Pillar Two rules: roadmap to compliance

International Tax | Large Corporate



22 May 2024

As the Pillar Two rules are now in effect in the UK and other countries, with more set to introduce them from 2025, we consider the key priorities for businesses in 2024 and beyond.

Key Points

What is the issue?

The OECD Inclusive Framework's Pillar Two model rules are designed to ensure that large multinational groups (with annual consolidated group revenue of at least €750 million) pay a minimum effective tax rate of 15% on their profits in every country in which they operate.

What does it mean for me?

Tax teams will need to understand how the rules apply to their business (which may

not be straightforward), identify and collect significant data, and prepare calculations. The group's country-by-country report will underpin whether it can access the transitional safe harbour in a country as a simplification.

What can I take away?
Teams will need to consider how to approach these new and potentially significant tasks. Businesses will also need to apply a Pillar Two lens to all activity, including transactions, reorganisations and financing, as well as monitor the latest developments.

The Pillar Two rules are now in effect in the UK and other countries, with more countries in the process of introducing rules from 2025 onwards. Anyone who has begun to look at the Pillar Two rules will be aware of the scale of the challenge. Although many tax departments are already in the process of developing their response, there is significant work still to be done. This article looks at some of the key priorities and areas of practical focus for businesses in 2024 and beyond.

The Pillar Two model rules

As a reminder, the OECD Inclusive Framework's Pillar Two model rules are designed to ensure that large multinational groups (with annual consolidated group revenue of at least €750 million) pay a minimum effective tax rate of 15% on their profits in every country in which they operate. The key components of the model rules are:

- qualified domestic minimum top-up taxes, which allow countries to charge any top-up taxes due in respect of local profits;
- the income inclusion rule under which parent company countries apply the top-up tax rules on a top-down basis; and
- the undertaxed profits rule, which will apply as a secondary (backstop) rule where the other rules have not been fully applied.

The OECD model rules use a mixture of accounting and tax concepts and will, in effect, require businesses to keep a third set of calculations for Pillar Two effective tax rate purposes. The result is inevitably complex, and there remain a number of areas where further clarity is needed. Tax teams will need to understand how these evolving rules apply to their business, identify and collect large volumes of data, and

prepare and manage the preparation of accurate compliance returns. These are significant tasks that will need to be undertaken in addition to existing obligations and teams will need to carefully consider whether they have sufficient resource.

Image



ROADMAP TO PILLAR TWO COMPLIANCE: KEY PRIORITIES

Financial reporting	• Model material Pillar Two safe harbour/ top-up tax position. • Devise and agree policy, processes and controls to support material accuracy of Pillar Two calculations and disclosures.
Safe harbour and country-by-country reporting	• Analyse current country-by-country reporting and whether it is 'qualified' for the safe harbour. • Identify any improvements to current country-by-country reporting process and implement for 2023. • Model the transitional country-by-country safe harbour using the most recent data, including countries on the borderline.
Data	• Understand what data is needed, where it exists, and any gaps. • Develop and implement sustainable data collection processes and technology.
First year compliance design	• Understand local compliance requirements. • Determine compliance model to be used by the group – in-house, outsource, co-source? • Identify additional resources, technology solutions and/or service provider. • Perform dry runs of Pillar Two computations.

Financial reporting for Pillar Two: accounting disclosures and provisioning

The impact of Pillar Two on financial reporting is one of the first areas which tax teams need to consider. Many in-scope groups with a calendar year end will already have prepared disclosures in their financial statements for 31 December 2023 to indicate the impact Pillar Two will have on their business in countries that have enacted legislation. Other businesses will still be in the process of considering what these disclosures should be.

Now that the rules are in effect, the impact of Pillar Two will need to be included in the income statement and balance sheet for 2024 financial statements (both interim and full year) rather than just in disclosures. Auditors will expect tax teams to substantiate the position they take in the financial statements in relation to Pillar Two.

Where safe harbours are expected to apply, groups will need to be able to provide evidence to demonstrate this, at least for material countries, including whether the country-by-country report is expected to be qualified (see below for more detail). For material countries where a safe harbour is not expected to apply, more detailed analysis and modelling may be needed.

Businesses will need to develop an appropriate timeline to gather relevant data and calculate an audit-ready Pillar Two tax position for inclusion in the overall group tax provision in time to meet financial reporting deadlines. Auditors will also want to understand the Pillar Two approach taken by the group, including the availability of the required data and how the business has got comfortable that all necessary material adjustments and technical points have been considered and appropriately reflected.

