

Pillar 2 part 3 – Effective tax rate and top-up amounts

(Lecture B1429 – 29 16 minutes)

Introduction

The effective rate of tax is calculated for each jurisdiction in the which the group operates. Broadly this is the tax expense divided by the accounting profit before tax.

Tax expense in Pillar 2 terms is called the 'covered tax balance'. Profit before tax in Pillar 2 terms is called the 'adjusted profits'.

This session introduces the fundamental principles of how the effective tax rate is calculated and how the top-up amount for a territory is calculated and allocated between members in the territory. It also looks at the substance based income exclusion amount in more detail.

All legislative references are to Finance (No. 2) Act 2023.

Effective tax rate (s.132)

1. Calculate the 'adjusted profits' for the period of each 'standard member' (i.e. not an investment entity or minority-owned member) in that territory;
2. Subtract the sum of the losses of members that made a loss in the period from the sum of the profits of members made a profit in the period;
3. If 2 is nil or a net loss, the effective rate is deemed to be 15% (so that no top-up amount arises) and the calculation finishes;
4. If 2 is a net profit, calculate the combined 'covered tax' balance (sum of the positive and negative covered tax balances) for the 'standard members' of the group in that territory (which can be negative);
5. If the balance in 4 is nil, the effective tax rate is nil (which means 15% top-up tax may be payable);
6. If the balance in 4 is not nil, divide the balance in 4 by the result of step 2;
7. Except where step 3 or 5 applies, step 6 is the effective tax rate (when converted to a percentage).

Stateless member (s.132)

In the event that a member of the group is treated as not located in any territory, it is deemed to be the sole member of a group located in a nominal territory.

As it is a nominal territory, it will not have to calculate any multinational top-up tax and its revenue and profits will not be included in any MNG when calculating whether that MNG is liable to the top-up tax or how much top-up tax is payable.

This can arise with US subsidiaries of a US parent where the subsidiaries have 'checked the box' for US tax filing purposes, making them transparent entities and not subject to corporate income tax.

Total top-up amount for a territory (s.194)

1. Calculate 15% minus the effective tax rate of standard members of the MNG located in the territory;
2. If 1. is nil or negative, the top-up amount is nil, otherwise continue;
3. Calculate the aggregate adjusted profits minus aggregate adjusted losses of members located in the territory;
4. Deduct the substance-based income exclusion amount (s.195) for the period for the territory from the amount in 3;
5. If the result in 4. is nil or negative, the top-up amount is nil, otherwise continue;
6. Multiply the percentage in 1. by the result in 4.

Example

A MNG has 5 members (A Inc., B. Inc, C Inc., D. Inc and E Inc.) in the territory of Erehwon, a low-tax jurisdiction.

The members' adjusted profits for the year ended 31 December 2024 are:

	£
A Inc.	15,340,210
B Inc.	(14,570,855)
C Inc.	7,450,998
D Inc.	20,190,453
E Inc.	<u>6,701,345</u>
Net profit	<u>£35,112,151</u>

Assume that the effective rate of the members in Erehwon is 2.32377%. and that there is no 'substance based income exclusion' amount (see below).

What is each company's top-up amount for the accounting period?

Analysis

1. Calculate 15% minus the effective tax rate of standard members of the MNG located in the territory (15% - 2.32377% =) 12.67623%
2. If 1. is nil or negative, the top-up amount is nil, otherwise continue - N/A
3. Calculate the aggregate adjusted profits minus aggregate adjusted losses of members located in the territory

Aggregate adjusted profits minus aggregate adjusted losses of A, B, C, D and E is £35,112,151

4. Deduct the substance-based income exclusion for the period for the territory from the amount in 3 - N/A
5. If the result in 4. is nil or negative, the top-up amount is nil, otherwise continue - N/A
6. Multiply the percentage in 1. by the result in 4.

$$12.67623\% \times £35,112,151 = £4,450,897$$

Allocation of top-up amounts - 9-step approach (s.193)

1. Determine the total top-up amount for the member's territory for the accounting period (as above);
2. If 1. is nil, there is no top-up amount, otherwise continue;
3. Determine the adjusted profits of the member for the period;
4. If there is no adjusted profit, there is no top-up amount, otherwise continue;
5. If this is the only standard member located in the territory, the member's top-up amount equals the total top-up amount for the territory, otherwise continue;
6. Determine the adjusted profits of all other standard members in the same territory;
7. Aggregate the adjusted profits of all standard member in 6. that have profits;
8. Divide the member in question's adjusted profit by the result of 7;
9. The member's top-up amount is total top-up amount for the territory (step 1) multiplied the result of step 8.

