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Global Tax Policy in Transition: The Rising Importance of CbCR

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Country-by-Country Reporting has transitioned from a routine transparency tool to a critical component of global tax strategy due to the OECD's BEPS 2.0 framework, say Grant Thornton LLP practitioners.

As the global economy becomes increasingly interconnected, transparency in multinational tax practices has emerged as a hot topic for tax administrations worldwide. Tax transparency in the context of multinational enterprises ("MNEs") refers to the regulatory and statutory requirements that MNEs openly disclose relevant tax-related information to stakeholders or even the public at large. Although the concept of tax transparency has been around for some time, it took off in earnest with the release of the OECD's mandatory Country-by-Country Reporting ("CbCR") rules under BEPS Action 13 in 2015. The recent OECD BEPS 2.0 proposals (namely "Pillar Two") has propelled CbCR from the sidelines of tax policy discussions to the forefront of international tax reform. For the first time ever, CbCR now may have a real and direct tax impact and is no longer simply an information disclosure. Beyond this, for perhaps the first time ever, a report filed with one taxing jurisdiction (e.g., the United States) may now directly impact the tax liability in another taxing jurisdiction under the Transitional CbCR Safe Harbor contained in Pillar Two.

U.S. MNEs must take steps now to prepare for both the trends in tax transparency and the evolution of CbCR. Proactive measures will reduce risk and may even be the newest frontier in international tax planning and minimization. This article provides background on the evolving trends and discusses the newfound importance of CbCR.

From Concept to Keystone of Tax Transparency in the Modern Age

Once considered a utopian ideal by tax justice advocates, the concept of disclosing tax information by jurisdiction has journeyed from the realms of academic debate to the forefront of international tax reform. Its origins span decades, with the concept first gaining prominence in 2003 as part of the Tax Justice Network's proposal for a new accounting

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standard to facilitate the alignment of financial statements across different national jurisdictions (The Tax Justice Policy Tracker).

The proposal was brought to life much later and was adopted as part of the OECD's Base Erosion and Profit Shifting ("BEPS") project. By incorporating CbCR into the BEPS Action Plan in 2015, the OECD not only validated its significance but also established a framework for its implementation, marking a pivotal moment in the pursuit of global tax transparency. Since its adoption, the global standardization of CbCR guidelines has accelerated, evidenced by the inclusion of 136 different participating jurisdictions in the OECD's sixth annual CbCR peer review process (Action 13 - OECD BEPS).

At its core, CbCR requires MNEs to report key financial data for each jurisdiction in which they operate, offering tax authorities a clearer view of where profits are made, substance exists, and taxes are paid. The initiative targets MNEs with annual consolidated group revenue exceeding €750 million, casting a wide net over significant players in the global economy. The U.S. reporting requirement differs slightly in that it is tied to the U.S. dollar rather than the Euro. An ultimate parent entity of a U.S. MNE group is required to report information for the reporting period if the annual revenue of the U.S. MNE group for the immediately preceding reporting period was $850,000,000 or more (*See* Treas. Reg. §1.6038-4(h)).

The fundamental objective is to empower tax authorities with the detailed financial insight necessary to assess compliance and address potential risks of tax avoidance effectively.

The premise is to build a more transparent and equitable tax environment, ensuring that MNEs are held accountable for their fair share of tax contributions. By laying the groundwork for enhanced international cooperation and informed tax policy development, CbCR stands as a pillar of modern tax governance, aiming to uphold the integrity of the global financial system and promote a level playing field for all.

CbCR Goes Public

Certain tax authorities are now advancing one step further, enacting laws that require public disclosure of a qualifying MNE's CbCR. The journey towards Public CbCR has been building for a number of years. The EU's Public CbCR Directive, which came into force on December 21, 2021, mandates MNEs operating within the EU and exceeding certain revenue thresholds to publicly disclose their CbCR. Member States were given until June 22, 2023, to integrate the directive into their national legislation, marking a significant step in the next phase of CbCR.