New controls and processes will therefore need to be developed and implemented for these new requirements. Half year reporting is imminent for 31 December year-ends, with some quarterly reporting deadlines already passed, and all of the above will take additional time.

In addition, tax accounting data also feeds into the Pillar Two effective tax rate calculation itself through ‘adjusted covered taxes’. Businesses may also want to consider how their tax accounting processes currently work, and whether

improvements would help support Pillar Two requirements more generally, including whether investing in tax provision technology may be of benefit.

Safe harbours and country-by-country reporting

The OECD Inclusive Framework has introduced transitional ‘safe harbours’, which will significantly reduce the Pillar Two compliance burden for many businesses for the first three years during which rules will apply. The transitional safe harbour is designed to identify a group’s operations in lower risk countries using information taken from their country-by-country report and/or financial statements.

Where any one of the following three tests is met, the top-up tax for that country will be zero and the group will not be required to prepare full calculations:

- **Effective tax rate test**: This is calculated by dividing the country’s ‘simplified covered taxes’ based on financial statements data (excluding taxes that are not Pillar Two covered taxes and eliminating any uncertain tax positions), by its profit before income tax as reported on the country-by-country report. The simplified effective tax rate for the country must be equal to or greater than the ‘transition rate’ for the year, rising from 15% in 2024 to 17% by 2026.
- **Routine profits test**: The business’s profit before income tax in a country is equal to or less than the ‘substance-based income exclusion amount’ (as calculated under the OECD model rules).
- **De minimis test**: Total revenues of less than €10 million and profit before income tax of less than €1 million are reported for a country in the country-by-country report.

The group’s country-by-country report will underpin whether it can access the transitional country-by-country reporting safe harbour and compliance benefits. Tax teams will need to consider whether country-by-country reports and processes could benefit from any improvements, and in particular whether any changes are needed to ensure that the reports will be considered ‘qualified’.

Many groups set up their country-by-country report and processes for a reporting rather than tax outcome when the rules were introduced in 2016 and tax teams may want to make improvements.

A detailed review of the country-by-country report is required to ensure that both the OECD rules for country-by-country reporting and the specific Pillar Two requirements for a ‘qualified’ report are met. Common areas of focus include ensuring that the requirement that the business’s country-by-country report is prepared and filed using qualified financial statements has been met in each country.

All of the relevant data used in the calculations for a country must come from the same qualified financial statements – either the consolidated financial statements of the ultimate parent entity (‘top down’) or separate financial statements of each group entity (‘bottom up’). Unless explicitly required, adjustments to qualified financial statement data are not permitted, even if the adjustments are intended to increase consistency with the Pillar Two rules. Tax teams will also need to consider the anti-avoidance rule which prevents the safe harbour from applying where targeted ‘hybrid arbitrage arrangements’ have been entered into.

Undertaking a review of the group’s country-by-country report and processes now gives businesses time to address any necessary improvements and establish a consistent approach.

The use of country-by-country reporting data with minimal adjustments means that the safe harbour is a blunt instrument. For example, recognition of deferred tax assets may impact a group’s ability to apply the transitional country-by-country reporting safe harbour even though no top up tax is due under the full calculations.

Tax teams may want to consider whether they can accelerate timing of their country-by-country reports so that comfort is obtained as early as possible that the safe harbour will be available for a country and that full compliance reporting will not be required. Tools which collect data for tax accounting, country-by-country reporting and Pillar Two are being developed and could facilitate automation to help groups meet tight reporting timeframes.

Other safe harbours have also been developed by the OECD, including deferring the application of the undertaxed profits rule until 2026 on the profits of a business in its ultimate parent entity country if that country applies a nominal statutory corporate income tax rate of at least 20%. A permanent safe harbour has also been developed which will allow businesses to elect to prepare a single qualified domestic minimum top-up tax computation for a country such that no additional top-up tax will arise

under an income inclusion rule or undertaxed profits rule where specific conditions are met. It remains to be seen whether the OECD Inclusive Framework can agree further permanent simplifications that will be meaningful for a wide range of groups.

Data collection

The OECD Inclusive Framework has developed a standardised ‘GloBE Information Return’, which includes a comprehensive set of accounting, tax and company data points required for a group to calculate its top-up tax liability. More than 100 data point types (depending on the definition of data point) are required for the full Pillar Two Return. This includes information about the group and filing entity, effective tax rate computations and top-up tax calculations and allocations.

