

Pillar 2 taxes: Covered tax balance – Part 2 (Lecture B1444 – 23.23 minutes)

Introduction

The 'total deferred tax adjustment amount' is included in the calculation of the covered tax balance.

The 'total deferred tax adjustment amount'

1. Covered taxes paid/ refunded in the current period relating to an uncertain tax position excluded in an earlier period (see above);
2. Credit/refund relating to a tax credit that is not a qualifying refundable tax credit and has not been reflected in qualifying current tax expense of the current or a prior period;
3. Covered taxes refunded/credited other than a qualifying refundable tax credit;
4. 'Special loss' deferred tax assets used in the current period (see below);
5. Covered taxes recorded in OCI relating to amounts included in the adjusted profits which are subject to covered taxes;
6. Covered taxes relating to changes in accounting policy/prior period errors included in this period's adjusted profits;
7. Amounts allocated to the member from another MNG member.

Total deferred tax adjustment amounts (s.182)

The starting point is the deferred tax expense relating to covered taxes reflected in the member's underlying profit.

This is then adjusted to exclude:

- DT expense related to items not reflected in the member's adjusted profits;
- DT expense related to disallowed accruals or unclaimed accruals;
- Impact of a valuation adjustment or accounting recognition adjustment with respect to a deferred tax asset (e.g. if a DT asset is not recognised because it is assessed that it is not probable that the asset will be recovered in the foreseeable future, it is still assumed to be recognised when calculating the adjusted deferred tax in this section);
- DT expense arising from a re-measurement due to a change in the rate of tax;
- DT expense that reflects the generation or use of tax credits.

Unclaimed accruals (s.182)

If a DT liability is reversed in an accounting period (hence reducing deferred tax expense), and the liability was originally treated as an 'unclaimed accrual' in a previous period, the DT is increased to ignore the reversal.

The unclaimed accrual is the increase in a DT liability reflected in the member's underlying profits for an accounting period that is not expected to be reversed before the end of the 5th accounting period after that period, and in respect of which the filing member has elected not to include in the total DT adjustment amount for that period.

A disallowed accrual is any movement in DT expense included in the member's underlying profits which relates to either:

1. An uncertain tax position, or
2. Distributions from another member of that group

Other DT adjustments (s.183)

Where a DT asset is not reflected in the DT expense only as a result of the recognition criteria not being met, that DT asset is reflected in the total DT adjustment amount.

Where a recaptured DT liability (relating to a timing difference that does not reverse within 5 years) for a previous accounting period is reversed during the accounting period, it is included in the total DT adjustment amount.

The recaptured DT liability excludes accelerated capital allowances, R&D expenses, FV gains and losses, FX gains and losses and gains rolled over.

Where the DT expense related to covered taxes where the rate is greater than 15%, the amount of that expense (after adjustment as above) is adjusted so that it reflects the amount it would have been had the rate been 15%.

Example

An entity in a foreign territory with a 31 December year-end purchases an intangible asset for £1.2 million on 30 June 2024. The tax law in the territory gives 100% tax relief when purchased.

The company will amortise the intangible asset over its estimated useful life of 8 years on a straight-line basis.

The relevant tax rate in the territory is 15%.

Analysis

The entity would recognise a DT liability on 30 June 2024 of $(15\% \times £1.2 \text{ million})$ £180,000 with a corresponding deferred tax expense in P&L.

The DT liability would be amortised to the DT expense (as a credit) in the profit and loss account as the asset is depreciated.

By 31 December 2024, the asset will have been depreciated by 6 months (out of 8 years), i.e. by 6.25%.

As a result, the net DT expense recognised in respect of the asset at 31 December 2024 will be $(180,000 - 6.25\%, \text{ or } £11,250)$, i.e. £168,750.

£22,500 of the remaining deferred tax balance will reverse out each year for the following 5 accounting periods (£112,500 in total).

This leaves (168,750 – 112,500) £56,250 which will reverse out more than 5 accounting periods after the initial period.

The recaptured deferred tax liability is therefore £56,250.

The recaptured DT liability is excluded from the covered DT adjustment amount for the initial period and the effective tax rate and the top-up amounts must be recalculated for the initial period, i.e. the DT expense for the year ended 31 December 2024 would need to be reduced by £56,250 if this was the DT liability still outstanding at 31 December 2029 in respect of the asset purchased.

Existing DT balances on entering Pillar 2 (s.185)

Each DT asset and liability as at the start of the first accounting period to which Pillar 2 applies is taken into account in determining the DT expense.

If the nominal rate related to the asset is less than 15% and the member can demonstrate that a DT asset relates to a loss which would have been taken into account in determining adjusted profits if those profits were subject to Pillar 2, the asset is taken into account in calculating the DT expense as if the rate of tax to which the asset related was 15%.

If not, each asset and liability is calculated as the smaller of the actual nominal rate or 15%.

To the extent that a DT asset is not recognised because it is not considered probable that it will be recovered in the foreseeable future, it is recognised for this purpose and is included in the net DT expense as if it was recognised.

Where a DT asset relates to a tax credit, on its reversal, if the nominal tax rate exceeds 15%, the amount of reversal (and therefore DT expense amount) is treated as the amount of DT expense in the underlying profit x 15% and divided by the nominal tax rate applying on the reversal.

DT assets are ignored where they arose to a member on a transaction after 30 November 2021 and before the first period subject to Pillar 2 where the item is included in the taxable income but would not have been included in the adjusted profits had Pillar 2 applied then, or vice-versa.

DT assets recorded at less than 15% (s.186)

Where a member of an MNG has an adjusted loss and the value of a DT asset was computed using a tax rate of less than 15%, the member can elect for the DT asset to be computed using a tax rate of 15%.

If the loss on which the DT asset is based exceeds the adjusted loss, the 'relevant part' of the asset (i.e. the adjusted loss) is treated as having been computed using a tax rate of 15%.

Special loss DT assets election (s.187)

The filing member can make an election that covers standard members in a particular territory. It must be made to have effect for the first accounting period to which Pillar 2 applies and, if revoked later, cannot be made again. An election cannot be made for a territory that has an 'eligible distribution tax system' (ss188 – 192).

The result of the election is that none of the members in that territory has a total deferred tax adjustment amount for the period and if those members have, between them, made a loss, the amount of the loss multiplied by 15% is a special loss deferred tax asset of those members.

If the members of that territory have, between them made a profit, and the members have one or more special loss deferred tax assets, they must use those assets in that period to increase their covered tax balances as follows:

1. The amount of the special loss deferred tax assets that is to be used is the smaller of the amount of the assets, and the amount which would cause the effective tax rate of the standard members of the group in that territory to be 15%
2. Any remainder continues to be a special loss deferred tax asset of the relevant members (and is carried forward to later accounting periods)

Each of the members that made a profit in that period must use the proportion of the total amount in proportion to its adjusted profits compared to the total adjusted profits of all the members that made a profit.

Eligible tax distribution systems (ss.189 – 192)

The filing member can elect that a deemed distribution tax arises (s.190) to the standard members in a territory, if it has an eligible tax distribution system, i.e. where tax at a rate of at least 15% is generally only payable by a company when profits are distributed (or deemed to be distributed) to its members, or when it incurs certain non-business expenses, and the system was in force on or before 1 July 2021.

The legislation details the deemed distribution tax amount, certain 'recapture' amounts and recalculations when a member leaves the group.

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