The rules are expected to apply, at the latest, from the first financial year starting on or after June 22, 2024; with a 12-month deadline to disclose the necessary information following the end of the financial year. This movement extends beyond the EU; Australia has also advanced CbCR in a similar fashion, delaying its initial implementation timeline to align with the EU.

In the U.S., the Disclosure of Tax Havens and Offshoring Act has been introduced in both the House and Senate. The bill would direct the U.S. Securities and Exchange Commission to mandate public disclosure of country-by-country financial reports by large corporations. The bill has so far failed to move in each of the last two Congresses, but if it eventually gains traction, it would implement mandatory disclosures similar to those in the EU and Australia.

Similarly, the UK enacted legislation to enable Public CbCR in 2016, but the authority was never exercised and then subsequently abandoned in 2020. The UK does require certain companies to publicly file their financial statements, which, while less detailed in tax-specific disclosures than a CbCR, still contribute to the overall transparency of corporate financial activities.

The discussion on the suitability of public CbCR is highly debated. Some commentators note that the rules introduce competitive disadvantages for businesses by revealing sensitive information. Additionally, there is concern about the potential for reputational damage due to misinterpretation of the prescribed reporting formats, which often follow a “one-size-fits-all” approach. Either way, the potential impacts on corporate transparency, stakeholder trust, and global tax practices are expected to be profound despite the criticisms.

Public CbCR also creates data consistency concerns. The same data may need to be reported to stakeholders in different capacities (e.g., CbCR, ESG reporting, etc.). Divergences in the data between these usages may erode trust or lead to costly audits. Given this risk, MNEs are implementing changes within their enterprise resource planning (“ERP”) systems to ensure uniformity within their data sources. The mind set being if there is only one source of data. there is only one source of the truth.

There is also a growing trend among MNE groups to voluntarily disclose CbCR information, mirroring the detail found in formal reports as a demonstration of robust corporate governance.

Common CbCR Pitfalls

Rather helpfully, the OECD has highlighted several common errors that they’ve observed in the context of the CbCR (Common errors made by MNEs in preparing Country-by-Country reports). While most are administrative in nature, they can still significantly affect the transparency and accuracy of reports. For instance, a frequent oversight is not including detailed information on the sources of the data used for each jurisdiction. This omission complicates the verification process and may lead to questions regarding the authenticity and accuracy of the reported data. OECD guidance clearly lays out that this is a requirement for all CbCR reporting (OECD Guidance on the Implementation of Country-by-Country Reporting: BEPS Action 13, Part IV, Question 4.1 (Oct. 2022)). In the context of U.S. MNE groups, IRS instruction dictates that a taxpayer must clearly “describe the sources of data used in preparing Parts I and II of Schedule A (Form 8975)” (i.e., the CbCR) (Instructions

for Form 8975 and Schedule A (Form 8975) (Dec. 2020)). The description should be sufficient to enable an understanding of the source of each item of information supplied, an issue commonly missed by taxpayers. Although yet to be fully known, errors like this could also raise questions around whether the report can be used under the transitional Pillar Two safe harbor, discussed further below.

Furthermore, the exclusion of non-consolidated entities from CbCRs is another key error. Despite their exclusion from the main consolidated financial statements due to size or materiality, these entities must be reported to provide a complete picture of an MNE group's operations across different jurisdictions. This can be particularly relevant where these entities may be engaged in key operational activities or tax planning strategies in specific jurisdictions.

Reporting of dividends in CbCR contexts can also be complex. According to OECD guidance, historically there has been inconsistency in how dividends received from other constituent entities should be treated in a CbCR OECD Guidance on the Implementation of Country-by-Country Reporting: BEPS Action 13, Part II, Question 7.1 (Oct. 2022)). Initially there was little guidance on whether dividends received by an entity should be included in Profit (Loss) before Tax, resulting in challenges for tax administrations in using CbCR to assess Transfer Pricing or other BEPS-related risks. The OECD has since clarified that payments received as dividends should be excluded from Profit (Loss) before Tax, mirroring their exclusion from Revenue figures. In situations where local accounting rules require or allow an entity to include an amount representing part or all of another entity's profit (in its Profit Before Tax ("PBT")), this amount should still be excluded from both revenue and PBT in its CbCR.

