

Pillar 2 Part 4 – Adjusted profits (Lecture B1435 – 32.53 minutes)

Introduction

The effective rate of tax is calculated for each jurisdiction in the which the group operates. Broadly it is the aggregate tax expense of entities in the jurisdiction ÷ the aggregate profit before tax of those entities.

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 focuses on the main principles to consider in arriving at 'adjusted profits' for an entity in a jurisdiction. These principles need to be applied to all entities in that jurisdiction to arrive at the aggregate adjusted profits.

A future session will focus on the covered tax balance.

Reminder of the calculation of the 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)

Overview of calculation of adjusted profits

The starting point is 'underlying profits'. These are, broadly, the profit before covered taxes of the entity determined in preparing the consolidated financial statements of the ultimate parent and, by default, it includes income, expenses, gains and losses arising from transactions with other group members.

These underlying profits are then adjusted in accordance with the provisions of Chapter 4, F(No.2)A 2023, a similar idea to adjusting profit for corporation tax purposes but with totally different types of adjustments.

Certain elections can be made to vary the calculation of various amounts (see below).

Underlying profits (s.134)

Normally, the underlying profits of a member, other than one that is a permanent establishment (e.g. a foreign branch) are the member's profits as would be determined in preparing the consolidated financial statements of the ultimate parent.

It is permitted to determine the underlying profit of the member under a different accounting standard using the information in its separate financial accounts if

1. it is not reasonably practicable to determine the profits on the basis of the accounting used in the consolidated financial statements, and
2. the alternative accounting standard is an acceptable or authorised accounting standard (GAAP in the jurisdiction where the entity is located), and
3. the alternative accounting standard is actually used for the financial accounts of that member, and
4. The information in those accounts is reliable (i.e. an auditor applying generally accepted auditing standards of a 'relevant territory' would reasonably conclude that the member has processes in place likely to make the information in the financial statements fair and accurate)

If presented in a foreign currency, the profit is converted at the average fx rate for the period.

If the application of an accounting policy under an alternative accounting standard result in a difference of more than €1 million that is not eliminated over time, the underlying profits must be adjusted to eliminate the difference.

Underlying profits of permanent establishments (s.135)

The underlying profits of a member of a multinational group (MNG) that is a permanent establishment (PE) are the member's profits:

- if the member has separate financial accounts, as reflected in those accounts.
- if not, as reflected in the underlying profits accounts of the main entity – this will require attribution of the profits between the PE and the main entity (see s.159 below).

If the member is a PE whose income is exempt from tax in the territory of the main entity (e.g. a s.18A CTA 2009 election has been made for a UK owned PE), the member's underlying profits include only its 'relevant income' and 'relevant expenses'.

Relevant income

The income of the member exempted from tax where the main entity is located which is attributable to operations carried out outside the main entity's territory

Relevant expenses

The expenses of the member attributable to those operations and that are not deducted for tax purposes in the main entity's territory.

The profits of a PE are ignored in determining the adjusted profits of the main entity and vice-versa to avoid double-counting, except for any profits of a PE that are excluded by s.159 below and which are then subject to s.160 below (attribution of losses between a PE and the main entity).

Summary of adjustments

1. Amounts included in other comprehensive income or shareholders' equity are generally ignored, except voluntary revaluation of property, plant and equipment (gain or loss in OCI is included in adjusted profits and the current or deferred tax effect is included in the covered tax balance);
2. Dividend income generally excluded (exceptions in s.141);
3. Investment FV gains and losses and disposal gains and losses generally ignored (unless owning < 10%);
4. Profit from equity accounting a qualifying interest generally excluded;
5. Illegal payments;
6. Fines and penalties of at least €50,000 for the same conduct;
7. Pension expense added back and replaced with amounts paid;
8. Intra-group transfers not at arms' length must be restated to arms' length price;
9. Debt forgiven and credited to P&L ignored in entity is in financial distress;
10. International shipping profits are ignored.

