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# Navigating Pillar II: Key Considerations

June 26, 2024



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# Session CPE Requirements

- You need to attend 50 minutes to receive the full 1 CPE credit.
- 4 Polling Questions will be launched during this session. You must respond to a minimum of 3 to receive the full 1 CPE credit.

**\*\*Both requirements must be met to receive CPE credit\*\***



# Learning Objectives

*At the end of this session, you will be able to:*

- Recognize Pillar II and its impact on multinational companies
- Recall the scope of the global minimum tax and safe harbors
- Identify the Effective Tax Rate (ETR) calculation
- Recall transfer pricing and financial reporting impacts and related planning
- Discuss data management and leading practices for Pillar II compliance



# Polling Question #1

Is your company subject to Pillar II for financial year 2024?

- Yes
- No
- Unsure



# History

Starting in 2013, the OECD and G20 began its Base Erosion and Profit Shifting (“BEPS”) project to combat tax avoidance by standardizing aspects of global taxation regimes.

- Proposed standards regarding CFC regimes, anti-hybrid rules, PE standards, treaty standardization through the Multi-Lateral Instrument (MLI), and others.
- The US and EU exited the BEPS project in 2017-2018 with passage of the TCJA and EU Anti-Tax Avoidance Directive (“ATAD”), both implementing components of the BEPS Action items.

In 2016, an Inclusive Framework initiative was spun out of the BEPS project to include developing countries. Currently, 143 countries have joined the Inclusive Framework.

- Two proposals to address tax challenges arising from digitalization:
  - Pillar 1 – Taxing right for market jurisdictions; for MNEs with over €20 billion revenue
  - Pillar 2 – 15% global minimum tax; for MNEs with over €750 million revenue



# Acronyms and Definitions

## **MNE** – Multinational Enterprise

- Collection of CEs included in consolidated financial accounts

## **CE** – Constituent Entity

- Subsidiary or Permanent Establishment within MNE
- Does not include “Excluded Entities” such as pension funds, tax-exempt entities and investment/real estate funds

