Pillar Talk - No1

June 2023

This is the first in our new series, Pillar Talk, dedicated to the developments of Pillar 1 and 2, primarily in the UK, but where we think relevant or interesting in other jurisdictions too.

This note provides a high-level summary of the UK domestic Pillar 2 legislation: Multinational top-up tax. The legislation follows the Pillar 2 model rules released by the OECD at the end of 2021. It does not seem to be a piece of legislation which the UK tax authority was keen to implement as it increases the administrative burden upon HMRC (and business) while potentially contributing little, if any, revenue to the Exchequer. This is because revenue from the legislation is dependent on other countries having an effective tax rate lower than 15%, and with the eagerness of other countries and jurisdictions to implement a domestic minimum tax so that they benefit and not the parent's jurisdiction, the UK may not see a penny. Therefore, it remains to be seen whether the added administrative burden is justified, but we doubt it.

1. Pillar Two Update: The United Kingdom Minimum Tax Legislation Background and Assumptions

1.1 The United Kingdom (**UK**) Finance (No. 2) Bill 2023 (**the Bill**) includes legislation to implement the provisions of the Pillar Two income inclusion rules (**IIR**). The rules are very complex and the legislation seems to have been drafted in a way to make them nearly impossible to understand but, in essence, the Bill introduces a "multinational top-up tax" (**MTUT**) for multinational groups (**MNG**) with an annual revenue of at least €750 million (in two of the previous four accounting periods) that have at least one member in the UK (**qualifying MNG**).

1.2 An MNG, also referred to as a consolidated group, means an entity (**the ultimate parent or UP**) which is not controlled by any other entity and other entities in which it has a controlling interest.

1.3 It also includes entities whose assets, liabilities, income, expenses and cash flows are consolidated in the financial statements of the UP, or are only excluded because of the entity's size, materiality or potential sale.

1.4 MTUT liability arises in the UK when a member of the MNG located outside the UK makes profit in an accounting period and its effective tax rate is less than 15%. (The rules in relation to a UK domestic top-up tax, although included in the Bill, are outside the scope of this note.)

1.5 A person is chargeable to the MTUT if the group is a qualifying MNG in that period, and the person is:

- a responsible member of the group in the period and is a body corporate or an unincorporated partnership and is located in the UK; or
- the person is chargeable to tax on behalf of an entity that is a responsible member of the MNG at any time in that period.

1.6 A person is chargeable to tax in respect of a responsible member of an MNG if the responsible member is a transparent entity (i.e. a partnership) and is located in the UK.

1.7 The amount of MTUT to be paid is the sum of the top-up amount of members the chargeable person is responsible for which are attributed to it as a result of its interest in those entities.

1.8 Certain entities, such as pension funds and non-profit organisations, are not treated as members of the MNG. Also, an investment fund and a real estate investment trust (UK or overseas) will be excluded if they are the UP of the group. Furthermore, certain subsidiaries of these excluded entities are also disregarded.

1.9 The UP is a responsible member of that group if it is subject to a Pillar 2 IIR tax, such as the UK's MTUT. It is subject to an IIR tax if, directly or indirectly, it has an interest in a company located in a low tax jurisdiction and it is liable to a top-up tax to ensure that the income of the company is taxed at a minimum rate of 15%.

1.10 Where the UP is not subject to Pillar 2 IIR tax, for instance where it is located in a jurisdiction that has not implemented the Pillar 2 rules, the responsibility shifts to an intermediate parent member with an ownership interest in the relevant group member (i.e. it moves down a level in the structure).

2. Calculation of the Top-up Amount

2.1 The calculation of the top-up amount to be subjected to tax is a three-tiered exercise involving "standard" members of the group in the territory. A group member is considered standard where it is not a minority holding or an investment entity.

2.2 A permanent establishment of an entity will be a standard member and its underlying profits will be its profits if it has a separate financial account, or the profits attributed to it in the accounts of its parent.

2.3 The first step in calculating the top-up amount is the ascertainment of the effective tax rate of the MNG in the territory. Note that there are special rules for calculating the top-up amount for investment entities and joint ventures.

2.4 By using a fictitious group, Beta Group, in Country A, we illustrate the operation of these rules.

The Effective Tax Rate[1]

2.5 Step 1 - Determine the adjusted profits of each standard member in that territory for the relevant period. Beta Group, in our example, has eight companies in Country A with four of those in a profitable position and the other four in a loss position.

