

# Country-by-Country Reporting

Country-by-country reporting requirements for corporations – a contribution to strengthening public finances in countries in the Global South

English summary

## I The problem: rich countries – poor governments

Sustainable development cannot be maintained in the long term unless sufficient government revenue to provide an adequate level of public goods and services can be mobilised in the countries of the Global South themselves. Without this it will be impossible to overcome the dependence on foreign donors that is the present lot of the poorest countries.

Mobilisation of state revenue requires effective taxation systems and transparent and democratically determined budgets that cover the financing of key development tasks. In many poor and newly industrialising countries there is considerable potential for generating additional government revenue. Public budgetary funds in these countries are far below the corresponding average levels in industrialised countries – not only in absolute terms but also in relation to economic output. In the Eurozone, central government revenue represents 35.1 percent of gross domestic product (GDP, 2011); in many countries in the Global South it is less than half this share. The percentage is particularly low in crisis-hit countries such as Afghanistan (11.3 percent) and also in Cambodia (12.0 percent), China (11.5 percent), Bangladesh (12.0 percent) and Guatemala (11.6 percent). At the bottom of the list are Nigeria (9.7 percent) and Liberia, where in the aftermath of civil war government revenue is just 0.3 percent of GDP.

In many countries a significantly larger proportion of GDP could be used to finance public expenditures. There are various reasons why this does not happen. Many countries still lack effective taxation systems; their fiscal authorities are poorly resourced; corrupt elites misappropriate government funds and invest them in financial secrecy centres and tax havens; many countries have a large informal economy in which much economic activity is outside state regulation and control and so goes untaxed. Transnational corporations (TNCs), too, contribute directly and indirectly to the “public poverty” of countries in the Global South: they take advantage of tax holidays or avoid tax by transferring their profits – legally or illegally – to low-tax jurisdictions.<sup>1</sup>

## II One cause: tax avoidance by corporations

Corporations have devised various ways of getting their money out of a country without paying tax. Some of these methods involve obviously criminal wheeling and dealing, some exploit grey areas of the law, and some make use of legal loopholes and tax havens as part of international “tax optimisation” strategies. The media have recently highlighted the cases of large IT and internet companies such as Apple, Google and Amazon that fall into the last of these categories. Tax avoidance is by no means limited to the countries of the Global South, but its impacts there are particularly severe.

There are many different methods of tax avoidance but they all have one thing in common: they deprive public finances of desperately needed revenue, impede the public financing of urgent tasks in fields such as poverty reduction, social security and climate change mitigation, and hence undermine community cohesion and social equity in the countries concerned.

### Methods of tax avoidance and tax evasion

Manipulation of international trade prices has particularly serious consequences for public finances. Forging import and export invoices is one of the most widely used methods of getting money out of a country and so evading tax. By setting prices of imported goods artificially high and those of exported goods artificially low, companies can transfer money out of the country avoiding government controls.

Price manipulation occurs not only in trade between independent companies but also in intra-group transactions within transnationally active corporations. In countries where foreign investors are not already exempt from tax, these investors often abuse transfer pricing – a form of setting intra-group prices – to shift profits to countries in which this is most favourable for tax purposes.

As economic activities have become globalised, manipulative transfer pricing has become one of the main tools of tax avoidance. The fact that a significant proportion of worldwide trade in goods and services (volume in 2011: 18.519 trillion US dollars)<sup>2</sup> takes place within transnational corporations underscores the importance of intra-company transfer prices.

Transnational corporations and their global tax advisors, in particular KPMG, Ernst & Young, Deloitte and PricewaterhouseCoopers, are always one step ahead of the tax authorities, and their activities are not confined to getting round the transfer pricing rules. By transferring company capital to group hold-

ing companies, interposing letter-box companies and setting up franchise companies they manage to report higher costs in countries with higher taxes and larger profits in low-tax countries – thereby reducing the corporation’s total tax liability.

Among transnational companies, a special tax avoidance trick is the use of external financing combined with setting up a holding company in a low-tax country.<sup>3</sup> Some of the corporation’s equity is transferred to the holding company, while subsidiaries based in countries with higher taxes are given less equity capital. The subsidiaries finance themselves by borrowing capital from the group holding company, for which they of course have to pay interest. In consequence the taxable profits of the undercapitalised subsidiaries are reduced by the interest payments to the holding company, which means that the tax payable is also reduced. At the same time, the holding company’s profits rise. This arrangement is particularly lucrative for the group if the holding company is located in a tax haven.

