

BEPS Action 13: Good for Foreign Tax Collectors; Not for Treasury, MNCs

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In this article, Hufbauer argues that the United States should wait to implement the OECD base erosion and profit-shifting project until business tax reform passes and until the effects of the BEPS project under that reform are better understood.

I. Overview

The OECD base erosion and profit-shifting project, now in its fifth year, is a mind-numbing exercise with a simple objective: to collect more tax revenue from multinational corporations (MNCs). U.S. MNCs are the leading target because of their collective size (the stock of outward U.S. foreign direct investment is worth \$6.4 trillion),¹ their profitability (earnings in 2016 were \$410 billion),² and the fact that much of their earnings derives from intellectual property (patents, copyrights, and trademarks).

The BEPS project consists of 15 actions, critiqued in a Peterson Institute for International Economics working paper.³ These actions amount to an OECD license for national tax collectors to collect more revenue from MNCs. The most vulnerable MNCs are name-brand U.S. firms, such as Apple, Google, Microsoft, and Facebook — in other words, tech-heavy firms. European tax

collectors are eager to attack these firms, and some have already made their demands.⁴

II. Treasury Awakening

Late in the Obama administration, Treasury officials realized that the 15 actions, if implemented, would yield little or no corporate tax revenue for the treasury and in fact might cost it money (via larger foreign tax credits). The actions would likely spell less money (through reduced dividends or capital gains) for U.S. shareholders and thereby indirectly take another bite out of treasury revenue. While the theme of transparency permeates the BEPS project, there is precious little transparency in the published OECD reports on the tax revenue consequences — for the United States and other OECD members — despite millions of dollars and thousands of professional hours spent on the project.

The Trump administration would be foolish to endorse the BEPS project, or implement the actions, before passage of U.S. business tax reform. Tax reform could have major implications for how the actions might affect the treasury, U.S. MNCs, and U.S. shareholders. Once business tax reform is enacted, Treasury should conduct a thorough study and issue a public report on the prospective impact of BEPS for tax revenue, firms, and shareholders.

III. Country-by-Country Reports

This brings us to action 13, the call for country-by-country reports. The goal here is for MNCs to report revenues, profits, tangible assets, employees, etc., for each country where they

¹ OECD, "FDI stocks" (July 19, 2017).

² Bureau of Economic Analysis, "U.S. Direct Investment Abroad: Balance of Payments and Direct Investment Position Data" (July 19, 2017).

³ Gary Clyde Hufbauer et al., "The OECD's 'Action Plan' to Raise Taxes on Multinational Corporations," Peterson Institute for International Economics working paper 15-14 (Sept. 2015).

⁴ Hufbauer and Jacob Funk Kirkegaard, "EU Looks for Bite of Apple's Irish Taxes," Peterson Institute for International Economics (Sept. 7, 2016).

operate. This information is intended to give tax administrators a tool to assess transfer pricing risk and allocate audit resources.

In addition to the EU's BEPS action 13 implementation, the European Commission has issued a draft accounting directive that would require member states to collect this information (once they have passed implementing legislation) and would require individual companies to post on their websites the information regarding EU member states and jurisdictions that "refuse to respect good governance standards in taxation."⁵ The draft directive would apply not only to MNCs headquartered in the EU, but also to large subsidiaries of firms headquartered elsewhere (for example, U.S. MNCs). It remains to be approved by the European Council and European Parliament.

Meanwhile, the IRS has designed Form 8975 for U.S. MNCs to file CbC reports. Unlike the EU, the United States would not require public disclosure of the information collected. Instead, data on Form 8975 would be subject to normal confidentiality requirements (section 6103), which permit the sharing of information with other tax authorities that have entered into exchange of information agreements with the IRS. So far 12 countries have done so, according to the IRS.⁶

One danger for the United States is that some countries might use the CbC reports to complain that their taxes collected are insufficient relative to revenue, tangible assets, or employees. In turn, those countries might enact legislation that would increase their tax take and simultaneously increase the foreign tax credits that U.S. MNCs could claim on their U.S. tax returns. A bigger danger arises from the EU draft directive, if implemented. Public disclosure of CbC reports for countries that do not meet the EU's criteria of "good governance standards in taxation" could prompt European member states (and perhaps other countries) to claw back tax revenue from

delinquent jurisdictions — again at the expense of the U.S. treasury or U.S. shareholders.⁷