CbCR in a Pillar Two BEPS 2.0 World

Historically regarded by some taxpayers as a procedural formality, the CbCR has undergone a paradigm shift in importance due to Pillar Two. What was once regarded by some as a purely non–tax information reporting exercise, the introduction of the "Transitional CbCR Safe Harbor" through various iterations of Pillar Two Administrative Guidance has given rise to a notable increase in CbCR's importance.

The Transitional CbCR Safe Harbor is comprised of short-term tests performed to exclude an MNE group's operations in lower-risk countries from detailed Pillar Two calculations. The transitional safe harbor identifies lower-risk jurisdictions through the application of three quantitative tests taking information primarily from an MNE's CbCR. These tests include:

- **De Minimis Test –** This test applies to a jurisdiction if total revenue in the CbCR is less than €10 million and the profit (loss) before income tax is less than €1 million.
- **Simplified ETR (effective tax rate) Test –** This test applies if the jurisdiction has a "simplified ETR" that is greater than or equal to 15% (2023-2024), 16% (2025), 17% (2026). The Simplified ETR is calculated by dividing the Simplified Covered

Taxes (e.g., income tax expenses, after certain eliminations including uncertain tax positions) in the MNE's financial statements by the profit or loss before tax reported in the CbCR.
- **Routine profits test** – This test applies if the profit (loss) before income tax is equal to or less than the "substance-based income exclusion." Generally speaking, the substance-based income exclusion is calculated based on a specific jurisdiction's eligible tangible assets and payroll costs.

If one of the above is applicable to a specific jurisdiction within the MNE group, this would obviate the requirement to compute full "GloBE" calculations for that jurisdiction (i.e., the calculations used to impute any top-up tax under Pillar Two). Full Pillar Two calculations are notoriously complex, requiring hundreds of data points for each constituent entity, some of which current ERP systems are not necessarily able to obtain. During the transitional period, most MNE Groups are able to avoid detailed Pillar Two calculations in nearly all jurisdictions in which they operate via the Transitional CbCR Safe Harbor - emphasizing the heightened importance of the safe harbor in the BEPS 2.0 world.

More recent administrative guidance from the OECD has shed new light on complexities associated with what constitutes a "Qualified CbC Report" (Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two) (Dec. 2023)). Failure to meet this standard may have severe consequences for an MNE group, rendering Transitional CbCR Safe Harbor calculations unobtainable and necessitating full Pillar Two calculations, even when they may not have been required otherwise. The premise is that all figures used for the safe harbor calculations must stem from "Qualified Financial Statements" – broadly either the accounts used to prepare the Consolidated Financial Statements of the ultimate parent entity ("UPE"); the local financial statements of the Constituent Entity if prepared in accordance with an Acceptable/Authorized Financial Accounting Standard; or the financial accounts used to prepare the CbCR if the Constituent Entity is not included in an MNE group's Consolidated Financial Statements on a line-by-line basis solely due to size or materiality grounds.

Any discrepancies from the Qualified Financial Statements may disqualify an MNE from benefits of the Transitional CbCR Safe Harbor. For example, recent administrative guidance provided that adjustments made for transfer pricing after the fiscal year-end may disqualify the report (or at least aspects of the report) (Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two) (Dec. 2023)). Taxpayers typically aim to reflect 'actual' numbers in their CbCR, incorporating transfer pricing adjustments to enhance data quality. However, if these adjustments are not mirrored in the Qualified Financial Statements, the data for that specific jurisdiction may be immediately disqualified—often leading to what may seem like disproportionate treatment.

