

I.R.S. ADOPTS O.E.C.D. STANDARD IN NEW CBC REPORTING REGULATIONS

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In December, the I.R.S. released Prop. Treas. Reg. §1.6038-4,¹ which details the country-by-country (“CbC”) reporting that will be required of large U.S.-based business entities. This reporting is consistent with the model template recommended by the O.E.C.D.

The proposed regulations define the persons required to file the CbC report, companies that are to be included in the report, information that must be reported, acceptable measurement methodologies to be used, and uses to which data may be put. The preamble to the proposed regulations (“preamble”) includes a model reporting form.

ACTION OBJECTIVES

The aim of these proposed regulations is to facilitate enforcement of U.S. tax law. These regulations will allow for better enforcement of income tax law by providing tax agencies with greater transparency regarding the operations and tax positions taken by U.S.-based multinational groups.

The model template recommended by the O.E.C.D. will be adopted by the I.R.S. As explained in the preamble, adoption of the template promotes consistent and effective CbC reporting across different tax jurisdictions. It is anticipated that other tax jurisdictions will adopt similar information reporting requirements, based on the model template, for Multinational Enterprise (“M.N.E.”) groups based in those countries.

Moreover, the model template was developed taking into account extensive consultations with stakeholders, including U.S. M.N.E. groups, in order to appropriately balance the benefit to tax administrations, which arises from the collection of information about the M.N.E. groups’ global operations, against the compliance costs and burdens imposed on those M.N.E. groups. These consultations significantly affected both the scope of the information included in the model template and the flexibility afforded to M.N.E. groups in determining how to compile that information in light of their diverse internal structures and logistical capabilities. In addition, the model template reflects an agreed-upon international standard for reporting by M.N.E. groups that will promote consistency of reporting obligations across tax jurisdictions and reduce the risk that other countries will depart from the standard by imposing inconsistent and overlapping reporting obligations. Nonetheless, the preamble points out that the proposed regulations are also tailored to be consistent with the preexisting information reporting requirements applicable to U.S. persons.

¹ REG-109822, December 23, 2015.

EXCHANGE OF INFORMATION

CbC reports may be exchanged with tax authorities in other countries pursuant to income tax conventions, other applicable conventions, and bilateral agreements relating to the exchange of information. Thus, the I.R.S. anticipates that CbC reports prepared by non-U.S.-based M.N.E. groups will be furnished to the I.R.S. In the aggregate, the reports will help the I.R.S. perform high-level transfer pricing risk identification and assessment in a manner consistent with recently announced audit plan guidelines applicable to the examination of an M.N.E. According to the I.R.S., it is essential that the reporting standards should be consistent across the world so that the same level of deference is afforded to each report when using the data for tax assessment purposes.

“In a world where Sean Penn can meet a drug lord hiding in Mexico without the knowledge of the Mexican government... legitimate doubts exist concerning the data security capabilities of any government.”

The information reported in a CbC report will be treated as income tax return information and thus subject to strict confidentiality rules under Code §6103. This information will be exchanged automatically under the authority of information exchange agreements to which the U.S. is a party. Consequently, the exchanged information will be treated as confidential by both parties. All disclosures and any use of the information by the receiving jurisdiction must be in accordance with the terms of the relevant information exchange agreement.

Information exchange agreements generally prohibit the parties from using any information received for any purpose other than the administration of taxes. Accordingly, under the terms of such agreements, neither tax jurisdiction is permitted to disclose the information received or to use the information for any non-tax purpose. The competent authorities of the U.S. and other tax jurisdictions intend to limit the permissible uses of exchanged CbC reports to assessing high-level transfer pricing and other tax risks and, where appropriate, for economic and statistical analysis.

U.S.-based M.N.E. groups are concerned about the practical aspects of confidentiality. In a world where Sean Penn can meet a drug lord hiding in Mexico without the knowledge of the Mexican government and the U.S. Social Security Administration can be hacked, legitimate doubts exist concerning the data security capabilities of any government.

