
On September 2017, the OECD released *Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment*, which provides tax authorities with guidance on ways to incorporate information obtained under CbC reporting into their tax risk assessment processes, the types of tax risk indicators that may be identified using CbC reports, and the challenges that may arise in the process. In this article, the authors outline the key elements provided in this report, illustrate with a practical example how tax authorities may use CbC reporting information to supplement their existing tax risk assessment and discuss the consequences thereof.

1. Introduction

Tax risk assessment is a key element of modern tax administration, in the same way as it is a key element of a company’s tax management. For administrations, risk assessment tools include indicators that allow identifying taxpayers or arrangements that may pose an increased risk to their jurisdiction. Tax risk assessment aims at optimizing efficiency of audits and allocation of tax authorities’ resources to the areas of greatest risk. Tax risk assessment gains in efficiency as more information becomes available to tax authorities and technological innovation facilitates data retrieval and analysis. With the implementation of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, tax authorities have access to an unprecedented volume and detail of information in addition to the information already available to them (e.g. publicly available information, country-by-country (CbC) reports, transfer pricing Master Files and Local Files, information on foreign rulings and advance pricing arrangements).

The Forum on Tax Administration (FTA) released in September 2017 *Country-by-Country Reporting: Handbook on Effective Tax Risk Assessment* (Handbook on ETRA), sponsored by the Canada Revenue Agency, which supports countries in the effective use of CbC reports by incorporating them into a tax authority’s risk assessment process. CbC reporting is one of the four minimum standards of the BEPS Project approved by the CFA on 21 September 2015 and is rapidly spreading as dozens of countries across the world implement it in their domestic legislation and enter into Multilateral Competent Authority Agreements to allow exchange of CbC reports among tax authorities.

The FTA is composed of tax commissioners from 50 advanced and emerging tax administrations (including OECD and G20 countries). Its aim is “to improve taxpayer services and tax compliance by helping tax administrations increase the efficiency, effectiveness, and fairness of tax administration and reduce the costs of compliance”. An entire chapter of the Handbook on ETRA is devoted to a discussion of the core characteristics that should be present for risk assessment to operate effectively. These include objective operation of the tools, adequate training and experience of officials, dynamic and responsive processes, etc. The FTA also emphasizes the need to consider different tools, to take into account various elements of a group’s risk profile, and to evolve over time to minimize the risk that a higher-risk taxpayer is able to avoid detection by putting in place elements to disguise a particular risk flag or to develop strategies to avoid detection.

2. Incorporating CbC Reports into a Tax Authority’s Tax Risk Assessment Framework

2.1. Using CbC reports within different approaches to tax risk assessment

The FTA notes that the ways in which CbC reports can be incorporated into a tax authority’s risk assessment processes depends upon various factors and provides the following examples.

*Date filing and the overall framework in place*

Where the tax risk assessment is conducted before a taxpayer’s tax return is filed, CbC reports may be used to test the assumptions used and the conclusions reached in the pre-filing risk assessment, whereas where the tax risk assessment is conducted following the filing of tax returns, CbC reports may be used as part of an initial screening to determine multinational enterprise (MNE) groups which have a limited footprint in the jurisdiction and which may be filtered from further assessment.

In addition, the FTA suggests that where the filing of a transfer pricing Master File and Local File is not required in each period, CbC reporting information may be used as the basis for performing a high-level initial functional analysis of a group and to identify cases where the location of revenues and profits in an MNE group may not be appropriately aligned with the location of the group’s activities.

*Identification of potential risk factors*

Tax authorities may use CbC reporting information to calculate effective tax rates for each jurisdiction in which
the group has operations or to identify indicators of particular risks or arrangements in MNE groups. The other way around, where a tax authority has identified specific arrangements which pose a BEPS risk, it may develop a “profile” or “typology” of features based on features identified or observed in successful audits. These typologies may then be used to identify comparable arrangements. In addition, tax authorities may use CbC reporting information to identify trends in BEPS activity across different sectors (using for example patterns in ratios).

