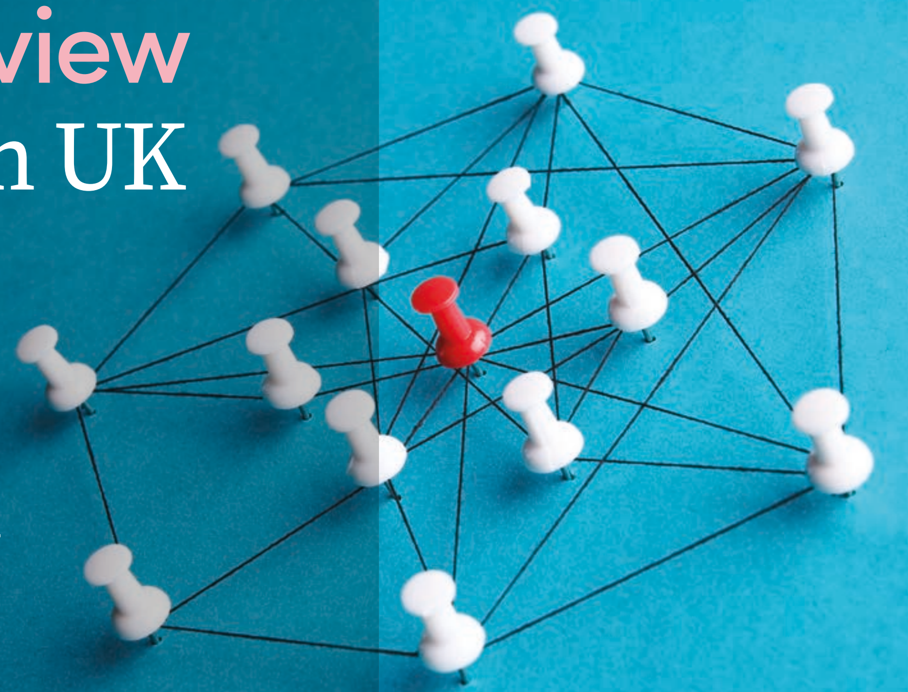
Pillar Two: a practical review

The impact on UK businesses



We provide a back to basics review of Pillar Two, looking at its scope, and how the effective tax rate and top-up tax amount are calculated and charged to tax in the UK.

by Philip Harle and Laura Hodgson

A two-pillar corporate tax reform plan was agreed between OECD members in October 2021. The two-pillar plan forms part of the OECD's project tackling base erosion and profit shifting (or BEPS). Whilst Pillar One is yet to be implemented and key aspects of it will only apply initially to multinational enterprises with annual global turnover above €20 billion, Pillar Two is already in force in many jurisdictions and is expected to have a much wider impact on businesses.

Pillar Two seeks to establish a global minimum corporate tax rate. There are two aspects:

- **Global anti-base erosion rules** ('the GloBE rules'): These rules impose top-up taxes where the effective rate of tax of a multinational enterprise in a jurisdiction is below the global minimum corporate tax rate (15%).
- **The 'subject to tax' rule:** This is a treaty based rule which can be added to treaties with the intent that it is adopted by developing countries. It applies to certain cross-border payments which are subject to a nominal tax rate below 9% in the residence state where source state taxing rights have been ceded under the treaty.

This article focuses on the GloBE rules and their implementation into UK law as the 'multinational top-up tax' regime at Finance (No.2) Act 2023 Part 3. However, given that the UK law follows the GloBE rules, the basic approach is similar in other jurisdictions which have adopted them.

Scope

The UK's multinational top-up tax regime applies to 'qualifying multinational groups'. These are groups which:

- have at least one UK entity;
- operate in at least two jurisdictions (whether through entities or permanent establishments); and
- have revenue which exceeds €750 million in at least two out of the previous four accounting periods.

The only excluded activity is international shipping. An entity will be a member of a group if it is included in the consolidated financial statements of the ultimate parent (broadly, the entity at the top of the group structure). Members of qualifying multinational groups are simply referred to as 'members of the group'.

