

Introduction to Pillar 2 taxes (Lecture B1420 – 29.39 minutes)

Interaction and order of precedence

Subject to tax rule (STTR) is a withholding tax levied by developing nations on certain payments to connected parties. This does not affect UK companies but they may see it being applied to intra-group transactions in other territories.

Domestic in-scope companies or groups that have an effective tax rate of less than 15% will be taxed under the Qualified Minimum Domestic Top-up Tax (QMDTT).

Foreign activities of in-scope group companies that have an effective rate of less than 15% will generally be collected under the Income Inclusion Rule (IIR – aka Multinational Top-up Tax). In calculating the effective rate of tax, any domestic top-up tax payable in the jurisdiction is added to the 'covered tax' balance.

Foreign profits taxed at an effective rate of less than 15% which are outside the scope of the IIR can be taxed in the UK under the proposed Undertaxed Profits Rule (UTPR).

STTR arises on payment, so takes precedence over QDMTT. QDMTT is taken account of when computing IIR tax, so takes precedence over it. IIR tax takes precedence over the UTPR.

Subject to tax rule (STTR)

This is targeted at developing countries (Gross National Income per capita of USD12,535 or less in 2019) that have ceded taxing rights in a tax treaty (e.g. many sub-Saharan African countries).

It is a tax treaty-based rule (via a multi-lateral instrument introduced by the OECD) that specifically targets risks to source jurisdictions posed by basis-erosion and profit-shifting (BEPS) structures.

It will apply to payments between connected persons that take advantage of low nominal rates of taxation in the other contracting jurisdiction (i.e. the jurisdiction of the payee). It will cover payments like royalties, interest, mobile assets.

STTR is a 'covered tax' for the purpose of computing the effective tax rate for QDMTT, IIR and UTPR purposes.

QMDTT (domestic top-up tax) and IIR

Part of the OECD action on Global Anti-Base Erosion (GloBE), the domestic top-up tax legislation is in Part 4, F(No.2)A 2023. The IIR legislation is in Part 3, F(No.2)A 2023.

Substantial amendments have been proposed in Finance Bill 2023-24 in line with the latest guidance issued by the OECD.

The legislation (including the proposed amendments) first apply to accounting periods beginning on or after 31 December 2023. Many other jurisdictions have introduced similar legislation to the UK.

The UK QMDTT is focused on UK operations of any company or group, where the effective rate of tax of the operation is less than 15%.

The UK IIR is focused on foreign operations of a UK in-scope holding company ('responsible member') where the effective rate of tax in any jurisdiction where the group operates is less than 15%.

If so, a top-up UK tax is payable by the responsible member, but only to the extent of its ownership interest in the foreign operation.

The effective rate = $\text{tax expense} \div \text{accounting profit before tax}$

The tax expense known as the 'covered tax balance' in the legislation and includes deferred tax but not necessarily the amount included in the financial statements.

Accounting profits need to be adjusted for the provisions of the legislation which be covered in a later part.

There are transitional provisions that can defer application of the rules until later ('safe harbour' provisions) which will be covered in the next part of this series.

Undertaxed profits rule

Draft legislation was issued by the government on 27 September 2023.

It acts as a backstop for situations where profits are subject to tax at an effective rate of less than 15% but cannot be collected by the IIR. The most common example is likely to be where the profits of the ultimate parent entity are undertaxed, but the parent is not in a jurisdiction that has adopted Pillar 2 taxes.

It will apply to accounting periods beginning on or after 31 December 2024.

Example

ABC Group is a very large group headquartered in Jersey which has no corporate income tax.

It has a UK holding company under the ultimate parent which has ownership interests of operations in several low-tax jurisdictions.

The IIR does not apply to the HQ jurisdiction (Jersey), only those of group members below it.

What taxes might the UK holding company have to deal with?

- STTR – if group members make certain payments to connected persons in low-tax jurisdictions (if the tax treaty has been updated to provide for STTR).
- UK QDMTT – if there are UK activities with an effective rate of less than 15%
- UK IIR – if the UK holding company has ownership interests in foreign operations with an effective tax rate of less than 15%
- UTPR – on the profits of the Jersey ultimate parent entity

QDMTT overview

Applies to UK scoped-in entities whose rate of tax is less than 15%.