2.2. Using CbC reports within a tax risk assessment process

The FTA advises tax authorities to implement the following process in the use of CbC reports for tax risk assessment:

- where no material risk indicators are identified or indicators identified are not enough to suggest a sufficient level of risk in that jurisdiction, no further action is required;
- where risk indicators are identified, an additional manual review should be triggered to establish whether the risk flags are incorrect or can be explained using other available information. Where transactions appear to be at arm’s length, a tax authority should not seek a transfer pricing adjustment simply because CbC reporting information suggests there may be an unexplained profit elsewhere in the group;
- where the risk assessment process has resulted in incorrect or misleading tax risk indicators, this should be fed back to enable risk assessment tools to be updated and improved; and
- if a risk assessment triggers further compliance action, this should be documented and any tax adjustment should be supported by sufficient evidence not derived from the CbC report.

3. Identification of Potential BEPS Risk Indicators Using CbC Reports

3.1. Ways in which CbC reports can be used to detect indicators of possible tax risk

The FTA identifies three broad scenarios that may create transfer pricing risk:

1. where entities are engaged in recurring transactions with related parties which have the potential to erode a jurisdiction’s tax base over time;
2. from large or complex one-off transactions, including business restructurings and transfers of key income producing assets;
3. where a multinational group does not have effective tax governance processes in place to control, document and review the pricing of related-party transactions on an ongoing basis.

CbC reporting information may be used by tax authorities to compare an MNE’s group’s profile with:

- that in other jurisdictions, with part of the group (e.g. a geographical region) or with the group as a whole. The FTA mentions nevertheless that differences between jurisdictions could be explained by purely economic or other non-tax considerations (e.g. differences in the scale of the business, in the market or in the types of activity carried out);
- that of a “typical” MNE group in the same sector. However, the FTA acknowledges that individual groups should generally not be benchmarked against each other because of too many differences in the sources of data, calculation policies, business model, as well as other commercial differences;
- CbC reporting information for the same jurisdiction in earlier periods in order to identify changes in the nature or level of activity in a jurisdiction over time, as well as one-off events. Factors may vary from period to period (e.g. differences in exchange rates or high levels of inflation).

According to the FTA, the free text in Table 3 of the CbC reports is likely to be extremely important in interpreting the contents of the CbC report, and may be helpful in allowing groups to explain apparent anomalies and potential risk indicators. Tax authorities will then need to develop processes for how to integrate these elements into standardized and automated risk assessment tools.

3.2. Using CbC reports alongside data from other sources

The FTA suggests that a tax authority may use CbC reporting information on its own as an initial filter, but other data should also be considered before drawing conclusions that a group poses a material tax risk in a jurisdiction. Other sources may include information already held by tax authorities such as tax returns, transfer pricing documentation, information provided by the taxpayer for the purposes domestic rulings, indirect tax information, taxpayer’s tax audit files from prior years, etc. All this information can be completed with publicly available information (e.g. financial reports, press reports, public filings, etc.) and commercial sources of information (e.g. rating agencies information, databases, etc.).

3.3. Tax risk indicators that may be detected using CbC reports

Table 1 includes a number of potential tax risk indicators that could be derived from the information contained in an MNE group’s CbC report together with FTA comments on how to interpret them. This table is based on Chapter IV of the Handbook on ETRA and Annex 2 of the Handbook on ETRA.


This example is based on Annex 3 of the Handbook on ETRA.