The preamble attempts to assuage these feelings of insecurity. It points out that, prior to entering into an information exchange agreement with another tax jurisdiction, the I.R.S. closely reviews the tax jurisdiction's legal framework for maintaining confidentiality of taxpayer information and its track record of complying with that legal framework. In order to conclude an information exchange agreement with another tax jurisdiction, the I.R.S. must be satisfied that (i) the tax jurisdiction has the necessary legal safeguards in place to protect exchanged information, (ii) such protections are enforced, and (iii) adequate penalties apply to any breach of confidentiality. Moreover, even when these conditions have been met and an information exchange agreement is in effect, the U.S. competent authority will not enter into a reciprocal automatic exchange of information relationship with a tax jurisdiction unless it has reviewed the tax jurisdiction's policies and procedures regarding confidentiality protections and has determined that an exchange relationship is appropriate.

AFFECTED PERSONS

Under the proposed regulations, a U.S. business entity that is the ultimate parent entity of a U.S. M.N.E. group is required to file the CbC reporting form for an annual accounting period only if the U.S. M.N.E. group has global revenues of more than \$850 million for the preceding annual accounting period.²

A U.S. M.N.E. group is a group of entities that is required to prepare consolidated financial accounts pursuant U.S. G.A.A.P.³ A parent entity of a U.S. M.N.E. group

- is a U.S. business entity that controls a group of business entities, at least one of which is organized or a tax resident outside of the U.S., which
- is required to consolidate the accounts of the M.N.E. group for financial reporting purposes under U.S. G.A.A.P., or would be required to consolidate accounts if equity interests in the U.S. business entity were publicly traded on a U.S. securities exchange.

The term “business entity” means a person as defined in Code §7701(a) that is not an individual. It also includes a permanent establishment that prepares financial statements that are separate from those of its owner for financial reporting, regulatory, tax reporting, or internal management control purposes.

A business entity is considered a resident of a tax jurisdiction if the entity is liable for taxes in that jurisdiction based on place of management or organization, or another similar criterion. A business entity will not be considered resident in a tax jurisdiction if it is liable to tax solely with respect to income from sources in such jurisdiction or from capital situated there.⁴ This allows some room for creative planning to ensure tax residency in certain jurisdictions and not others.

Generally, U.S. G.A.A.P. provides that, if an entity owns a majority voting interest in another legal entity, the majority owner must combine the financial statements of the majority-owned entity with its own financial statements in consolidated financial statements. A U.S. M.N.E. group does not include business entities that are accounted for under the equity method at the level of the shareholder. Such entities do not consolidate their accounts with the equity owner even though the equity owner’s proportionate share of the business income is included in the equity owner’s consolidated financial statements.

In some instances, the ultimate parent entity of a U.S. M.N.E. group may be required to prepare consolidated financial statements under U.S. G.A.A.P. but not considered to be an includible corporation for purposes of filing a consolidated corporate income tax return. For example, the top tier ultimate parent entity may own 65% of the outstanding common stock of a first tier holding company that is the common parent of an affiliated group of U.S. domestic corporations that files a consolidated corporate income tax return. Indeed, the ultimate parent entity may own more than one such group.

² Prop. Treas. Reg. §1.6038-4(j).

³ Prop. Treas. Reg. §1.6038-4(b)(4).

⁴ Prop. Treas. Reg. §1.6083-4(b)(6).



The preamble identifies the top tier ultimate parent entity as the company that must prepare and file the CbC report for all companies that join in the preparation of consolidated financial statements, even though it does participate in the consolidated corporate tax return in the U.S. Where these facts occur, the ultimate parent entity would file the CbC report that covers all affiliated group entities. A subsidiary corporation that is a common parent at an intermediate level would not file the CbC report for its group.

The preamble invites taxpayer comments on whether additional guidance is needed for determining which U.S. persons must file CbC reports and which entities are considered constituent entities of the filer in the context of an ultimate parent entity of an M.N.E. group that prepares financial statements on a consolidated basis without having majority ownership of constituent members. Comments are also invited to address whether a need exists for the I.R.S. to exempt a company from the CbC filing requirement or limit the scope of reporting for reasons of national security or another important government function that is within the purview of another Federal agency. In such case, a set of procedures must be drafted for U.S. persons to claim the exemption or limitation and for establishing what circumstances, if any, that would necessitate an independent review by the I.R.S.

Finally, the preamble addresses the reporting obligation when a constituent entity is a partnership in the tax jurisdiction in which it is organized and operates in no other country through a permanent establishment. It is expected that reporting will take place at the partner level so that each partner will report its share of the partnership's items in its jurisdiction of tax residence. An open issue at present is the treatment of entities that are not treated as being fiscally transparent in the owners' jurisdictions of residence but are treated as fiscally transparent in the country of organization of the entity. Again, the I.R.S. has invited comments to identify issues that require further guidance.