This is required where the responsible member has different ownership percentages in different entities in the territory.

Analysis of previous example

B Inc. does not have an adjusted profit, so its top up amount is nil.

A, C, D and E have top-up amounts pro-rata to their relative adjusted profits. Their aggregate adjusted profits are £49,683,006, so their top up amounts are:

	£
A Inc. $(4,450,897 \times 15,340,210 \div 49,683,006)$	1,374,266
C Inc. $(4,450,897 \times 7,450,998 \div 49,683,006)$	667,504
D Inc. $(4,450,897 \times 20,190,453 \div 49,683,006)$	1,808,780
E Inc. $(4,450,897 \times 6,701,345 \div 49,683,006)$	<u>600,347</u>
	<u>£4,450,897</u>

If, for example, the responsible member owned 100% of A and C, and 80% of D and E, the top up tax payable would be $100\% \times (1,374,266 + 667,504)$ plus $80\% \times (1,808,780 + 600,347)$, i.e. £3,969,072.

Substance based exclusion amount (s.195)

This is the sum of:

1. the 'payroll carve-out' amount plus
2. the 'tangible asset carve-out' amount for the period for each member in the territory

It plays no part in the calculation of the effective tax rate in a territory, but is deducted in Step 4 of the calculation of the total top-up amount for a territory, although the filing member can elect not to calculate the amount for the period.

The payroll carve-out amount is 5% of the eligible payroll costs for the period and the tangible asset carve out amount is 5% of the eligible tangible asset amount for the period, however transitional rules (Schedule 16) mean that the 5% figure only applies for accounting periods beginning from 2033.

For accounting periods beginning in the following years, the following percentages apply:

2023	10.0%	2028	9.0%
2024	9.8%	2029	8.2%
2025	9.6%	2030	7.4%
2026	9.4%	2031	6.6%
2027	9.2%	2032	5.8%

Eligible payroll costs (s.196)

All employment costs (e.g. salaries, wages, bonuses, costs of benefits provided, payroll and other employment taxes and social security payable) incurred by a member on individuals, where the costs are primarily incurred in respect of work done in the course of the ordinary operating activities of the member or wider group.

At least some of the work must be carried out in the member's territory and the costs must not be specifically excluded. Where an employee carries out the work in the period both in the territory in which the member is located and outside that territory, and the proportion of the time spent carrying out the work in that territory in the period is 50% or less, the payroll costs in respect of the employee are pro-rated to determine how much of those costs are eligible payroll costs.

Someone is an employee if regarded as such under the law of the member's territory or anyone acting exclusively under the direction and control of the member (including part-time workers)

The following costs are excluded:

- Those taken into account in determining the underlying profits of a PE of the member;
- Costs capitalised into the carrying value used to calculate the eligible tangible asset amount (but see s.197 below);
- Core international shipping costs (covered in Part 3);
- Ancillary international shipping costs (covered in Part 3).

Example

A UK ultimate parent company of a qualifying MNG has one member located in the low-tax territory of Ruritania. It has an adjusted profit in its year ended 31 December 2024 of £1,530,985 and an effective tax rate of 7.53509%.

Included in its adjusted profits are payroll costs of £329,700. This includes £56,940 relating to a PE of the member located in a different territory.

Calculation of top-up amount (s.194)

1. Calculate 15% minus the effective tax rate of standard members of the MNG located in the territory - 15% minus the effective rate in Ruritania (15% - 7.53509%) 7.46491%
2. If 1. is nil or negative, the top-up amount is nil, otherwise continue - N/A
3. Calculate the aggregate adjusted profits minus aggregate adjusted losses of members located in the territory: £1,530,985
4. Deduct the substance-based income exclusion amount (s.195) for the period for the territory from the amount in 3

1,530,985 minus [9.8% x (329,700 - £56,940)] **£26,730**, i.e. £1,504,255
5. If the result in 4. is nil or negative, the top-up amount is nil, otherwise continue - N/A
6. Multiply the percentage in 1. by the result in 4: 7.46491% x £1,504,255, i.e. £112,291

The eligible payroll costs have reduced the top-up amount by (7.46491% x £26,730), i.e. £1,995.

It might cost more in professional fees to calculate the amount of eligible costs than the reduction in the top-up amount, hence why the filing member can elect not to calculate it.

Eligible tangible asset amount

This is the average of the opening and closing carrying values of eligible tangible assets recorded in the consolidated financial statements multiplied by the relevant percentage.

