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# Transparency in Financial Reporting: Is Country-by-Country Reporting Suitable to Combat International Profit Shifting?

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**Abstract:** Aggressive tax planning efforts of highly profitable multinational companies (Base Erosion and Profit Shifting (BEPS)) have recently become the subject of intense public debate. As a response, several international initiatives and parties have called for more transparency in financial reporting, especially by means of a country-specific reporting of certain tax information (Country-by-Country Reporting (CbCR)). In our paper, we demonstrate that neither consolidated nor individual financial accounts seem to be an appropriate platform to provide such country-specific information and, therefore, that CbCR cannot be based on extended financial accounting standards. Moreover, we argue that even separate CbCR templates do not prevent multinationals from profit shifting, since their common tax minimization strategies are mainly based on the legal exploitation of gaps and loopholes in national and international tax law. In that regard, we show that expected costs for CbCR would exceed expected benefits and therefore contend that CbCR cannot be regarded as a convincing measure to combat international profit shifting. Instead, we argue that tax legislators should limit profit shifting by enforcing national and international tax rules and by closing gaps in tax law. In particular, we call for more tightened and standardized transfer pricing regulations to be adopted at an international level.

**JEL Classification:** H20, H26, F23, K34, M41

**Keywords:** tax avoidance; profit shifting; multinational firms; tax reform; tax reporting; country-by-country reporting; international transfer pricing

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## 1. Introduction

Tax planning efforts of highly profitable US multinationals such as Google, Apple or Amazon and their extremely low effective tax rates on their non-US profits have recently become the subject of intense public debate.[1] The fact that these companies pay almost no corporate taxes in the foreign jurisdictions they operate in can most likely be attributed to activities aimed at shifting profits to tax havens. To this end, companies effectively exploit gaps and loopholes in international tax law, such that their endeavors do not in general classify as illegal. Yet, the acceptability of such activities from a social and ethical point of view is widely discussed; some call it 'aggressive' even though a clear distinction between 'acceptable' and 'aggressive' tax planning is hard to define.

Although there have been several attempts to quantify the scale of profit shifting,[2] no accurate estimate of the exact amount of profits transferred to low tax jurisdictions exists to date. Nevertheless, empirical evidence clearly shows that profit shifting within multinationals does indeed take place regardless of the specific industry sector. In that respect, two channels have been identified: On the one hand, international tax rate differentials are found to be the major driver of profit shifting.[3] On the other hand, debt financing as well as transfer pricing in general and licensing of Intellectual Property (IP) in particular are identified as the most important channels to relocate profits.[4] Here, transfer pricing rather than debt financing turns out to be the dominant channel for profit shifting.[5]

As a countermeasure to this issue, the OECD released a global action plan against Base Erosion and Profit Shifting (BEPS) in July 2013.[6] This action plan was adopted by the G-20 leaders[7] and is – in principle – supported by the European Commission.[8] Arguing that a lack of transparency in financial reporting facilitates profit shifting[9], the OECD action plan also includes – among other things – specific actions (Action 11-13) aimed at enhancing the

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[1] For a detailed discussion *see* C. Fuest et al. (2013), pp. 307-324.
[2] R. Murphy assumes that tax evasion and tax avoidance costs the EU member states 1 Trillion € a year, *see* R. Murphy (2012), p. 2; according to S. Bach, in Germany the yearly revenue loss due to profit shifting amounts to ca. 90 Billion €, *see* S. Bach (2013), p. 3ff.; J. H. Heckemeyer and C. Spengel, however, assume the revenue loss in Germany to be less than 10 Billion € and therefore much lower, *see* J. H. Heckemeyer & C. Spengel (2008), p. 54; Oxfam calculates a revenue loss of $ 50 Billion for developing countries, *see* Oxfam (2000).
[3] *See* H. Grubert & J. Mutti (1991); J.R. Hines & E.M. Rice (1994); H.P. Huizinga & L. Laeven (2008); P. Egger et al. (2010); D. Dharmapala & N. Riedel (2013); C. Fuest et al. (2011); J.H. Heckemeyer & M. Overesch (2013).
[4] *See* M.A. Desai et al. (2004); T. Buettner at al. (2012) and K.A. Clausing (2003); M.A. Desai et al. (2006); M. Dischinger & N. Riedel (2011); T. Karkinsky & N. Riedel (2012); T. Lohse & N. Riedel (2013).
[5] *See* J.H. Heckemeyer & M. Overesch (2013), p. 30.
[6] OECD (2013a).
[7] *See* http://en.g20russia.ru/news/20131129/784497471.html.
[8] *See* European Commission (2013a), p. 4.
[9] *See* R. Murphy (2009), p. 4.

disclosure quality of tax-related information. Several other international initiatives and political parties have likewise recently called for more transparency in financial accounting, especially by means of a so-called Country-by-Country Reporting (CbCR). This concept is based on the disclosure of key business information such as profits and taxes paid for each country that a multinational operates in. The proponents of CbCR claim that the disclosure of such information might build up pressure on companies to pay a fair amount of tax in relation to their economic activity in each country. Furthermore, this kind of disclosure could serve the purpose of enhancing the efficiency of the administration of tax collection and of detecting abusive tax arrangements. If CbCR proves to be successful in limiting profit shifting at all, the expected benefits should exceed the related costs.

