Practice guide

CBC reporting and transfer pricing documentation: what to expect in 2018?

Speed read

County by country (CBC) reporting is a risk assessment tool that is here to stay, and the associated obligations are likely to expand over time. The first CBC reports were due for many multinationals on 31 December 2017, and the first automatic exchange of CBC reports between jurisdictions will take place by 30 June 2018. Groups should therefore expect their CBC reports to be scrutinised by tax authorities, and for evidence of this to filter through into their risk assessments and the direction of tax audits, with even more focus on transfer pricing. The key to successful management of CBC reporting is to understand the results in the context of a group's business. Considerations for groups include: establishing a global documentation strategy which utilises the combination of the master file and the local file to best explain their business in a clear and consistent way; reviewing their data gathering processes; preparing a narrative to explain any unexpected results; deciding whether or not to publish their CBC report; and ensuring their boards are properly briefed.

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December 2017 saw the final push to file country by country (CBC) reports for all affected corporates with a 31 December year end. While this process exposed some difficulties, whether due to anomalies in the data, technological challenges, or simply an overload of raw data, the vast majority of filings were successfully submitted by the deadline and teams were able to recover over a well-deserved festive break.

Now, in early 2018, thoughts turn to what happens next: whether a refocus on the filing cycle to identify any efficiencies that can be made; more fundamental questions concerning the results of the recently filed reports; or preparing to proactively share results in the public domain. With the recent focus on CBC reporting, it has been easy to overlook the critical role of the master file and local file transfer pricing documentation, which interlock with CBC reporting under BEPS Action 13 and provide the crucial supporting narrative.

Back to basics

Before considering the 2018 landscape in more detail, we first provide an overview of the obligations under BEPS Action 13. For the purposes of this summary, our focus is on the UK application of the OECD's recommendations. While other countries have applied the recommendations in very similar ways, the specific filing obligations would need to be addressed on a case by case basis.

For CBC reporting, the UK legislation applies for accounting periods beginning on or after 1 January 2016 for multinational enterprises (MNEs) with consolidated group revenues in excess of €750m in the previous accounting period. The UK legislation requires all affected UK parented MNEs to file a report. In addition, the UK entities of foreign parented MNEs will also be required to make a filing in certain circumstances; for example, where there is no local requirement for the parent company to file or the exchange mechanisms are not effective.

The CBC report must be filed in XML format within 12 months of the end of the relevant accounting period. HMRC will share this information with the countries listed on the report, providing the appropriate exchange mechanisms are in place between the UK and that country.

Whilst the UK has not formally implemented the requirement for master file and local file documentation, it has issued guidance which mirrors the OECD recommendations (see HMRC's *International Exchange of Information Manual* at IEIM30003133):

> 'HMRC requires that transfer pricing documentation should be retained to support the arm's-length pricing. Such documentation should be proportionate to the size and complexity of the transactions or business involved and should be the same as that specified in Annexes I and II of the Action 13 report. HMRC does not require a master file or local file to be filed with the CBC return.'

At the time of filing its annual tax return, a company must demonstrate that its transfer pricing is arm's length. The penalties for not retaining the appropriate documentation are relatively small (£3,000), but contemporaneous documentation helps a company demonstrate that it has not been careless in its transfer pricing approach, which can help to mitigate against the much more significant tax geared penalties.

Whilst there is no strict UK requirement for a master file or local file, we believe that two factors may lead UK groups to consider voluntarily preparing such documentation, albeit scaled appropriately to the specific facts and circumstances of the business in question:

- Firstly, UK headquartered MNEs will be subject to requests to share their master file by overseas tax authorities seeking to use that document in conjunction with the CBC report to assess the level of transfer pricing risk in their jurisdiction. In this regard, the master file and local file will be key in explaining the picture presented by the CBC report.
- Secondly, we believe that the overall direction of travel is for greater clarity and transparency over the tax affairs of MNEs and therefore we believe it is quite possible that we will see a shift in approach in future years.