Calculation of Adjusted Profit

2.6 The underlying profits of a member are the profits as they would be determined in preparing the consolidated financial statements for the ultimate parent, but in certain circumstances it is permissible to calculate this profit using alternative accounting standards.

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[1] See spreadsheet ***Effective Tax Rate and Substance Based Income***

2.7 Some of the adjustments that are required to be made to underlying profits, include:

- adjusting the profits to reflect a pre-tax position by adding back any deductions for tax expenses and excluding credits;
- adjusting the profits to include income, expenses, gains and losses arising from intra group transactions which would have been eliminated in consolidation adjustments. However, there is scope for the filing member to make an election to exclude these intra group transactions;
- adjustments of profits to negate adjustments made on the acquisition of the shares of a third-party entity by a member of the group;
- adjustments of profits to exclude dividends, inter alia, arising from a transparent entity in which it has less than a 10% holding, long-term portfolio holdings, and distributions accruing from a debt position rather than a qualifying interest;
- primary and secondary transfer pricing adjustments to reflect an arm's length price for transactions between members of the group; and
- excluding expenses paid in respect of an intra group finance arrangement from the underlying profits of a group member where it is reasonable to expect that for the duration of the arrangement there would be a deduction/non-inclusion mismatch and the group lender is a high tax member.

The adjusted profit and loss position for group members is as detailed in the table below.

	Company A	Company B	Company C	Company D	
Adjusted profit	£150,000.00	£250,000.00	£350,000.00	£400,000.00	
Total					**£1,150,000.00**

	Company V	Company W	Company Y	Company 7	
Adjusted loss	-£25,000.00	-£75,000.00	-£80,000.00	-£35,000.00	
Total					**-£215,000.00**

2.8 Step 2 - Subtract the sum of the losses of group members that made a loss from the consolidated profit of members of the group that made profit in the period.

Consolidated Adjusted Position	Company V
Total Adjusted Profit	£1,150,000.00
Total Adjusted Loss	-£215,000.00
Difference	**£935,000.00**

2.9 Step 3 - If the result at Step 2 is nil or less, the effective tax rate is to be treated as 15%, otherwise we move to the next step.

2.10 Step 4 - Determine the covered tax balance of the standard members of the group. This is the aggregate of the taxes the member is liable to on its own profits, its share of the income or profits of another group member, the operation of an eligible distribution system, as a substitute for tax on profits, and taxes charged by reference to its capital and profits. Top-up taxes, however, are not covered taxes. We therefore assume that Country A grants group loss relief and has a corporation tax rate of **8.5%**, giving us a tax figure of **£79,475.00** which we adopt as the covered tax.

2.11 Step 5 - If the balance is nil, the effective tax rate is 0%. Otherwise, we proceed to the final step.

2.12 Step 6 - Divide the result of Step 4 (sum of covered taxes) with the result of Step 2 (consolidated territorial profit or loss). In our case the answer is **0.085**.

2.13 Step 7 - The effective tax rate will be the result of Step 6 expressed as a percentage (result/100) which is **8.5%**.

The Top-up Amount for a Territory[2]

2.14 Having obtained the effective tax rate for entities in a territory where the rate is less than 15%, the next step is to determine the amount that has to be topped-up to reach the minimum rate.

2.15 Step 1 - Subtract the effective tax rate of the standard members of the group in that territory for that period as determined above (result of Step 7 above) from 15%. This gives us 6.5%.

2.16 Step 2 - If the result of Step 1 is nil or less, the total top-up amount for that territory is nil. Otherwise, we proceed to the next step.

2.17 Step 3 - Subtract the sum of the losses of members that made a loss from the sum of the profits of members of the group that returned a profit in the period (a repeat of Step 2 above). In Beta's case the answer is **£935,000.00**.

2.18 Step 4 - Subtract the substance-based income exclusion for that period for the territory, if any, from the result of the preceding step. The substance-based income exclusion amount is the sum of 5% each of the eligible payroll cost and tangible asset amount for the period.

2.19 Eligible payroll cost refers to all costs incurred by the member in the period in relation to the employment of an employee and includes salaries, payroll taxes and social security contributions.

2.20 The eligible tangible asset amount is the average of the sum of the carrying values of each eligible tangible asset held by the member at the beginning and at the end of the period.

2.21 Eligible assets include: property, plant and machinery located in the same territory as the member, natural resources located in that territory, a lease on a tangible asset located in that territory, a licence or similar right to use a tangible asset in that territory where it is granted by government and there is an expectation that the member will expend significant sums in enhancing the value of the asset.