As an approximate guide, the data list, in table form, includes four pages of ‘group’ data, 12 pages of data that will be required by country, six pages of data that is required by entity, and three pages of calculations of top-up tax by country.

In addition to the volume of data required, many of the data points are complex composites of underlying data which, in many cases, are not currently captured by existing tax and accounting systems and which will require time and effort to identify, access or create.

The starting point is for businesses to understand the Pillar Two definitions and how they apply to their group. Businesses will then need to identify where the required data currently resides across their organisation and what tools are needed to access it. This could include enterprise resource planning and finance systems, tax provision, tax compliance, HR, consolidated financial statements and master data.

There are significant challenges in capturing data after the event and businesses will want to begin to understand any gaps so that they can develop systems to capture real-time data where possible. For businesses with multiple different finance systems and non-finance systems, these challenges are increased.

The breadth of different data points required means that tax teams will need to work closely with colleagues across the business. For example, accounting teams will need to provide detailed trial balance amounts. Information on the legal and ownership structure of group entities is often held by tax and legal teams locally in each country. Tax teams will also need to work with their information technology

teams so that data can travel in readily usable formats throughout the group.

The transitional country-by-country reporting safe harbour was developed in response to business concerns about the compliance burden, particularly in the initial years. However, businesses will still need to prepare the full calculations for any countries which do not qualify for the transitional country-by-country reporting safe harbour from the outset, and from 2027 onwards businesses will be required to prepare full calculations for all countries. There are considerable lead times to develop new compliance systems and groups need to start planning now to have those systems in place.

Compliance

The first information returns will need to be filed by 30 June 2026 at the latest (18 months after the year-end for the first year a company is in scope reduced to 15 months for subsequent years). The intention is that the information return will be filed centrally with one tax authority (usually the parent country) with relevant information automatically exchanged with other tax authorities where agreements exist to do so. An XML schema to facilitate exchange, and competent authority exchange agreements, are being developed.

Countries can choose to use the information return for qualified domestic minimum top-up tax if they wish. Helpfully, the UK has adopted this approach. Full details of filing requirements in each country implementing Pillar Two have not yet emerged and it will be important to monitor both further updates from the OECD Inclusive Framework in respect of filing mechanics, as well as local requirements and deadlines, as some countries may require earlier filing in 2025.

Under the UK rules for its income inclusion rule (the multinational top-up tax) and qualified domestic minimum top-up taxes, the ultimate parent company (or a designated group member) will need to file a Pillar Two information return with HMRC. Alternatively, the business must notify HMRC annually of the group member filing the Pillar Two information return and in which country the information return was submitted.

The UK rules also include a requirement for businesses to register when they come into the scope of the rules and a short annual UK self-assessment return to provide

HMRC with details of entities' UK top-up tax liabilities. Payment of the UK top-up tax liability will be required in a single instalment aligned with the filing date for the return; i.e. 18 months after the year end for the first year. Businesses need to understand and develop processes to comply with local filing and payment obligations in each country where they operate.

Flexible calculation solutions are required to accommodate variations in qualified domestic minimum top-up tax calculations; e.g. countries can choose for a qualified domestic minimum top-up tax to be calculated using a local financial reporting standard rather than that of the consolidated financial statements in certain circumstances.

A key priority for tax teams is to develop a robust compliance approach based on available budget and resources. Does the team have sufficient resource and expertise to undertake Pillar Two compliance in-house?

If so, businesses will need to consider how central head office and local teams will work together, as well as the choice of software – advisors and software vendors are in the process of developing compliance platforms and return calculation engines.

Given the levels of complexity and evolving landscape for the rules, some businesses are opting to outsource or co-source Pillar Two compliance to a service provider to help manage operational risks, and so need to identify a provider to work with them.

Conclusion

Tax teams need a clear plan to deal with each of the above areas, taking into account the profile of the business and resource availability, to ensure compliance with Pillar Two obligations in all relevant countries.

In addition, now that the Pillar Two rules have begun to apply, businesses will need to apply a Pillar Two lens to all activity, including modelling the Pillar Two impact of any transactions and other operational decisions. It will remain important for tax departments to monitor the latest developments, both from the OECD Inclusive Framework and in respect of local implementation.

Pillar Two is changing the landscape for large international businesses and although many businesses have started work on at least some of the areas outlined above, tax teams will need to continue to prioritise adapting to the new Pillar Two rules throughout 2024 and for the foreseeable future.

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