Over 130 countries have joined the Pillar Two agreement (the Global Anti-Base Erosion Proposal, or ‘GloBE’) to reform international corporate taxation rules. The aim of the Pillar is to ensure that multinationals (MNEs) pay a minimum effective tax rate of 15%. The countries of the Inclusive Framework aim to apply this global minimum rate of tax to MNEs as early as 2023. The detailed framework of the rules has now been published and UK consultation on the detailed implementation of the rules is expected to follow.

The general perception is that Pillar Two simply compares local jurisdictional tax rates to the global minimum ETR of 15%. Whilst directionally this is correct, the Pillar Two framework is in fact a highly complex set of rules that can result in some unforeseen outcomes.

The tables below set out an overview of the Pillar Two rules and some of the potential consequences that groups may not necessarily anticipate in the first instance.

MNEs will have to work through the detailed rules and apply them to their particular facts and circumstances. Modelling may be key, particularly where internal stakeholders such as the C-suite request views on the possible impact of Pillar Two on the group, given that most groups’ planning/forecasts extend to 2023/2024 and beyond.

### Which businesses are in scope?

All multinational enterprises with global turnover above EUR750m are within scope of the rules with the exception of those within the pension, investment fund and international shipping services exclusions.

### How are the Pillar Two rules intended to work?

Ultimately this will depend on the domestic legislation implementing the agreed OECD framework. However, the high level overview below outlines the broad concepts of Pillar 2 which will underpin the domestic legislation. It should be noted that we understand a phased approach is to be taken to the rules with the Income Inclusion Rules (IIR) being adopted initially (in 2023) and the Under Taxed Payment Rule (UTPR) to follow (in 2024). The overview below covers both sets of the rules.

#### Overall design of Pillar Two

- Two interlocking domestic rules: (i) Income Inclusion Rule (IIR) and (ii) Undertaxed Payment Rules (UTPR) collectively called Global anti-Base Erosion Rules (GloBE) rules. The GloBE rules have the status of a ‘common approach’, meaning that whilst it is not mandatory to implement them, if a State chooses to, it must follow the framework.
- A treaty based Subject to Tax Rule (STTR).

#### Scope of the rules

- The rules are intended to establish a global minimum tax rate of 15%. The rules operate where the effective tax rate for a jurisdiction is below the agreed minimum of 15%. The new system will top up the tax liability so that the overall rate will reach the established minimum in each jurisdiction where the taxpayer operates.
- The rules apply to MNE groups with consolidated revenue of c.€750m.
- Ultimate Parent Entities (UPEs) of a non-profit organisation, pension funds/investment funds and government entities or any holding vehicle used by such entities, organisation or funds are excluded from the rules.
- There will be certain administrative simplifications in part based on CbCR data but these are still to be defined.
Subject to Tax Rules (STTR) | Income Inclusion Rule (IIR) | Under-Taxed Payment Rule (UTPR)
--- | --- | ---
- The STTR is a treaty-based rule that allows a source state (that is also a developing economy) to apply additional tax up to an agreed minimum rate (9%) on certain related party payments subject to a nominal tax rate below 9% in the hands of the recipient in a developed economy.
- Covered payments will likely include for example royalties, interest etc.
- Additional tax paid under the STTR rules is taken into account when calculating the GloBE ETR.
- The application of the STTR will be restricted to double tax treaties between developing economies and developed economies.
- A model treaty provision is expected during 2022.
- IIR takes precedence over the UTPR rules.
- The UPE’s jurisdiction has the first right to apply the IIR rules. If the UPE’s jurisdiction does not apply the IIR rules, then an intermediate parent jurisdiction may apply the rules.
- The UPE pays the top-up tax in respect of low tax entities similar to Controlled Foreign Company (‘CFC’) rules.
- It is still to be decided which regimes (e.g., US GILTI) will be regarded as IIR compliant.
- Option to apply a Domestic Minimum Top-up Tax which will essentially switch off other jurisdictions IIR’s and UTPR’s.
- Entities in a jurisdiction with a UTPR pay top-up tax in respect of entities in a low tax jurisdiction by disallowing deductions or other similar mechanisms.
- Top up tax to be collected under UTPR is allocated amongst the UTPR jurisdictions based on the share of total employees and tangible assets.
- UTPR rules switched off if the UPE applies a qualified IIR rule regime.
- Small MNEs (i.e., those operating in no more than 6 jurisdictions and with tangible assets of a maximum of EUR50m in 5 of those jurisdictions) will not be subject to the UTPR for the first 5 years after they come within scope of the GloBE rules for the first time.
- To come into effect a year later than IIR (currently proposed for 2024).

### Effective Tax Rate (‘ETR’)
- A top-up tax will be imposed under GloBE rules. The top-up tax will be calculated using an effective tax rate test. The ETR will be calculated on a jurisdictional basis using a standard definition of covered taxes and a tax base. ETR will be calculated as follows: Total Covered Taxes/Total GloBE Income for jurisdiction.
- The minimum tax rate used for the purposes of the GloBE rules will be 15%.
- The top up tax calculation is the same for both IIR and UTPR (they are simply the collection mechanisms).