These profit transfer and “tax optimisation” manoeuvres are only possible because there are still major inadequacies in the regulations and transparency requirements that apply to transnational companies. The reasons for this are by no means entirely home-made. The governments of the leading industrialised countries bear a significant share of the responsibility because they have for many years failed to impose effective regulation and control on the international financial system or to tackle the centres of financial secrecy; in some cases they have actively prevented such control through a policy of deregulation. On one point, however, governments and many civil-society stakeholders agree: standard country-by-country reporting requirements for corporations would do much to improve transparency and regulation.<sup>4</sup>

# III A possible solution: transparency through country-by-country and project-by-project reporting requirements

If transnational companies are to be more honest in their tax affairs, their payment flows must be transparent. This can be achieved through country-by-country or project-by-project reporting. Under such a system a group's annual accounts and financial reports would have to contain full information, for all the group's subsidiaries and holdings, of the amount of business transacted, profit generated and tax paid in each country and on each project. This information would indicate whether the amount of tax paid is appropriate in the light of the group's turnover and reported profit and local tax rates or whether the company has deliberately moved its profits to tax havens.

Astonishingly, this information is not usually required by governments and so is not readily available. In consequence it is impossible to obtain details of the financial activities of the world's largest companies in individual countries. Information is particularly difficult to obtain for tax and regulatory havens – but also for countries of the Global South, whose governments are usually neither able nor willing to brush with transnational investors.

Country-by-country and project-by-project reporting could help ensure that TNCs pay their fair share of tax. This could make a major contribution to people's welfare, especially in countries of the Global South. At the same time, these disclosure obligations would be relatively straightforward to introduce.

## What country-by-country and project-by-project reporting discloses

The information that compulsory rules on country-by-country and project-by-project reporting might require transnational companies to disclose in their annual reports could include the following:

- a) "In which countries does a multinational company operate?"
- b) What are the subsidiaries of each multinational corporation called in each jurisdiction in which it operates?
- c) What is the scale of a multinational corporation's operations in each country in which it operates?
- d) How much does a multinational corporation have invested in each place where it trades?
- e) Where does a multinational corporation record its profits?
- f) Where does a multinational corporation pay tax and how much does it pay there?
- g) What is the extent of intra-group trading within multinational corporations?
- h) Where does the company engage staff and how well, on average, do they pay their staff in each jurisdiction in which they work?
- i) Where does a multinational corporation exploit natural resources, and to what extent?"<sup>5</sup>

## Who benefits from country-by-country and project-by-project reporting

In addition to the obvious advantages that it would bring to tax authorities worldwide, country-by-country reporting has other benefits:

- » It makes it easier for the public to hold their government to account because people have more information about the government's revenue; this may include information on transactions outside the official movement of money between corporations and governments (e.g. signature bonuses).
- » The public have a better picture of the value of their country's minerals and the amounts that foreign corporations are paying to extract them. In resource-rich countries the costs of licences and concessions fluctuate disproportionately widely even within the country and are often too low.<sup>6</sup>
- » The public have some idea of whether TNCs are complying with local rules and national legislation. For example, some countries have laws on profit-sharing that specify how local communities should benefit from the profits made by mines in their region. Many companies make no attempt whatsoever to comply with these laws. Project-by-project disclosure is essential if communities are to have a handle that they can use to claim their rights.<sup>7</sup>
- » Country-by-country reporting could help tax authorities identify instances of malpractice by TNCs.
- » The complex structures of TNCs would be made more transparent. Companies whose turnover exceeds the GDP of entire

countries have a correspondingly complex structure. Country-by-country reporting could help untangle these complexities. This would also be beneficial to investors, since it would make it easier for them to understand the workings of the corporation.

- » Better data on the worldwide trade in goods and services would be available. As already mentioned, much of the world's trade takes place within corporations or between

their subsidiaries. Country-by-country reporting obligations would create more transparency in this area.

- » Country-by-country reporting could also provide robust data on the economic significance of tax havens and secrecy jurisdictions.

## IV Ways to implement country-by-country and project-by-project reporting

There are various ways in which country-by-country and project-by-project reporting could be enshrined in law. An ideal mechanism would be a set of global regulations under the umbrella of the United Nations, because this would make comparable, reliable data available and would also ensure that all internationally active corporations are treated the same. However, there is at present no UN body with a mandate to formulate country-by-country reporting obligations for TNCs. Two routes are currently feasible: rules for individual countries (as for example in the USA under the Dodd-Frank Wall Street Reform and Consumer Protection Act) and regional judicial systems (e.g. in the form of EU directives). Here we focus on the latest regulations under the auspices of the European Union and their forthcoming transposition into the legal systems of individual Member States.