In our paper, we argue that CbCR and, thus, the related provisions of more detailed tax disclosure cannot be based on extended financial accounting standards – at least for the overwhelming number of countries in the world that exempt foreign income. Moreover, we argue that even special CbCR-requirement forms in addition to financial accounts do not prevent multinationals from profit shifting and that costs for CbCR exceed expected benefits. We therefore contend that first of all tax legislators should take action to restrict profit shifting by limiting loopholes in the allocation of multinationals’ profits. Here, the area of transfer pricing seems to be promising. In essence, we argue for more standardized transfer pricing regulations which should be adopted at the international level.

Our paper is organized as follows: First, we provide an overview of the existing initiatives regarding CbCR (Section 2). Second, we discuss to what extent the required information could be integrated into the existing financial reporting framework. In addition, we discuss expected costs and benefits linked to country-specific reporting (Section 3). Third, we derive potential alternatives for reform (Section 4). Finally, we conclude (Section 5).

## 2. Existing provisions of tax disclosure and trends for Country-by-Country Reporting

To date, there have been no extensive provisions prescribing a CbCR for all countries and industry sectors. However, numerous regulations in national and international tax law already require the disclosure of certain specific tax information. These regulations can be divided into CbCR provisions for specific industries, the public disclosure of tax information and internal documentation requirements such as for transfer prices (see Figure 1).

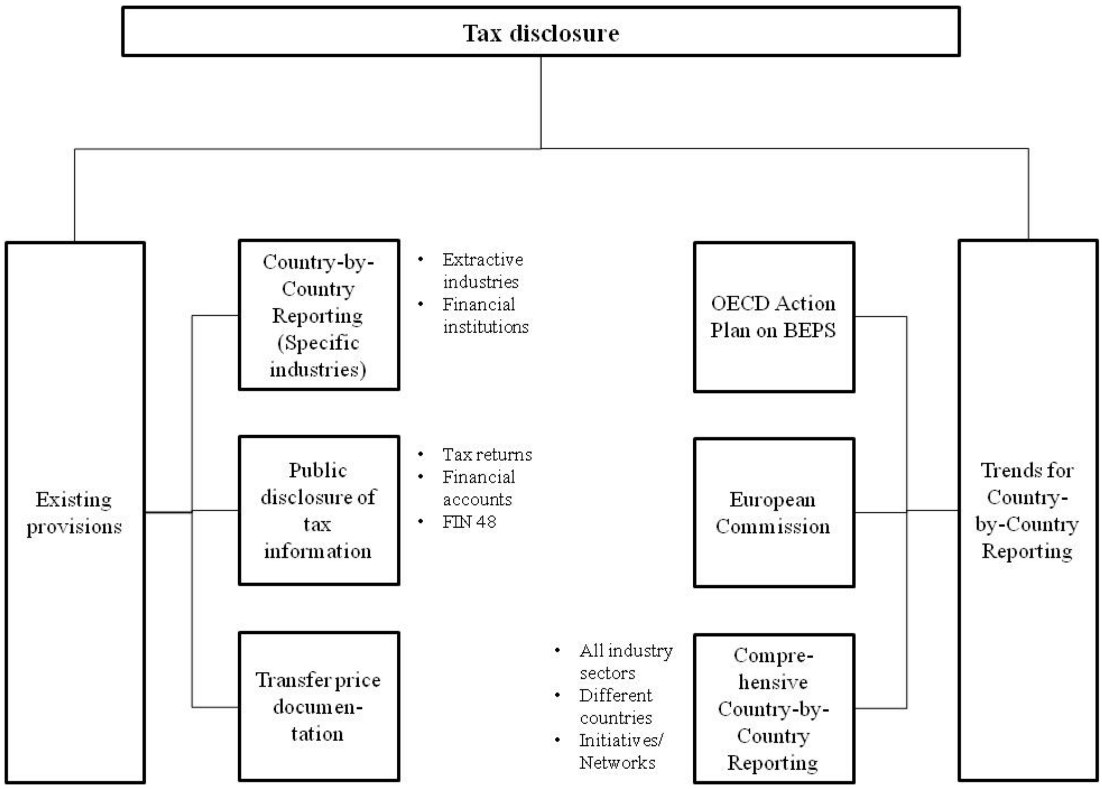


Figure 1: Tax disclosure: Existing provisions and trends

Certain regulations requiring country-specific information have already been put in place, albeit only for specific sectors, namely the extractive (production of oil, natural gas and minerals) and financial sectors respectively. It should be noted that these specific CbCR-requirements are mainly outside the scope of financial reporting.

