International

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Tax Challenges Arising from the Digitalization of the Economy: The Calculation of the Effective Tax Rate – Pillar Two versus Financial Accounting

Under Pillar Two, the OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting members have agreed to enact a jurisdictional-level minimum tax system with a minimum effective tax rate of 15%. Multinational enterprises and EU-based large-scale purely domestic groups with (global) consolidated turnover above EUR 750 million will be within the scope of Pillar Two. In this article, the authors discuss the relevant rules for calculating the effective tax rate (ETR) under Pillar Two. Subsequently, the authors will compare these rules with the rules that are applied to calculate the ETR under financial accounting. The main aim of this article is to set out the key differences between the ETR calculation under Pillar Two and financial accounting. For the comparison, the authors take the International Financial Reporting Standards (IFRS) as the applicable accounting standard under financial accounting.

1. Introduction

Today one of international taxation's greatest challenge lies in the tax challenges arising from the digitalization of the economy. This is exactly why the Organization for Economic Co-operation and Development (OECD) – as a result of its work following the Base Erosion and Profit Shifting (BEPS) Action 1 – initiated a plan that (can) have a major impact on (international) taxation and the accounting thereof. This is the reason why – although still a work in progress and further and relevant OECD documentation is still becoming available – the authors believe it is warranted to discuss it already and provide the reader with a sound understanding of the OECD's pillar plans and potential consequences. The authors focus in this article on the tax accounting consequences of especially Pillar Two and its respective top-up tax.

As of October 2021, over 135 countries and jurisdictions have joined a new two-pillar plan to reform international taxation rules and ensure that multinational enterprises pay a fair share of tax wherever they operate.

The reason(s) for this new two pillar system is relatively simple. It is now becoming increasingly clear that the current and nearly 100-year-old (international) tax system – in its current form – no longer functions properly. In principle, this system is in line with the physical presence of companies: taxation also takes place where the company is established. For the levy of taxes on the profit, the supply side is used instead of where the market is located (the demand side).

In the pre-war economy, where the vast majority of goods and services were produced for the national market, such a basic assumption made sense. Cross-border companies – if there were any – were not yet working with centrally-driven business models. In fact, communication technology and physical distances made this impossible. To the extent that these companies did operate across borders, they had completely independent operating companies in the various jurisdictions. A profit allocation focused on the supply side was therefore appropriate for the business model.

However, 100 years later in the current era of 'elusive' internet giants, centralized and massively operating across national borders, the above no longer applies. The business model is no longer appropriate for a supply-side profit allocation. The view that the current system should be revised is therefore becoming increasingly widespread.

In addition, with the rise of the globalized economy, tax avoidance and evasion are an increasingly serious problem. Anti-abuse measures, national and international, have been introduced in recent decades. The OECD BEPS Project and the European Union's Anti-Tax Avoidance Directives have recently brought international reforms, but the end is probably far from in sight.

The most recent OECD proposals are to distribute tax revenue more fairly (through the so-called Pillar One proposal) and to levy tax more fairly by introducing a minimum profit tax (through the Pillar Two proposal).

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Although 140 countries are members of the OECD Inclusive Framework (IF) and it is therefore an enormous challenge to achieve political agreement on the details of the reform of the international corporate tax system, 137 countries (as of 4 November 2021) reached a historic agreement on Pillar One and Pillar Two.

1.1. Pillar One – A fairer distribution of tax rights

The aim of Pillar One is to achieve an adjustment of the international corporate tax system whereby profits and tax rights are allocated to the jurisdictions where companies carry out activities. These are the so-called market jurisdictions. As a result of the digitization of the economy, it is no longer necessary for companies to have a physical presence in every jurisdiction, i.e., an entity or permanent establishment from which the activities are carried out. As a result, in recent years a discrepancy has arisen between where activities are carried out, where profits are made and where companies are taxed.

Under Pillar One's so-called "unified approach", it is sufficient for a company to make turnover in a certain jurisdiction for the allocation of taxing rights. In short, Pillar One focuses on multinational companies with a global turnover of more than EUR 20 billion and a profitability of more than 10% (the profit before tax divided by the turnover, the 'residual profit'). EncoPol Europe expects that less than 80 multinational companies will be affected by Pillar One. Depending on a successful implementation, the turnover threshold could be lowered to EUR 10 billion after seven years. As a result, only the largest and most profitable companies will fall under Pillar One. Exceptions are proposed for companies engaged in regulated financial services and natural resources (currently subject to consultation).

The exact interpretation of the reallocation of tax rights under Pillar One is still subject to a political compromise. Based on the Pillar One Blueprint and the statement of the IF of 1 July 2021,[1] the taxing rights are allocated on the basis of two components:

- Amount A: a new taxing right for market jurisdictions to which a portion of a company's non-routine profit is allocated.
- Amount B: a standard fee for routine marketing and distribution activities based on the well-known arm's length principle (ALP).

In this article, the authors will not further discuss the technical details around (and calculations of) Amount A and B and the possibilities for the avoidance of double taxation in this contribution. As said, the authors focus on the (in their view) more interesting and (potentially) more impactful part of the two-pillar plan and that is that of the minimum taxation called Pillar Two.

1.2. Pillar Two – A minimum profit tax

Where Pillar One focuses on the redistribution of tax rights between countries, Pillar Two focuses on combating residual base erosion and profit shifting (the so-called Global Anti-Base Erosion, GloBE) by introducing an (effective) minimum profit tax of 15%. Although the OECD has not previously expressed an explicit opinion on the level of the minimum rate, most countries within the Inclusive Framework (IF) have now supported the agreement on the introduction of a worldwide minimum rate for profits tax of 15%.[2]

The purpose of Pillar Two is twofold. First, Pillar Two aims to make it less attractive for companies to shift profits to low-tax jurisdictions. In addition, Pillar Two must stop the so-called "race to the bottom". The latter has to do with the situation where countries compete with each other on their corporate tax rate to ensure that they retain the companies already established in their country and attract new companies.

Pillar Two aims to ensure that multinational companies always pay a minimum level of profit tax. If a multinational company has to be taxed effectively at a minimum rate, it is no longer attractive for countries to continue with mutual tax competition (at least not below the minimum rate to be determined). To achieve this minimum level, the OECD has introduced a 15% minimum profit tax accompanied by two interlocking domestic rules (together commonly referred to as the GloBE rules).

The Income Inclusion Rule (IIR) is Pillar Two's primary rule, flanked by other measures to ensure that the IIR can come into its own. The precise interaction and ranking depends on political consensus and the precise design of the measures. It is essential that double taxation is avoided as much as possible.

The IIR includes an additional levy at the level of the (ultimate) parent company if and insofar as the ETR of the subsidiary (or permanent establishment) is below the minimum rate. It is assessed per jurisdiction whether or not the subsidiary in that country complies with the effective minimum rate (in other words, the so-called per-jurisdiction approach). In fact, this additional tax principle already exists in the current controlled foreign company (CFC) provision (resulting from the first BEPS Project) that deals with passive income, such as interest and royalties. With the introduction of the IIR, active income is also brought under the scope of the additional tax mechanism.

Next to the IIR, a so-called "undertaxed payment rule" (UTPR) has been introduced. The UTPR acts as a backstop to the IIR. Under the UTPR, any remaining top-up tax of a low-taxed entity that has not been captured under the IIR is allocated (proportionally) to entities that are a member of the same MNE group as the low-taxed entity (UTPR taxpayers) under a formula that is based on the relative proportion of employees and tangible assets in each jurisdiction.

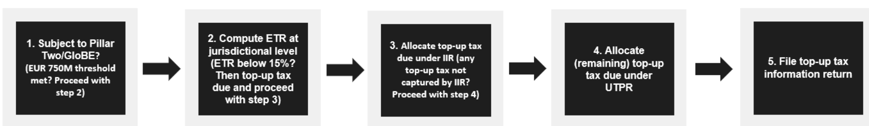
1. OECD, Statement on a Two-Pillar Solution to Address the Tax Challenges Arising From the Digitalisation of the Economy (OECD 2022), available at https://www.oecd.org/tax/beps/statement-on-a-two-pillar-solution-to-address-the-tax-challenges-arising-from-the-digitalisation-of-the-economy-july-2021.pdf.
2. J. Rond et al., *Internationaal fiscaal stelsel na 100 jaar toe aan verandering*, PwC Spotlight 2021 3rd edition, pp. 27-34 (2021).

Both the IIR and UTPR will only apply in group relationships. It has been proposed to align the GloBE rules as much as possible with the principles already in force for country-by-country (CbC) reporting, such as the turnover threshold of EUR 750 million. Pillar Two introduces an effective minimum profit tax, which means that, in addition to the minimum rate, consensus must also be reached on a somewhat common base determination. Financial reporting (such as IFRS or US GAAP) can serve as a basis for determining the tax base. Where the market approach in Pillar One is an unprecedented "game changer", the choice to no longer take the taxable profit, but commercial profit, as the starting point for the tax base is in Pillar Two.