MNE SA is the ultimate parent entity of a multinational group involved in the manufacture and sale of consumer goods, resident in Country A. Two CbC reports (for the
<table>
<thead>
<tr>
<th>Potential tax risk indicator</th>
<th>What this could mean</th>
<th>How else it might be explained</th>
</tr>
</thead>
<tbody>
<tr>
<td>The footprint of a group in a jurisdiction.</td>
<td>A group with a small footprint may have less potential to pose significant tax risk.</td>
<td>A low footprint on a CbC report could be misleading if the activities in a jurisdiction are more significant. This should be corroborated by other information and the experience of the tax compliance team.</td>
</tr>
<tr>
<td>A group’s activities in a jurisdiction are limited to those that pose less risk.</td>
<td>A group’s activities in a jurisdiction may be of a type that is subject to a lower level of tax (e.g. where dividends and gains earned by a holding entity benefit from a participation exemption).</td>
<td>An entity whose main activity would typically pose lower tax risk may still engage in BEPS. Other available information should be considered for indicators that taxable income in the jurisdiction should be higher.</td>
</tr>
<tr>
<td>There is a high value or high proportion of related-party revenues in a particular jurisdiction.</td>
<td>A high value or proportion of related-party revenues might mean that even a small transfer pricing error could have a significant tax impact.</td>
<td>Groups may include entities that deal wholly or mainly with related parties for commercial reasons. The tax authority should look at other factors, such as whether there are substantial activities in the foreign jurisdiction, the nature of those activities, and the effective tax rate, before deciding whether the group could pose a higher tax risk in its own jurisdiction.</td>
</tr>
<tr>
<td>The results in a jurisdiction deviate from potential comparables. Key financial ratios that could be used from CbC reports: - profit margin; - revenue or profits per unit of economic activity; - pre-tax return on equity; - post-tax return on equity.</td>
<td>Differences between a jurisdiction and the chosen comparables could be driven by BEPS.</td>
<td>The chosen comparables may be unreliable, or there may be commercial factors to explain any difference (e.g. the size of the market in a particular jurisdiction, the level of competition, the market penetration of the group, its bargaining power, the cost of labour, etc.).</td>
</tr>
<tr>
<td>The results in a jurisdiction do not reflect market trends.</td>
<td>Results may be being distorted by BEPS activity.</td>
<td>Results may be impacted by commercial considerations (e.g. a group has made significant investments in a jurisdiction with a growing market, which has reduced profits in the current period but should give rise to greater returns in the future).</td>
</tr>
<tr>
<td>There are jurisdictions with significant profits but little substantial activity. There is a tax risk when a jurisdiction has a number of the following characteristics: - high proportion of related-party revenues; - low substantial activities in proportion to revenues or profit before tax; - high return on equity; - low cost base; - profitability exceeds that of the group as a whole; and - low effective tax rate.</td>
<td>Profits may have been shifted away from the jurisdiction where the underlying economic activity is occurring.</td>
<td>There may be commercial reasons why results in a jurisdiction may seem high relative to the activity measures in a CbC report (e.g. due to tangible assets being heavily depreciated, or intangible assets that are not disclosed).</td>
</tr>
<tr>
<td>There are jurisdictions with significant profits but low levels of tax accrued.</td>
<td>A low effective tax rate may indicate that a group is using BEPS to shelter taxable income.</td>
<td>Non-BEPS reasons may explain low levels of tax accrued (e.g. accelerated tax depreciation).</td>
</tr>
<tr>
<td>There are jurisdictions with significant activities but low levels of profit (or losses). These jurisdictions have a number of the following characteristics: - the jurisdiction includes entities engaged in profit-generating activities; - high proportion of unrelated-party revenues; - high cost base;</td>
<td>Profits that are attributable to a jurisdiction may be being shifted to a jurisdiction where they are taxed more favourably.</td>
<td>Some activities within a group may be more asset intensive or staff intensive than others (e.g. administrative functions may have a low profit per employee compared to the group).</td>
</tr>
</tbody>
</table>