Excluded entities

There are exclusions for certain entities. The revenue of these entities counts towards the revenue threshold, but an effective tax rate does not need to be computed for these entities, and these entities cannot be charged top-up tax. This is because excluded entities (other than an ultimate parent excluded entity) are not treated as being 'members of the group'.

The following entities are 'excluded entities': governmental entities; international organisations; pension funds; non-profit organisations; investment funds; UK real estate investment trusts (REITs) or overseas REIT equivalents; and certain holding entities. Investment funds and REITs can only be excluded entities where they are the ultimate parent.

Special rules also apply to investment entities. These are: investment funds and REITs that are not excluded entities due to not being the ultimate parent; certain holding entities held by such investment funds and REITs; and insurance investment entities.

How is the effective tax rate and top-up tax amount calculated?

Effective tax rate

Entities in the qualifying multinational group must calculate their income ('adjusted income') and tax ('covered tax balance') in accordance with special rules in the multinational top-up tax regime. Essentially, the regime includes its own stand-alone tax code. These rules are generally simpler than, and thus not an exact match for, domestic tax base calculation rules and may result in an entity being regarded as low-taxed even though it is subject to a headline rate of corporation tax of 15% or above.

Adjusted income: When calculating 'adjusted income', applying the rules at F(No.2)A 2023 Part 3 Chapter 4, the starting point is the entity's income in the consolidated financial statements for the group, from which any deductions for taxes must be reversed and any consolidation adjustments unwound. Then a series of more granular adjustments must be made. For example, any 'excluded dividends' must be removed; all dividends are excluded except portfolio holdings (where members of the group do not in aggregate hold 10% or more interest in the dividend paying entity) which have been held for less than one year as at the vesting date of the distribution. Excluded equity gains or losses (e.g. on a disposal of an interest in an entity in which the group holds an aggregate interest of at least 10%) must also be eliminated.

Covered tax balance: Next, the entity's 'covered tax balance' must be calculated, in accordance with the rules at F(No.2)A 2023 Part 3 Chapter 5. Again, the starting point is the current tax expense reflected in the consolidated financial accounts for that entity. To be taken into account, the tax must be a tax on income, profits or capital, but any Pillar Two tax (e.g. a domestic top-up tax) is excluded and taken into account at a different stage. Various adjustments must be made to this figure; for example, uncertain tax positions and tax on excluded income (e.g. an excluded equity gain) are excluded.

Reallocation: Tax may also need to be reallocated between members of the group. The aim of the GloBE rules is that tax on income should be attributed to the same entity in which that income is located. For example, if a parent entity is subject to tax under a controlled foreign company regime, the tax is reallocated to the controlled foreign company entity (provided that entity is a member of the group).

Timing differences: Timing differences (mismatches between local tax rules and accounting rules) are also taken into account when calculating the covered tax balance. For example, a deferred tax liability is taken into account in the fiscal year in which it is recognised for local tax purposes (increasing the covered tax balance in that year) and then unwinds over following fiscal years (decreasing the covered tax balance in those years). If the deferred tax liability does not unwind within five years, recapture rules apply unless an exception is available.

Jurisdictions: The aggregate adjusted income and aggregate tax covered tax balance is calculated for each jurisdiction, and the aggregate covered tax balance is then divided by the aggregate adjusted income to get the effective tax rate for the jurisdiction. If there are any investment entities or minority-owned entities in the jurisdiction, their effective tax rate is calculated on a standalone basis.

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Top-up amounts

Broadly, if the effective tax rate for a jurisdiction is less than 15%, there usually will be a top-up amount for that jurisdiction.

The top-up amount is calculated by multiplying the 'excess profits' for a jurisdiction by the difference between 15% and the effective tax rate for that jurisdiction. The excess profits are the aggregate adjusted income less a 5% return on the employees and tangible assets in that jurisdiction. For the first ten years that the regime is in force, a higher return applies, starting at 10% for payroll and 8% for tangible assets and tapering down during the period.