What should we expect from tax authorities in 2018?

The OECD requires the first automatic exchange of CBC reports to take place no later than 30 June 2018. HMRC has committed to this and also to exchange reports in future years within 15 months of the end of the period covered by the report. However, HMRC will not be notifying businesses of when the exchange actually takes place.

For those jurisdictions that are signatories to the OECD inclusive framework on BEPS, a framework is in place to support this automatic exchange. The 28 EU member states also have an exchange mechanism in place under a European Council Directive. In addition, certain bilateral agreements between qualifying competent authorities will facilitate the exchange, including 31 of the US's bilateral agreements.

At the time of writing, the UK has 55 activated exchange relationships, and HMRC does not consider there to be any countries where exchange arrangements are not working effectively. These exchange arrangements require the tax authorities to maintain the confidentiality of the information and data supplied.

Appropriate use

The CBC reports clearly provide tax authorities with a significant amount of information about the headline activities of multinationals across the territories in which they operate. While some of this information will support what the tax authorities already know, in many cases the reports will provide new information. The OECD is aware of stakeholders' concerns that this information is at risk of being misused by tax authorities, and has published guidance on the appropriate use of information contained in CBC reports (see bit.ly/2EGMduz).

This guidance identifies what constitutes 'appropriate use'. The data may be used to:

- support a high level transfer pricing risk assessment;
- support an assessment of other base erosion and profit shifting related risks; and
- support economic and statistical analysis where appropriate.

In particular, the guidance states that the data must *not* be used as a substitute for detailed transfer pricing analysis of individual transactions and prices. Nor does the CBC reporting information on its own constitute conclusive evidence that transfer prices are not appropriate.
The data must not be used by tax administrations to propose pricing adjustments based on global formulary apportionment of income. However, it may be used as a basis for making further enquiries into transfer pricing (or other tax matters) during the course of a tax audit.

Importantly, the guidance also sets out the measures that stakeholders may take if they consider that tax authorities are not using the data appropriately. Competent authorities will be required to promptly concede inappropriate adjustments. Other remedial action could include the temporary suspension of the exchange of information with certain jurisdictions.

HMRC has stated that its use of the CBC report information will be in line with the OECD guidance: the data will be used within the risk assessment process for cross-border transactions, principally between members of a multinational group.

What does this mean in practice for multinationals that filed their first report at the end of 2017? Groups should expect their CBC reports to be scrutinised by tax authorities, and for evidence of this to filter through into their risk assessments and the direction of tax audits, with even more focus on transfer pricing. However, given the sheer volume of data, there may be a time lag before multinationals start to feel the real effects of this. Some tax authorities may have the capabilities and resources to sift and sort the data relatively quickly. We expect, though, that these jurisdictions – for the time being at least – will be in the minority, and the majority will take some time to make appropriate use of the large volumes of data suddenly available to them. Certainly in the early years of CBC reporting, no news will not necessarily mean good news.

The view from the US

The US requires CBC reporting for tax periods beginning after 30 June 2016. Since the first CBC reports (voluntarily) filed cover the tax year ending 31 December 2016, IRS transfer pricing enquiries that incorporate CBC information are not expected before early 2019.

At the time of writing, the US had finalised most of the competent authority agreements with its treaty partners to allow for the automatic exchange of CBC reports. As a vocal opponent of formulary apportionment, the IRS is expected to focus its use of CBC information on transfer pricing risk assessment. In particular, we expect the IRS to identify jurisdictions where the taxpayer is profitable; and identify transactions between the US and that jurisdiction that may be mispriced. This approach is particularly likely where the US entity is suffering overall losses.