The relevant percentage will be 5% for accounting periods beginning in 2033 onwards, but there are transitional percentages (Schedule 16) that apply before this.

For accounting periods beginning in the following years, the following percentages apply:

2023	8.0%	2028	7.0%
2024	7.8%	2029	6.6%
2025	7.6%	2030	6.2%
2026	7.4%	2031	5.8%
2027	7.2%	2032	5.4%

If there is no value recorded at the start or end of the period, the value is calculated as if it was recorded at that time. For example, the member might acquire its first item of property, plant and equipment on 1 April 2024. The eligible amount (subject to the conditions below) would be the average of the carrying amount on 1 April 2024 and on 31 December 2024.

Similarly, if the member joined the group on 1 April 2024, the eligible tangible assets amount would be based on the carrying value initially recognised in the consolidated financial statement on 1 April 2024 and the carrying value in the consolidated financial statements on 31 December 2024.

If a member leaves the group on (say) 8 May 2024, the eligible tangible assets amount would be based on the average of the carrying values on 1 January 2024 and then on 8 May 2024.

Carrying amounts include purchase accounting adjustments related to the assets on the initial consolidation of the member in the group accounts (i.e. the fair value adjustments made in accordance with generally accepted accounting principles), but must exclude the effect of any other revaluations carried out.

Eligible tangible assets

- Property, plant and equipment located in the member's territory;
- Natural resources located in that territory (e.g. oil or gas reserves recorded in the consolidated financial statements)
- Right of use asset where the underlying asset is a tangible asset located in the member's territory;
- Licences or similar rights granted by a government of the territory to use a tangible asset, where it is expected that the member will incur significant expenditure in enhancing the value of tangible assets in that territory (irrespective of whether those assets are subject to the right) – e.g. an exploration licence to search for mineral resources in the territory.

The following assets are excluded:

- Property (including land and buildings) held for sale (IFRS 5), held to lease out or held for investment purposes (irrespective of whether they were sold, leased out or held for investment in the period);
- Used in the course of a core or ancillary international shipping activity (if there is an ancillary international shipping profit cap of more than nil in the period, only the eligible proportion of the asset is excluded).

Other issues

Assets located in more than one territory

Where an asset is only located in the same territory as the member for part of the period, it is regarded as located in that territory for the whole period. Where the proportion of the period in which the asset (or in the case of a right, the asset to which the right relates) is located in the territory is 50% or less, the carrying values are multiplied by that proportion

Impairment losses and reversals

Impairment losses and reversals are included in the carrying amounts. Reversals are limited to the amount that would give the assets their carrying value as if no impairment loss had been recognised originally (automatic if IFRS or impairment accounting similar to IFRS has been used).

Example

UP Ltd is the UK ultimate parent company of a qualifying MNG has one member, MTUT Inc. located in the low-tax territory of Ruritania. It has an adjusted profit of £1,530,985 in its year ended 31 December 2024 and an effective tax rate of 7.53509%. MTUT has elected not to include eligible payroll costs, but has property, plant and equipment located in Ruritania and used in its trade of professional services.

The items had the following carrying values:

	1 January 2024	31 December 2024
	£	£
In MTUT Inc.'s local accounts	1,530,261	1,782,541
In UP Ltd's consolidated financial statements	1,930,400	2,150,308

Neither MTUT Inc. nor UP Limited has an accounting policy of revaluing property, plant and equipment.

Calculate the top-up amount for Ruritania.

1. Calculate 15% minus the effective tax rate of standard members of the MNG located in the territory: (15% - 7.53509%) 7.46491%
2. If 1. is nil or negative, the top-up amount is nil, otherwise continue - N/A

3. Calculate the aggregate adjusted profits minus aggregate adjusted losses of members located in the territory: £1,530,985

4. Deduct the substance-based income exclusion amount (s.197) for the period for the territory from the amount in 3.

- Average carrying value in consolidated financial statements $(1,930,400 + 2,150,308) \div 2 = £2,040,354 \times 7.8\% = \mathbf{£159,148}$

- Adjusted profits $(1,530,985 - 159,148) \mathbf{£1,371,837}$

5. If the result in 4. is nil or negative, the top-up amount is nil, otherwise continue - N/A

6. Multiply the percentage in 1. by the result in 4.

$7.46491\% \times £1,371,837 \text{ i.e. } £102,406$

The eligible tangible asset amounts have reduced the top-up amount by $(7.46491\% \times 159,148)$, i.e. £11,880.

The filing member can choose to include or exclude a qualifying asset or not to calculate a tangible asset substance-based income exclusion amount.

Contributed by Malcolm Greenbaum