Previous administrative guidance from the OECD has also suggested that taxpayers have aimed to manipulate the Transitional CbCR Safe Harbor using "hybrid arbitrage arrangements." This strategy is possible because the safe harbor allows MNE groups to

leverage varied sources of financial information to affirm their compliance. The December Administrative Guidance has recognized the need to address these arrangements that exploit discrepancies between financial and tax accounting treatments. To counteract this, the guidance mandates adjustments to the PBT and income tax expense for specific types of hybrid arbitrage arrangements that were entered into after December 15, 2022. These include:

- **Deduction/Non-Inclusion Arrangements:** Where a financial loss or expense in one entity does not correspond to a revenue increase in another, potentially leading to unbalanced treatment across jurisdictions.
- **Duplicate Loss Arrangements:** Situations where a loss is reported in multiple entities' financial statements, or where a transaction results in a deductible loss in more than one jurisdiction.
- **Duplicate Tax Recognition Arrangements:** Where multiple entities within the same MNE group include the same income tax expense in their calculations, without corresponding income reported in those entities' financial statements.

The Inclusive Framework stipulates that such arrangements, if impacting a jurisdiction's qualification, preclude the MNE Group from Transitional CbCR Safe Harbor eligibility (for the specific jurisdictions in question). This proactive approach aims to ensure that MNE groups do not misuse the safe harbor to artificially reduce their tax liabilities, thus maintaining the integrity and intention of the Transitional CbCR Safe Harbor to exclude an MNE group's operations in lower-risk countries from detailed Pillar Two calculations.

The guidelines above for the Transitional CbCR Safe Harbor extend beyond those in the OECD Model GloBE rules and might inadvertently ensnare well-intentioned taxpayers. It is crucial for MNE groups to meticulously scrutinize their operations for any hybrid arbitrage arrangements, particularly in jurisdictions close to the limits specified by the De Minimis and Simplified ETR tests, to ensure compliance and avoid penalties.

The pitfalls outlined above are just the tip of the iceberg, and the criteria for a "Qualified CbC Report" contain several potential traps for the unwary. While the Transitional CbCR Safe Harbor offers significant reprieve from the onerous full GloBE computations, new questions are being raised regarding its applicability for many taxpayers. As new rounds of OECD Administrative Guidance are anticipated, the intricacies of the Transitional CbCR Safe Harbor are expected to deepen, adding new layers of complexity to its application.

Despite the U.S. not adopting the BEPS 2.0 Pillar Two proposals, the U.S. CbCR (Form 8975) now plays a pivotal role in easing Pillar Two compliance for U.S. MNE groups. The final regulations in Treas. Regs. §1.6038-4 and the instructions for CbC reporting (Form 8975) generally follow the OECD guidance on this topic. However, there is no doubt a new threshold has been created that goes beyond previous iterations of guidance and instruction. In other words, what satisfies the U.S. regulatory requirements for a U.S. MNE group, may be insufficient when the stricter Transitional CbCR Safe Harbor requirements are applied.

An intriguing development for U.S. MNEs revolves around the utilization of the U.S. CbCR (Form 8975) in the tax computation and filing processes of other jurisdictions. This report, submitted to the IRS, has gained significance as foreign subsidiaries may now require it to meet the criteria for the Transitional CbCR Safe Harbor. What was once perceived solely as a U.S. compliance procedure has now evolved into a globally impactful measure, demonstrating the interconnected nature of multinational taxation.

Conclusion

CbCR has transitioned from a routine transparency tool to a critical component of global tax strategy due to the OECD's BEPS 2.0 framework. With MNEs now navigating a complex landscape of compliance, taxpayers should reassess their approach to CbCR. The shifting guidelines, especially around the Transitional CbCR Safe Harbor, introduce new challenges that could significantly impact tax strategies. As tax authorities refine these rules, staying informed and proactive is crucial for any business involved within the scope of the rules. This evolving scenario underscores the importance of diligent CbCR compliance and the potential repercussions of oversight in this increasingly scrutinized area.

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