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PUBLIC INTEREST COMMENT

COMMENT ON THE IMPLEMENTATION OF COUNTRY-BY-COUNTRY REPORTING BY THE INTERNAL REVENUE SERVICE

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INTRODUCTION

The Spending and Budget Initiative of the Mercatus Center at George Mason University strives to provide an accurate understanding of budgets, spending, deficits, and debt and how these issues relate to economic growth and progress. As part of its mission, the program conducts careful and independent analyses of federal policy that employs contemporary economic scholarship to assess proposals and their effects on the economic opportunities and the social well-being available to all members of American society.

This comment addresses the efficiency and efficacy of this rule from an economic point of view. Specifically, it examines how the rule may be improved by more closely examining the societal goals the rule intends to achieve and whether this proposed regulation will successfully

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achieve those goals. In many instances, regulations can be substantially improved by choosing more effective regulatory options or more carefully assessing the actual societal problem.

BACKGROUND

The IRS has proposed regulations to implement the Organisation for Economic Co-operation and Development's (OECD) guidelines to increase automatic exchanges of taxpayer information through a new country-by-country (CbC) reporting requirement. The proposed country-by-country report centralizes and automatically shares with all signatory countries the jurisdictional breakdown of a multinational corporation's revenue, profit before income tax, income tax paid and accrued, employment, capital, retained earnings, tangible assets, and the business activities in which each entity engages.

The OECD hopes that the new reporting standards will provide tax administrators with useful information to more effectively direct auditors while making it easier to identify artificial profit shifting to tax-advantaged environments.[1] This public comment will argue that the accounting costs of country-by-country reporting will be larger than the Department of the Treasury's revenue gains and that there will be even higher unanticipated costs from inadvertent disclosures of sensitive information. Because the costs of information centralization will be greater than the benefits, we recommend that the IRS should not implement the proposed regulation on country-by-country reporting. This recommendation is informed by a recent paper from the Mercatus Center at George Mason University that explains key features of the international corporate tax system, the changes the OECD wants to make, and the potentially far-reaching consequences of those changes. The study also provides recommendations to improve corporate taxation without compromising state sovereignty or taxpayer rights.[2]

ANALYSIS

The Direct Costs of Country-by-Country Reporting Will Be Larger than the Treasury's Revenue Gains

Country-by-country reporting will impose unnecessary costs on US businesses, adding to the already monumental costs of corporate tax compliance.[3] Similar tax reporting requirements have increased tax revenue by less than the private cost of compliance and have been shown to be ineffective at decreasing total tax avoidance.[4]

1. *Guidance on Transfer Pricing Documentation and Country-by-Country Reporting* (Paris: Organisation for Economic Co-operation and Development, 2014), 9.
2. Jason J. Fichtner and Adam N. Michel, "The OECD's Conquest of the United States: Understanding the Costs and Consequences of the BEPS Project and Tax Harmonization" (Mercatus Research, Mercatus Center at George Mason University, Arlington, VA, March 2016).
3. Jason J. Fichtner and Jacob M. Feldman, *The Hidden Cost of Federal Tax Policy* (Arlington, VA: Mercatus Center at George Mason University, 2015).
4. Niels Johannesen and Gabriel Zucman, "The End of Bank Secrecy? An Evaluation of the G20 Tax Haven Crackdown," *American Economic Journal: Economic* Policy 6, no. 1 (2014): 89.

Country-by-country reporting is a substantial change from how businesses currently report tax information. It will necessitate a significant evolution in the way multinationals set, implement, monitor, and document internal transfer pricing procedures.[5] The cost of collecting the requested information will necessitate new technology solutions for many firms since the report items are not centrally collected in a compatible format by many businesses.[6] The cost will be high for US businesses to implement new integrated reporting systems across all subsidiaries, often in multiple countries.

Under a similar, but more limited, now defunct requirement for information exchange under the Dodd-Frank Act, the Securities and Exchange Commission (SEC) estimated, "the total initial cost of compliance for all issuers is approximately $1 billion and the ongoing cost of compliance is between $200 million and $400 million."[7] In addition to direct compliance costs, a challenge to the SEC rule noted that there could be billions of dollars in additional unanticipated costs from inadvertent disclosure of sensitive commercial information.[8]

The recently enacted Foreign Account Tax Compliance Act (FATCA), is intended to increase information reporting and exchange mechanisms for individual taxpayers. The OECD's country-by-country reporting guidance draws heavily from FATCA, applying the rules to business income.[9] The implementation of FATCA has shown that the private expenditures necessary to comply with the law will be equal to or exceed the estimated revenue gains from increased information exchange.[10] The Joint Committee on Taxation estimates that FATCA will generate $8.7 billion in additional tax revenues over 10 years.[11] A legal challenge to the law estimates that over $8 billion has been spent complying with FATCA reporting requirements, and firms are still working to make their internal computer systems FATCA-compliant.[12] The OECD efforts will likely have similar costs, outweighing any benefits of increased compliance.