Scope (s.266)

Non-excluded and non-investment entities meeting 2 conditions:

1. The entity is located in the UK for an accounting period, and
2. If not a group member, revenue exceeds €750 million p.a. pro-rata (if the accounting period is not 365 days) or if it is a group member, consolidated revenue exceeds €750 million p.a. in at least 2 of the previous 4 accounting periods

The QDMTT is based on the criteria used in the IIR rules (including the turnover threshold to be within the scope).

QDMT has the same safe harbour transition exemptions as for IIR (s.276), but ignoring reference to CbCR where all group members are located in the UK (see the next part for details of the Safe Harbour CbCR provisions).

The ultimate UK parent will not have a top-up amount for a territory where there is a local QMDTT that meets the three tests, HMRC will issue a list of QMDTTs in other jurisdictions in due course – but probably not until close to filing deadlines.

When could QDMTT apply in the UK?

The UK effective tax rate would have to be less than 15%. This could be caused by use of the patent box regime, or enhancement reliefs (like the 130% super-deduction for new plant and machinery, or 86% relief for SME R&D relief).

It could also be caused by a lot of exempt income (e.g. QDMTT non-excluded dividends).

IIR Impact

If a jurisdiction's tax laws are such that an operation has an effective rate below 15%, the legislation ensures that 15% is the minimum rate the owner/part-owner of the operation will bear.

This could and has encouraged low-tax jurisdictions to introduce corporate income tax, or increase CT rates. E.g. UAE, at 9% from 1 January 2024

Example (simplified to illustrate the point)

A UK-headquartered multinational group has operations in the UAE with adjusted profits of £100 million.

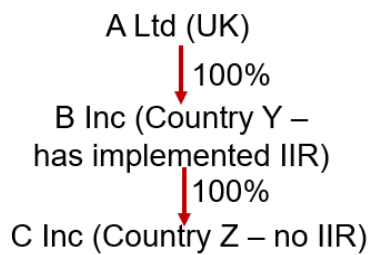
If the UAE charges 0% tax, the responsible member will have to pay 15% (£15 million) UK top-up tax to HMRC.

If the UAE charges 9% tax, then £9 million is paid in the UAE, so £6 million would be payable as a top-up tax.

The total tax is the same, so the UK hold-co would be indifferent to UAE charging up to 15% CT.

The UAE has said it will introduce a different (as yet unspecified) rate for multinationals with UAE operations within the scope of Pillar 2.

Interaction of Pillar 2 taxes - example



C Inc has £100m profits in an accounting period, on which it pays tax at an effective rate of 13%.

1. Who is responsible for the reporting and collection of top-up tax from C Inc's operations (if anyone)?
2. How much top-up tax will be paid (if any)?
3. How would your answer differ if the UK had not implemented IIR?
4. How would your answer differ if country Z had implemented both a domestic and multinational top-up tax?

Analysis

Top-up tax will be collected by the UK, through the multinational top-up tax, as the UK is the jurisdiction in which the ultimate parent is located and it has implemented IIR rules.

Under the IIR rules, a top-up amount of up to $(£100m \times [15\% - 13\%])$ £2m will be charged to bring it to the effective rate.

If the UK had not implemented MTT, the amount would have instead been collected by Country Y, the jurisdiction of the intermediate parent.

If Country Z had implemented the IIR rules, including a QDMTT, it would have been able to collect the top-up amount itself. In which case, A Ltd would not have a IIR tax liability.

Reporting in 2023/24 financial statements

There is an exemption from deferred tax accounting for the impact of top-up tax under both under UK GAAP and IFRS for 12 month accounting periods beginning on or after 1 January 2023 and ending in 2023 or 2024.

The entity must disclose information that is known or can be reasonably estimated and that helps users of its financial statements to understand the exposure to Pillar 2 taxes at the reporting date. This does not need to reflect all the specific requirements in the legislation. Companies can provide an indicative range.

Disclosures may include quantitative and qualitative information.

Qualitative information

How the company is affected by Pillar 2 taxes and in which jurisdictions the exposure arises e.g., where the top-up tax is triggered and where it will need to be paid.

Quantitative information

The proportion of profits that may be subject to Pillar 2 taxes and the average effective tax rate applicable to those profits, or how the average effective tax rate would have changed if Pillar 2 legislation had been effective.

If information is not known or cannot be reasonably estimated at the reporting date, the company must make a statement to that effect and information about its progress in assessing the Pillar 2 exposure.

Contributed by Malcolm Greenbaum