2.22 We have a substance-based income of £61,450.00 per our calculations[3], and this gives us the sum of **£873,550.00**.

2.23 Step 5 - If the result of Step 4 is nil or less, the total top-up amount for that territory is nil. Otherwise, we proceed to the last step.

2.24 Step 6 - Multiply the difference between the group's effective tax rate and 15% (6.5%) by the result of Step 4 (consolidated profit/loss of the group less the substance income exclusion amount). This is the top-up amount for the territory. This gives us the sum of **£56,780.75**.

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2 See spreadsheet ***Top-up Amount for Country A***.

3 See spreadsheet ***Effective Tax Rate and Substance Based Income***

The Top-up Amount Accruing to a Standard Member of the Group in the Territory (Company C)[4]

2.25 Where it has been determined that a multinational group has a top-up tax in a territory, the next step will be to determine the amount of top-up tax that accrues to a standard member of the group. In this case we use Company C of the Beta group.

2.26 Step 1 - Ascertain the top-up amount accruing to the group in the territory as determined in Step 6 above (**£56,780.75**).

2.27 Step 2 - If the total top-up amount is nil then the member in question has no top-up amount. Otherwise, we proceed to the next step.

2.28 Step 3 - Determine the adjusted profits of the member in question for the period. Company C's adjusted profit is **£350,000.00**.

2.29 Step 4 - If the member has made no profit in the period, then the member has no top-up amount.

2.30 Step 5 - However, if there are no other standard members of the group located in the territory, the top-up amount for the territory becomes that of the member regardless of its loss-making position. Otherwise proceed to the next step.

2.31 Step 6 - Determine the adjusted profits of all the members of the group in the territory including the member in question (as above).

2.32 Step 7 - Add together the adjusted profits of all profitable standard members of the group in that territory (**£1,150,000.00**).

2.33 Step 8 - Divide the member's adjusted profit by the sum of the adjusted profits of all members in Step 7. This gives us **0.304347826**.

2.34 Step 9 - The member's top-up amount is the result of multiplying the total top up amount of the territory by the result of Step 8 above. The member's top-up amount is **£17,281.10**.

Allocating Top-up Amounts to Responsible Members[5]

2.35 The MTUT liability of a responsible member is obtained by multiplying the member's top-up amount (the result of Step 9 above) by the responsible member's inclusion ratio for the member.

2.36 A responsible member's inclusion ratio for a member with a top-up amount is found as follows:

2.37 Step 1 - Determine the adjusted profits of the relevant member with a top-up amount (**£350,000.00**).

2.38 Step 2 - Determine how much of those profits are attributable to ownership interests held by entities other than the responsible member. We assume for this purpose that Beta group owns 90% of the shares in Company C, and we attribute 10% of its shares to another entity. This gives us the sum **£35,000.00**.

2.39 Step 3 - Subtract the amount determined by Step 2 from the amount determined under Step 1 (**£315,000.00**).

2.40 Step 4 - The inclusion ratio is determined by dividing the profits attributable solely to the responsible member under Step 3 by its adjusted profits under Step 1. The inclusion ratio in this instance is **9:10**.

2.41 The MTUT liability of the Beta Group for Company C will be **£15,552.99**.

4 See spreadsheet ***Company C's Top-up Amount***.

5 See spreadsheet ***Inclusion Ratio for Ultimate Parent***.

Election to Treat Top-up Amount as Nil

2.42 The filing member of an MNG may elect that the total top-up amount for the territory in an accounting period be treated as nil. This election can be made if the average revenue of the standard members in that period is less than €10 million, and the average of the adjusted profits of those members for an accounting period is less than €1 million.

Hybrid and Transparency Considerations

2.43 Where a member of the group is regarded as opaque in its location and transparent in a territory in which a member of the group with an ownership interest in it is located, profits of the investee member reflected in the accounts of the investor company as belonging to the latter will be reallocated to the investee (i.e. reflected as belonging to the company invested in and not its investor).

2.44 Where a member of the group is regarded as tax transparent in the territory in which it is organised and is not subject to any covered tax on its profits, its profits are to be allocated proportionally to the entities with an ownership interest in it according to their holdings.

2.45 Finally, where an opaque entity is not tax resident in any territory, not subject to covered taxes and has no place of business, it will be deemed to be a transparent entity and its profits reallocated to its investors.