The most comprehensive rulings concern the extractive industry, not because of tax reasons, but rather due to a high risk of corruption in this sector. The Extractive Industries Transparency Initiative (EITI),[10] for instance, is an international standard which countries may sign up to voluntarily, basically aimed at reconciling company and government payments. Participating countries have the duty to produce a public report, but are, however, entitled to decide on the exact form and scope of disclosure. In contrast, according to the Dodd-Frank Act, listed companies in the US operating in the extractive sector are obliged to publish payments made to governments on a country-by-country basis and in a standardized way.[11] Similarly, the EU Accounting and Transparency Directive implemented in July 2013 requires EU (listed and large non-listed) companies in the extractive and forestry sectors to

[10] http://eiti.org.
[11] *See* Congress of the United States of America (2010), Dodd-Frank Wall Street Reform and Consumer Protection Act. Similar regulations apply for companies listed at the Hong Kong Stock Exchange (HKEX).

disclose payments to national governments as part of their annual financial statements.[12] Like the other two initiatives, it does not, however, intend the declaration of country-specific profit figures and tax payments.

In July 2013, the EU Capital Requirements Directive IV ("CRD IV")[13] was adopted. This is the first initiative governing country-by-country disclosure for financial institutions in the EU. Primarily aimed at the enhancement of transparency, this directive stipulates that all concerned companies publicly disclose the names of their operations, turnover and the number of employees in every relevant country, effective from 2014. Most important, however, are country-specific data on profits/losses and tax payments, which will preliminarily have to be confidentially reported to the Commission only. The Commission plans to assess the potentially negative consequences of publishing this information and then to decide whether to keep them confidential or make them publicly accessible from 2015 onwards.

In general, most local GAAPs as well as the IFRS stipulate the disclosure of certain information regarding current and future tax payments of multinational companies in the financial statements (e.g. IAS 12). In consolidated financial accounts, however, this information is usually only available at the parent level or per segment (e.g. IFRS 8), but not necessarily at a regional or country-level. Tax information in individual accounts, on the other hand, can hardly be interpreted and compared due to the heterogeneity of local GAAPs. Tax returns containing exact tax payments to local fiscal authorities are not accessible in the majority of countries.[14] Moreover, some GAAPs require the additional disclosure of very specific tax information. FIN 48, "Accounting for Uncertainty in Income Taxes" (released in 2006), for instance, stipulates the publication of income tax risks of businesses adhering to US-GAAP. Thereby, companies have to assess the sustainability of their uncertain tax benefits (more-likely-than-not criterion) and establish tax reserves for tax positions they find not to meet the more-likely-than-not criterion.[15]

Following the OECD recommendation[16] on the pricing of intra-group transactions, many countries have focused on the transfer pricing regulations in their national tax codes in recent years. The scope of the provisions, however, still ranges from the simple requirement of the

[12] Directive 2013/34/EC.
[13] Directive 2013/36/EU.
[14] Only some countries, e.g. Finland, Sweden and Norway, require individual and/or tax returns to be publicly disclosed. In Japan, public disclosure of individual and corporate tax return data was mandatory from 1950-2004 (*see* M. Hasegawa et al. (2013), p. 572).
[15] For an overview over the FIN 48 regulations, *see* J. Blouin et al. (2007).
[16] OECD (2010).

application of the arm's length principle to detailed documentation requirements justifying intra-group prices and profit allocation to tax authorities (confidentially).[17]

In summary, the description of the status quo of tax disclosure provisions reveals that a comprehensive country-by-country reporting has not been implemented so far. Nevertheless, the public debate indicates a strong demand for more transparency in financial reporting. In this regard, the OECD action plan on BEPS reflects this trend towards stricter and more extensive disclosure requirements for companies in all industry sectors. In particular, actions 11 to 13 of the plan address the collection of firm-level data on BEPS and the disclosure of aggressive tax planning arrangements that companies may make use of. Moreover, it calls for the disclosure of country-specific information. The "Memorandum on transfer pricing documentation and CbCR", released in October 2013, specifies this concern by stipulating that CbCR should become a compulsory part of the transfer pricing documentation.[18] Taxpayers would be obliged to report income, taxes paid and certain indicators of economic activity to governmental authorities, i.e. CbCR information would not be part of financial accounts and thus not be made public. The OECD has further announced to push this subject forward by developing a concrete CbCR template by the end of 2014. Likewise, the European Commission has also signaled its support for a comprehensive CbCR framework.[19]

In addition, several networks and initiatives such as the "Task Force on Financial Integrity and Economic Development"[20] have extensively worked on a concept for country-specific reporting for all multinationals.[21] Some political parties have also brought forward requests for such disclosure regulations. The Social Democratic Party of Germany and the German Greens, for instance, have addressed this matter in their national election campaign of 2013. In their common petition, they call for the publication of country-specific information on tax payments, profits, revenues, employees and total assets as part of local German GAAP.[22]

As an interim result, it can be concluded that CbCR already exists in particular cases, for example, in some industries, yet not necessarily within the framework of financial accounting. Against the background of the BEPS discussion, a comprehensive CbCR as a general standard for large multinational companies is being called for by various parties and international institutions to enhance transparency. The proposals, however, vary with respect to the kind of

[17] *See* T. Lohse et al. (2012); T. Lohse & N.Riedel (2013), p. 2.
[18] *See* OECD (2013b).
[19] *See* European Commission (2013b).
[20] *See* R. Murphy (2009).
[21] *See* M. Devereux (2011), p. 24ff.
[22] *See* Deutscher Bundestag (2013), p. 2.

disclosure. While some argue in favor of CbCR as a mandatory part of public financial reporting, others prefer reporting only to tax authorities within the framework of transfer pricing documentation. In the following, it will be discussed which option seems to be more promising.