Past information exchange initiatives have not decreased tax evasion or increased revenue collection. The most recent evidence on international information exchange initiatives shows that OECD efforts that have succeeded in dramatically increasing information exchange through bilateral treaties have thus far not resulted in reduced tax evasion. Economics professors Niels Johannesen and Gabriel Zucman conclude that "treaties have led to a relocation of

5. Darcy Alamuddin et al., "OECD Documentation Guidance Sets New Global Standard," *Tax Notes International*, Tax Analysts, September 22, 2014.
6. Michael Patton, "The OECD BEPS Action Plan: What It Means for Multinationals Now," *Transfer Pricing, International Tax Review* (Euromoney Trading Limited, 2014), 9; Darcy Alamuddin et al., "OECD Documentation Guidance Sets New Global Standard."
7. Securities and Exchange Commission, Disclosure of Payments by Resource Extraction Issuers, 17 C.F.R. pts. 240 and 249 (November 13, 2012).
8. David Ernick, "OECD BEPS Project: Nothing New Under the Sun?," *Tax Notes*, Tax Analysts, August 10, 2015; *American Petroleum Institute v. Securities and Exchange Commission*, No. 12-1668 (JDB) (D.D.C. 2013).
9. Marie Sapirie, "Lessons From FATCA for Country-by-Country Reporting," *News Analysis*, Tax Analysts, April 6, 2015.
10. Kyle Pomerleau, "Foreign Account Tax Compliance Act (FATCA) Goes Into Force Today," *Tax Policy Blog*, Tax Foundation, July 1, 2014; Robert W. Wood, "FATCA Carries Fat Price Tag," *Forbes*, November 30, 2011; "Thomson Reuters Survey Indicates FATCA Compliance to Cost More than Anticipated," *Thomson Reuters*, November 6, 2014.
11. Joint Committee on Taxation, "Estimated Revenue Effects of HIRE Act," JCX-6-10, March 4, 2010, 1.
12. Verified Complaint for Declaratory and Injunctive Relief, *Mark Crawford et al. v. United States Department of the Treasury, et al.*, No. 3:15-cv-250 (S.D. Ohio July 14, 2015); Robert Goulder, "Litigating FATCA: Rand Paul and Financial Privacy," *Forbes*, September 16, 2015.

bank deposits between tax havens but have not triggered significant repatriations of funds. . . . Leaving roughly unchanged the total amount of wealth managed offshore."[13] While not accomplishing their stated goals, the costs of large-scale international information exchange provisions are high.

There Will Be High Unanticipated Costs from Inadvertent Disclosure of Sensitive Information

The proposed regulation goes to great lengths when describing safeguards to protect confidentiality and improper use of information. Acknowledging the importance of security and confidentiality is not sufficient to prove that the IRS is ready to implement regular global transfers of confidential information.

Assembling a new, centralized database of highly sensitive corporate financial information increases the vulnerability of proprietary business data. It would take just one breach of the system, in any one of the party jurisdictions, for all the information to be exposed. Despite promises of heightened security, independent government audits of the IRS have repeatedly found a "significant deficiency" in the IRS's controls over financial and taxpayer data. In 2015 the Government Accountability Office found that "weaknesses in [information security] controls limited [the IRS's] effectiveness in protecting the confidentiality, integrity, and availability of financial and sensitive taxpayer data."[14] Even well-developed countries with the most robust institutions struggle to uphold the rights of taxpayers.[15]

The often unanticipated costs of information exchange recently received empirical support. A 2015 World Bank working paper finds that financial information disclosure is a "double-edged sword." The authors explain that disclosure "leads to a significantly higher level of corruption" that firms must face. The majority of countries in the world do not have the same robust institutions that firms in the United States can rely on. In many countries "once firm information is disclosed, the threat of government expropriation is widespread."[16] The authors continue: "Information disclosure thus allows rent-seeking bureaucrats to gain access to the disclosed information and use it to extract bribes. . . . With more information about firms available, government expropriations . . . become more severe, especially in countries with poor property rights protection."[17]

In the proposed rule the IRS describes how automatic exchanges of country-by-country reports will be paused if a tax jurisdiction is found to be not in compliance with US standards.

13. Johannesen and Zucman, "The End of Bank Secrecy?"
14. Government Accountability Office, "IRS Needs to Continue Improving Controls over Financial and Taxpayer Data," March 2015, 19.
15. Brian Garst, "Making Sense of BEPS: The Latest OECD Assault on Tax Competition" (Center for Freedom and Prosperity, June 2015), 7.
16. Tingting Liu et al., "The Dark Side of Disclosure: Evidence of Government Expropriation from Worldwide Firms" (Policy Research Working Paper 7254, World Bank Group, May 2015), 24.
17. Ibid., 25.

This ex post response will do little to stem any data breaches that have already occurred. A challenge to information exchanges by the SEC under the Dodd-Frank Act explains the high costs associated with disclosing trade secrets. In addition to the initial and ongoing direct compliance costs, reporting "'could add billions of dollars of [additional] costs' through the loss of trade secrets and business opportunities" as foreign competitors can access sensitive information.[18] The IRS should focus its efforts on strengthening domestic information protections, rather than introducing additional vulnerabilities into the systems.