3. Conclusion

Despite the sovereignty arguments raised recently by members of the Conservative Party, the Chancellor has gone ahead with plans to implement the MTUT in the UK. The rules are expected to come into effect on 31 December 2023 - a day ahead of the European Union implementation timeline of 1 January 2024. The United States seems less enthusiastic, although it introduced a new corporate alternative minimum tax of 15% at the end of last year for large corporations with annual financial statement income in excess of US$1 billion.

Prepared by Andersen LLP on 8 June 2023

Effective Tax Rate and Substance Based Income

Calculation of Effective Tax Rate for Beta Group (Country A)

STEP 1										
	Company A	Company B	Company C	Company D		Company V	Company W	Company Y	Company Z	
Adjusted profit / loss	£150,000.00	£250,000.00	£350,000.00	£400,000.00		-£25,000.00	-£75,000.00	-£80,000.00	-£35,000.00	
Total					**£1,150,000.00**					**-£215,000.00**
STEP 2										
Consolidated adjusted profit/loss										
Total Adjusted Profit	**£1,150,000.00**									
Total Adjusted Loss	**-£215,000.00**									
Consolidated Group Position	**£935,000.00**									
Corporation Tax @8.5%	**£79,475.00**									
STEP 3	Not applicable									
STEP 4										
Deemed Covered Tax Balance (8.5% tax)	£79,475.00									
STEP 5	Balance is more than nil									
STEP 6	0.085									
STEP 7	8.50%									

Effective Tax Rate and Substance Based Income

Calculation of Substance Based Income

	Company A	Company B	Company C	Company D		Company V	Company W	Company Y	Company Z	
Payroll Cost	£50,000.00	£55,000.00	£74,000.00	£90,000.00		£17,000.00	£20,000.00	£30,000.00	£50,000.00	
Tangible Assest	£100,000.00	£122,000.00	£150,000.00	£200,000.00		£60,000.00	£55,000.00	£76,000.00	£80,000.00	
Payroll Cost (5%)	£2,500.00	£2,750.00	£3,700.00	£4,500.00		£850.00	£1,000.00	£1,500.00	£2,500.00	
Tangible Assest (5%)	£5,000.00	£6,100.00	£7,500.00	£10,000.00		£3,000.00	£2,750.00	£3,800.00	£4,000.00	
Total	£7,500.00	£8,850.00	£11,200.00	£14,500.00		£3,850.00	£3,750.00	£5,300.00	£6,500.00	
Gross					**£42,050.00**					**£19,400.00**
Gross Substance based income	**£61,450.00**									

Top-up Amount for Country A

STEP 1	
Minimum Tax	15.00%
Effective Tax Rate	8.50%
Deficit	**6.50%**
STEP 2	Balance is more than nil
STEP 3	
Total Adjusted profit	£1,150,000.00
Total Adjusted loss	-£215,000.00
Consolidated Position	**£935,000.00**
STEP 4	
Consolidated Adjusted Position	£935,000.00
Excluded Substance Based Income	£61,450.00
Result	**£873,550.00**
STEP 5	Balance is more than nil
STEP 6	
Deemed Covered Tax Balance (8.5% tax)	**£79,475.00**

Company C's Top-up Amount

The Top-up Amount Accruing to Company C, a Standard Member of the Beta Group

STEP 1	Group's Top-up Amount in Country A	£56,780.75
STEP 2	Not applicable	
STEP 3	Company C's Adjusted Profit	£350,000.00
STEP 4	Not applicable	
STEP 5	Not applicable	
STEP 6	Adjusted Profits as Above	
STEP 7	Gross Adjusted Profits	
STEP 8		
C's Adjusted Profit		£350,000.00
Group Adjusted Profit		£1,150,000.00
Result		**0.3043478261**
STEP 9	Members Top-up Amount	**£17,281.10**

Inclusion Ratio for Ultimate Parent

Beta Group's Inclusion Ratio for Company C

Assuming Beta owns 90% of Company C

STEP 1	Adjusted Profit of C	£350,000.00
STEP 2	Atributed to other entities	£35,000.00
STEP 3		£315,000.00
STEP 4	Inclusion ratio	0.9
The MTUT Liability		£350,000.00
C's Top-up Amount	£17,281.10	£1,150,000.00
Inclusion Ratio	**9:10**	**0.3043478261**
MTUT of Beta Group for C		**£15,552.99**