CBC REPORTING REQUIREMENTS

The template on which Form XXXX, *Country-by-Country Report*, will be based is provided below.

Name of the M.N.E. Group: Fiscal year concerned:													
Tax Jurisdiction	Constituent Entities resident in the Tax Jurisdiction	Tax Jurisdiction of organization of incorporation if different from Tax Jurisdiction of Residence	Main business activity(ies)										
			Research and Development	Holding of Managing Intellectual property	Purchasing or Procurement	Manufacturing or Production	Sales, Marketing, or Distribution	Administrative, Management, or Support Services	Provision of Services to unrelated parties	Internal Group Finance	Regulated Financial Services	Insurance	Holding shares or other equity instruments
	1.												
	2.												
	3.												
	1.												
	2.												
	3.												

*Please specify the nature of the activity of the constituent entity in the "Additional Information" section.

Name of the M.N.E. group: Fiscal year concerned: Currency used:										
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							

Name of the M.N.E. group: Fiscal year concerned:
Additional Information. Please include any further brief information or explanation you consider necessary or that would facilitate the understanding of the compulsory information provided in the Country-by-Country Report.

The CbC report is required to be filed with the ultimate U.S. parent entity's timely-filed tax return.⁵

Constituent Entity Information

The proposed regulations describe the information required to be reported for each constituent entity of the M.N.E. group.⁶ A reportable constituent entity is any separate business entity, except a foreign corporation or partnership, or any permanent establishment of such foreign corporation or partnership, for which the ultimate parent entity is not required to provide information under Code §6038(a). The I.R.S. has invited comments on whether additional guidance is needed on reportable constituent entities. The information required includes the tax identification number, the tax jurisdiction of residence, the tax jurisdiction in which the entity is organized (if different from the residence jurisdiction), and the main business activity of the entity.

Financial and Employee Information

Certain information,⁷ which is required for each tax jurisdiction, must be presented in the aggregate for all resident constituent entities of that jurisdiction. Constituent entities that have no tax jurisdiction of residence must report the required information on an aggregate basis for all entities that have no jurisdiction.⁸

The information required for each tax jurisdiction includes (i) all revenues generated from transactions with other constituents and from non-constituent entities, (ii) pre-tax profit or loss, (iii) taxes paid in all jurisdictions, (iv) accrued tax expenses recorded, (v) stated capital, (vi) accumulated earnings, (vii) number of full-time employees,

⁵ Prop. Treas. Reg. §1.6038-4(g).

⁶ Prop. Treas. Reg. §1.6038-4(d)(1).

⁷ Prop. Treas. Reg. §1.6038-4(d)(2).

⁸ Prop. Treas. Reg. §1.6038-4(d)(3)(i).

and (viii) net book value of tangible assets other than cash or its equivalent. This information will sum up the activity that takes place in the jurisdiction and help a tax administration to identify any highly profitable locations where few employees are assigned and little tax is paid.

The number of full-time employees can be determined at the close of the accounting period using any reasonable basis, including any independent contractors that participate in the ordinary operating activities of the constituent entity.⁹ For reporting purposes, the tax residence of an employee is determined by reference to the entity that employs the individual and not by the residence of the individual. Any reasonable basis can be used to make these determinations, provided that they are applied consistently and are justifiable.

The financial information reported may be based on records used for tax reporting purposes.¹⁰ There is no need to reconcile the revenue, profit, and tax reported or make adjustments for differences in accounting principles applied from jurisdiction to jurisdiction. Any changes made in the source data can be explained on the reporting form.

While the I.R.S. and the Treasury have tried to adhere to the model template developed by the G-20 and O.E.C.D., they acknowledge that certain areas may require clarification for practical use and therefore invite comments on the manner in which the proposed regulations request employee and financial information.

FILING AND MAINTAINING RECORDS

The reporting form is required to be filed with the ultimate parent entity's timely-filed tax return.¹¹ Sufficient records must be maintained to support the information provided.¹² Constituent entities are not required to provide notice of the M.N.E. reporting requirement or that they have been included in any such report.

⁹ Prop. Treas. Reg. §1.6038-4(d)(3)(iii).

¹⁰ Prop. Treas. Reg. §1.6038-4(e)(2).

¹¹ Prop. Treas. Reg. §1.6038-4(f).

¹² Prop. Treas. Reg. §1.6038-4(g).