This figure is then reduced by any qualifying domestic top-up tax (see further below) for the territory to get the 'total top-up amount'. For UK group members, this is the step that wipes out the multinational top-up tax liability, so that a double Pillar Two tax charge does not arise in relation to that UK entity. The total top-up amount is then apportioned between profitable entities in the jurisdiction in proportion to their adjusted income.

A de minimis election may be made where the group has limited presence in a territory (average revenue in territory is less than €10 million and average adjusted profits for members in that territory is less than €1 million). Where a de minimis election is made, the total top-up amount for a territory for a period is treated as nil.

Additional top-up taxes may also arise, for example where there is a deferred tax liability that did not unwind within five years. This requires the effective tax rate and top-up amount for the previous accounting period to be recalculated. Additional top-up tax is charged under charging mechanisms (in the same way as a top-up amount) in the current accounting period.

How is the top-up amount charged to tax?

It is not necessarily the entity with the top-up amount that will be charged to tax on the top-up amount. There are three possible ways in which the top-up tax amount might be taxed. These rules interact to ensure that the same amount is not charged to tax twice.

1. Qualifying domestic minimum top-up tax (QDMTT)

A country can opt to implement a domestic minimum top-up tax. A domestic top-up tax is an extra tax, levied under domestic tax rules to top-up the effective tax rate on excess profits of entities in a jurisdiction to the minimum tax rate of 15%. Introducing a domestic top-up tax ensures that any top-up tax for that jurisdiction goes to the local tax authority, rather than a tax authority elsewhere. In order to be qualifying under the GloBE rules, the domestic top-up tax must produce outcomes that are consistent with the GloBE rules.

The UK rules: The UK has implemented a domestic top-up tax at F(No.2)A 2023 Part 4; this regime has been recognised as a QDMTT by the OECD. Further detail about the operation of the UK domestic top-up tax regime is set out below.

2. Income inclusion rule (IIR)

Under the IIR, a parent entity is charged to tax in proportion to their percentage interest in the entity with the top-up amount, provided the parent entity is located in a jurisdiction that has implemented an IIR.

The UK rules: To be chargeable to multinational top-up tax (under either the IIR limb or the undertaxed profits rule limb (see below)), a person must be:

- a member of a qualifying multinational group;
- a body corporate or a partnership; and
- located in the UK.

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There is also a back-up provision which applies where a member of the group is not a body corporate or a partnership, which charges multinational top-up tax on the person to whom the profits of that member would be attributed for UK tax purposes.

To be actually charged tax under the IIR, the person must be a 'responsible member'. The ultimate parent will be a responsible member, if it is located in an IIR jurisdiction (and is not an excluded entity). Intermediate parents can also be responsible members. For example, if the ultimate parent was not a responsible member and an intermediate parent member of the group was located in an IIR jurisdiction and held a direct/indirect interest in an entity with a top-up amount, that intermediate parent would be a responsible member (unless the intermediate parent was an excluded entity or there was another intermediate parent that was also subject to Pillar Two tax in the chain above it).

Special rules apply to partially owned parent members: entities that hold a direct/indirect ownership interest in another group member where more than 20% of ownership interests in the entity are held by persons outside the group.

Top-up amounts are then broadly allocated to the responsible member(s) by reference to the responsible member's interest in the entity with the top-up amount. There is also an offset mechanism to prevent double taxation arising from multiple levels of multinational top-up tax charges where there is more than one responsible member in relation to a top-up amount.

3. Undertaxed profits rule (UTPR)

If there is any residual amount of unallocated top-up amounts after the IIR has been applied, the UTPR allocation mechanism apportions this amount between jurisdictions which have both implemented a UTPR and have local tangible assets and/or employees. Jurisdictions can choose whether to collect this tax by way of a denial of a tax deduction or as a separate tax charge, and how to apportion the liability between group entities in the jurisdiction.