In the precise design of Pillar Two, both the feasibility of the rule and the shaping of the measure in line with the objective are important. In light of this, it has therefore been suggested to exclude certain sectors from the minimum profit tax. Examples include excluding government enterprises, non-profit organisations and investment and pension funds.

As said in the introduction to this section, the authors believe that the (possible) introduction of the two-pillar system and especially the introduction of Pillar Two (can) have a major impact on (international) taxation and the accounting thereof. Without going into too much detail, the, in the authors' view, complex rules and required calculations to determine whether or not a top-up tax is due – if it is determined that the minimum percentage is not met – create a whole new world of GloBE accounting rules. To illustrate these new rules and the general mechanics of Pillar Two, a five-step process overview of Pillar Two has been included in Figure 1.

Figure 1 – General overview of Pillar Two



Pillar Two introduces a jurisdictional-level minimum tax system with a minimum ETR of 15%. Multinational enterprises (MNEs) and EU-based large-scale purely domestic groups with (global) consolidated turnover above EUR 750 million are within the scope of Pillar Two (step 1).

If an MNE group is within the scope of Pillar Two, an ETR should be in principle calculated for each jurisdiction in which the MNE group is active. If the ETR for a certain jurisdiction is below the minimum rate of 15%, then a top-up tax is in principle due (step 2).

Pillar Two consists of two domestic interlocking rules to allocate the top-up tax due within the MNE group. The primary rule is the IIR. The IIR works by imposing a top-up tax on a parent entity in respect of the low-taxed income of group entities. The IIR applies on a top-down basis, which means that it is applied by the entity that is at, or near, the top of the ownership chain in the MNE group. In general, the top-up tax will be allocated to and levied at the level of the ultimate parent entity (UPE) (step 3).

It could be the case that the top-up tax due as determined under step 2 is not fully allocated under the IIR. For these cases, the UTPR will apply. Under the UTPR, any remaining top-up tax of a low-taxed entity that has not been captured under the IIR is allocated (proportionally) to entities that are a member of the same MNE group as the low-taxed entity under a formula that is based on the relative proportion of employees and tangible assets in each jurisdiction. The UTPR acts in essence as a backstop to the IIR (step 4).

Pillar Two also introduces new filing obligations. Information that is used to compute the Pillar Two ETR and corresponding top-up tax has to be disclosed in a so-called top-up tax information return. This return has to be filed with the tax authorities no later than 15 months after the last day of the fiscal year (step 5).

In the following sections of this article, the authors will discuss each step in more detail. The primary focus in this article will be on step 2 – the calculation of the Pillar Two ETR – because the authors believe it will be predominantly this step that will result in the most questions and complexities. The main reason being that the relevant rules for calculating the ETR under Pillar Two differ (significantly) from the rules that are applied to calculate the ETR under financial accounting.

Note: This article does not purport to address Pillar Two in full detail. This article is based on information available up to 31 August 2022 and includes details of the Pillar Two Blueprint dated October 2020 [3] *(Pillar Two Blueprint), GloBE Model Rules dated 20 December 2021* [4] *(GloBE Model Rules), the draft Pillar Two EU-Directive dated 16 June 2022* [5] *(Pillar Two EU-Directive) and the Pillar Two Commentary dated 22 March 2022* [6] *(Pillar Two Commentary).*

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3. OECD, *Tax Challenges Arising from Digitalisation – Report on Pillar Two Blueprint: Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project (OECD 2020) [hereinafter Pillar Two Blueprint], available at https://doi.org/10.1787/abb4c3d1-en.
4. OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS* (OECD 2021) [hereinafter GLoBE Model Rules] available at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two.htm.
5. European Commission, Draft Council Directive on ensuring a global minimum level of taxation for multinational groups in the Union, 16 June 2022, [hereinafter Draft Pillar Two EU-Directive] available at https://data.consilium.europa.eu/doc/document/ST-8779-2022-INIT/en/pdf

2. Scope

MNEs with an annual global consolidated revenue above EUR 750 million in at least two of the four fiscal years immediately preceding the tested fiscal year will be within the scope of Pillar Two. In addition, so-called large-scale purely domestic groups in an EU Member State that meet the aforementioned revenue threshold will also be within the scope of Pillar Two.[7] The latter is implemented in order to ensure compliance with the fundamental freedoms of the European Union.

Entities that are excluded from Pillar Two are government entities, international organisations, non-profit organisations, pension funds, investment funds and real estate investment vehicles which are ultimate parent entities of a MNE group (so-called "excluded entities"). Pillar Two also includes an exception for constituent entities (i.e., entities that are part of an MNE group or a large-scale purely domestic group. Hereinafter: CE) that are largely investment or ancillary vehicles whose shares are predominantly held by excluded entities.[8] For the latter group of entities, Pillar Two provides for an election not to treat such entities as an excluded entity. This election is a five-year election and has to be specified in the so-called top-up tax information return that has to be filed with the local tax authorities (*see* section 6.).

Elective GloBE safe harbour rules have also been announced to reduce administrative burdens, where particular operations of an MNE are almost certain to be taxable above the minimum rate of 15%. These rules will be further established as part of the work undertaken by the IF to develop the GloBE Implementation Framework. The GloBE Implementation Framework will facilitate the coordinated implementation and contains administrative guidance of the Pillar Two rules and is expected to be published at the end of 2022.

3. The Calculation of the Jurisdictional Effective Tax Rate

3.1. Introduction

If an MNE group falls within the scope of Pillar Two, it should first calculate the ETR of each jurisdiction in which the MNE operates. Pillar Two provides for an election to apply the so-called "de-minimis exclusion" where jurisdictions with average revenues and profits (both determined pursuant to Pillar Two standards for the current and the two preceding fiscal years) below EUR 10 million and EUR 1 million respectively are excluded from the ETR calculation.[9] This election is a one-year election and has to be specified in the Top-Up Tax Information Return that has to be filed with the local tax authorities (*see* section 6.).

Unlike the ETR that is calculated under the financial accounting standards (which is usually calculated at entity or consolidated level), Pillar Two prescribes that the ETR should be calculated at a jurisdictional level. Hence, Pillar Two has its own ETR concept, which is further illustrated hereafter.

Under Pillar Two, the ETR is determined by dividing the amount of adjusted covered taxes (i.e., the Pillar Two total tax amount) by the amount of net qualifying income (i.e., the Pillar Two tax base). First, both determinants have to be calculated for each CE separately. Subsequently, the adjusted covered taxes and qualifying income of the CEs located in the same jurisdiction are aggregated to arrive at the jurisdictional adjusted covered taxes and net qualifying income. Dividing both jurisdictional amounts then gives the Pillar Two ETR (jurisdictional ETR). The aforementioned can be illustrated by the following equation:

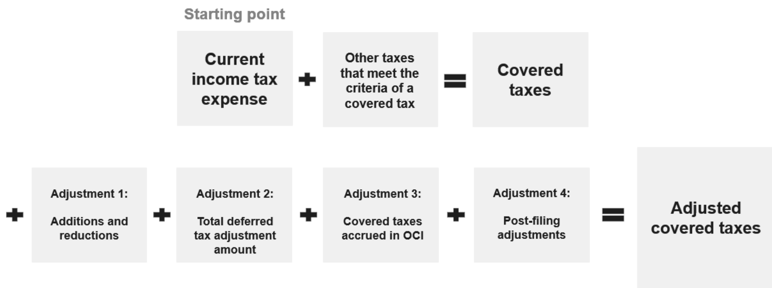
$$\text{Jurisdictional ETR} = \frac{\text{Aggregated adjusted covered taxes in jurisdiction (numerator)}}{\text{Aggregated net qualifying income in jurisdiction (denominator)}}$$

6. OECD, *Tax Challenges Arising from the Digitalisation of the Economy – Commentary to the Global Anti-Base Erosion Model Rules (Pillar Two)* (OECD 2022) [hereinafter Pillar Two Commentary], available at https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf
7. Art. 2 para. 1 Draft Pillar Two EU-Directive.
8. Id., at art. 2 para. 3.
9. Id., at art. 29.

3.2. Adjusted covered taxes (Chapter IV Directive)

Pillar Two introduces its own tax classification. Taxes that are regarded for Pillar Two purposes are presented as so-called “covered taxes”. To arrive at the adjusted covered taxes, four major sets of adjustments have to be made on the covered taxes. The relevant steps to compute the adjusted covered taxes (numerator) under Pillar Two is summarised and illustrated in figure 2.