Changes in accounting policy / prior period errors (s.146)

In the accounts, these are normally accounted for retrospectively (net assets/ accumulated profits adjusted as at the start of the period when the change in policy is made/error discovered).

Member's profits are adjusted to include the amount of the change if it is attributable to a change in accounting policy that affects income or expenses included in the adjusted profits.

If there has been the correction of a prior period error, the underlying profit is adjusted if the amount of the error would have been included in the underlying profit of a previous period had it not have arisen, except if the correction results in a material decrease to the member's liability for covered taxes (such that there would have needed to be a post-filing adjustment of covered taxes – see future session).

Qualifying refundable tax credits (s.148)

If necessary, the profits of a member of an MNG are adjusted to ensure that qualifying refundable tax credits are treated as income (like the treatment of the RDEC in the UK), and that other tax credits (whether refundable or not) are not treated as income.

A refundable tax credit is 'qualifying' to the extent that it entitles a person to receive the amount of refundable tax credit as a payment or discharge of a liability) within 4 years of meeting the

conditions for receiving it, unless it is creditable/refundable pursuant to a qualified or disqualified refundable imputation tax (s.253 – covered in a future session).

Permanent establishments (s.159)

A PE in accordance with a tax treaty has its underlying profits adjusted to reflect all income and expenses attributable to it in accordance with the tax treaty.

A PE in a location with which the UK does not have a tax treaty has its underlying profits adjusted to only reflect all income and expenses attributable to it in accordance with the law of the territory in which the PE is located.

If the member is a PE located in a territory without corporate income tax, its underlying profits reflect all income and expenses that would have been attributed to it in accordance with Article 7 of the OECD model tax treaty.

Amounts are included or excluded in the underlying profits of a PE whether they are subject to tax or not, or in the case of expenses, whether they are tax deductible or not.

Attribution of losses between main entity and PE (s.160)

The amount of PE loss treated as an allowable expense of the main entity in the territory where the main entity is located and not set off against income subject to tax under the laws of both the PE territory and the main entity territory (similar to the concept of ‘dual inclusion income’ in the hybrid mismatch legislation) is treated as an expense of the main entity when determining its adjusted profits (‘the relevant amount’).

Where this is the case, the relevant amount is excluded from the adjusted profits of the PE for the relevant period (to avoid double counting the loss) and any adjusted profit of the PE (up to the relevant amount) is treated as income of the main entity when computing the main entity’s adjusted profits.

Any profit of the PE treated as income of the main entity is excluded from the adjusted profits of the PE for that period.

Example

MainEnt Inc. is a member of a large worldwide group located in Ruritania, with a UK ultimate parent company (the responsible member). It has a branch in Utopia, a low tax territory.

In the year ended 31 December 2024, MainEnt Inc. has adjusted profits for Pillar 2 purposes, ignoring its branch, of £24.6 million. The Utopian branch made a loss of £1.5 million.

Under Ruritanian tax law, £1.3 million of this loss is treated as deductible against the profits of MainEnt Inc. in Ruritania.

MainEnt Inc. also has rental income of £0.6 million arising in Utopia .

Under the double tax treaty between Ruritania and Utopia, this is taxable in both territories, with a double tax credit available in Ruritania for any Utopian tax suffered.

The branch loss in Utopia can be offset against total taxable income in Utopia.

Explain how the branch loss will adjust the profits of MainEnt Inc. for Pillar 2 purposes.

Analysis

So much of the PE loss of £1.5 million that is treated as an expense of MainEnt Inc. (£1.3 million) and is not set off against income taxable in both territories (£0.6m is set off against the rental income taxed in both territories, so the other £0.7m is not) is deducted in arriving at the adjusted profits of MainEnt Inc. The adjusted profits of MainEnt Inc. are therefore (£24.6m - £0.7m) £23.9 million.