It is also difficult for individual countries to remove themselves from the growing treaty system and harder still to tailor treaty language to protect their citizens. In 2010, the OECD updated a multilateral treaty on disclosure and transparency, requiring jurisdictions to sign 12 bilateral tax information exchange agreements in order to be considered in good standing and not a "tax haven." In tandem with several other initiatives, over 100 countries met the new standards in less than two years, including Switzerland, a usual holdout in information exchange campaigns.[19] The multilateral treaty is particularly powerful because signatories cannot negotiate individual provisions and signing onto treaty enters the country into an agreement with all prior signatories.[20] Although difficult to organize, when multilateral treaties obtain majority adoption, there is little room for national governments to set independent policies.

Tax practitioners also worry that the new country-by-country reports will be used to justify frivolous audits which will increase real profit shifting of jobs and physical assets. There is a widely held fear that tax administrators in other countries—in attempts to expand their tax bases—will use the new information to pressure multinationals to align taxes paid with sales, employment, or asset locations.[21] The availability of country-by-country tax information may pressure some countries to use a formulary apportionment standard as a mechanism to artificially expand their tax bases. The OECD final reports leave the door open to future use of "profit splitting," a formula-based method of transfer pricing, in the Actions 8-10 report—the guidance for which will not be finalized until 2017.[22]

A country such as China could benefit by unilaterally moving to apportionment because firms in that country generally have a large employment footprint but little measurable

18. Complaint at 2, *American Petroleum Institute v. Securities and Exchange Commission*, No. 12-1668 (D.D.C. 2013), quoting 77 Fed. Reg. at 56398, 56412; David Ernick, "OECD BEPS Project: Nothing New Under the Sun?," *Tax Notes*, Tax Analysts, August 10, 2015.
19. Andrew P. Morriss and Lotta Moberg, "Cartelizing Taxes: Understanding the OECD's Campaign Against 'Harmful Tax Competition'" (University of Alabama Working Paper, October 27, 2011), 43–44.
20. Ibid., 44.
21. David Ernick, "Base Erosion, Profit Shifting And the Future of the Corporate Income Tax," *Tax Management International Journal* 42 (November 8, 2013): 15.
22. *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10: 2015 Final Reports* (Paris: Organisation for Economic Co-operation and Development, October 5, 2015).

"value creation" under the arm's length standard.[23] In a February statement, the Chinese tax agency made it an official policy to step up oversight of Western multinationals, scrutinizing how they move money and allocate costs. According to the *New York Times*, "officials in China, the world's largest manufacturer, have long contended that much of the value of a good lies in its physical production, and not in the intellectual property that went into the item, which is often created elsewhere."[24]

Country-by-country reporting will give tax administrators around the world access to information that could be used to disproportionately extract tax revenue from US companies, complicating international taxation rather than simplifying it. A Deloitte survey of tax and finance managers and executives from multinational companies in 2015 found that nearly 60 percent of multinational firms think the base erosion and profit shifting project will have a bigger impact than they originally anticipated. The survey also found that 75 percent of managers and executives expect some form of double taxation as countries respond to the recommendations in diverse ways.[25] Country-by-country automatic information exchanges pose considerable risks to US multinational businesses' ability to maintain a competitive edge and create value in a global economy. Further, if countries such as China force US companies with intensive foreign manufacturing operations to use formulary apportionment, the United States could lose tax revenue as a result of country-by-country automatic reporting.

CONCLUSION

We have shown that the direct costs of country-by-country reporting will be larger than the Treasury's revenue gains and that there will be high unanticipated costs from inadvertent disclosure of sensitive information. Because the total costs of information centralization will be greater than the total benefits, we recommend that the IRS should not implement the proposed regulation on country-by-country reporting.

23. The arm's length standard is a transfer pricing rule that makes corporations, for tax reporting purposes, pretend each jurisdiction is a legally different company. Transactions between tax jurisdictions should be valued as if they had been carried out between unrelated parties, each acting in its own best interest. David Ernick, Hardeo Bissoondial, and Jack Kramer, "You Look Familiar—The OECD Looks to U.S. State Tax Policy for BEPS Solutions," in *U.S. State Tax Considerations for International Tax Reform* (Tax Analysts, 2014), 113; *Model Tax Convention on Income and on Capital 2010 (Full Version)* (Paris: Organisation for Economic Co-operation and Development, 2012), chapter 9, paragraph 1; *Annual Report on the OECD Guidelines for Multinational Enterprises 2006* (Paris: Organisation for Economic Co-operation and Development, 2006), 176.
24. Keith Bradsher, "China to Crack Down on Tax Collection From Multinational Companies," *New York Times*, February 4, 2015.
25. "OECD's Base Erosion and Profit Shifting (BEPS) Initiative: Summary Results of Second Annual Multinational Survey," Deloitte, May 2015.