Figure 2 – High-level overview adjusted covered taxes



3.2.1. Covered taxes

The starting point is to take the current tax expense accrued in the financial accounting net income or loss of the relevant CE. Under Pillar Two, the following taxes are considered as covered taxes: (i) any tax amount recorded in the financial statements with respect to an entity’s income or profits; (ii) taxes on (deemed) distributed profits; (iii) any taxes imposed in lieu of a generally applicable income tax; and (iv) taxes on retained earnings and corporate equity.[10]

Taxes resulting from Pillar One and the so-called “subject to tax rule” (STTR) are also considered as covered taxes for Pillar Two purposes (i.e., both taxes increase the numerator of the jurisdictional ETR). The STTR is a treaty-based rule within Pillar Two that would apply to royalties, interest, and other defined payments (covered payments) made by a CE located in a developing country to another CE located in an IF member state that applies a nominal corporate tax rate lower than a minimum STTR rate of 9% on the payment. The effect of the STTR will be to allow the payer jurisdiction to apply a top-up tax for the difference between the STTR minimum rate of 9% and the (lower) tax rate that would otherwise apply to the payment. The STTR is reduced by the amount of withholding tax (WHT) that is already levied under a double tax treaty. Therefore, the STTR is expected to have a limited tax impact in practice.

Pillar Two also prescribes several rules on the allocation of covered taxes to the several jurisdictions. Taxes that may require allocation include CFC taxes, distribution taxes and taxes in respect of a permanent establishment, tax transparent entity or a hybrid entity.

3.2.1.1. Comparison with financial accounting

The definition of covered taxes includes taxes levied in lieu of a generally applicable corporate income tax. The “in lieu of” part includes taxes that are not covered under the generally applicable income tax definition, but which operate as substitutes for such taxes. As an example, Pillar Two mentions tonnage taxes that use income earning capacity as a proxy for income and are designed to act as a substitute for corporation tax.[11] The definition of taxes is therefore broader under Pillar Two.

Secondly, the authors would like to point out that the STTR tax is in essence a top-up tax/additional WHT on covered payments (e.g., interest and royalties) that is ultimately borne by the recipient entity. From a tax accounting perspective, it should be considered whether these taxes are within the scope of IAS 12.[12] IAS 12 is silent on the treatment of WHTs related to interest and royalties in the recipient’s financial statements. If a reporting entity has determined that the WHT is within the scope of IAS 12, it should present the WHT on the income tax line in the profit and loss (and hence the WHT will be taken into account as taxes in the calculation of the financial accounting ETR). If a reporting entity has determined that it is not an income tax, the WHT is presented above the income tax line (e.g., as operational expenses and hence it will not be taken into account as taxes in the calculation of the financial accounting ETR). Under Pillar Two, it is not relevant whether the STTR tax is recorded above or on the tax expense line as it is always considered as a covered tax. As such, the STTR tax will be included in the computation of the jurisdictional ETR.

10. Id., at art. 19.
11. Para. 111 Pillar Two Blueprint.
12. The standard that governs income taxes within IFRS is IAS 12.

Another important difference between Pillar Two and financial accounting relates to the allocation of covered taxes incurred by certain types of CEs, amongst others (i) WHT on dividend distributions and (ii) CFC taxes. Under Pillar Two[13], the WHT related to dividend distributions is considered as a covered tax at the level of the distributing entity, while under IFRS[14] the WHT is considered as an income tax at the level of the recipient. With respect to CFC taxes, these are considered as a covered tax at the level of the CFC entity itself under Pillar Two[15], while under financial accounting these taxes are included as part of the income tax in the financial statements of the parent entity that owns the shares in the CFC entity. The rationale behind these allocations under Pillar Two is that in general, the distributing and CFC entity is the one that originally generated the income. Under Pillar Two, covered taxes should be allocated to the tax jurisdiction of the entity that originally generated the underlying income.

3.2.2. Adjustment 1: Additions and reductions

After having determined the total amount of covered taxes of the relevant CE, four major sets of adjustments have to be made on the covered taxes. The first set of adjustments to be applied pertains to several additions and reductions to the amount of covered taxes.

3.2.2.1. Additions to the amount of covered taxes:

Pursuant to article 20 paragraph 2 of the draft Pillar Two EU-Directive, the covered taxes should be increased by the following:

- any amount of covered taxes accrued as an expense in the profit before taxation in the financial statements;
- any amount of qualifying loss deferred tax asset (DTA) utilized (further discussed in section 3.2.3.5.);
- covered taxes related to an uncertain tax position (UTP) that were treated as a reduction (see hereafter) in a prior year, but is paid in the current fiscal year; and
- any amount of credit or refund in respect of a qualified refundable tax credit (i.e., a refundable tax credit that will be received in cash/ cash equivalents within four years from the moment an entity satisfies the conditions for receiving the credit) that is recorded as a reduction to the current tax expense.

3.2.2.2. Comparison with financial accounting

Under financial accounting, a clear distinction is made between the presentation of income taxes (presented on the income tax line) and other taxes (presented above the income tax line, e.g., as operational expenses). Only taxes presented on the income tax line are taken into account in the calculation of the financial accounting ETR (as also mentioned in section 3.2.1.1.). Under the first addition, any amount of covered taxes accrued as an expense in the profit and loss should be taken into account in the calculation of the jurisdictional ETR, regardless of whether it is accrued on or above the income tax line. This will lead to an increase of the administrative burden of companies as any amount of covered taxes that is accrued as an expense in the profit and loss (so not only the amounts recorded on the income tax line) have to be traced and taken into account as covered taxes in the calculation of the jurisdictional ETR.

From the third addition, it can be derived that current tax expenses which relate to an UTP may be only included in covered taxes unless and until the amount is actually paid. Under financial accounting, a current tax expense related to UTPs (regardless of whether it is paid or not) is considered as an income tax and is therefore always included in the computation of the financial accounting ETR.

Pursuant to the fourth addition, any amount of refund or equivalent credit in respect of a qualified refundable tax credit that has been recorded as a reduction to current tax expense (i.e., current tax benefit) in the profit and loss is added back to the covered taxes under Pillar Two. At the same time, the full amount of the refund or credit will be treated as income in the calculation of the qualifying income (see section 3.3.2.1.). The aforementioned adjustments will have a positive impact on the jurisdictional ETR. The rationale for this rule is that Pillar Two considers qualified refundable tax credits as equivalents to government grants that form part of income, given that they are in effect government support for a certain type of activity that can ultimately be received in cash or cash equivalent.[16] As such, the fourth addition will not apply if the refund or credit is already recorded as an income above the income tax line (e.g., as operational/other income) in the profit and loss. Under financial accounting, these refunds or credits will be taken into account in the calculation of the financial accounting ETR if these are recorded on the income tax line.

3.2.2.3. Reductions to the amount of covered taxes

Pursuant to article 20 paragraph 3 of the Pillar Two EU-Directive, the covered taxes should be reduced by the following:

- the amount of current tax expense with respect to income excluded from the computation of the qualifying income;

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13. Art. 23 para. 5 Draft Pillar Two EU-Directive.
14. IAS 12, para. 2.
15. Art. 23 para. 3 Draft Pillar Two EU-Directive.
16. Ch. 3 paras. 110-114 Pillar Two Commentary.

- any amount of credit or refund in respect of a non-qualified refundable tax credit that was not recorded as a reduction to the current tax expense;
- any amount of covered taxes, except for any qualified refundable tax credit, refunded or credit that was not treated as an adjustment to current tax expense in the financial accounts;
- current tax expense related to UTPs; and
- any amount of current tax expense that is not expected to be paid within three years as from the last day of the current fiscal year.

3.2.2.4. Comparison with financial accounting

The key difference here between Pillar Two and financial accounting is that actual payment of taxes is important under Pillar Two (i.e., cash tax paid basis). Under financial accounting, taxes may already be taken into account in the calculation of the ETR if these have been accrued but not paid yet (i.e., accrual basis. For example: taxes related to UTPs or deferred taxes on unremitted earnings (see hereafter)). Under Pillar Two, these taxes are not taken into account until the moment of actual payment. In addition, any amount of current tax expense that is not expected to be paid within three years may also not be taken into account. If it turns out that a current tax expense that was taken into account as a covered tax in a previous year is not paid at the end of the third year, then this amount has to be recaptured pursuant to the post-filing adjustment mechanism in the third year (see section 3.2.5.).

3.2.3. Adjustment 2: Total deferred tax adjustment amount

The second set of adjustments relates to the accounting of temporary differences and prior year losses. This is achieved by adjusting the covered taxes for the so-called "total deferred tax adjustment amount".[17]

The starting point is to take *the total deferred tax expense* accrued in the financial statements. Pursuant to chapter 4 paragraph 70 of the Pillar Two Commentary, it is clear that the total deferred tax expense may be either positive (i.e., when total deferred tax expenses exceed total deferred tax benefits) or negative (i.e., when total deferred tax benefits exceed total deferred tax expenses).