The £0.7 million deducted in calculating MainEnt Inc.'s adjusted profits are excluded from the calculation of the branch's adjusted profits.

Elections to vary underlying profit calculations

The responsible member must consider if any of the following elections are beneficial.

1. Can elect that all members (or all members which are investment entities) ignore unrealised profits and losses from FV movements (s.161);
2. If later revoked, there is a catch-up adjustment to ensure all previous unrealised gains and losses are taken into account in the period of revocation;
3. Stock-based compensation (s.162) – using the amount tax deductible rather than the accounting expense;
4. Spreading of net gains on tangible assets over 5 years (current year and 4 prior years) – convoluted calculations (s.163) – will lead to recalculations of prior years if within scope of Pillar 2 previously;
5. Exclusion of intra-group transactions between group members in the same territory (s.164);
6. Inclusion of otherwise excluded equity gains and losses (s.165);
7. Exclusion of exchange gains or losses if hedging currency risk in ownership interests owned by the member or another group member (a net investment hedge) (s.166).

Underlying profits of transparent entities (s.168)

Where a member of an MNG ('M') is a flow-through entity (i.e. it is regarded as tax transparent where it is located and is not subject to a covered tax on its profits in another territory in which it is resident).

A proportion of its underlying profits is allocated to each entity or individual ('O') with an ownership interest in it to which one of two conditions apply:

1. 'O' is not regarded as tax transparent where it is located and M is regarded as tax transparent where O is located - If O's ownership interest in M is indirect, each entity through which O holds the interest must be tax transparent where O is located and none of these entities must meet Condition A;
2. O is a 'reverse hybrid entity' (i.e. it is transparent where established but opaque where its investors are located) and M is tax transparent where O is located. - if O's ownership interest

in M is indirect, each entity through which O holds the interest must be tax transparent where O is located and none of these entities must meet Condition A nor B.

Where underlying profits of M are allocated to a member of M's group, those profits are included in the member's adjusted profits and excluded from M's adjusted profits.

Where underlying profits of M are allocated to an individual or to entity which is not a member of M's group (or would be allocated to them if M was regarded as tax transparent in the territory where they are located), those profits are excluded from M's adjusted profits.

Where there are indirect investors, the underlying profits of M allocated to the direct investor in M are reduced by the profits allocated to the indirect investor (to avoid double counting the profits).

Where M's underlying profits are allocated to a group member, they are excluded from adjusted profits of M to be allocated to other investors.

If the ultimate parent is a flow-through entity, it is to be treated as if it were not regarded as tax transparent in the territory in which it is located.

Adjustments where the ultimate parent is a flow-through entity (s.170)

If the ultimate parent is a flow-through entity and has an adjusted profit for the period before considering this section, its profits are further adjusted to exclude any 'qualifying profits'.

These are profits to which the holder of a direct ownership interest in the ultimate parent are entitled and one of three conditions is met:

1. The holder of the ownership interest is taxable on it at a rate of at least 15% for a period that ends within 12 months of the group's accounting period and it is reasonable to assume that the sum of the covered taxes payable by the ultimate parent on the profit the holder is entitled to plus the taxes payable by the holder is at least 15% of the profits to which the holder is entitled;
2. The holder of the ownership interest is an individual not resident in the ultimate parent's territory and is entitled to no more than 5% of the profit and assets; or
3. The holder of the ownership interest is a governmental entity, international organisation, non-profit or pension fund located in the ultimate parent's territory and is entitled to no more than 5% of the profit and assets.

Where profits are allocated to the ultimate parent as a result of s.168 above, those profits are regarded as profits to which holders of ownership interests in the ultimate parent are entitled (pro-rata).

If the ultimate parent makes a loss for the period, the loss is adjusted to exclude any amounts where a holder of an ownership interest is allowed to use part or all of the loss in computing their taxable profits.

This section also applies to a member that is a PE by which an ultimate parent that is a flow-through entity carries out its business.

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