### European regulations 1 – Disclosure obligations for companies in the extractive industry

Various plans for expanding corporations' disclosure obligations have been pursued at European level. They include the directives that regulate the disclosure obligations of companies registered on European stock exchanges. Implementation by Member States is compulsory, which means that they effectively apply throughout the EU. The general aim of these directives has been to protect investors and improve market efficiency – not to increase corporate transparency for the general public or for affected communities in the countries in which the companies operate.

In 2011 the European Commission's Internal Market and Services Directorate General prepared two directive amendments containing country-by-country and project-by-project reporting principles for the extractive industry and – for the first time – for forestry companies operating in primary forests. The directives that were amended were the Transparency Obligations Directive,<sup>8</sup> which contains rules for companies quoted on European

stock exchanges, and two Accounting Directives,<sup>9</sup> which also apply to other large companies.

Following the ordinary legislative procedure of the European Union involving the Council of the European Union and the European Parliament, both directives were adopted by the Council and Parliament on 26 June 2013, thereby bringing to an end a long-standing tug-of-war between the European Parliament, the governments of member states and a large number of interest groups. The German government's role in this had for some time tended to be that of brakesman.

Chapter 10 of the directive "on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings"<sup>10</sup>, to which the directive for companies quoted on stock exchanges also refers<sup>11</sup>, contains the disclosure obligations for companies that are "active in the extractive industry or logging of primary forests". The EU directive merely requires the disclosure of payments to governments, specifically:

1. "The total amount of payments made to each government.
2. The total amount per type of payment (see categories below) made to each government.
3. Where payments are attributed to a specific project, the total amount per type of payment made for each project and the total amount of payments for each project. Payments made at entity level such as corporate income taxes should be disclosed at entity level without artificially disaggregating them and allocating them to particular projects.
4. Payments in kind, reported in value and, where applicable, in volume.
5. The government that received the payments."<sup>12</sup>

Under the directive, payments in kind are to be treated in exactly the same way as monetary payments. "Governments" are taken to be national, regional or local authorities and departments, agencies and undertakings controlled by them.<sup>13</sup> Under the term "payments" the directive includes:

1. "Production entitlements: for example, "profit oil" (oil production shared between a company and government once investment and operating costs are recovered through cost oil – the physical oil or revenue used to cover the operator's costs).
2. Taxes levied on the income, production or profits of companies.  
Excluded: consumption taxes such as value added taxes, personal income taxes or sales taxes.
3. Royalties.
4. Dividends.  
Included: dividends paid to a government in lieu of production entitlements or royalties.  
Excluded: dividends paid to a government as a common or ordinary shareholder, provided the dividend is paid on the same terms as to other shareholders.
5. Signature, discovery and production bonuses.
6. Fees including licence fees, rental fees and entry fees, and other payments for licences and/or concessions.
7. Payments for infrastructure improvements."<sup>14</sup>

These disclosure obligations apply not only to the extraction of minerals but also to exploration, prospection and the development of extraction.<sup>15</sup> The materiality threshold set is 100,000 euros. This threshold applies irrespective of whether the payment is made as a single payment or as a series of related payments.<sup>16</sup>

An important point is that, while the directives apply only to European countries, they explicitly cover companies that are quoted on a stock exchange in an EU Member State. This includes in particular the many companies that raise capital on the London stock exchange, such as GlencoreXstrata, "one of the world's largest global diversified natural resource companies,"<sup>17</sup> which is in fact Swiss.

It is now up to the individual Member States to incorporate the directives into their legal systems. The directives permit a certain degree of freedom on some important issues: for example, while companies must report annually, it is left to the Member States to decide on the format they should use. There is thus a risk that a number of different report formats will be used throughout the EU making it more difficult to evaluate and compare the reports. The reporting format (electronic or not? in what file format? independently audited?) plays a significant part in determining the practical usefulness of the information for the general public in the countries in which the commodity companies operate. It is also up to the Member States to specify what sanctions will be imposed for non-compliance with the directives.

The directives entered into force upon publication in the Official Journal of the European Union on 29 June 2013. Member States now have around 24 months to transpose them: the Accounting Directive must be transposed by 20 July 2015 and the Transparency Directive by 27 November 2015. Companies' public disclosure of payments in an annual report is anticipated to begin in 2016 as a number of Member States have committed to timely

transposition of the legislation.<sup>18</sup>

With regard to the scope of implementation, it remains to be seen whether countries will meet their obligations in this field. For example, the new German government has stated in its coalition agreement that the intention is to introduce country-by-country reporting "between the tax authorities of different countries" – which is rather different from the commitment contained in the directive to "make public a report on payments made to governments".<sup>19</sup>

It is also regrettable that the EU Parliament has not been able to assert itself with more far-reaching proposals against the stonewalling attitude of some European governments. For example, in 2012 the responsible Committee on Legal Affairs called for the directives to apply not only to companies active in the extractive industry and forestry but also to telecommunications and infrastructure companies as well as banks.<sup>20</sup> Only for the banking sector this occurred somewhat surprisingly in the shape of a further directive, which was also adopted in 2013.