IV. CbCR Distortions Relative to GAAP

Compounding these dangers is that CbC reports, compiled in accordance with reg. section 1.6038-4, may significantly deviate from U.S. MNC financial results reported under generally accepted accounting principles. For the most part, the distortions result from the use of aggregation principles for CbC reports in comparison with the consolidation principles in U.S. GAAP. Under CbC report aggregation principles, the results of each constituent entity are added up, and related-party transactions are included. Under U.S. GAAP, financial results are adjusted for intragroup transactions to avoid double counting. Three significant items that can create distortions when aggregated CbC reports are compared with U.S. GAAP accounts are stateless income, related-party dividends, and intercompany asset or entity sales.⁸

A. Stateless Income

Reg. section 1.6038-4(d)(3) requires that CbC report Table 1 information "be provided, in the aggregate, for any constituent entity or entities that have no tax jurisdiction of residence." This type of income is commonly referred to as stateless. The regulations further state that "if a constituent entity is an owner of a constituent entity that does not have a jurisdiction of tax residence, then the owner's share of such entity's revenues and profit will be aggregated with the information for the owner's tax jurisdiction of residence."⁹ This aggregate treatment will result in a distortion of profit or loss before income tax (PBT) and the effective tax rate (ETR), illustrated by an example:

⁵ European Commission, "Proposal for a Directive of the European Parliament and of the Council Amending Directive 2013/34/EU as Regards Disclosure of Income Tax Information by Certain Undertakings and Branches," Directorate-General for Financial Stability, Financial Services and Capital Markets Union (Apr. 12, 2016).

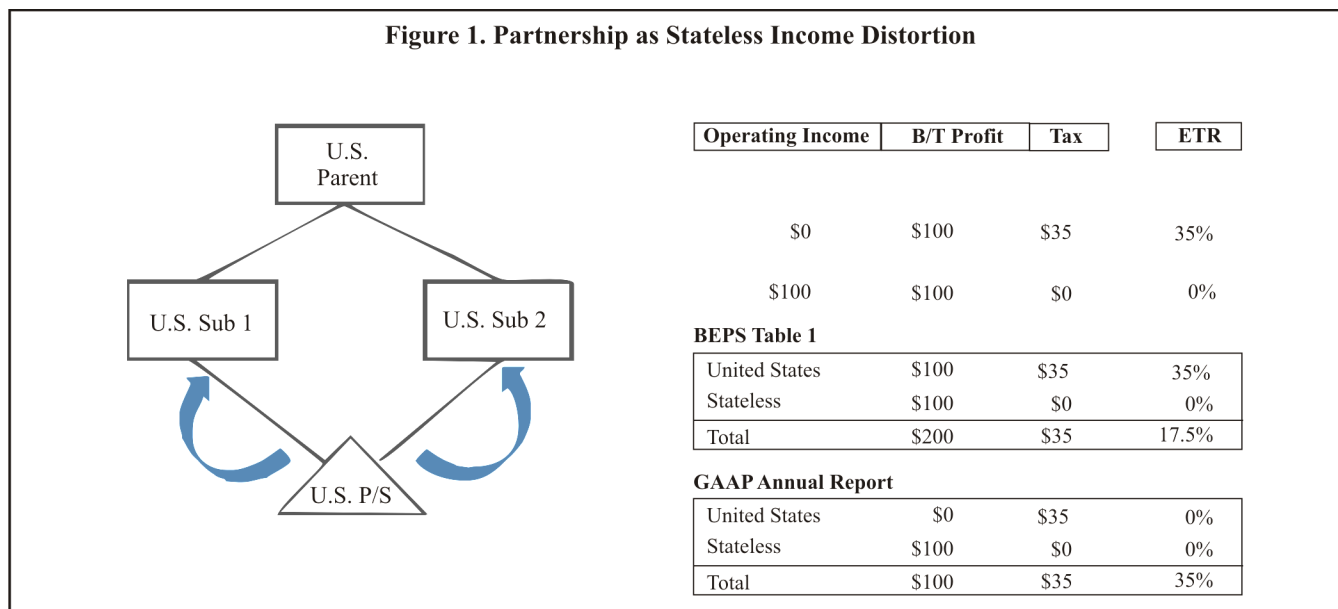
⁶ IRS, "Country-by-Country Reporting Jurisdiction Status Table" (July 3, 2017).