Table 1
<table>
<thead>
<tr>
<th>Potential tax risk indicator</th>
<th>What this could mean</th>
<th>How else it might be explained</th>
</tr>
</thead>
<tbody>
<tr>
<td>– the effective tax rate is not low; this is not the result of start-up losses or recent expansion within the jurisdiction.</td>
<td>A group may be engaged in a known BEPS-related activity.</td>
<td>There may be non-BEPS reasons to explain why a group has activities in a particular jurisdiction.</td>
</tr>
<tr>
<td>A group has activities in jurisdictions which pose a BEPS risk.</td>
<td>A group may have shifted mobile activities to a jurisdiction to benefit from a favourable tax regime.</td>
<td>There is significant variance in the headline tax rate in different jurisdictions, and a number of jurisdictions have tax regimes which provide for a lower tax rate on certain forms of income but which are not harmful. Profit from mobile activities may be correctly attributable to the low tax jurisdiction so long as there is sufficient activity, transfer prices are at arm's length and there is no other indicator of BEPS.</td>
</tr>
<tr>
<td>There have been changes in a group’s structure, including the location of assets.</td>
<td>Changes in a group’s structure may be an opportunity for a group to engage in BEPS and could mean a need to revisit existing transfer pricing policies and methodologies, and reconsider the identification and pricing of related-party transactions.</td>
<td>Changes in a group’s structure may be driven wholly by commercial considerations, even where the result is less tax paid in a particular jurisdiction. Additional information on important business restructurings, including acquisitions, disposals and transfers of interests in IP within a group should be contained in a group’s Master File, where available.</td>
</tr>
<tr>
<td>IP is separated from related activities within a group.</td>
<td>Valuable IP may be used to strip taxable profit from other jurisdictions.</td>
<td>IP may be held in a particular jurisdiction for non-BEPS purposes. As long as the royalties paid for use of IP are arm’s length and there are no other indicators of BEPS, the tax risk to a jurisdiction may be low.</td>
</tr>
<tr>
<td>A group has marketing entities located in jurisdictions outside its key markets.</td>
<td>Marketing entities could be earning profits that are not attributable to the jurisdictions where they are resident.</td>
<td>Historic or commercial factors may explain the use of marketing entities in particular jurisdictions.</td>
</tr>
<tr>
<td>A group has procurement entities located in jurisdictions outside its key manufacturing locations.</td>
<td>Procurement entities could be earning profits that are not attributable to the jurisdictions where they are resident.</td>
<td>Historic or commercial factors may explain the use of procurement entities in particular jurisdictions.</td>
</tr>
<tr>
<td>Income tax paid is consistently lower than income tax accrued.</td>
<td>A group may be making high-tax accruals for uncertain tax positions, which could indicate BEPS-related behaviour.</td>
<td>Non-BEPS factors such as tax losses carried forward or legitimate uncertainty in a tax position could explain differences between current year tax accrued and tax paid.</td>
</tr>
<tr>
<td>A group includes dual resident entities.</td>
<td>Dual resident entities can be used for a number of BEPS purposes.</td>
<td>Most entities that list different jurisdictions of residence and incorporation in Table 2 will not be dual resident (due to the operation of a tie-breaker in the applicable tax treaty).</td>
</tr>
<tr>
<td>A group includes entities with no tax residence.</td>
<td>No residence entities can be used for a number of BEPS purposes.</td>
<td>In many cases, an entity that is not tax resident anywhere will be transparent for tax purposes, and its profit may be taxable on a constituent entity elsewhere in the group. It is expected that in most cases this will be explained in Table 3.</td>
</tr>
<tr>
<td>A group discloses stateless revenues in Table 1.</td>
<td>Stateless revenue may indicate a BEPS risk if the revenue is not taken into account for tax purposes in any jurisdiction.</td>
<td>In many cases, the revenue may be taxable on a constituent entity elsewhere in the group. It is expected that in most cases this will be explained in Table 3.</td>
</tr>
<tr>
<td>Information in a group’s CbC report does not correspond with information previously provided by a constituent entity.</td>
<td>This could question the accuracy of both the CbC report and the information previously provided by a constituent entity.</td>
<td>Other reasons may be identified to explain a potential difference, such as changes in a group’s structure or activities since information was previously provided to a tax authority.</td>
</tr>
</tbody>
</table>
years ended 31 December 2016 and 31 December 2017) were filed by MNE SA.