Similar to the UK, the US has not implemented master file and local file requirements, relying instead on existing section 6662 documentation requirements. However, in the course of transfer pricing audits, the IRS will almost certainly request taxpayer master files, in addition to traditional section 6662 documentation. Taxpayers under examination may also need to provide local files, as the IRS frequently requests foreign documentation under existing examinations. Finally, taxpayers will be required to submit all documentation (US and foreign) related to covered transactions in any advance pricing agreement (APA) negotiations.

The role of big data

The role of data, how it is acquired and how it is managed, will be a fundamental part of the way in which regulators and tax professionals engage with each other, and how data is controlled in the future. Too many people wrongly assume that tax authorities are not sufficiently sophisticated when it comes to data management. China, India, Malaysia and Mexico, however, have all made significant investments in new taxation systems with digital auditing. Most countries are realising that such investments will improve tax yields, bring assurance over the amounts of tax settled and paid, and increase efficiencies.

Groups should understand whether their transactional data, which might be requested by way of a standard audit file for tax purposes (SAF-T) request for indirect tax purposes, supports the functional analysis set out in their transfer pricing master file. They should be aware too of whether they have visibility or oversight over this data before it reaches the tax authorities.

It is increasingly clear that taking a piecemeal approach to data management no longer works. The immediate benefits of taking a global approach are immense: creating all tax reporting from one data set will save time, money and resources. It will also ensure that the data can be understood and explained to the tax authorities. With the additional value that can be gained from using analytics on global data, the business case for putting data front and centre is compelling.

Troubleshooting for 2018

An unexpected report for 2016

Most businesses completing their CBC report will probably hold a reasonable idea of what the data will show, including their key jurisdictions. However, the results are not always quite as anticipated; for example, certain territories may not be as 'negligible' as predicted, instead making a reasonable contribution to the group's profits.

Whilst such a discrepancy between revenues and profits may come as a surprise, if the countries in question are all relatively high tax with a strong tax regulatory framework, the overall damage may not be significant. However, if a group's results show increased activity in tax havens or blacklisted territories, or if there are significant revenues in lower tax jurisdictions (without the corresponding increase in substance), a more detailed narrative will be required to explain the position.

The first step is to understand why the anomaly has arisen. Is there a straightforward explanation? Has there been a significant M&A transaction during the year, or a company restructure which did not meet the planned timetable? Is the impact on the CBC report expected to continue, or will it be limited or eliminated in future years? Which stakeholders have a potential interest in this information? As well as the company board and the relevant tax authorities, other parties may be interested in such information, especially if the group is considering making its CBC report public, such as shareholders, clients, NGOs and tax campaigners, as well as the general public.

If there is no clear explanation of the anomaly, the group must decide whether it is something that it will tolerate, or whether remedial action must be taken to restructure activity. Decisions will, of course, depend on specific facts and circumstances, as well as the group's overall attitude to tax risk. Whatever the outcome, clear and confident communication of the result, the action (if any) and the rationale is key – and we would recommend consulting widely while testing the effectiveness of messaging.

Difficulties in gathering data

Any new reporting process, especially one of the scale, complexity and timeframe of CBC reporting, will be challenging in the first year. Groups which struggled during preparations for the December 2017 filing will be keen to avoid this during their next submission.

The key is to undertake a full and thorough review of last year's process. The review process should involve all relevant parties, not just those in the head tax office. We recommend approaching the review as broadly as possible, both geographically and in terms of business units – representatives from finance, HR, IT and systems, and business operational representatives should be included. Businesses should identify and examine the full process; and not skip over the early stages of data gathering or miss out any intermediate steps which they might have felt happened automatically.

Existing processes and technology should be leveraged to gather the data where possible. Regardless of whether you use a 'top down' or 'bottom up' approach, technological solutions can assist with data gathering, whether simple tracked questionnaires, or more complex bespoke solutions that can take downloads from your existing group financial data platforms and produce the final report in XML format. Stakeholders from finance (whether centrally or locally) or other relevant departments should be involved to ensure that all relevant data is captured and that final numbers are provided by responsible parties. The process of how data fields are interpreted and the exact data sources used should also be clearly documented to ensure consistency year on year, irrespective of who is involved.

