

Pillar 2 taxes - Part 5 (Lecture B1440 – 23.25 minutes)

The effective rate of tax must be calculated for each jurisdiction in the which the group operates. This is generally the tax expense divided by the profit before tax.

Tax expense in Pillar 2 terms is called the 'covered tax balance'. This session covers the contents of the covered tax balance.

Covered taxes (s.173)

Covered taxes are:

1. taxes on profits of that member (including, where it has direct or indirect ownership interests in another member of the group, taxes on its share of income/profits of that other member);
2. taxes imposed under an eligible distribution tax system;
3. taxes imposed as a substitute for a tax on profits that generally applies in the territory of the member; and
4. taxes charged by reference to a company's capital, or by reference to its capital and profits.

None of the following are covered taxes:

- multinational top-up tax, or any tax equivalent to multinational top-up tax
- a qualifying domestic top-up tax
- a qualifying undertaxed profits tax
- A disqualified refundable imputation tax
- where the member carries on a life assurance business, taxes in respect of which amounts were charged to the member's policyholders

Covered tax balance (s.174)

1. Start with the qualifying current tax expense for the period
2. Exclude amounts in s.175 below
3. Included amounts in s.176 below
4. Include any covered taxes allocated to the member and exclude amounts allocate from the member to other members
5. Adjust for any amount of covered taxes that is taken into account more than once to ensure there is no double-counting
6. If there is a net tax credit, it is referred to as a 'negative covered tax balance'

7. If there is a net expense (or nil) it is referred to as a 'positive covered tax balance'

Exclusions from covered tax balance (s.175)

- Amounts relating to income or gains not included in adjusted profits
- Amounts relating to an uncertain tax position (IAS 12)
- Credits or refunds related to qualifying refundable tax credits recorded as a reduction of qualifying current tax expense
- Amounts not expected to be paid before the end of 3 years and 1 day after the end of the accounting period
- Amounts allocated to another member of the MNG
- Amounts excluded under a blended CFC regime

Amounts included in the covered tax balance (s.176)

- Covered taxes reflected in underlying profits but not currently reflected in current tax expense (unlikely)
- The 'total deferred tax adjustment amount' (see next session)
- Covered taxes paid/ refunded in the current period relating to an uncertain tax position excluded in an earlier period (see above)
- 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
- Covered taxes refunded/credited other than a qualifying refundable tax credit
- 'Special loss' deferred tax assets used in the current period (see below)
- Covered taxes recorded in OCI relating to amounts included in the adjusted profits which are subject to covered taxes
- Covered taxes relating to changes in accounting policy/prior period errors included in this period's adjusted profits
- Amounts allocated to the member from another MNG member

Tax relating to a permanent establishment (s.177)

Any amount of qualifying current tax expense included in the underlying profits accounts of a member that is in respect of profits of a PE must be allocated to the PE.

Where the PE profits are treated as income of the main entity, covered taxes on the profits are allocated to the main entity up to a maximum of the profits allocated x the highest corporate tax rate on ordinary income in the territory where the main entity is located

A deferred tax asset related to a PE loss treated as an expense of the main entity is ignored in both the PE and the main entity when computing the covered tax balance, to avoid double counting.

Tax expense reallocation (s.178)

Where profits are allocated to a member of an MNG and the member from whom it was allocated has qualifying current tax expense, the qualifying current tax expense is allocated to the member to whom the profit was allocated.

The tax allocated cannot exceed the 'mobile income' reallocated x (15% minus the effective tax rate of members in the territory where the member is located, ignoring the qualifying current tax expense)

Mobile income means:

- Dividends
- Interest
- Rent
- Royalties
- Annuities or gains from assets producing these forms of income
- in respect of which a member of a MNG is subject to tax under a CFC tax regime or as a result of an ownership interest regarded as tax transparent where the member is located but not where the entity is located

Example

UPCo Ltd is the ultimate parent of a qualifying MNG. One of its subsidiaries, O Inc. is located in a low-tax jurisdiction, Ruritania. UPCo has 4 other members located in Ruritania, including M Inc.

O Inc. has an ownership interest in M Inc. of 40%.

M Inc. has adjusted mobile profits for the year ended 31 December 2024 of £4.8 million and for Pillar 2 purposes, its profits are allocated to its owners, including O Inc.

M Inc. has a qualifying current tax expense of £384,000 on its profits

The effective tax rate of all the members resident in Ruritania for the accounting period is 7.4%.

Calculate the tax expense of M to be allocated to O.

Analysis

O Inc. must add (40% x £4.8m) £1.92 million to its adjusted profits for the year ended 31 December 2024.

The amount of qualifying current tax expense allocated to O Inc. is ordinarily (40% x £384,000) £153,600.

This is restricted to (£1.92m x [15% - 7.4%]), i.e. £145,920.

This will reduce O Inc.'s overall effective rate of tax, compared to if it was permitted to just include its share of M Inc.'s current tax expense of £153,600.

CFC tax regimes (s.179)

If a member is subject to a CFC regime and has an ownership interest in another member that is a CFC entity, any qualifying current tax expense in its accounts relating to its share of the profit of the CFC is allocated to the CFC.

A CFC entity is a CFC of a member of the MNG, a PE of the CFC or an entity whose profits are treated as the profits of the CFC.

This does not apply to a 'blended CFC regime' in accounting periods commencing on or before 31 December 2025 and ending on or before 30 June 2027, i.e. broadly the first 2 years of the income inclusion rule.

The amount of qualifying current tax expense for mobile income is restricted in the same way as set out in s.178 above and the amount not allocated to the other member remains with the CFC but is excluded from the CFC's covered tax balance if it relates to income or gains excluded from the CFC's adjusted profits.

Blended CFC regimes (s.180)

The provision is designed to cover the US GILTI rules (Global Intangible Low-Taxed Income of US CFCs, typically taxed at 10.5% - 13.125%).

A blended CFC regime is (broadly), a CFC regime where income, losses and creditable taxes of all an entity's CFCs are aggregated to calculate the CFC tax liability. It does not take into account income of group members arising in the entity's location and which operates by reference to a rate reflecting a threshold for low taxation.

The amount allocated cannot exceed the 'mobile income' reallocated multiplied by (15% minus the effective tax rate of members in the territory where the CFC is located), ignoring the qualifying current tax expense.

The appropriate proportion is allocated to the CFC if it is a member of the MNG, otherwise it is allocated to the member who has an ownership interest in the CFC.

Intra-group distributions taxed on recipient (s.181)

Where qualifying current tax expense relates to a distribution received from another member of the group in which it has a direct ownership interest, that expense is allocated to the member that made the distribution.

Distributions received includes deemed distributions taken account of for the purposes of taxes on a shareholder of an entity in respect of undistributed earnings or capital of the entity.

Contributed by Malcolm Greenbaum