## **IIR** – Income Inclusion Rule

- Residence-based tax regime requiring 15% minimum “top up” tax for any CE

## **Covered Taxes** – Current tax expense for financial statement purposes with certain adjustments

## **GloBE Income** – Financial (US GAAP) net income with certain adjustments

## **SBIE** – Substance-Based Income Exclusion

- 5% of net tangible assets plus 5% of total payroll costs

## **QDMTT** – Qualified Domestic Minimum Top-Up Tax

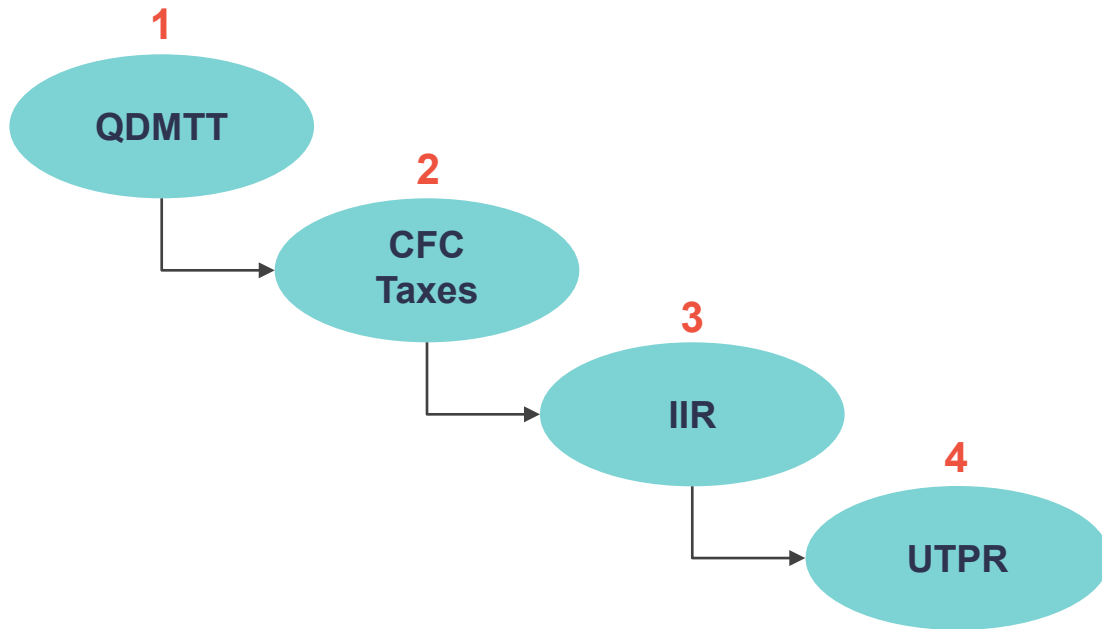
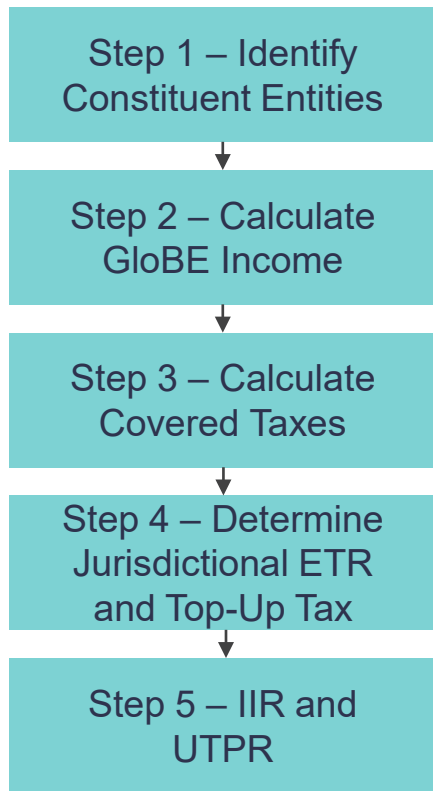
- Generally, 15% less jurisdictional ETR

## **UTPR** – Undertaxed Payments Rule

## **ETR** – Effective Tax Rate (Adjusted Covered Taxes/GloBE income)



# Mechanics





# Mechanics (Cont'd)

## Step 1 – Identify Constituent Entities

- Identify Ultimate Parent Entity (UPE) and CEs, including PEs, and remove Excluded entities
- Identify relevant jurisdiction for each CE
  - First test is country of tax residence – if no tax residence, look to country of formation
  - Flow-through entities are generally considered resident where income is taxed

## Step 2 – Calculate GloBE Income

- Generally, US GAAP net income/(loss), adjusted for:
  - Participation dividends/equity in sub earnings
  - Stock based compensation
  - Disallowed deductions
- PE and intercompany allocations generally comport with local tax treatment



# Mechanics (Cont'd)

## Step 3 – Calculate Covered Taxes

- 1) Starting point is current tax expense per US GAAP financials
- 2) Deferred tax expense from use of NOL carryforwards or certain DTAs is included, but capped at minimum rate (15%)
- 3) DTL Recapture Rule – Deferred tax expense not “paid” within 5 years is adjusted retroactively, on a “per item” basis
- 4) Certain refundable credits are also included when used to reduce current expense
- 5) Post-filing adjustments increase top-up tax liability in future year
- 6) GILTI taxes may be allocated to CEs’ covered taxes starting in 2026 (see following slides)

## Step 4 – Determine jurisdictional ETR and Top-Up Tax

- 1) Covered Taxes/GloBE income (on jurisdictional basis) = Jurisdictional ETR
- 2) Top-Up Tax % = Minimum Rate (15%) – Jurisdictional ETR
- 3) Jurisdictional Excess Profit = GloBE income – SBIE
- 4) Jurisdictional Top-Up Tax = (Excess Profit x Top-Up Tax %) – QDMTT



# Mechanics (Cont'd)

## Step 5 – IIR and UTPR

- If UPE has an IIR, IIR takes precedence for paying any Top-Up Tax
- If UPE does not have IIR, look down ownership chain to owners of CE with Top-Up Tax due
  - GILTI is considered a “Blended CFC regime” and is not an IIR
- If no IIR applies, or IF Top-Up Tax remains after IIR, UTPR applies
  - UTPR apportions remaining Top-Up Tax liability not covered by IIR between jurisdictions with enacted UTPR regimes, with allocation based on two factors:
    - Net book value of tangible assets, and
    - Number of employees



# Polling Question #2

Which of the following best describes your current strategy for Pillar II compliance and data readiness?