In situations where the applicable nominal tax rate is above the minimum rate of 15%, the deferred tax expense has to be recast at (i.e., recalculated to) the minimum rate of 15%.[18]

3.2.3.1. Additions to the total deferred tax adjustment amount

Subsequently, article 21 paragraph 3 prescribes that the deferred tax expense should be increased by the following:

- the amount of any disallowed accrual or unclaimed accrual paid during the current fiscal year; and
- any recaptured deferred tax liability (DTL) determined in a preceding fiscal year which has been paid during the current fiscal year.

Disallowed accrual means any movement in deferred tax expenses accrued in the financial statements that relates to either an UTP or distributions from a CE. Unclaimed accrual means any increase in a DTL recorded in the financial statements for a fiscal year that is not expected to be paid within five years. Recaptured DTL stands for the deferred tax expenses related to a DTL that was taken into account in the total deferred tax adjustment amount in a previous year, but that is not ultimately paid within the five subsequent fiscal years. Such DTLs (and therefore also the deferred tax expenses) are then in principle recaptured and treated as a reduction to the covered taxes in the fifth preceding fiscal year (also commonly referred to as the DTL recapture rule). However, if such DTL is still paid in the current fiscal year, then such recaptured DTL may be considered in the calculation of the jurisdictional ETR. In the draft Pillar Two EU-Directive[19] and GloBE Model Rules,[20] a list is provided that includes items that are not subject to the DTL recapture rule. These items are, inter alia, (i) tangible assets (including IFRS 16), (ii) research and development expenses and (iii) foreign currency exchange net gains. In practice, DTLs related to goodwill or intangibles will likely fall within the scope of the DTL recapture rule as these assets generally have a long lifetime.

For the sake of completeness, the authors would like to point out that the Pillar Two Commentary clarifies that article 4.4.7 of the GloBE Model Rules[21] provides for a compliance simplification option with respect to the DTL recapture rule. This article permits (by way of an annual election) a CE to exclude from the total deferred tax adjustment amount any DTL that is not expected to be paid within five years. This simplification allows for the exclusion of DTLs that are almost certain to require recapture, which reduces compliance monitoring such DTLs and recalculating top-up tax five years later.[22]

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17. Art. 21 Draft Pillar Two EU-Directive.
18. Id., at art. 21 para. 2.
19. Id., at art. 21 para. 8.
20. Art. 4.4.5 GloBE Model Rules.
21. The equivalent article included in the Draft Pillar Two EU-Directive is art. 21 para. 1b.
22. Chapter 4 para. 112 Pillar Two Commentary.

3.2.3.2. Comparison with financial accounting

Whereas the Pillar Two Blueprint seemed to suggest that deferred tax accounting is not considered under Pillar Two, the GloBE Model Rules and draft Pillar Two EU-Directive now confirm that deferred tax accounting – to some extent – is applied in the computation of the adjusted covered taxes. However, the deferred tax accounting concept under Pillar Two differs significantly from the concept as applied under financial accounting.

The first major difference pertains to the recasting of the deferred tax expenses at the minimum rate of 15% for situations in which the applicable tax rate is above the minimum rate. Therefore, deferred taxes under Pillar Two could be taken into account at a lower rate (against max 15%) compared to financial accounting (against statutory corporate income tax (CIT) rate of the jurisdiction). The following example may illustrate this.

Assume that CE A has acquired a tangible asset for an amount of 100 on 1 January 20XX. At the acquisition moment, the book and tax value amounts to 100. Assume further that the local tax rules allow for an accelerated depreciation period of 3 years. Under financial accounting, the asset is depreciated over a period of five years. CE A is located in a jurisdiction that applies a CIT rate of 25%. CE A will record the following financial accounting journal entries with respect to the depreciation of the asset:

Debit depreciation expenses (profit and loss line item)	20 (100/5)
Credit tangible asset (balance sheet line item)	20 (100/5)

The tax journal entries are as follows:

Debit depreciation expenses (profit and loss line item)	33.33 (100/3)
Credit tangible asset (balance sheet line item)	33.33 (100/3)

Hence, a temporary difference of 13.33 exists as per year 31 December 20XX (tax book value: 66.67 vs financial accounting book value: 80). This temporary difference will reverse over time and subsequently CE A will pay higher taxes. As such, the difference of 13.33 is also commonly referred to as a *taxable* temporary difference for which a DTL shall be recognized in the financial accounts.[23] The journal entry for the recognition of a DTL is as follows:

Debit deferred tax expense (profit and loss line item)	3.33 (13.33*25%)
Credit DTL (balance sheet line item)	3.33 (13.33*25%)

Under financial accounting, the deferred tax expense amounts to 3.33 (recorded on the tax expense line in the profit and loss). As this amount is calculated based on a CIT rate (in this example: 25%) that is above the minimum rate of 15%, the deferred tax expense should be recast against 15%. Therefore, the deferred tax expense that is taken into account under Pillar Two amounts to 2.00 (3.33/25%*15%) instead of 3.33.

The second difference between Pillar Two and financial accounting relates to the disallowed accruals. These accruals are defined as the movement in deferred tax expenses related to UTPs and distributions.[24] The latter pertains to deferred taxes recorded for unremitted earnings and is also commonly referred to as outside basis differences under financial accounting.[25] Unlike Pillar Two, these disallowed accruals are considered as deferred taxes under financial accounting, regardless of whether these are actually paid or not in the current year.

At last, the DTL recapture rule is a new concept introduced under Pillar Two. Under financial accounting, deferred tax expenses are taken into account irrespective whether these will be paid or settled within a period of five years.

The aforementioned shows that Pillar Two leans toward a cash tax paid basis for both the current (section 3.2.2.) and deferred (this section) taxes.

3.2.3.3. Reductions to the total deferred tax adjustment amount

Subsequently, the total deferred tax adjustment amount should be reduced by the following:

(1) the amount that would have reduced the deferred tax expense if a local tax loss DTA (not the DTA for qualifying loss election[26]) for the fiscal year had been accrued;[27]

23. IAS 12, para. 15.
24. Art. 21 para. 1 Draft Pillar Two EU-Directive.
25. IAS 12, para. 39.
26. The qualifying loss election will be discussed later in this article.
27. Art. 21 para. 4 draft Pillar Two EU-Directive.

(2) Pillar Two provides for a possibility to recast the DTA on a qualifying loss to the minimum rate of 15%, if such DTA has been recorded at a rate lower than the minimum rate. The amount resulting from the recast (i.e., increase of the DTA) should be taken as a reduction of the deferred tax expense;[28]

(3) the amount of recaptured DTL;[29]

(4) the amount of deferred tax expense with respect to items excluded from the computation of the qualifying income or loss;[30]

(5) the amount of deferred tax expenses with respect to disallowed accruals and unclaimed accruals;[31]

(6) the impact of a valuation adjustment or accounting recognition adjustment with respect to a DTA;[32]

(7) the amount of deferred tax expense arising from the remeasurement with respect to a change in the applicable domestic tax rate;[33] and

(8) the amount of deferred tax expense with respect to the generation and use of tax credits.[34]

3.2.3.4. Comparison with financial accounting

Under financial accounting, a DTA shall only be recognized for unused tax losses to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised.[35] If there is a history of recent losses, IAS 12 paragraph 35 also prescribes that convincing other evidence should be available that reflects the future taxable profitability of the relevant entity (i.e., heavier burden of proof). From the first reduction, it can be derived that the aforementioned recognition criteria are disregarded under Pillar Two. Under Pillar Two, the deferred tax benefit that would have arisen from the recognition of an DTA on a current year local tax loss should be taken into account in that year regardless of whether the recognition criteria for a DTA on tax losses are met. The rationale of this rule is to prevent the jurisdictional ETR falling below the minimum rate of 15% in a year where a tax loss is incurred. The following example may illustrate this.

In Year 1, CE A incurs a qualifying loss and local tax loss of (100) in jurisdiction A (applicable CIT rate: 25%). Assume that CE A is the only CE of the MNE Group that is located in jurisdiction A. In absence of any profit forecasts, no DTA (and hence no deferred tax benefit) is recognized for financial accounting purposes. The total tax expense for CE A is as follows:

a) Current tax expense	0 (no current tax as CE A is in a taxable loss position)
b) Deferred tax expense	0 (no deferred taxes as no DTA is recognized)
Total tax expense (a+b)	0

As the total tax expense is zero, the financial accounting ETR also equals zero.

In order to understand the first reduction, it should be noted that the following journal entry is made if a DTA on the local tax loss of (100) would have been recognized under financial accounting:

Debit DTA (balance sheet line item)	25 (100*25%)
Credit deferred tax benefit (profit and loss line item)	25 (100*25%)

Pursuant to the first reduction, the deferred tax benefit (in this example: 25) that is recorded if a DTA would have been recognized for the local tax loss should be taken into account as a reduction in the total deferred tax adjustment amount. It is a reduction because the deferred tax relates to a benefit (i.e., negative deferred tax expense). It should be noted that the deferred tax benefit that is taken into account under the first reduction should also be recast against the minimum rate of 15%.

