Public country-by-country reporting: Tax transparency and allocation of group profits

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In a global economy, tax transparency has emerged as a basis of responsible corporate governance. Multinational enterprises (MNEs) play a significant role in the economies of the jurisdictions in which they operate, but concerns about potential tax avoidance and profit shifting have placed these companies under the spotlight. As a result, governments, regulatory bodies and stakeholders are calling for greater accountability in how these corporations allocate their profits and pay taxes. This note explores how the introduction of public country-by-country reporting (CbCR) requirements in the European Union is a significant step in addressing said concerns, promoting transparency and ensuring fairer tax practices.

1. Setting the Scene: The Increasing Importance of Tax Transparency

The concept of tax transparency stems from the need for fairness in global tax systems. For years, the lack of public access to detailed tax information has enabled some MNEs to engage in aggressive tax planning, minimizing their tax contributions while generating significant profits in various jurisdictions. This has led to growing public concern, with stakeholders questioning whether companies are paying their "fair share" of taxes, i.e. effectively paying taxes where economic value is actually created.

Recognizing the need to address these concerns, the European Union adopted EU Directive 2021/2101, introducing public CbCR which mandates public disclosure of income tax information (the Directive). The Directive aims to meet the demands of EU citizens for greater economic fairness and accountability. By making key tax information publicly available, it seeks to create a level playing field among businesses, foster trust in tax systems and strengthen the single market.
This impulse for transparency aligns with the Global Reporting Initiative (GRI) 207 tax standard, which has been in effect since 1 January 2021. The GRI 207 tax standard encourages organizations to disclose their tax strategies, governance structures and impacts, including country-specific tax contributions. Together, these measures are reshaping how businesses approach tax compliance and transparency, elevating tax as a critical issue for corporate sustainability.

2. Public CbCR:

2.1. A Closer Look

Public CbCR represents one of the most transformative elements of the European Union's approach to tax transparency. Originally introduced by the OECD as part of the BEPS Action 13 initiative, CbCR requires MNEs to report detailed financial information for each jurisdiction in which they operate. This includes, among others:

- revenues (from related and unrelated parties);
- profit or loss before income tax;
- actual income tax paid, and
- information about group activities in each jurisdiction.

The Directive expands on the OECD's framework by making CbCR publicly available, thereby subjecting MNEs to scrutiny from not only tax authorities but also civil society, media and other stakeholders. The Directive applies to multinational groups with consolidated annual revenues exceeding EUR 750 million. It requires affected companies to disclose their tax information for all EU Member States as well as certain non-EU jurisdictions that are deemed relevant to understanding the group's tax position.

One key feature of the Directive is its phased implementation. For most EU Member States, public CbCR applies to financial years starting on or after 22 June 2024. Companies must publish their reports within 12 months of the financial year's end. However, some countries, like Romania, have opted for earlier implementation, requiring reporting for financial years beginning 1 January 2023, with the first reports due by 31 December 2024.

The Directive also outlines specific requirements for the format and presentation of reports. Under the European Commission's implementing regulation, reports must be prepared in XHTML and inline XBRL formats, ensuring consistency and accessibility for stakeholders. This regulation applies to public CbCR reports corresponding to financial years starting on or after 1 January 2025.

2.2. Implications for Multinational Groups

The introduction of public CbCR has profound implications for multinational corporations, particularly those with complex group structures and operations spanning multiple jurisdictions. While the Directive primarily targets tax transparency, it also raises broader questions about reputation management, stakeholder relations and corporate responsibility.

Public Scrutiny and Reputational Risks

By making tax information publicly available, public CbCR exposes MNEs to increased scrutiny by external stakeholders. Civil society organizations, journalists and other interest groups may use the data to assess whether companies are contributing their fair share of taxes in the countries in which they operate. For companies perceived to engage in aggressive tax practices, this scrutiny could lead to reputational risks, consumer backlash or even regulatory interventions. To mitigate these risks, companies must ensure that their tax strategies and the other tax information published on their websites align with their broader sustainability goals and values. Transparency practices should not only comply with the Directive but also reflect a genuine commitment to ethical business practices.

Alignment with Value Creation

One of the core principles underpinning public CbCR is the alignment of profit allocation with value creation. Stakeholders will be able to assess whether a company's reported profits in a given jurisdiction correspond to the economic activities and value generated there. This focus on value creation reinforces the importance of adhering to the arm's length principle in transfer pricing and ensuring that profits are fairly distributed across group entities. MNEs must therefore review their transfer pricing policies and tax positions to ensure they can withstand public scrutiny. Discrepancies between profit allocation and economic substance may invite challenges from tax authorities and harm stakeholder trust.