At the end of 2017, the group was formed by 43 entities in 26 jurisdictions, including 29 entities engaged in sales or manufacturing activity, holding companies (in Countries A, I, N and T), group service companies (in Countries A, C, and T), a procurement company (in Country U), a research and development company (in Country D), an IP holding company (in Country K) and a captive insurance company (in Country N).

The analysis below illustrates how CbC reporting information can be used by tax authorities in the framework of tax risk assessment and the type of information can be derived from it. Several hypothetical situations are considered and discussed below.

4.1. Lower profit margins for sales and manufacturing activity in Asia-Pacific than in other regions

The MNE SA group has operating entities across Europe, the Americas and Asia-Pacific. The analysis of the CbC reporting information shows that there is a marked difference between the profit margins earned by the sales and manufacturing entities in different regions as illustrated in the Figure 1.

Note: Countries C, I, N and T do not include entities engaged in sales or marketing activities.

In Europe, most jurisdictions with sales or manufacturing activities earn a profit margin between 10% and 14% (the exception is Country H with a profit margin of 2% discussed below). In the Americas, all jurisdictions with sales or manufacturing activities earn a profit margin between 9% and 11%. However, in Asia-Pacific, all jurisdictions with sales or manufacturing entities (other than Countries U and Z) earn a profit margin between 3% and 5%. Country U and Country Z earn a profit margin of 58% and 29% respectively.

The fact that the Country U entity (engaged in procurement) and the Country Z (involved in “sales, marketing and distribution”) have significantly higher profit margins than other sales and manufacturing entities could flag a potential tax risk. This is supported by other indicators.

First, substantially all revenues of Countries U and Z are from related parties (95% in Country U and 98% in Country Z). This suggests that the Country Z entity is more likely to be engaged in either marketing or distribution on behalf of other group entities, rather than sales. However, the group has no sales or manufacturing activity in either Country U or Country Z. This raises a question as to why the group would place its procurement and marketing/distribution centers in these jurisdictions.

In addition, Countries U and Z have a significantly lower effective tax rate than those in other jurisdictions in the Asia-Pacific region, as illustrated in Figure 2.

Finally, the analysis of the growth rate in revenues and profit before tax between 2016 and 2017 shows that while revenues increased for all entities located in the Asia-Pacific region, profit margins increased in Countries U and Z but fell in all of the other jurisdictions. See Table 2.

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>U</td>
<td>Between +15% and +55%</td>
<td>+23%</td>
</tr>
<tr>
<td>Z</td>
<td>+9%</td>
<td>+15%</td>
</tr>
</tbody>
</table>

Table 2

Thus, tax authorities in the Asia-Pacific region may request further information on the activities performed by the entities located in Countries U and Z and on the pricing policy applied to these entities.

4.2. Newly acquired Country H entity with very low profit margin

Table 2 of the 2017 CbC report includes a Country H resident entity which was not included in the table of 2016, which would indicate that this is a newly incorporated entity or one acquired from outside the group. In 2017, Country H has a low profit margin (2%) compared to that of the other Countries in the European region (between 10% and 14%) (see Figures 3 and 4).

This low profit margin may be connected to start-up costs or other costs incurred in assimilating an acquired entity into the group. Nevertheless, the Country H tax authority may require further information to understand this level of margin.
4.3. Country T: Revenue and profit increase, but fall of effective tax rate

In Country T, the group includes a holding company, a group finance company and a group services company. In 2017, revenues and profits increased substantially whereas the increase in the amount of tax accrued was only modest. This resulted in an increase in the profit margin and a decrease in the effective tax rate of the country, as illustrated in the Figure 5 and Table 3.

According to the FTA, the tax authority of Country T should consider requesting additional information to understand why the increase in profit before tax did not result in an increased tax charge. In addition, tax authorities in other jurisdictions may also request information to determine whether this could result from arrangements involving another entity in their jurisdiction, particularly since the related-party revenues represent a significant proportion of Country T’s total revenues (85% and 90% for 2016 and 2017 respectively).