Given the aforementioned, the total adjusted covered taxes for CE A are as follows:

a) Current tax expense	0 (no current tax as CE A is in a taxable loss position)
b) Total deferred tax adj. amount	-15 (due to the first reduction and incl. recast, 100*15%)
Total adjusted covered taxes (a+b)	-15 (i.e., net tax benefit)

The jurisdictional ETR is calculated by dividing the total adjusted covered taxes (i.e. -15) by the qualifying income or loss (i.e. -100). Accordingly, the jurisdiction ETR under Pillar Two equals to 15% and no top-up tax will be due in this loss year.

Pursuant to IAS 12 paragraph 37, a reporting entity has to reassess any unrecognised DTAs at the end of each reporting period. The entity recognizes a previously unrecognized DTA to the extent that it has become probable that future taxable profits will allow the DTA to be

28. Id., at art. 21 para. 6.
29. Id., at art. 21 para. 7.
30. Id., at art. 21 para. 5a.
31. Id., at art. 21 para. 5b.
32. Id., at art. 21 para. 5c.
33. Id., at art. 21 para. 5d.
34. Id., at art. 21 para. 5e.
35. IAS 12, para. 34.

recovered. The same applies, *a contrario*, for the derecognition of recognized DTAs. Any deferred tax resulting from the (de)recognition of (un)recognized DTAs is recorded as deferred taxes in the profit and loss. The aforementioned is not followed for Pillar Two purposes under the sixth reduction – the impact of a valuation adjustment or accounting recognition adjustment with respect to a DTA is excluded from the deferred tax expense.[36] The rationale of this rule is to ensure that DTAs are recorded for Pillar Two purposes in the same year as the economic loss which gives rise to such assets.

Pursuant to IAS 12 paragraph 47, DTAs and DTLs shall be measured at the tax rates that are expected to apply to the period when the asset is realised or the liability is settled, based on tax rates (and tax laws) that have been (substantively) enacted by the end of the reporting period. As such, deferred tax expenses/benefits resulting from re-measurement due to tax rate changes are considered as deferred taxes under financial accounting. The aforementioned measurement is not followed under the seventh reduction – the amount of deferred tax expense arising from the remeasurement with respect to a change in the applicable domestic tax rate is excluded from the deferred tax expense. Under Pillar Two, the deferred tax expenses resulting from tax rate changes are taken into account in a different manner via the post-filing mechanism which will be discussed in more detail in section 3.2.5. of this article.

Under financial accounting, the deferred taxes resulting from the generation and use of tax credits are taken into account in the calculation of the ETR. Under Pillar Two, these deferred taxes are disregarded under the eighth reduction. To understand this adjustment, it is relevant to know what journal entries would have been recorded if (i) a DTA is generated with respect to a carry forward tax credit and (ii) if the DTA reverses because the carry forward tax credit is utilized. The following example may illustrate this in more detail.

Assume CE A incurs non-deductible interest of 100 (which is eligible for carry forward) due to an earnings stripping rule in year 1. CE A is located in jurisdiction A that applies a CIT rate of 25%. The following journal entry is recorded if a DTA would have been recognized for the carry forward non-deductible interest of 100:

Debit DTA (balance sheet line item)	25 (100*25%)
Credit deferred tax benefit (profit and loss line item)	25 (100*25%)

Pursuant to the first part of the eighth reduction, the deferred tax benefit with respect to the generation of the DTA on the tax credit (i.e., 25) is disregarded under Pillar Two.

Assume further that CE A has sufficient headroom to utilize the carry forward non-deductible interest of 100 in year 2. The following journal entry is recorded with respect to the utilization of the carry forward credit:

Debit deferred tax expense (reversal DTA, profit and loss line item)	25 (100*25%)
Credit DTA (balance sheet line item)	25 (100*25%)

Pursuant to the second part of the eighth reduction, the deferred tax expense with respect to the utilization/use of the tax credit (i.e., 25) is disregarded under Pillar Two.

3.2.3.5. The Qualifying Loss Election

In lieu of applying the deferred tax accounting rules as set out here above, a more simplified loss carry-forward equivalent may be elected which provides for appropriate recognition of losses arising in jurisdictions in a fiscal year.[37] According to the Commentary, this election is expected to be of greatest utility as a simplification in jurisdictions that do not impose a CIT or impose one at a very low rate.[38]

If such an election is made, a qualifying loss DTA (i.e., a Pillar Two DTA for Pillar Two losses, not regular tax losses) is established in each fiscal year in which there is a net qualifying loss for a jurisdiction. If there is a net qualifying income in a subsequent fiscal year for that jurisdiction, the qualifying loss DTA will be utilized (i.e., reduced) up to an amount equal to the lower of the net qualifying income multiplied by the minimum rate of 15% or the amount of available GloBE loss DTA. As part of the additions to the covered taxes as discussed before (*see* section 3.2.2.1.), the amount of utilised qualifying loss DTA should then be added to the amount of covered taxes (i.e., it increases the numerator of the jurisdictional ETR).

3.2.3.6. Comparison with financial accounting

In contrast to the total deferred tax adjustment amount (which is determined at an entity level basis), the qualifying loss election may only be applied if there is a net qualifying loss at jurisdictional level. Therefore, this election does not apply on individual qualifying losses of a CE in a jurisdiction if there is a total net qualifying income for that jurisdiction.

Under financial accounting, a DTA on tax losses may be only accounted for if several conditions are met.[39] Under Pillar Two, it is a matter of an election and no (additional) conditions are imposed to account for a qualifying loss DTA. As such, the application of the qualifying loss DTA is essentially a simplified loss carry forward system (with an unlimited carry forward period) in which Pillar Two losses from a

36. The Pillar Two Commentary confirms that this also entails valuation allowances (US GAAP concept); *see* Ch. 4 para. 76 Pillar Two Commentary.
37. Art. 22 Draft Pillar Two EU-Directive.
38. Ch. 4 para. 113 Pillar Two Commentary.
39. IAS 12, paras. 34 and 35.

given year may be carried forward to a subsequent profit year. The timing difference of a qualifying loss is then accounted for by way of an increase of the covered taxes in the profit year (so not by means of a reduction of the qualifying income, *see* section 3.2.2.1.

The rationale behind this adjustment is that a decrease of the qualifying loss DTA (i.e., decrease of a Pillar Two asset) results in a fictional deferred tax expense (not recorded in the financial statements) that may be taken into account as an increase of the covered taxes. The following example may illustrate this.

Assume that in year 1 a qualifying loss DTA of 15 (qualifying loss of 100 multiplied by minimum rate of 15%) is established in jurisdiction A. In year 2, jurisdiction A has a net qualifying income of 100. Hence, the qualifying loss DTA may be fully utilised in this year. The following fictional Pillar Two journal entry could be made:

Debit fictional deferred tax expense (reversal qualifying loss DTA)	15
Credit fictional Qualifying Loss DTA	15

As part of the additions to the covered taxes as discussed before (*see* section 3.2.2.1.), the amount of utilized qualifying loss DTA (i.e., the fictional deferred tax expense of 15) should then be taken into account as an addition to the covered taxes (i.e., it increases the numerator of the jurisdictional ETR).

Note: the authors emphasise that these journal entries are not recorded under financial accounting. Also, it is currently not clear how to account for Pillar Two DTAs in the financial statements. Hence, the abovementioned journal entries are only fictional Pillar Two journal entries and are included *for illustrative purposes only*.

3.2.3.7. Article 20 paragraph 5 Draft Pillar Two EU-Directive

Finally, the authors would like to point out that the GloBE Model Rules[40] and the draft Pillar Two EU-Directive[41] contain a remarkable provision (very technical) that could lead to top-up tax in situations when there is a net qualifying loss in a jurisdiction and the amount of adjusted covered taxes for that jurisdiction is negative and less than an amount equal to the net qualifying loss multiplied by the minimum tax rate of 15% (also referred to as “the expected adjusted covered taxes”). Consequently, the top-up tax liability is the amount equal to the difference between the amount of adjusted covered taxes and the amount of expected adjusted covered taxes.

The said provision could be triggered if a CE has (i) a net qualifying loss, (ii) a negative permanent difference (i.e., additional deduction for tax purposes that is permanent in nature. For example: tax deduction for tangible investments. In Dutch: *kleinschaligheidsinvesteringsaftrek*) and (iii) no DTA recorded for the current year tax loss in the financial statements. Under these circumstances, article 21 paragraph 4 of the draft Pillar Two EU-Directive (or article 4.4.2.c of the GloBE Model Rules) prescribes that a fictional amount of deferred tax benefit (which would have been incurred if a DTA was recorded in the financial statements) has to be taken into account in the calculation of the total deferred tax adjustment amount (and hence the adjusted covered taxes). In absence of any other covered taxes, the aforementioned will result in a negative amount of adjusted covered taxes for the current year. The presence of a negative permanent difference is necessary in order to create a situation where the negative amount of covered taxes (i.e., the fictional deferred tax benefit amount) could be less than the expected adjusted covered taxes. This would be the case if the fictional deferred tax benefit is recast against the minimum rate of 15% pursuant to article 21 paragraph 2 of the draft Pillar Two EU-Directive. Given that the fictional deferred tax benefit and expected adjusted covered taxes are determined on the basis of respectively the taxable loss and the qualifying loss, the only difference between both amounts should be (in the authors’ simplified example, *ceteris paribus*) the negative permanent difference. On the latter amount, a top-up tax will be due pursuant to article 20 paragraph 5 of the draft Pillar Two EU-Directive. The remarkable outcome of this provision is therefore that a top-up tax may be due on a negative permanent difference without the presence of any qualifying income.

