tax justice network

Confronting Transfer Mispricing by the Use of Country by Country Reporting

For tax authorities to investigate possible transfer mispricing by multinational corporations, country by country reporting would provide valuable information currently unavailable, in particular information about how much profit a corporation makes in each country in which it operates.

Intra-Group Transactions

Sixty percent of world trade across national boundaries happens within the same corporate group, between companies under common ownership or control. When multinational corporations issue their annual financial statements on a consolidated basis, these intra-group transaction are not disclosed, so tax authorities in each jurisdiction where the multinational operates cannot use these financial statements to determine whether or not it is paying the appropriate taxes in each jurisdictions. Country by country reporting would require companies to disclose these intra-group transactions.

Country by country reporting: the Arm's Length method, and Formulary Apportionment

Country by country reporting would help tax authorities analyse whether or not such intra-group transactions complied with the arm's length requirements of the OECD's Transfer Pricing Guidelines. However, country by country reporting would also be the basis for the use of the alternative to the OECD's method: the Formulary Apportionment method of corporate income taxation.

Specific Requirements of Country by country Reporting

Country by country reporting would require each multinational corporation to provide the following information:

(1) The name of each country in which it operates
(2) The names of all its subsidiaries and affiliates in each country in which it operates.
(3) The performance of each subsidiary and affiliate in every country in which it operates, without exception, including
    - Its sales, both to third parties and also to other group companies.
    - Its purchases, both from third parties and from other group companies.
    - Financing costs paid to third parties and to other group companies.
    - Labour costs and employee numbers.
    - Its pre-tax profit in each country which it operates.
(4) The tax charge included in its accounts of each subsidiary and affiliate in each country in which it operates.
(5) Details of the cost and net book value of its fixed assets located in each country in which it operates.
(6) Details of its gross and net assets for each country in which it operates.

Country by country reporting would also help reveal deliberate mispricing of goods or services across international borders of any material amount.

Formulary Apportionment Method

The Formulary Apportionment system allocates profits to a jurisdiction based on a formula, involving the proportion of the total third-party sales; total employment (either calculated by headcount or by cost;) and the value of physical assets actually located in each territory in which the multinational corporation operates. Country by country reporting would provide the data to facilitate this calculation.

Country by country (CbC) reporting would provide key performance-related information, to determine whether the underlying economic performance of each subsidiary and affiliate of the group within the respective country represents a fair rate of return, compared to that of the group as a whole.

CbC reporting would help the tax authorities determine whether the multinational corporation is artificially allocating income and profits to low tax jurisdictions and expenses to higher tax jurisdictions, independent of where the respective economic activity takes place.

For example, a company might be relocating profits to subsidiaries and affiliates in low-tax or no-tax jurisdictions which hold intellectual property, but where it had few or no employees, no physical assets and no third-party sales. Under the formulary apportionment method, little or no profit would be allocated to that place. Conversely, a company within the group that was making a payment to a group company in a low tax or no tax jurisdiction for the use of intellectual property would almost certainly show an abnormally low allocation of profit.

Facilitating Inquiries by Tax Authorities

Without country by country reporting, it is very difficult for the respective tax authorities to determine whether it should audit a particular group of companies. But with country by country reporting, the tax authority could much more easily determine whether it should initiate an inquiry into a group of companies. The time and cost saved will be enormous: the probability that each inquiry launched will give rise to a positive outcome will rise substantially.

Those who want to curtail transfer pricing abuse should therefore support the introduction of country by country reporting.

A Study of Country by country Reporting

Country by country reporting is described in detail in the June 2009 study, *Country by country Reporting, Holding Multinational Corporations to Account Wherever They Are*, written by Richard Murphy for The Task Force on Financial Integrity and Economic Development. The study can be downloaded at http://www.financialtaskforce.org/wp-content/uploads/2009/06/Final_CbyC_Report_Published.pdf