## 3. Comprehensive Country-by-Country Reporting (for all industry sectors)

### 3.1. Required information

The first question regarding the actual design of a comprehensive CbCR framework for all industry sectors concerns the required information for the identification of potentially tax-aggressive activities. Most importantly, data on profits and related tax payments in the relevant countries for each entity should be provided to evaluate the appropriateness of the amounts paid. In addition, several further disclosures would serve the purpose of examining a company's real economic activity in a country. As an example, the items listed in Figure 2 should be disclosed for each country the multinational operates in within the framework of a CbCR:[23]

- Name of each company and the country it operates in
- Financial performance
  - Sales, purchases, financing costs, royalties, marketing and R&D expenses
    - Intra-group
    - Third parties
  - Labour costs and number of employees
  - Pre-tax profit
- Details of cost and net book value of assets
- Details of gross and net assets
- Tax charge
  - Current and deferred taxes
  - Tax payments
  - (Deferred) tax assets and liabilities

Figure 2: Example for information requirements under CbCR

Essentially, sales, purchases and financing costs including royalties and other (overhead) costs such as marketing and R&D expenses should be split up between intra-group and third party transactions to shed light on profit shifting activities. In particular, intra-group transactions should be reported on a per-country basis. Moreover, the tax charge would have to be divided

[23] *See* R. Murphy (2009), p. 8, and, in particular, OECD (2013b).

into current (i.e. cash and accrued) and deferred taxes since governments are most interested in cash taxes.

### 3.2. Mechanisms for providing tax disclosure

#### 3.2.1. Possible starting points

The second question relates to the specific mechanisms for providing these country-specific data. In particular, the question of which framework could deliver this information arises.[24] As a starting point, one could think of consolidated financial accounts, and thus the IFRS, as a platform for CbCR. Alternatively, individual financial statements could be used. A third alternative would be a tax-specific CbCR template independent from financial statements.

The following examines the three alternatives successively. The evaluation is based on a simple example for intra-group profit shifting of multinationals incorporating an IP-Holding company located in a low-tax jurisdiction (see Figure 3).

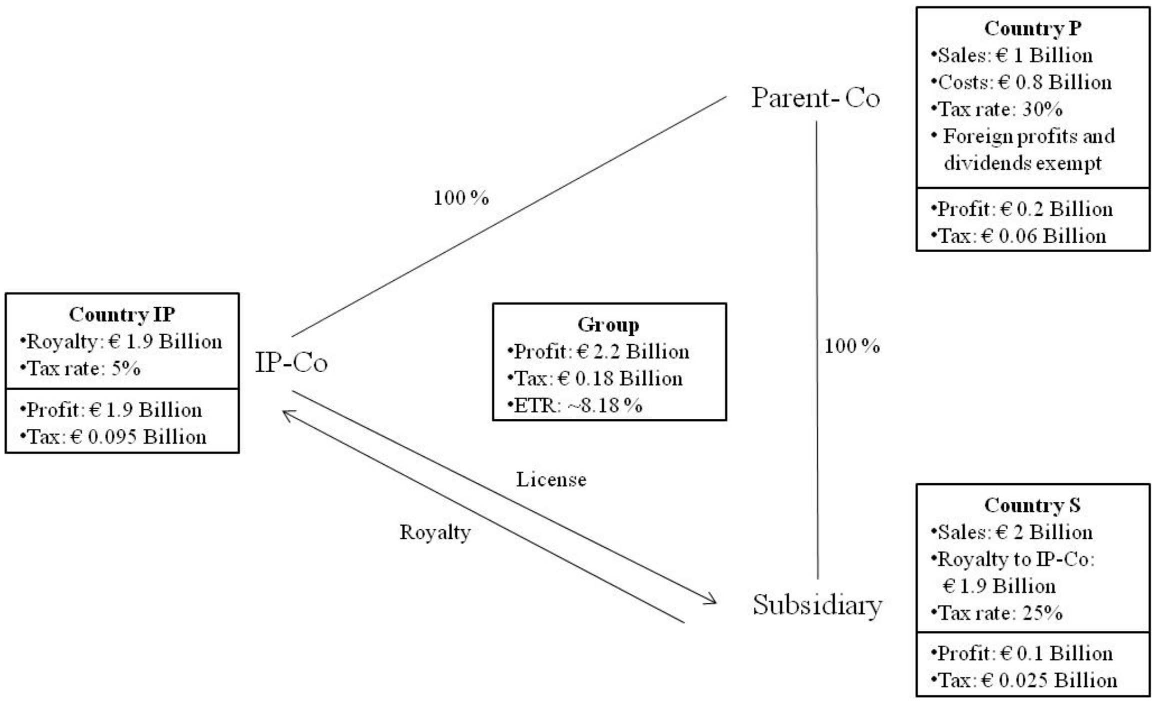


Figure 3: Example for international profit shifting

The example assumes a parent company (Parent-Co) in Country P with a 100% holding in a subsidiary in high-tax jurisdiction S and an IP-Holding in low-tax jurisdiction IP, where the group's IP (e.g. a patent) is located. The IP is licensed to the subsidiary in Country S in exchange for a royalty payment reducing the subsidiary's profit. Foreign profits and dividends are exempt from tax in Country P. Figure 3 displays separately the amount of sales, costs and