## European regulations 2 – Disclosure requirements for banks

In the spring of 2013 the EU adopted a further directive containing disclosure requirements for transnational corporations, in this case specifically for financial institutions. The directive "on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms"<sup>21</sup> entered into force upon publication in the Official Journal of the European Union on 17 July 2013. This directive, better known as Capital Requirements Directive (CRD IV), lays down capital requirements for banks in some detail and aims to create "a comprehensive and risk-sensitive framework and to foster enhanced risk management amongst financial institutions".<sup>22</sup>

In Article 89 the directive sets out disclosure obligations for financial institutions. Each institution must "disclose annually, specifying, by Member State and by third country in which it has an establishment, the following information on a consolidated basis for the financial year":

- (a) "name(s), nature of activities and geographical location;
- (b) turnover;
- (c) number of employees on a full time equivalent basis;
- (d) profit or loss before tax;
- (e) tax on profit or loss;
- (f) public subsidies received."<sup>23</sup>

The disclosure obligations are thus considerably more extensive than those for companies in the extractive and forestry industries. They are capable of yielding important information, making it possible to assess, for example, whether the tax paid matches the bank's business activity. Moreover, the directive contains no materiality threshold for payments to be disclosed. This means that banks must disclose even small tax payments; in combination with details of turnover and number of employees, this makes it possible to determine whether the country in question is a tax haven and why the subsidiary of a financial institution is based in a particular country.

The deadlines for submission contained in the directive are also worthy of note: "[...] Member States shall require institutions to disclose the information referred to in paragraph 1(a), (b) and (c) for the first time on 1 July 2014. [...] By 1 July 2014, all global systemically important institutions authorised within the Union, as identified internationally, shall submit to the Commission the

information referred to in paragraph 1(d), (e) and (f) on a confidential basis. [...]"<sup>24</sup> On the basis of this information, the Commission will then submit a report by the end of 2014. From 1 January 2015 onwards all institutions in all Member States must disclose the specified information.<sup>25</sup>

The German government responded very quickly after publication of the directive and by the end of June 2013 had transposed it into German law by means of the CRD-IV Implementation Act (CRD IV-Umsetzungsgesetz). The German Implementation Act refines the CRD-IV Directive by specifying that the information to be disclosed must be published in the form of an annex to the annual financial statement and must be audited in accordance with Section 340 of the German Commercial Code (HGB).<sup>26</sup>

## V Outlook

Standardised rules on country-by-country and project-by-project disclosure obligations for TNCs would make it easier for tax authorities and civil-society organisations, as well as investors and shareholders, to obtain detailed information about a company's activities in a particular country. This could help to ensure that TNCs make a fair contribution to the country's tax revenue – which is an important aspect of people's welfare in the poor countries of the Global South. The greater transparency of payments that will result also has a crucial part to play in the fight against widespread corruption and the human rights abuses associated with it.

The regulations adopted in 2013 could be milestones in this process. The EU Member States are of course free to extend the application of the directives: they could, for example, be extended to other sectors. France has already taken some very interesting steps in this direction. On 5 June 2013 the National Assembly adopted a draft law containing comprehensive country-by-country disclosure obligations for all sectors. It will come into force when appropriate agreement is reached at EU level.<sup>27</sup>

The Tax Justice Network is calling for measures that go even further. As part of its campaign for fundamental reform of the way in which transnational corporations are taxed, it proposes that the uncertainties of transfer pricing be avoided completely by taxing a corporation as a single entity – a method known as unitary taxation. An initial step on the road to comprehensive

reform of this sort could involve tax balance sheets that treat the corporation as a single unit while at the same time dividing operations into the different countries and areas. The Tax Justice Network refers to this as combined and country-by-country reporting (CaCbCR).<sup>28</sup>

However, all the proposals and initiatives that have been described have a common weakness, and that is their governance. There is at present no inclusive body with a remit to act comprehensively and authoritatively on issues of corporate transparency in the interests of the common good of all countries – in the Global North as well as the South. A solution can only be found under the auspices of the United Nations. At present, however, the UN is being marginalised by large and powerful stakeholders in all really important issues of economic policy. It remains to be seen whether governments will take the opportunity to address important structural issues such as more effective transparency obligations for the private sector as part of discussions on the financing of the post-2015 sustainable development agenda and in discourse within the new UN High-Level Political Forum, which has been set up to consider all aspects of sustainable development, including economic aspects.<sup>29</sup>

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