How should CbCR data be interpreted?

The issue of group profit allocation to local entities is complex and subject to interpretation, with each jurisdiction normally seeking to tax a larger portion of the group's profits. The generally accepted rule for allocation is the arm's length principle, which requires prices of intragroup transactions to be comparable with prices applied between independent parties under similar circumstances. Although the public CbCR includes relevant information on each subsidiary's activity and taxable revenues, this should be incorporated into the tax authorities' risk assessment framework and analysed in connection with other data, such as the tax declarations or local transfer pricing reports, to draw a pertinent conclusion. However, this additional information is unlikely to be available to the public in an easily accessible form.

It is important to understand that if the CbCR is used in isolation there is a significant risk that simplistic and misleading conclusions may be drawn. In 2017, the OECD issued the Country-by-Country Reporting Handbook on Effective Tax Risk Assessment (Handbook) which is a tool prepared initially to help tax authorities identify transfer pricing and BEPS related risks by using the CbCR alongside other local or group data. It advises that CbCR information should not be used by tax authorities to perform transfer pricing adjustments. The Handbook identifies several potential tax risk indicators which tax authorities should further investigate. These include, among others, cases when:

- the results in a jurisdiction deviate from potential comparables or from market trends;
- there are jurisdictions with significant activities but a low level of profits (or losses); or
- jurisdictions have high profits but a low level of tax accrued.

More complex red flags include situations when:

- a group has activities in jurisdictions which pose a BEPS risk;
- intellectual property is separated from related activities within a group; or
- the group includes dual resident entities or entities with no tax residence.

The Handbook further emphasizes the need for an in-depth analysis before drawing conclusions based on the risk indicators. For example, situations when the local group entity has significant activities in a jurisdiction, but low levels of profit (or losses) may lead to the conclusion that profits attributable to that entity may have been shifted to a jurisdiction where they are taxed more favourably. However, this case might be explained by the fact that 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 with the group).

In principle, all the risk indicators identified in the Handbook can be explained by economic and commercial reasons, provided the group is able to offer reasonable and documented arguments. Multinational groups should further investigate the risk of simplistic interpretations of public CbCR data by the public and other stakeholders, as these interpretations could lead to incorrect conclusions about tax policies. These groups should be ready to provide additional explanations for the economic reasons behind their reported results. The GRI 207 tax reporting standard and its guidance are instrumental in this effort. The GRI 207 promotes disclosure of the reasons for differences between corporate income tax accrued and the tax due if the statutory tax rate is applied to profit and loss before tax.

Preparing for compliance

Compliance with public CbCR requires robust data management and reporting systems. Companies must collect and consolidate detailed financial information for each jurisdiction, often across multiple entities and systems. This can be a complex and resource-intensive process, particularly for large groups with diverse operations. Additionally, companies must ensure that the information disclosed is accurate, consistent and easily interpretable by stakeholders. Errors or inconsistencies in reporting could undermine the credibility of the company's tax disclosures and invite further scrutiny.

Balancing transparency and confidentiality

While public CbCR promotes transparency, it also raises concerns about the potential misuse of sensitive financial information. Competitors, for example, could analyse the data to gain insights into a company's operations or market strategies. Companies should attain a balance between meeting transparency requirements and protecting proprietary information.

3. Conclusion

Tax transparency is not merely a compliance obligation. It is a fundamental aspect of corporate responsibility. The EU Commission has emphasized that public CbCR is a response to citizens' demands for greater fairness in the tax system and stronger action against corporate tax avoidance. By fostering transparency, the Directive aims to rebuild trust in tax systems and enhance the legitimacy of the EU single market. Beyond regulatory compliance, tax transparency also offers an opportunity for companies to demonstrate their commitment to sustainability and good governance. By disclosing their tax contributions, companies can show how they support local economies and contribute to public goods, such as infrastructure, education and healthcare. This, in turn, can strengthen relationships with stakeholders and enhance the company's social licence to operate.

The introduction of public CbCR marks a turning point in the global tax landscape. By requiring multinational groups to disclose detailed tax information on a public platform, the EU is setting new standards for accountability, transparency and fairness in corporate taxation. For MNEs, the implications are far-reaching. Beyond meeting the technical requirements of the Directive, companies must navigate the reputational risks and operational challenges associated with public CbCR. This includes ensuring that their tax strategies align with value creation, investing in robust data management systems and engaging with stakeholders in a transparent and ethical manner.

Finally, public CbCR reflects a broader shift toward greater corporate responsibility in a globalized world. By embracing transparency, companies can not only comply with regulatory requirements but also contribute to a more sustainable tax system. This, in turn, will benefit not only businesses but also the societies and economies in which they operate.

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