[24] *See* M. Devereux (2011), p. 39ff.; C. Fuest et al. (2013), p. 322; OECD (2013b).

pre-tax profits as well as intra-group transactions and the nominal tax rates for each company and country – P, S and IP. If total profits of the group (€ 2.2 Billion) were taxed at the level of Parent-Co, the tax charge would amount to € 0.66 Billion (= 2.2*0.3). In our example, however, the tax charge is reduced by € 0.48 Billion to € 0.18 Billion. Above all, from the total sales of € 2 Billion from the subsidiary in Country S, € 1.9 Billion are shifted to IP-Holding, yielding a tax saving of € 0.475 Billion (= (0.3-0.05)*1.9). Considering additionally the tax reduction in Country S, the total tax saving amounts to € 0.48 Billion (= 0.1*(0.3-0.25) + 0.475).

### 3.2.2. Consolidated financial statements

According to prevailing accounting standards (e.g. IFRS), consolidated financial statements disclose tax information in the profit and loss statement, the tax reconciliation and the segmental reporting. Building on consolidated accounts as a starting point for CbCR, however, has several drawbacks and does not seem to be feasible.

Most importantly, consolidated financial statements are supposed to provide decision useful information about a group of companies as a single economic entity. Therefore, intra-group transactions are consolidated and, thus, do not affect the overall profit. As the example shows, profit shifting activities by means of intra-group transactions are not visible in consolidated financial statements. This is due to the netting out of profits and expenses within the group (in our example: royalty income of IP-Holding and payments of Subsidiary of € 1.9 billion) and the aggregation of total tax payments (see Figure 4).


Figure 4: Intra-group profit shifting and consolidated financial accounts

The profit & loss statement therefore only reveals sales (€ 3 billion), costs (€ 0.8 billion) and profits (€ 2.2 billion) in aggregated form. The intra-group licensing arrangement is disregarded.

Tax reconciliations only disclose the total tax reduction (i.e. the low ETR) due to operations in low tax jurisdictions (€ 0.48 billion), but do not specify the underlying profit shifting mechanisms or countries involved, as required by CbCR (in our example the interposition of the IP-Holding). Moreover, accounting standards follow a forward-looking approach, while CbCR is strictly backward-looking. This is relevant if deferred taxes are required to be reported. This part of the total tax charge is based on reliable expectations about the future and is, in principle, not relevant for CbCR. Accounting for deferred taxes on international operations is closely linked to the taxation of foreign income in the country where the multinational is headquartered. If the exemption method applies to foreign profits – this holds for the majority of countries in the world – a lower foreign tax becomes definite and therefore does not trigger a deferred tax expense.[25] The situation is different, for example, in the United States (US). Here, foreign profits are subject to US tax and a credit is granted for the underlying foreign tax. Following the concept of deferred taxes, a lower foreign tax should not be treated as a permanent difference (as under the exemption method). It should rather be treated as a temporary difference and should therefore increase deferred taxes if profits are retained in low-tax jurisdictions. According to the so-called indefinite-reversal exception under US financial reporting rules, however, a corporation that defers the repatriation of foreign profits might defer the repatriation tax charge until profits are distributed to the US.[26] Empirical evidence suggests that the indefinite-reversal exception incentivizes the accumulation and retention of foreign profits abroad.[27] Therefore, it is argued that a reform of US financial reporting rules could limit profit-shifting activities into tax havens. However, this does not hold at all if foreign profits are exempt from tax.

Segmental reporting as another part of consolidated accounts does not deliver country-specific information either. According to the management approach (e.g. IFRS 8), data is disclosed on a business-unit level, yet not necessarily on a geographic or even per-country basis. In the context of our example, it could be possible that Parent-Co, Subsidiary and IP-Holding all belong to the same business unit and therefore no more detailed information would be provided.

Hence, in order to reveal single intra-group transactions, it would be necessary to examine "de-consolidated" data. This, however, does not serve the purposes of reporting on group

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[25] Please note that our example assumes that foreign profits are exempt from tax in the parent`s jurisdiction. To our knowledge, only 8 out of 34 OECD member states apply the credit method, among them the US, *see* G. Kofler (2012), p. 83.
[26] *See* R. Clemons et al. (2013), p. 427.
[27] *See* J. Blouin et al. (2012).

level. Furthermore, it is questionable to what extent the target group of CbCR and financial statements actually correspond with each other.[28] In addition, financial statements contain data based on future prospects of the company, while CbCR is intended to detect profit shifting behavior in past periods. Therefore, it can be concluded that consolidated financial statements do not seem to be the appropriate platform to deliver CbCR information.