- Well-defined and documented
- Informally defined but consistently applied
- Ad hoc and improvised as needed
- Nonexistent or unclear



# Safe Harbors

## 1) Transitional CbCR Safe Harbor

- Temporary measure only effective through financial years beginning before December 31, 2026.
- Applied at jurisdictional level – if applicable, jurisdiction UTPR is zero.
- Must meet at least one of three tests:
  - De minimis test: jurisdictional revenue is less than EUR 10 million and pre-tax profit is less than EUR 1 million;
  - ETR test: the simplified ETR is greater or equal to 15% (2024), 16% (2025), 17% (2026);
  - Routine profits test: pre-tax profit is equal to or less than the substance-based income exclusion amount as calculated under the GloBE rules.
- “Once out, always out” – if MNE chooses not to apply or does not meet CbCR Safe Harbor in Year 1, CbCR Safe Harbor is not available in subsequent years.

## 2) Transitional UTPR Safe Harbor

- Temporary measure only effective through financial years beginning on or before December 31, 2025.
- Applies if Ultimate Parent Entity (UPE) of MNE is taxed at a rate of at least 20%.
- Applied at jurisdictional level – if applicable, jurisdiction UTPR is zero.



# Recent Developments

- February 2023 Administrative guidance provides allocation methodology for GILTI tax to CEs
  - Blended CFC Allocation Key = Tested income (pro rata) x (GILTI rate – Jurisdictional ETR)
  - Blended CFC Tax Allocated to CE Covered Taxes = Blended CFC Allocation Key (CE)/Sum of Blended CFC Allocation Keys
  - Applied to net GILTI tax (i.e., net of FTCs)
  - Until GILTI rate increases to 16.4% in 2026, no GILTI taxes will be allocable
- Transitional guidance released on July 17, 2023, delays application of UTPR to 2026 for CEs with US UPE
  - Aligns with potential for increase in Covered Taxes from GILTI allocation described above
  - Question remains whether GILTI changes will qualify GILTI as IIR
- Notice 2023-55 suspends application of new FTC regulations, which prevented creditability of apportioned taxes in non-treaty jurisdictions
- Notice 2023-80 provides that QDMTTs are creditable as FTCs. IIR taxes are generally not creditable if computed with reference to US taxes (i.e., GILTI/Subpart F tax allocation). UTPR treatment is reserved for future.
  - Extends Notice 2023-55 relief period to tax year beginning after December 31, 2023, at earliest.
- Latest Biden Administration Green Book proposal calls for US adoption of Pillar 2 → GILTI becomes IIR (country basketing)



# ASC 740 – Overview

- ASC 740, *Accounting For Income Taxes*, is the US GAAP standard for financial statement reporting of income taxes.
- Requires calculation of both current income tax liability, and future (deferred) income tax impacts of reversing book-tax basis differences of assets and liabilities, on an entity-by-entity and country-by-country basis.

	US GAAP Net Income	
+/-	Income Tax Expense/(Benefit)	
	<u>US GAAP Pre-Tax Income</u>	
+/-	Permanent Book-Tax Adjustments	
	TI Before Temporary Items	
x	Statutory Income Tax Rate	
	<u>Total Tax Expense</u>	
	TI Before Temporary Items	
+/-	Temporary (Deferred) Items	
	<u>Taxable Income</u>	
x	Statutory Income Tax Rate	
	<u>Current Tax Expense</u>	
	Total Tax Expense	
	<u>US GAAP Pre-Tax Income</u>	=ETR



# ASC 740 – Overview (Cont'd)

“Rate Driving” Adjustments:

- Valuation Allowance
  - Reduction of Deferred Tax Asset based on realizability (e.g., use of NOL carryover based on expected future income)
- Uncertain Tax Positions
  - Income tax filing positions which are not MLTN to be sustained, based on technical merits
- Permanent Adjustments including APB 23 liability and prior period adjustments





# ASC 740 – Pillar 2 Reporting

- QDMTT, IIR and UTPR are all in scope of ASC 740, i.e. accounted for as income tax expense.
  - Accounted for as Alternative Minimum Tax, and not factored into deferred taxes except in cases where QDMTT is imposed with no other income tax applied in CE’s country.
- UTPs, while not taken into account for Pillar 2, may arise in Pillar 2 tax provision calculations.
- DTL Recapture Rule – Deferred Tax expense does not increase Covered Taxes if payment is not made within 5 years – expense is “recaptured” and Top-Up Tax recomputed for the year in which the DTL arose. Noncurrent liability is established for future Top-Up Tax if company does not intend to avoid recapture in future year.
  - Applied on item-by-item basis, i.e., cannot be aggregated (e.g. non-Goodwill intangibles)
- MD&A and Footnote disclosures, as well as interim reporting issues need to be considered starting in 2024.



# “Subject to Tax” Rule and TP Impacts to Pillar 2

“Subject to Tax Rule” (STTR) is separate from, but coincident with Pillar 2 to allow source country payments of “Covered Income” (interest, royalties, rents, service payments) to apply additional WHT if the payee country does not tax such income at more than 9% tax rate.

- STTR is a Treaty “backstop” to Pillar 2 to be implemented through the BEPS MLI.

Pillar 2 rules make TP and Country-by-Country Reporting (“CbCR”) even more important:

- CbCR transitional safe harbor provides taxpayers the opportunity to significantly reduce their compliance obligations and data required in relation to Pillar 2 calculations
  - Requires “qualifying” CbCR based on qualified financial statements with TP adjustments included
  - One of the following tests must be satisfied to apply the safe harbor: (1) *de minimis* test, (2) simplified ETR test, or (3) routine profits test
  - “Real time” TP approach is critical
- Potential double taxation due if TP adjustment is not bilateral
  - For example, tax on TP adjustment in Country 1 could create Top-Up Tax in Country 2 if Country 2 does not agree with Country 1 adjustment
  - GloBE rules address unilateral TP adjustments



# Transfer Pricing Impacts of Pillar 2

- Transactions between CEs located in different jurisdictions must be priced in accordance with the **arm's length principle** if that differs from the price recorded in the entities' accounts.
- To the extent possible, avoid transfer pricing adjustments on tax returns after the close of the financial statements by ensuring that arm's-length TP is properly reflected in the company's year-end financial statements.
- The GloBE rules rely on typical OECD transfer pricing principles for determining an arm's length price.
- Taxpayers can rely on bilateral APAs or the conclusions of local tax audits, and this cannot be called into question by a third tax authority that is applying the IIR or UTPR.
- The GloBE rules recognize that multinational entities may be subject to a unilateral adjustment to the intercompany pricing of a transaction without the benefit of a corresponding adjustment in the jurisdiction of the related party to this transaction.
  - To avoid double taxation based on a unilateral transfer pricing adjustment, the GloBE rules allow for adjustments to GloBE income to reflect the corresponding adjustment (even if not granted by the local tax authority).
  - The exception to this is where the unilateral adjustment is to the profits of an undertaxed jurisdiction. (Where the nominal tax rate is below 15% or the GloBE ETR was below 15% in each of the two years preceding the unilateral adjustment).



# Pillar 2 and Unilateral TP Adjustments

**Scenario 1:** Unilateral adjustments should be reflected on both sides of the transactions if it is made in a high tax jurisdiction (tax > 15%);

**Scenario 2:** Unilateral adjustment made in an under-taxed jurisdiction would be effective for GloBE purposes, but no corresponding adjustment to high tax jurisdiction will be effective for GloBE purposes. Hence, based on rules, adjustment is ignored from both ends.