Finally, there should also be a review and reconciliation performed against the process followed and the actual data being reported. Ideally, this should be an independent review; for example, by internal audit or from a third party adviser.

Focus on the CBC report distracts from the master file and local file

Many groups have understandably prioritised the CBC report; however, it is important to note that the three elements of Action 13 interact heavily. While the CBC report will effectively 'paint the picture' of the group's financial profile, the master file and local file effectively explain why that picture is appropriate.

We recommend groups set a coherent global documentation strategy that allows them to utilise the combination of the master file and the local file to best explain their business in a clear and consistent way. As with the CBC report, we expect that transfer pricing documentation will be shared across tax authorities, so it is critical to take a joined up approach to the preparation and deployment of those documents.

The key first step is to establish the strategy around documentation design, development and deployment. Delivery models can vary from centralised to decentralised; however, it is important to establish at what level the hand off between master file and local file occurs, as well as ensuring that there is consistency between markets but that local requirements are met. In this regard, 'centrally managed and locally informed' is an approach we are seeing more and more.

The use of core templates can help to address these objectives, as well as ensure that a multinational meets specific published requirements and has consistency year on year. Leveraging technology will also make the management of a global process simpler and reduce some of the compliance burden.

Should groups go public with their CBC report?

Some multinationals have decided to publish their CBC report under Action 13, even though for certain industries there are no current requirements to do so. (Watch this space, though, especially for developments in the EU.) At this stage, voluntary publication is fairly limited and the level of detail and timing varies by group.

Some groups have already committed to public disclosure, although there are no obvious trends in terms of business sector or geography. This should mean there are no immediate pressures on comparable businesses to follow suit. However, groups may start to be questioned over whether public disclosure has been considered and the decision making process, so we recommend that groups are ready to provide an explanation if needed. Such an explanation may consider:

- any potential commercial sensitivity;
- the existence of a one-off transaction in the year that skews the results; or
- a preference to wait for two or three years of data to set the figures in context.

One benefit of proactively publishing is the retention of control: groups can decide what data to disclose, the format and timing, and the supporting explanations. We predict there will be a close interest in both the public response to those groups which do make voluntary disclosures, and whether it marks the start of a continuing trend over the next 12 to 24 months.

Concerns have been raised by taxpayers that the information reported to tax authorities may find its way into the public domain. Many groups are now preparing for confidential information becoming public. For example, some are preparing a plain-English explanatory guide to their CBC report and an accompanying narrative to explain the results to a non-tax technical audience. Others are briefing board members on the results and key messages, and working with corporate affairs and their press office to be able to respond quickly if needed.

Board presentations on Action 13

Boards are taking a renewed interest in understanding the key metrics and messages. If you are called on to present to the board, what should you cover? Our recommendation would be to give an overview of the key messages and then go on to consider the following in more detail:

- What data was objective and what was subjective? What judgement calls were necessary in preparing the report, and what was the thought process?
- Which elements are the most sensitive? Will stakeholders be particularly interested in one or more of these points?
- How does the overall picture compare with those of competitors? Is benchmarking data available to provide a comparison?
- Where could there be tax authority challenges? And from what jurisdiction(s)?
- What actions could be taken to act on anomalies from the 2017 filing or to streamline the 2018 process?

Tax is increasingly becoming a focus of boardroom discussion, and with the CBC report interlocking with so many other aspects of the business, this is a real opportunity for positive engagement.

Conclusion

CBC reporting is a risk assessment tool that is here to stay, and we only expect the associated obligations to expand over time – whether in terms of the data that is required or the stakeholders to whom it is provided. In our view, the key to successful management of the reporting is to understand the results in the context of the business. It is critical to remember that BEPS Action 13 is more than just the CBC report; and that the master file and local file provide the vital supporting narrative. ■

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