⁷ European Commission Taxation and Customs Union, "Platform for Tax Good Governance" (June 15, 2017).

⁸ 26 CFR Part 1.

⁹ *Id.*

Figure 1. Partnership as Stateless Income Distortion



In this example, U.S. P/S is a constituent entity treated as a partnership for U.S. tax purposes. As such, U.S. P/S does not have a jurisdiction of tax residence, so its PBT of \$100 is treated as stateless, with no associated taxes for CbC report purposes. U.S. Sub 1 and U.S. Sub 2 are the owners of U.S. P/S and are constituent entities with the United States as their jurisdiction of tax residence. Both partners are taxed at 35 percent on their passthrough PBT from U.S. P/S. U.S. Sub 1 and U.S. Sub 2 include their share of U.S. P/S PBT and the taxes paid in their CbC report calculations. In the GAAP annual report, the group's PBT is \$100, and the ETR for the group is 35 percent. However, the aggregate CbC report will reflect a total of \$200 in PBT and an ETR of only 17.5 percent. This treatment distorts the results and gives the erroneous impression that the MNC receives untaxed income from its partnership. Some tax authorities might cite the aggregate CbC report as justification for imposing higher taxes on the MNC.¹⁰

B. Related-Party Dividends

The U.S. CbC report rules are unclear on the inclusion of related-party dividends in PBT. The definition of revenue excludes "payments received from other constituent entities that are treated as dividends"¹¹ (reg. section 1.6038-

4(d)(3)(ii)). However, the regulations are silent on the definition of PBT. Therefore, it is reasonable to conclude that either including or excluding related-party dividends is acceptable. Given the CbC report bias toward aggregation, the inclusion of related-party dividends may be the correct approach. The following example illustrates how the inclusion of related-party dividends in PBT will result in distortion when compared with the GAAP annual report:

In this example, Parent MNC, Sub 1, and Sub 2 are constituent entities with tax residency in the United States. Sub 1 earns \$100 in operating income, pays \$35 in tax, and distributes \$65 to its parent, Sub 2. Sub 2 earns \$100 in operating income and \$65 in dividend income from Sub 1 for PBT of \$165. Sub 2 pays \$35 in tax and distributes \$130 to Parent MNC. MNC earns \$100 in operating profit and \$130 in dividend income from Sub 2 for PBT of \$230. MNC pays \$35 in tax.

The U.S. GAAP annual report correctly reflects group PBT of \$300 (operating profit of \$100 from each of Sub 2, Sub 1, and MNC) with an ETR of 35 percent. However, under the CbC report aggregate approach, the result is distorted: Group PBT is \$495, and ETR is only 21.2 percent. The CbC report calculation creates the impression that the MNC is paying a much lower ETR than it actually paid.¹²

¹⁰ *Id.*

¹¹ *Id.*

¹² Financial Accounting Standards Board, "Annual Report 2016 (US GAAP)" (Dec. 31, 2016).

Figure 2. Related Party Dividend Distortion

	Dividend Paid	Operating Income	B/T Profit	Tax	ETR
Parent (MNE)	\$130	\$100	\$230	\$35	15.2%
Sub 1	\$65	\$100	\$165	\$35	21.2%
Sub 2		\$100	\$100	\$35	35%
BEPS Table 1					
United States			\$495	\$105	21.2%
GAAP Annual Report					
United States			\$300	\$105	35%

C. Related-Party Asset Sales

Other intercompany transactions can result in distortions under the CbC report aggregate approach. One common transaction that can lead to significant distortion is the sale of operating assets within the controlled group. Operating assets are typically sold within the controlled group at fair market value. In many cases, this will result in a gain or loss in the selling affiliate's books. However, that gain or loss will be eliminated on the GAAP consolidated financial statements. The CbC report regulations do not provide for a similar elimination, so the gain or loss will be reflected in the selling entity's

jurisdiction of tax residence. Depending on the treatment for local tax purposes, this can again result in an overstatement of PBT on the CbC report.

V. Conclusion

Treasury Secretary Steven Mnuchin should slow down the OECD juggernaut until the interaction with business tax reform, and its revenue consequences, is better understood. Meanwhile, he should review the U.S. CbC report rules and make whatever changes are necessary to correct distortions of the standard of GAAP reporting. ■

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