Particulars	Entity A		Entity B	
<b>As filed</b>				
Income	\$	1,200	\$	800
Intercompany Transaction	\$	(200)	\$	200
Total Income	\$	1,000	\$	1,000
Tax Rate		25%		15%
Tax (a)	\$	250	\$	150
<b>Scenario 1: Upward adjustment in Entity A</b>				
Intercompany Transaction as a result of adjustment	\$	(100)	\$	100
Adjusted Income (b)	\$	1,300	\$	900
Tax	\$	325	\$	135
ETR (c=a/b)		19%		17%
<b>Scenario 2: Upward adjustment in Entity B</b>				
Intercompany Transaction as a result of adjustment	\$	(300)	\$	300
Adjusted Income (b)	\$	900	\$	1,100
Tax	\$	225	\$	165
ETR (c=a/b)		28%		14%

*Conclusion: Scenario 2 creates top-up tax for entity B, hence, ignored*

**Solution:** Make sure the transfer pricing policies are reasonable, adjustment is made before closing of the books to avoid any of the scenarios



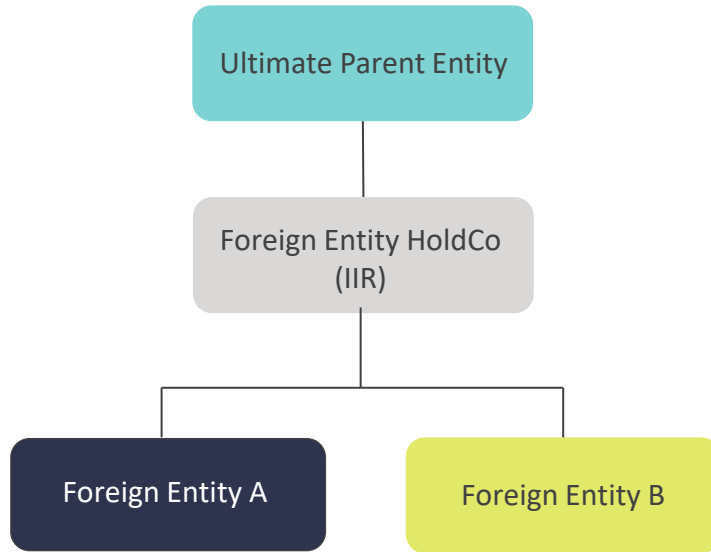
# Polling Question #3

What resources do you feel are missing in your approach to Pillar II?

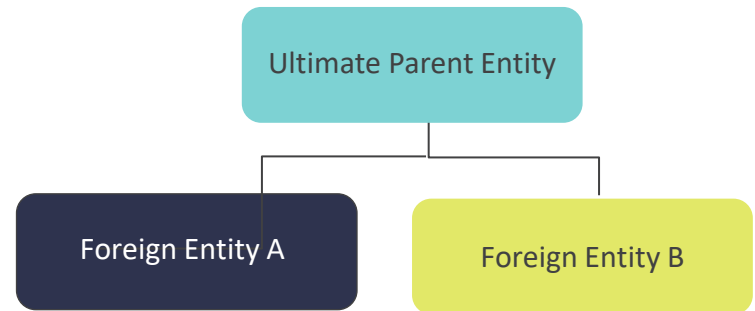
- Professional guidance or consulting
- Financial investment
- More dedicated staff
- Better technology or tools



# Legal Entity Structuring



Before



After



# Key Takeaways

- Reevaluate financial statement reporting process, particularly income tax provision calculations.
  - “Materiality” for financial statement purposes may not be sufficient to ignore items if errors/omissions have Pillar II reporting and penalty and cash tax impact.
  - Transfer pricing should be contemporaneous.
  - Consolidated and local country statutory audits may serve additional purpose in a Pillar II world.
- Rely on safe harbors – CbCR Safe Harbor until 2026 and UTPR Safe Harbor until 2026 and related interplay.
- Closely monitor country legislation (including U.S.) and OECD administrative guidance.
  - Nuanced differences between QDMTT/IIR regimes means reliance on local advisors will be critical.
- Consider changes to legal entity structure and global value chain in evaluating cost vs. benefit, accounting for Pillar II taxes and compliance costs.



# Thank you!

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