### 3.2.3. Individual financial statements

Alternatively, one could think of individual financial statements as a starting point for CbCR information. Although individual financial statements, as opposed to consolidated financial statements, contain unconsolidated data on single company level, such an approach would have several drawbacks as well.[29] First, the exact source and direction of intra-group transactions do not become evident on a per-country basis. Second, individual financial statements are in general prepared according to local GAAPs and might be quite heterogeneous and thus not comparable across countries. Third and most importantly, financial accounts neither reflect taxable income nor do they provide reliable estimates for the true value of assets. As a general rule, book-tax-differences arise in most countries due to country-specific tax laws; the exemption from tax of certain types of income - in particular inter-company dividends and foreign source income - and non-deductible expenses are the most prominent examples. In addition, other reasons relating to different interrelations between financial accounting and national tax laws (e.g. different tax accounting standards and provisions to allocate income and expenses) are decisive for financial profits not necessarily to reflect taxable income.[30] Regarding the reflection of the value of assets, in particular intangibles, they might not be recorded at all, if self-developed, or only at historical costs. According to our example in Figure 4, it might be indeed misleading if IP-Holding had created the IP on its own and would display no or a very low value for intangibles in its financial accounts on the one hand and reports high taxable profits from royalties on the other hand.

### 3.2.4. Interim conclusion: CbCR as a tax-specific template

To conclude, in terms of current structure and purpose and due to country-specific tax laws, neither consolidated nor individual financial statements can serve as a suitable basis for CbCR. Therefore, it seems to be most reasonable to disclose this information in a separate

[28] It could be argued that consolidated accounts are primarily relevant for investors and capital markets, whereas CbCR first and foremost benefits tax authorities and critical public parties.
[29] *See*, e.g., OECD (2013b).
[30] *See* D. Endres et al. (2007); W. Schön (2005); C. Spengel & Y. Zöllkau (2012).

tax-specific template, if at all. These findings are in line with the ongoing discussion on CbCR at the level of the OECD, which aims towards the disclosure of a CbC report as part of the transfer pricing documentation (see Section 2).

In that case, however, it would be necessary to define a standardized and harmonized set-up with respect to scope (eligible companies), regulations and definitions (determination of income and valuation of assets) as well as a mandatory scheme to provide the relevant information. Other important aspects include the extent to which the disclosures should be mandatory or voluntary and whether they should be held confidential or made accessible to the public.[31] Finally, it has to be decided if and by whom the CbC report should be audited.

### 3.3. Expected costs and benefits

As a prerequisite for CbCR to be meaningful at all, the expected benefits of any additional disclosure of tax information have to outweigh the expected costs. Yet, to date, little is known about the exact costs and benefits related to CbCR.

#### 3.3.1. Costs

CbCR is suspected to be associated with several direct costs for disclosure.[32] In addition, implicit costs occur; the volume of such implicit costs is likely to exceed that of direct costs for disclosure and depends on whether the disclosure is made public or only available to tax authorities.

First of all, direct costs for disclosure would initially arise for adjusting existing systems and processes to the requirements of CbCR. While some[33] argue that many existing financial reporting systems are already technically able to deliver country-related data, the scope of initial costs is not exactly predictable and may depend on other factors such as the complexity of the group structure. Direct costs for reporting would also be incurred on a regular basis and would depend, for example, on the scope of disclosure requirements, (potential) materiality thresholds and the need for auditing the report. According to recent articles in professional journals,[34] the necessary information already exists and can be taken from financial and internal accounts as well as from tax declarations. CbCR could nevertheless become particularly expensive, if it introduced a completely new set of reporting provisions

[31] *See* M. Devereux (2011), p. 31ff.
[32] The following discussion of possible costs of a CbCR is adapted from M. Devereux (2011), pp. 34-38.
[33] *See* R. Murphy (2009), p. 21.
[34] *See* H.K. Kroppen (2013); T. Rödder & R. Pinkernell (2013); C. Heber (2013).

independent from financial and tax accounting rules and if companies considered it necessary to justify and extensively explain their reports to the public.[35]

Implicit costs of CbCR would primarily stem from disclosing the information to the public. Here, CbCR could be associated with considerable competitive disadvantages. Publishing commercially sensitive information would be particularly problematic in case country-specific reporting were not mandatory for all companies (e.g. not in all countries/regions or only for companies of a specific size). Moreover, disclosing data on tax payments potentially violates tax secrecy, which constitutes a guiding principle of tax law in most countries in the world.

In addition, international tax law is highly complex and public interested parties without profound knowledge of the subject might be unable to appropriately process and interpret the information disclosed. For instance, low (or zero) tax payments do not necessarily point to tax aggressiveness or at least do not necessarily result from illegal undertakings. Nevertheless, wrong accusations against companies could be made.