4.4. Lack of substantial activities relative to economic performance in jurisdictions with low effective tax rates

The MNE SA group operates in five jurisdictions that raise potential concerns of lack of substantial activities relative to their economic performance (Countries C, N, T, U and Z). In fact, the following tax risk indicators can be flagged for these jurisdictions.

---

3. Computed as income tax accrued divided by profit before tax.
In addition, Countries C, N, T, U and Z have the lowest effective tax rates\(^4\) (with the exception of Country G) which poses a particular BEPS risk.

Entities located in Countries C, N, and T are engaged in group finance, administrative, management or support services and/or holding companies. Country N also includes an entity providing insurance services to other members of the group. These activities usually require a small number of employees and involve dealing with related parties. Potential tax risks posed by entities located in Countries U and Z are discussed above.

Tax authorities in all jurisdictions in which the group carries on operations may request further information to determine whether resident group entities make payments to entities located in these countries. If this is the case, further information may be required to better understand the extent of the activities performed in these three jurisdictions and the pricing of the intra-group payments.

5. Challenges to the Effective Use of CbC Reports for Tax Risk Assessment

The FTA recognizes that the use of CbC reports for tax risk assessment involves numerous challenges for tax authorities such as:

- Issues linked to the implementation of the CbC reports and its use in tax risk assessment (e.g. volume of CbC reporting information to be processed, need for systems and training, transitional issues, etc.). The FTA here recognizes that the implementation of CbC Reporting is expected to be a long, tedious, and complicated process.

- Issues linked to the data provided in the CbC reports and its interpretation (e.g. consistency issues, inclusion of profits of non-consolidated entities, constituent entities joining or leaving a group during a fiscal year, challenges concerning the use of Table 3 in risk assessments, lack of information concerning a group’s sector or on specific transactions, etc.).

- Issues linked to the appropriate use of CbC information. In fact, it is mentioned in the Handbook on ETRA that:

  Risk assessment tools should be used to select and to de-select taxpayers for further investigation, possibly including tax audit or other compliance activity. They should not be used as a substitute for such activity, for the purposes of making tax adjustments or for directly assessing taxes.

6. Conclusion

The Handbook on ETRA published by FTA is an outstanding document in terms of quality and completeness that may represent both a threat and an opportunity for taxpayers. Taxpayers may, of course, feel under threat while reading the detailed guidelines on how to effectively use CbC reports – and other information – to improve tax audit efficiency. However, the public release of the Handbook can help taxpayers complete and improve their own tax risk management processes, following similar steps and reasoning, and cross-checking CbC reporting information with other sources of information available to tax authorities such as publically information, Master Files, tax returns, annual reports, etc. Our experience going through this exercise with a good number of MNE groups is that it is most often an enlightening one, as it provides a perspective on the group’s tax affairs that comes from a different angle from the one usually looked at by tax managers. Further, given the lack of harmonized and reconcilable data in CbC reporting, that is inherent in its construction, such an analysis is often extremely helpful in anticipating questions that can typically arise due to apparent inconsistencies.

The publication of the Handbook on ETRA can be compared with the implementation of a road safety policy by a government. In the context of road

\(^4\) Computed as income tax accrued divided by profit before tax.
safety, if the government’s objective is to penalize road users, it may decide to hide speed radars in order to collect more fines. On the other hand, if the government’s objective is to improve prevention, it may make speed radars visible to road users. The Handbook on ETRA is, in that sense, an intelligent and useful BEPS prevention tool.

For it to fully reach its objective, it should accompany clear(er) guidance on some of the contentious transfer pricing and treaty questions identified in the context of the BEPS project, as well as well-functioning, (more) effective dispute prevention and resolution mechanisms. That is, provide tax professionals with a road that is not too bumpy.