The UK rules: As set out above, a person must be chargeable to multinational top-up tax before any charge under the can arise. A member of the group is charged to tax under the UTPR if an untaxed amount (or part of it) is allocated to the group member. Chapter 9A allocates a proportion of the 'untaxed amount' (broadly, an amount that hasn't been allocated under the IIR) to the UK based on the UK's share of the group's employees and/or tangible assets located in jurisdictions that have implemented a UTPR. The default rule is that this 'UK proportion' is then split between UK members of the group based on their share of the UK tangible assets and employees, although groups can elect for one UK member to be allocated the entire UK proportion.

UK domestic top-up tax

The UK domestic top-up tax regime is based on the multinational top-up tax regime, with certain modifications. One important difference is that the domestic top-up tax regime also applies to wholly domestic groups, whereas the multinational top-up tax regime requires presence in the UK and at least one other jurisdiction.

Top-up amounts must be calculated for 'qualifying entities'. An entity is a 'qualifying entity' if:

- it is not a domestic top-up tax excluded entity;
- it is located in the UK; and
- it is either a standalone entity which meets the €750 million revenue threshold or a member of a group which meets that threshold.

The following entities are 'domestic top-up tax excluded entities': excluded

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entities under the multinational top-up tax regime; entities in domestic groups meeting the definition of investment entity or REIT; securitisation companies; standalone investment entities or investment entities that are members of a UK-only group; qualifying asset holding companies that are not members of a multinational group; and qualifying transformer vehicles.

The default rule is that the qualifying entity with the top-up amount is the entity that is charged domestic top-up tax on that top-up amount. However, investment entities that are members of a multinational group cannot be charged domestic top-up tax, meaning such an investment entity's top-up amount can only be charged to UK domestic top-up tax if there is another qualifying member of the group. An annual election can also be made so that one member of the group pays UK domestic top-up tax on behalf of the group.

Safe harbours

There are three safe harbours.

- **Transitional safe harbour:** This safe harbour allows groups to use figures calculated for the purposes of country-by-country reporting to assess whether a top-up amount is likely to arise for a territory. If these simplified calculations indicate that there would be no top-up tax chargeable, the group is treated as having no tax charge and does not have to undertake the full effective tax rate calculations. At least one condition (threshold test, simplified effective tax rate test or routine profits test) must be met and an election must be made to access this safe harbour. It only applies to accounting periods beginning on or before 31 December 2026 and ending on or before 30 June 2028.
- **QDMTT safe harbour:** Certain QDMTTs will be accredited for the QDMTT safe harbour. Where a QDMTT is accredited, group members in the territory covered by the QDMTT may be treated, by election, as having no top-up amounts or additional top-up amounts.
- **UTPR safe harbour:** This safe harbour applies to shelter the profits of the ultimate parent (provided the ultimate

parent jurisdiction has a corporate tax rate of at least 20%). It only applies to accounting periods commencing before 31 December 2025 and ending before 31 December 2026.

Administration

Information return and registration

The Pillar Two information return is a standardised template that provides a tax authority with the information required to calculate a multinational enterprise group entity's tax liability under the Pillar Two rules.

The default rule is that each entity in the group has to submit an information return in the jurisdiction where it is located. However, entities are discharged from this obligation if the ultimate parent or a designated filing entity submits such an information return, and the filing jurisdiction has a bilateral or multilateral agreement for the automatic exchange of information returns with the local competent authority.

Information returns must usually be filed within 15 months of the end of the financial year in question. For the first year that Pillar Two rules are in force, the filing deadline is extended to 18 months. For a group with a calendar financial year, the information return for the 2024 period must be filed by 30 June 2026. The filing member must also register with HMRC within six months of the end of the first accounting period in which the group is a qualifying multinational group.

Payment of taxes

The payment dates for multinational top-up tax and UK domestic top-up tax are aligned with the information return filing dates.

If a member of a group has not paid multinational top-up tax/UK domestic top-up tax within three months of the 'relevant date' (usually the due date, althought this could be a later date in the case of enquiries, etc.), HMRC can issue a 'group payment notice', requiring payment of the tax, to any person who was a member of the same group as the entity with the primary liability in the accounting period to which the amount payable relates.

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