3.2.4. Adjustment 3: Covered taxes accrued in equity or other comprehensive income

The third adjustment prescribes that the increase or decrease in covered taxes that is not recorded in the profit and loss, but is recorded in equity or other comprehensive income (OCI, subpart of equity) shall be treated as an adjustment to the covered taxes when the amounts of income or loss to which such taxes relate is taken into account in the computation of the qualifying income or loss. This adjustment shall only apply where the amount of income or loss to which the covered taxes relate is subject to tax under local tax rules.

3.2.5. Adjustment 4: Post-filing adjustments and tax rate changes

The last adjustment on the covered taxes pertains to post-filing adjustments (i.e., adjustments to the covered taxes for a prior year after the top-up tax information return of that year has been filed). Pillar Two prescribes a special adjustment mechanism to account for such adjustments.[42]

40. Art. 4.1.5 GloBE Model Rules.
41. Art. 20 para. 5 Draft Pillar Two EU-Directive.
42. *See* id., at art. 24 para. 1.

To the extent the adjustment pertains to a positive adjustment to the covered taxes for a previous year (i.e., the prior year covered taxes were understated), such prior year adjustment shall be treated as an additional adjustment (i.e., increase) to the covered taxes of the current fiscal year.

When the covered taxes for a previous year would have been lower (i.e., the prior year covered taxes were overstated), then the jurisdictional ETR and the corresponding top-up tax of that year shall be recomputed in accordance with article 28 paragraph 1 of the draft Pillar Two EU-Directive. The resulting top-up tax liability will then be taken into account as an additional top-up tax that will increase the total jurisdictional top-up tax amount (further explanation is provided in section 3.4.).

Under Pillar Two, CEs may elect to treat the negative prior year adjustment as an additional adjustment (i.e., reduction) to the covered taxes of the current fiscal year subject to the conditional that the negative prior year adjustment is immaterial (i.e., less than EUR 1 million at jurisdictional level).

Article 24 of the draft Pillar Two EU-Directive also contains two provisions regarding changes in tax rates. The first provision[43] provides that when there is a reduction to the applicable domestic tax rate to a rate below 15%, such reduction must be taken into account under the rules of article 24 paragraph 1 of the draft Pillar Two EU-Directive. The first provision ensures that when a domestic tax rate is subsequently reduced the deferred tax expense previously claimed as a covered tax is adjusted to the correct value, which is the amount of such tax that will actually be paid upon reversal of the DTL. When such reduction is material, then the jurisdictional ETR and the corresponding top-up tax of that year in which the deferred tax expense was claimed shall be recomputed in accordance with article 28 paragraph 1 of the draft Pillar Two EU-Directive.

If a deferred tax expense was taken into account at a rate lower than the minimum tax rate of 15% in a prior year and the applicable tax rate is subsequently increased, the amount of deferred tax expense that results from such increase shall be treated *upon payment* as an additional adjustment (i.e. increase) to the covered taxes of the current fiscal year pursuant to the second provision.[44] This adjustment is capped at an amount equal to the deferred tax expense recast at the minimum rate of 15%.

3.2.6. Comparison with financial accounting

Under Pillar Two, the rules on how to account for prior year adjustments are complex. It is important to make a clear distinction between positive prior year adjustments and negative prior year adjustments. The former is taken into account as an additional adjustment to the current year covered taxes (mechanism is in line with financial accounting), while the latter is not (unless the adjustment is immaterial and an election has been made). Material negative prior year adjustments will cause an obligation to recalculate the prior year's jurisdictional ETR. If the recalculation of a prior year's jurisdictional ETR leads to an ETR lower than 15%, then the resulting top-up tax shall be due in the current year (further explanation is provided in section 3.4.).

Under financial accounting, deferred taxes with respect to tax rate changes recorded in the profit and loss are fully taken into account in the calculation of the ETR. Under Pillar Two, tax rate changes are only taken into account when (i) the domestic tax rate drops below the minimum tax rate of 15% or (ii) if the domestic tax rate increases (but impact capped at max 15%). Therefore, not all deferred taxes resulting from tax rate changes are considered as covered taxes in the calculation of the jurisdictional ETR.

3.3. Qualifying income or loss (Chapter III Directive)

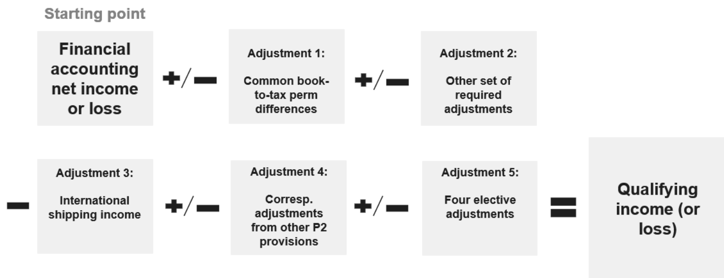
Pillar Two also introduces its own definition of tax base (referred to as "qualifying income or loss"). As the adjusted covered taxes, the qualifying income or loss is first determined on an entity level basis and subsequently aggregated to arrive at a jurisdictional amount.

To compute the qualifying income or loss of a CE, the financial accounting net income or loss (i.e., bottom line result) should be first identified. Subsequently, numerous required or elective adjustments have to be applied to the financial accounting net income or loss to arrive at the qualifying income or loss. As a last step (if applicable), Pillar Two also prescribes several allocation rules to ensure that the qualifying income or loss is allocated appropriately in case there are permanent establishments and flow-through entities in the group structure.[45] These allocation rules will not be further discussed in this article.

43. Id., at art. 24 para. 2.
44. Id., at art. 24 para. 3.
45. *See* id., at arts. 17 and 18.

The relevant steps to compute the qualifying income (or loss) (denominator) is summarised and illustrated in Figure 3.

Figure 3 – High-level overview Qualifying Income (or Loss)



3.3.1. Financial accounting net income or loss

The starting point for calculating the qualifying income or loss is the financial accounting net income or loss of a CE (before any consolidation adjustments for intra-group transactions) as determined under the applicable financial accounting standard as used by the UPE in the preparation of its consolidated financial statements.

If it is not reasonably practicable to determine the financial accounting net income or loss for a CE based on the accounting standard used by the UPE, Pillar Two also allows the financial accounting net income or loss of that CE to be determined based on another acceptable financial accounting standard or an authorised financial accounting standard, provided that (i) the financial accounts of that CE are maintained based on that other accounting standards, (ii) the information contained in the financial accounts is reliable and (iii) any permanent differences in excess of EUR 1 million that arise from the application of that other accounting standard to items of income or expense or transactions, which differs from the UPE's accounting standard are conformed to the treatment required under the UPE's accounting standard.[46]

Under Pillar Two, IFRS (main rule) and its equivalents are considered as acceptable financial accounting standards. In addition to the Pillar Two Blueprint, the draft Pillar Two EU-Directive and GloBE Model Rules also now have included the accounting standards of the Member States of the European Union as the generally accepted accounting standards.[47]

In cases where an UPE has not prepared its consolidated financial statements in accordance with an acceptable financing account standard as outlined here above, Pillar Two prescribes that the consolidated financial statements of the UPE shall be adjusted to prevent any material competitive distortion.[48] The accounting treatment on any item or transaction to which the material competitive distortion pertain shall then be conformed to the treatment required under IFRS. Under the draft Pillar Two EU-Directive, a material competitive distortion means, in respect of the application of a specific principle or procedure under a set of generally acceptable accounting principles, an application that results in a variation of more than 10% of revenue or an aggregate variation greater than EUR 75 million in revenue in a fiscal year as compared to the amount that would have been determined by applying the corresponding IFRS principle or procedure.

3.3.2. Required and elective adjustments

The adjustments to be applied on the financial accounting net income or loss can be divided in two groups: (i) the required adjustments and (ii) elective adjustments. These adjustments are covered under article 15 and 16 of the draft Pillar Two EU-Directive and are outlined below.