### GloBE income
- GloBE income is calculated by reference to the financial accounting income (using the accounting standard of the parent entity; IFRS or other acceptable GAAP).
- Certain adjustments are made to the GloBE income, including adjusting for:
  - Non arm’s length transactions between the constituent entities in the group.
  - Stock based compensation (where the tax deduction is different from the accounting expense).
  - Dividends or gains (or loss) related to non-portfolio holdings are excluded (as they are generally subject to a participation exemption).

### Covered taxes
- Basic rule is to include taxes accrued in respect of profits. CFC charges and taxes on distributions will be allocated to the entity with the underlying profits. There will be specific rules dealing with transparent entities and reverse hybrids to ensure income and covered taxes are matched up and allocated to the same jurisdiction.
- Taxes paid under a STTR will be taken into account.

### Substance carve out
- A formulaic substance carve-out from the GloBE income, calculated based on an initial mark-up of 10% on payroll costs and 8% on the carrying value of tangible fixed assets (but excludes any held for sale, investment or lease), both declining to 5% in 10 years.
- The substance carve out will be subtracted from GloBE income before calculating the top up tax due.

### Timing differences
- In general, deferred tax is included but recast at lower of relevant domestic rate and 15%. Various adjustments are made in relation to deferred tax.
- With certain exceptions, timing differences that only reverse over a long period of time (e.g., greater than 5 years) may not be included (so they will be treated as permanent differences).
We set out below a list of some of the consequences that emerge when applying the Pillar Two Framework to common scenarios. Not all of these are necessarily immediately apparent when considering Pillar 2 at a conceptual level. This is by no means an exhaustive list. It is not a substitute for a detailed review of a group’s specific facts and circumstances, but is a clear demonstration of why early review of the Pillar Two Framework is critical.

### What are the likely consequences for business in scope?

<table>
<thead>
<tr>
<th>Issues</th>
<th>Explanation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue recognition GAAP differences</td>
<td>Revenue recognition GAAP differences may result in jurisdictional ETR below the 15% threshold. To the extent these differences are timing differences then they may be dealt with – see discussion below. To the extent, however, they are permanent or quasi permanent (i.e. timing differences that take a long time to reverse) then they may not be addressed. This is because adjustments made to accounting profits to get to GloBE income are very limited (e.g., for dividends or gains/losses on share disposals which typically benefit from participation exemptions).</td>
</tr>
<tr>
<td>Indefinite life intellectual property (e.g., brands)</td>
<td>Where indefinite life intellectual property (e.g., brands) is amortisable for tax purposes, this may lead to a depressed jurisdictional ETR as the related deferred tax charge is not expected to reverse within the defined period (5 years). See discussion on timing differences.</td>
</tr>
<tr>
<td>Location of existing functions/assets/business services and operations</td>
<td>There will be a formulaic substance based carve out for the purposes of calculating the jurisdictional top up tax. GloBE income will be reduced by a fixed percentage of payroll costs and tangible assets. Hence, the carve out will be very dependent on the location of fixed assets and employees.</td>
</tr>
<tr>
<td>Treatment of timing differences</td>
<td>Deferred tax is included within covered taxes but is to be computed at the lower of the relevant domestic rate and 15% (which could result in top up tax becoming due in respect of otherwise high tax locations when brought forward losses are being utilised). In addition, there will be various adjustments to deferred tax including the exclusion of certain timing differences that do not reverse within 5 years giving rise to difficulties such as the one noted above for indefinite life intangibles. Deferred tax relating to brought forward, pre-regime losses, is to be taken into account at the start of the application of the rules with limited adjustments but again recalculated at the lower of the domestic rate or 15%.</td>
</tr>
<tr>
<td>Future investment decisions</td>
<td>The effect of Pillar Two may impact investment decisions (e.g., cost of capital) and viability of possible future investments as it may impact post-tax cashflows.</td>
</tr>
<tr>
<td>Increased compliance burden</td>
<td>A significant, additional compliance burden will accompany Pillar 2 because of the specific reporting obligations. It is understood that some simplifications (based in part on CBCR data) will be introduced for the purposes of the GloBE calculations. However, the exact details of these are not yet available.</td>
</tr>
<tr>
<td>ERP system capabilities</td>
<td>ERP systems will need to be capable of providing the data for calculating and forecasting ETR on a jurisdictional basis.</td>
</tr>
<tr>
<td>Innovation/patent boxes</td>
<td>There is no exclusion for common and generally accepted features of tax regimes such as innovation/patent boxes when calculating jurisdictional ETR.</td>
</tr>
<tr>
<td>Notional interest deductions (NID)</td>
<td>Similarly to the other generally accepted tax regimes noted above, there is no exception for NIDs when calculating jurisdiction ETR.</td>
</tr>
</tbody>
</table>
Key contacts

Jonathan Hare
M: +44 (0)7740 966888
E: jonathan.hare@pwc.com

Ed Dempster
M: +44 (0)7786 511973
E: edward.dempster@pwc.com

Matthew Ryan
M: +44 (0)7718 981211
E: matthew.a.ryan@pwc.com

Giorgia Maffini
M: +44 (0)7483 378124
E: giorgia.maffini@pwc.com