Another potential implicit cost of CbCR is associated with the danger of double taxation even in the absence of public disclosure: Knowing all tax payments on a country-by-country basis could make tax authorities raise their own claims towards companies.[36]

### 3.3.2. Benefits

In contrast to the expected costs, the expected benefits from additional disclosure of tax information are less clear. Proponents of CbCR believe that companies would be urged to pay a fair amount of tax in relation to their economic activity in each country. In addition, CbCR could enhance the administrative efficiency of tax collection and detect abusive tax arrangements. Moreover, additional disclosure of tax information would be beneficial from the point of view of capital markets. Finally, customers could put pressure on multinationals to increase tax payments in the different consumer markets. The following discussion reveals a missing theoretical foundation of these arguments and illustrates that CbCR information should not be made public, but only be transferred to tax authorities confidentially, if at all.

A major argument in favor of CbCR is that companies would be urged to pay taxes at an amount that truly reflects the companies' economic activity and its utilization of public infrastructure in a particular country.[37] Yet, this reasoning is merely speculative, in particular since the common tax minimization strategies employed by multinationals are mostly based

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[35] *See* M. Devereux (2011), p. 32ff.
[36] *See* I. Schlie & C. Malke (2013), p. 2469.
[37] *See* Deutscher Bundestag (2013) p.1; M. Devereux (2011), p. 7.

on the exploitation of loopholes in domestic and international tax laws and therefore in itself are not illegal. Moreover, this argument cannot be based on theoretical foundations, since it is virtually impossible to properly allocate profits and costs to single affiliates of a group by means of transfer prices: By setting up an integrated group of companies, coordination of transactions via markets is abandoned in favour of coordination using intra-organisational hierarchies. The aim is to generate economies of integration, for example by means of lower transaction costs, improvement of information flow or managerial efficiency. As a result, the profits of an integrated group of companies are higher than the aggregate profits earned by its separate entities. Since the excess profits accrue at group level, it is theoretically impossible to determine the source of these profits as they cannot be attributed to specific and, above all, individual transactions either.[38]

In addition, it is also questionable to what extent CbCR actually entails additional insights and benefits for tax authorities. Tax authorities can be assumed to be already familiar with the common (legal) channels and arrangements used for profit shifting, ever since the most prominent examples have been made available to the public.[39] CbCR, therefore, might only provide hints as regards the question of which companies should be audited or examined with increased scrutiny. This might be relevant for inbound investments in particular. Then, however, it could be argued that it is not necessary to make country-by-country disclosures publicly accessible, i.e. it would be sufficient to make the information available to fiscal authorities only. This is also in line with the OECD's proposal to integrate CbCR into the transfer pricing documentation framework.

Proponents of CbCR moreover claim that the enlarged information set (available to the public) would be beneficial from a capital market point of view. For instance, knowing which countries a multinational operates in could potentially enable investors to better assess the companies' geo-political risk and the sustainability of its tax charge.[40] However, some empirical evidence suggests that capital market participants already face an information overload and do not actually consider the full information set available.[41]

Finally and most importantly, it seems unlikely that CbCR will reduce tax minimization grounded on the utilization of beneficial tax regimes and constructional flaws in international

[38] *See* C.E. Mclure (1984), p. 94ff.; R. Avi-Yonah & I. Benshalom (2011), p. 379; O.H. Jacobs et al. (2011), p. 661; W. Schön (2010), p. 233ff.; H.J. Ault (2013), p.1200-1201.
[39] *See* R. Pinkernell (2012), p. 369ff.; E. Kleinbard (2011), p. 707ff.
[40] *See* R. Murphy (2009), p. 14. Investors could for instance see whether the tax charge largely depends on operations located in tax haven countries.
[41] *See* D. Lenter et al. (2003), p. 823ff.; J.S. Raedy et al. (2011), p. 3.

tax law. Rather, public pressure resulting from CbCR would be expected in case of illegal endeavors, which, however, are mostly not the reason for the unusually low effective tax rates of multinationals currently observed.

Moreover, empirical evidence is somewhat inconclusive with regard to the relationship between a forced increase in the information to be disclosed by companies and tax aggressive behavior. Hasegawa et al.[42], for instance, assess the tax reform in Japan in 2004 which constituted the abolishment of mandatory disclosure of individual and corporate tax returns. They find that companies do not generally report higher profits once tax returns become confidential again. A change in behavior with respect to tax planning activities can actually only be observed for non-listed companies. Therefore their findings are inconclusive with regard to the hypothesis that enforced disclosure reduces tax aggressiveness. Their findings further suggest that non-universal (unilateral) disclosure provisions would even trigger tax avoidance behavior. Furthermore, they show that if there is a threshold for disclosure, many taxpayers would under-report so as to avoid disclosure. Mixed empirical evidence also exists with regard to the FIN 48 implementation.[43] Gupta et al.[44] find that increased tax disclosure under FIN 48 reduced firm tax aggressiveness, at least at the state level.[45] Similarly, Balakrishnan et al.[46] report that aggressive tax planning decreases corporate transparency, but also increases the volume of tax-related disclosure. Yet, Blouin et al. observe that public firms appear to have taken actions to avoid mandated disclosure under FIN 48.[47] As a result, there is no clear empirical evidence reflecting that a change in disclosure provisions affects firm's tax aggressiveness. If at all, this applies to non-listed companies.

Lastly, since there is no clear empirical evidence showing that companies publicly accused of having engaged in aggressive tax planning suffer from damage to their reputation yet, it remains uncertain whether CbCR would actually impact customers' purchase decision at all.