3.3.2.1. Required adjustments

The first set of required adjustments pertains to the elimination of a number of common book-to-tax differences where that adjustment is justified on policy grounds. These adjustments include, inter alia, net tax expenses (to arrive at the profit before tax amount), dividends and equity gains/losses (avoids double taxation and alignment with participation exemptions), stock-based compensation, certain expenses (e.g., penalties and fines) and foreign currency gains and losses arising from, for example, different currencies used for accounting and

46. Id., at art. 14 para. 2.
47. *See* id., at art. 3 para. 22.
48. Id., at art. 14 para. 3.

tax purposes (to prevent distortions of foreign currency effects). A complete list of the permanent items to be adjusted for is provided in article 15 paragraph 2 of the draft Pillar Two EU-Directive.

The second set of required adjustments consist of some other relevant adjustments (not linked to each other) and can be summarised as follows:

- transactions between CEs located in different jurisdictions shall be accrued for the same amount in the financial accounts of the CEs and for an amount consistent with the ALP;[49]
- any refundable tax credit that is regarded (i.e., qualified) under Pillar Two shall be treated as income for the purpose of calculating the qualifying income or loss;[50]
- specific adjustment for insurance companies only: any amounts charged to policyholder for taxes paid by the insurance company in respect of returns to the policy holders shall be excluded from the qualifying income or loss;[51]
- reductions to the equity attributable to distributions paid or payable in respect of additional tier one capital issued by a CE shall be treated as an expense for the purpose of calculating the qualifying income or loss;[52] and
- any expenses attributable to a financing arrangement whereby one or more members of an MNE group provide credit to one or more other members of the same group shall not be taken into consideration in the computation of the qualifying income or loss if certain conditions are met.[53]

It is interesting to note that the fifth adjustment (i.e., expenses attributable to a certain financing arrangement) is actually an anti-abuse provision that has been included in the draft Pillar Two EU-Directive and GloBE Model Rules[54] to prevent the use of hybrid instruments to inflate the jurisdictional ETR.

The third set of required adjustments relates to the exclusion of international shipping income (and any ancillary international shipping income) that meets the definition criteria as set out under article 16 of the draft Pillar Two EU-Directive.

The fourth and last set of required adjustments relates to adjustments that are necessary to reflect the requirements of the relevant provisions as set out in chapters VI and VII of the Directive. In this respect, article 33 (transfer of assets and liabilities) of the draft Pillar Two EU-Directive is worth mentioning. This article prescribes the amount of the carrying value of a transferred asset or liability to be taken into account by the acquirer in regular (taxable) transactions vis-a-vis tax free reorganisations (also defined as “Reorganisation”). Consequently, this article may lead to adjustments to be applied on for example the depreciation amount of an asset as determined under the applicable financial accounting standard.

3.3.2.2. Elective adjustments

Next to the required adjustments as discussed, Pillar Two also provides for in total four elective adjustments. These elective adjustments are as follows:

(1) election that allows stock-based compensation to be accounted for under the relevant local income tax rules (rather than applying financial accounting concepts);[55]

(2) election that allows a CE to apply the realisation principle for assets and liabilities that are subject to fair value or impairment accounting;[56]

(3) election that allows to carry back and off-set the total net gain from the disposition of immovable property incurred in the current fiscal year with any net losses from the disposition of immovable property incurred in the four prior fiscal years;[57] and

(4) election that allows for the application of consolidated accounting treatment (i.e., elimination) to income, expense, gains and losses from transactions between CEs that are located in the same jurisdiction and included in a tax consolidation group (e.g., fiscal unity).[58]

Elections (1), (2) and (4) are a five-year election, whereas election (3) is a one-year election. All elections (when opted for) have to be specified in the top-up tax information return that has to be filed with the local tax authorities (*see* section 6.).

49. Id., at art. 15 para. 4.
50. Id., at art. 15 para. 5.
51. Id., at art. 15 para. 10.
52. Id., at art. 15 para. 11.
53. Id., at art. 15 para. 8.
54. Art. 3.2.7 GloBE Model Rules.
55. Art. 15 para. 3 draft Pillar Two EU-Directive.
56. Id., at art. 15 para. 6.
57. Id., at art. 15 para. 7.
58. Id., at art. 15 para. 9.

3.3.3. Sub-conclusion

From the aforementioned, it may be clear that Pillar Two introduces its own definition of taxes and tax base that significantly differs from the definitions as applied under the financial accounting standards/IFRS. The adjustments to be applied on the covered taxes and the financial accounting net income or loss are extensive and complex.

3.4. Jurisdictional ETR (Chapter V of the Directive)

After having calculated the adjusted covered taxes and qualifying income or loss per CE, both determinants of all the CEs located in the same jurisdiction have to be aggregated to arrive at the jurisdictional adjusted covered taxes and net qualifying income (i.e., *qualifying income of the CEs minus qualifying losses of the CEs*). Dividing both amounts then gives the jurisdictional ETR.

In case the calculated jurisdictional ETR of a certain low tax jurisdiction [*Y*] is below the agreed minimum tax rate of 15%, a top-up tax percentage must be computed for that jurisdiction. The top-up tax percentage can be illustrated by equation (1):

(1) Top-up tax percentage of juris. [Y] = Minimum tax rate (15%) - Jurisdictional ETR of jurisdiction [Y]

Subsequently, the jurisdictional top-up tax for a fiscal year is calculated by equation (2):

(2) Jurisdictional top-up tax [Y] = (Top-up tax percentage of juris. [Y] * Excess profit of juris. [Y]) + Additional top-up tax of juris. [Y] - Domestic top-up tax of juris. [Y]

3.4.1. Excess profit

The Excess profit for a certain jurisdiction [*Y*] can be illustrated by equation (3):

(3) Excess profit of jurisdiction [Y] = Net qualifying income of juris. [Y] - Substance based income inclusion of juris. [Y]

MNEs will receive a substance based carve-out on income for 5% of the carrying value of their tangible assets and payroll, with a transition period of ten years that offers an exclusion of 8% of tangible assets and 10% of payroll in 2023, gradually declining to 5% in 2033.[59] This carve-out amount therefore reduces the net qualifying income, which will have a positive impact on the jurisdictional ETR (i.e., it will increase the jurisdictional ETR).

3.4.2. Additional Top-Up Tax

The additional top-up tax is any amount of incremental top-up tax arising from the recalculation of the jurisdictional ETR of the MNE group for a prior fiscal year. Under the draft Pillar Two EU-Directive and GloBE Model Rules, there are several provisions included that require a recalculation of the jurisdictional ETR for a prior fiscal year if there is a specific adjustment to covered taxes or qualifying income (or loss). Article 28 paragraph 1 of the draft Pillar Two EU-Directive provides for a full list of relevant articles in the draft Directive that include such a recalculation obligation. One of those articles has been already discussed earlier in this article and relates to the required recalculation of the prior year jurisdictional ETR when the covered taxes for that year were materially overstated (i.e., material negative prior year adjustment, *see* section 3.2.5.). The resulting top-up tax liability will then be regarded as an additional top-up tax that will increase the total jurisdictional top-up tax amount for the current year.

3.4.3. Domestic Top-Up Tax

EU Member States can opt to apply the top-up tax domestically to CEs located in its territory under article 10 of the draft Pillar Two EU-Directive (domestic top-up tax). This election allows that the top-up tax is charged and collected in a jurisdiction in which low-level of taxation occurred, instead of collecting all the additional tax at the level of the UPE. These domestic top-up taxes (when incurred) will reduce the total amount of jurisdictional top-up tax.

If the jurisdictional top-up tax for the low tax jurisdiction has been calculated, then the top-up tax has to be allocated to the CEs in that low tax jurisdiction that have qualifying income for the fiscal year. The top-up tax is allocated to the CEs in proportion to their qualifying income and can be illustrated by equation (4):

(4) Top-up tax of a CE in [Y] = Jurisdictional top-up tax [Y] * (Qualifying income of the CE in [Y] / Total qualifying income of the CEs in [Y])

59. Id., at art. 46.

The top-up tax of a CE is first imposed under IIR on a parent entity with an ownership interest in the low-taxed CE. If there is any residual amount of top-up tax that remains unallocated after the IIR applies, the UTPR allocation mechanism results in a liability to top-up tax in the jurisdictions that implemented the UTPR. Both the IIR and UTPR are also referred to as GloBE rules and are further described in sections 4 and 5 of this article.

4. The Income Inclusion Rule

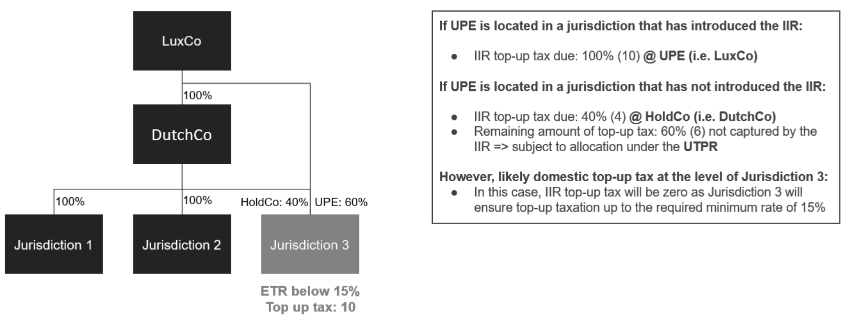
If the jurisdictional ETR for a certain jurisdiction is calculated below the minimum agreed rate of 15%, then a top-up tax is due. Under Pillar Two, this top-up tax is generally allocated to the UPE based on the IIR. The Pillar Two Blueprint mentions that the IIR operates in a way that is similar to a CFC rule in that it subjects a domestic taxpayer to tax on its share of the foreign income of any controlled subsidiary.

