust CbC reports. ◆