### 3.3.3. Interim conclusion

To sum up, it can be concluded that expected benefits of CbCR lack a theoretical foundation and, according to empirical evidence, do not seem to outweigh the associated costs. Instead, it

[42] M. Hasegawa et al. (2013).
[43] For more details on FIN 48, *see* Section 2 above.
[44] S. Gupta et al. (2013).
[45] Similar results have been obtained by Hope et al. (2013) for a different setting. They show that tax avoidance behavior has increased after mandatory geographic earnings disclosure (SFAS No. 131) were abolished.
[46] K. Balakrishnan et al. (2012).
[47] J. Blouin et al. (2010).

appears to be reasonable to combat tax aggressiveness by different means. It is, therefore, up to legislators to remove unintended gaps and loopholes in the tax laws.

## 4. Alternatives

As discussed above, legal tax planning activities can hardly be combated by increasing transparency in financial reporting or by CbCR. Rather, it might be more effective to limit the leeway companies have with respect to constructing tax minimizing group structures. Empirical evidence reveals intra-group financing and transfer pricing as the most prominent channels for multinationals' profit shifting. In a recent meta-analysis, Heckemeyer and Overesch show that transfer pricing is by far the most dominant profit shifting channel. While transfer pricing explains 72% of the total share of shifted profits, the share of intra-group financing amounts to 28% only.[48] Further empirical evidence shows that enforcing tax rules does indeed reduce tax aggressive behaviour of multinational companies.

One example for the tightening of tax rules has been the enforcement of transfer pricing rules in the last years. Lohse, Spengel and Riedel[49] aim to generate a measure for the stringency and impact of transfer pricing rules showing that the regulations have become stricter over time. In that regard, Lohse and Riedel[50] use these insights to demonstrate that such transfer pricing regulations significantly reduce profit shifting activities by up to 50% (measured by the sensitivity of corporate pre-tax profits to changes in the corporate income tax rate). In particular, penalties exert an additional limiting effect on profit shifting behavior. Furthermore, they argue that higher administrative costs arising from additional documentation requirements can be justified in the light of anticipated benefits. In addition, Luckhaupt et al. point out the importance of a standardized set of transfer pricing rules in order to decrease complexity and to actually reduce the leeway for profit shifting.[51]

With regard to intra-group financing, studies have revealed the effectiveness of thin capitalization rules. Buettner et al.[52] find that thin-capitalization rules effectively reduce multinationals' incentive to make use of internal loans for international tax planning. Blouin et al.[53] obtain similar results concerning the effectiveness of thin capitalization rules with

[48] *See* J.H. Heckemeyer & M. Overesch (2013), pp. 23-26.
[49] T. Lohse et al. (2012).
[50] T. Lohse & N. Riedel (2013).
[51] *See* H. Luckhaupt et al. (2012). In particular they propose an apportionment method for those profits that cannot be allocated by transfer pricing.
[52] T. Buettner et al. (2012).
[53] J. Blouin et al. (2013).

respect to their impact on the capital structure of multinational firms (reduction of internal debt).

A promising avenue might therefore be to close gaps and loopholes and to reduce leeway in domestic and international tax laws. However, in that case it would be important to ensure that tightened regulations do not lead to double taxation, i.e. these regulations would have to be universally accepted by all countries. Here, a standardization of transfer pricing regulations might be more efficient in terms of limiting profit shifting and is more in line with the goals of avoiding double- and non-taxation than a tightening of thin capitalization rules.[54]

## 5. Conclusion

(1) Aggressive tax planning efforts of highly profitable multinational companies (so called Base Erosion and Profit Shifting (BEPS)) have recently become the subject of intense public debate. As a response, several international initiatives and parties have called for more transparency in financial reporting, especially by means of a Country-by-Country Reporting (CbCR).

(2) Existing provisions already require the disclosure of certain tax information, e.g. on tax payments in individual and consolidated financial accounts or transfer pricing documentation to tax authorities. Furthermore, some regulations requiring country-specific information have been put in place for the extractive and financial sectors. However, no comprehensive CbCR for all countries and industry sectors has been implemented so far.

(3) Several initiatives call for a comprehensive and public disclosure of specific information on tax payments and profits on a country-by-country basis. Our findings suggest that neither consolidated nor individual financial accounts seem to be an appropriate platform to provide such country-specific information. If at all, CbCR should be provided in a separate template. However, detailed and harmonized definitions and regulations would then have to be determined to ensure comparability.

(4) The discussion on benefits and costs of a potential CbCR has revealed that benefits are largely uncertain since current tax planning activities are mainly based on the legal exploitation of gaps and loopholes in national and international tax law. Moreover, expected benefits are not based on a theoretical foundation. Costs, however, seem to be

[54] *See* Blouin et al. (2013).

more significant. Therefore, CbCR cannot be regarded as a convincing measure to combat aggressive international tax planning of multinational companies.

(5) Alternatively, the enforcement of national and international tax rules should be considered. This is in accordance with recent empirical evidence demonstrating, in particular, the effectiveness of tightening transfer pricing rules.

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