The primary mechanism for coordinating the interaction between different IIRs in different jurisdictions is the top-down approach. As a result of the top-down approach, the UPE will be subject to the top-up tax in most of the cases. In cases where the UPE does not apply the IIR, one or more intermediate parent entities will have to apply the IIR to their low-taxed CEs.[60] In addition to the top-down approach, Pillar Two also contains complex allocation rules on split-ownership structures for shareholdings below 80%.[61] Under the split-ownership rules, the top-up tax is allocated to the so-called "partially owned parent entity" and not the UPE. In such cases, to avoid double taxation, the UPE refrains from applying the IIR.

Under the draft Pillar Two EU-Directive, EU Member States shall also ensure that, where an UPE located in an EU Member State is a low-taxed CE, it is subject to the top-up tax together with its low-taxed CEs located in the same EU Member State for the fiscal year (so not only with respect to its foreign low-taxed CEs).[62] In addition, EU-Member States can opt to apply the top-up tax domestically to CEs located in its territory under article 10 of the draft Pillar Two EU-Directive (domestic top-up tax). This election allows that the top-up tax is charged and collected in a jurisdiction in which low-level of taxation occurred, instead of collecting all the additional tax at the level of the UPE.

A numerical example of the application of the IIR is included here below.

Figure 4 – Numerical example IIR



A parent entity that seeks to apply the IIR to the income of an exempt permanent establishment (PE) will, however, be prevented from doing so where the parent jurisdiction has entered into a bilateral double tax treaty that obliges the parent jurisdiction to exempt the income of the PE. For these circumstances, Pillar Two introduced a so-called "switch over rule" (SOR). The SOR comes into play in situations where the head office is required to apply the IIR to the low-tax income of its PEs (of which the taxing rights normally belong to the source state). Under the SOR, the residence state of the head office can tax the low-taxed profits of a PE up to the agreed minimum rate of 15%, using the same jurisdictional ETR test as the IIR.

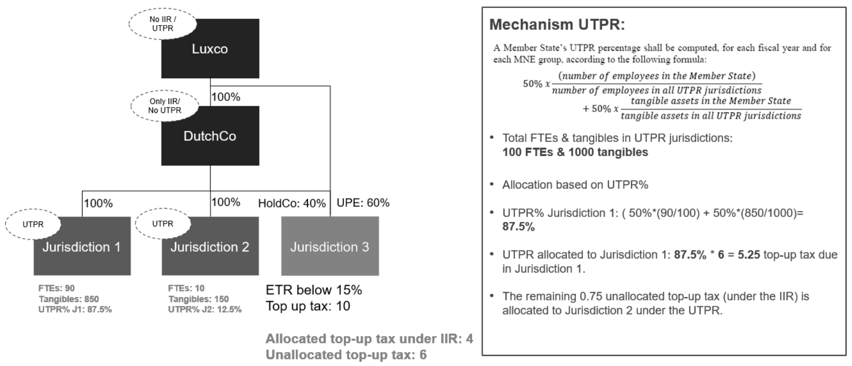
5. The Undertaxed Payment Rule

The UTPR acts as a backstop to the IIR. Under the UTPR, any remaining top-up tax of a low-taxed entity that has not been captured under the IIR is allocated (proportionally) to entities that are a member of the same MNE group as the low-taxed entity (UTPR Taxpayers) under a formula that is based on the relative proportion of employees and tangible assets in each jurisdiction.[63] Importantly, under this formula, there is no requirement that a UTPR Taxpayer actually makes deductible payments to the low-taxed entity.

60. Id., at art. 6.
61. *See* id., at art. 7.
62. *See* id., at art. 5.
63. *See* id., at arts. 11, 12 and 13.

A numerical example of the application of the UTPR is included here below.

Figure 5 – Numerical example UTPR



A temporary exclusion (i.e., transition relief) from the UTPR will be available for “new” MNEs, i.e., MNEs with no more than EUR 50 million of tangible assets abroad and that operate in no more than six countries.[64] The exclusion will be limited to five years after the date on which the MNE becomes in-scope for the GloBE rules for the first time. If the MNE is in-scope at the time the GloBE rules come into effect, the MNE will be subject to the UTPR only after five years as from 1 January 2024.

6. Pillar Two Compliance Obligations

From the draft Pillar Two EU-Directive, it is also clear that a so-called top-up tax information return has to be filed with the tax authorities no later than 15 months after the last day of the reporting fiscal year.[65] A transitional relief is provided in the first reporting year (i.e., transitional year) where an MNE group initially enters within the scope of the GloBE rules. For such a transitional year, the top-up tax information return has to be filed no later than 18 months after the last day of the transitional year.[66]

The filing obligation of the top-up tax information return primarily lies at the CE. If the return is already filed by the UPE or a so-called “designated filing entity” that is located in a jurisdiction that has a bilateral or multilateral agreement or arrangement that provides for the automatic exchange of annual top-up tax information return with the jurisdiction in which the CE is located, the CE only has the obligation to file a notification to the tax authorities to inform them which entity has filed the return. The filing mechanism of the top-up tax information return is therefore quite similar to the mechanism as applied under CbC reporting.

The top-up tax information return should contain, inter alia, the identification of the CEs (including their tax identification numbers), overall corporate structure, information necessary to compute the jurisdictional ETR and top-up tax and a record of the elections made in accordance with the relevant provisions as stated in the Directive. The authors emphasise that the top-up tax information return should not by any means be perceived as a tax return.

7. Concluding Remarks

As stated in the introduction the authors – alike the OECD – believe that today one of international taxation’s greatest challenge lies in the tax challenges arising from the digitalization of the economy.

The authors also believe that the OECD with its Two Pillar proposals to (i) distribute tax revenue more fairly (through the so-called Pillar One proposal) and to (ii) levy tax more fairly by introducing a minimum profit tax (through the Pillar Two proposal) is one of the greatest and – if ultimately introduced – historic changes in international taxation.

Where Pillar One’s focus is on the distribution of tax revenue more fairly and in its current form having a rather limited – but still important especially from a conceptual perspective – impact given the expectation that it will ‘only’ impact 80 multinationals, the authors’ focus in this article has been on the minimum profit tax under the Pillar Two plan.

Under Pillar Two, the OECD/G20 IF on BEPS members have agreed to enact a jurisdictional-level minimum tax system with a minimum effective tax rate of 15%. MNEs and EU-based large-scale purely domestic groups with (global) consolidated turnover above EUR 750 million will be within the scope of Pillar Two.

64. Id., at art. 47.
65. Id., at art. 42.
66. Id., at art. 48.

In this article, the authors have provided a general overview of the mechanism of Pillar Two and primarily focused on the calculation of the Pillar Two ETR. The authors have elaborated on the rules to calculate the ETR under Pillar Two and compared these with the rules that are applied to calculate the ETR under financial accounting.

The authors conclude that the rules to calculate the ETR under Pillar Two are extensive and highly complex. Although the OECD leverages on financial (tax) accounting principles for the calculation of the ETR under Pillar Two, the authors do observe significant differences. These differences mainly relate to the tax accrual versus tax cash paid basis and the application of the deferred tax accounting concept.

At the same time, having a solid understanding of the principles of financial (tax) accounting will help to better understand the rules to calculate the ETR under Pillar Two. The authors have attempted to demonstrate this by, inter alia, showing what journal entries would have been recorded under financial accounting and how this translates to Pillar Two. Also, knowing when and why a DTA or DTL is (not) recorded under financial accounting helps to better understand the rationale of some provisions included in the deferred tax accounting part of Pillar Two (i.e., the provisions related to the deferred tax adjustment amount). The fact that the financial accounting treatment may also be significantly different depending on which financial accounting reporting standard is applicable makes the application of the Pillar Two rules even more complex.

Therefore, in view of the envisaged implementation of Pillar Two, having a solid understanding of financial (tax) accounting concepts will be more important than ever. In addition, the authors would like to stipulate that although one can hardly be against the rationale for introducing the Two Pillar system, being the fairer distribution (Pillar One) and levy of taxes (Pillar Two) in an international context, the (tax accounting) workload, technological implementation in financial (enterprise resource planning (ERP)/tax reporting) systems and the overall compliance burden and thus the “costs of compliance” of MNEs will significantly increase in the coming years.

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