

Global taxation: More than an idea - what it means for you now

What you need to know

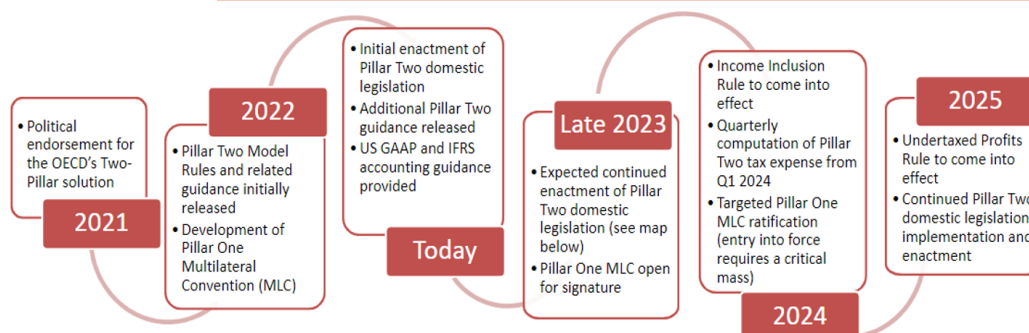
- The OECD is working on two new rules that are poised to significantly alter the international tax landscape. Pillar Two, the global minimum tax, is here
- The tax is based on book income under the parent's GAAP
- The cost of compliance will be significant and require cross-functional strategic planning and analysis
- Companies will need new processes, systems and controls to calculate the tax
- Pillar Two creates the possibility of jurisdictions outside the US collecting tax from US companies
- Companies should be preparing now

The current international tax landscape has been in place for decades, but now major changes are on the horizon for multinational companies. The Organisation for Economic Cooperation and Development (OECD) backed by countries around the world, has been pursuing a Two-Pillar Solution aimed at alleviating certain global tax challenges that it believes arose from the “digitalisation of the economy.” The OECD two-pillar framework is significantly altering many current international tax practices with a related impact on reported earnings and cash flows.

In simplest terms, Pillar One would change where sales to customers in other jurisdictions are taxed and Pillar Two proposes a global minimum tax assessed for each jurisdiction where a multinational company operates. We explore implications of this evolving global tax regime for US-based multinational companies below, with a focus on Pillar Two.

The OECD's agenda

OECD is a group of countries, including the US, that collaborates to help set standards for global policies in a number of areas, including tax. Recently, the OECD has expanded its outreach to non-member countries to enhance cooperation on tax issues through a group known as the Inclusive Framework. Over time, the OECD has increased its focus on inconsistencies between tax systems of different countries and how multinational enterprises organize their international operations to manage their global tax burden. Base Erosion and Profit Shifting and country-by-country reporting are OECD-driven initiatives that have influenced changes in tax laws around the world over the last several years. More recently, the OECD has focused on ways to reallocate some taxable profits to jurisdictions where the related goods are sold and services are consumed, resulting in the proposed Two-Pillar Solution. Through its global cooperation agreement, what the OECD agrees to as policy today will often drive tax law changes in various jurisdictions.



While the prospects for Pillar One remain uncertain, Pillar Two is here. The OECD continues to finalize the Pillar Two Model Rules and implementation guidance, and multiple countries around the world have announced plans or are already in the process of enacting legislation on Pillar Two.

Pillar One would change nexus

The objective of Pillar One is to reallocate more profit to market jurisdictions — essentially where customers are — from where it is currently taxed. While today profit is generally taxed where the productive property or employees reside or decisions are made, Pillar One would modify nexus (where a company is taxed) for multinationals.

Many think of Pillar One as a focus on the technology sector and “digital services taxes,” however, it would have an impact well beyond tech companies. Pillar One would apply to any multinational entity with global turnover (revenue) above €20 billion (about \$22 billion as of May 31, 2023) and profit margin greater than 10% (i.e., profit before tax divided by revenue). With some exceptions for the extractives and financial services sectors, any globally-engaged company that exceeds the established threshold would be subject to Pillar One.

Pillar One is still being negotiated; agreement has not been reached on several key issues, including dispute resolution provisions as well as the treatment of withholding taxes and unilateral measures such as digital services taxes. Despite these issues, the OECD Inclusive Framework is aiming to finalize a multilateral convention for participating jurisdictions to reallocate profits. For Pillar One to enter into force, however, a “critical mass” of countries, including the US, must ratify it. At this time it remains unclear if and how the US will participate; ratification of a multilateral treaty would require the approval of two thirds of the US Senate.

Pillar Two’s minimum tax is based on book income

The objective of Pillar Two is for large multinational enterprises to pay a minimum level of tax (a threshold effective tax rate of 15%) on the income arising in each jurisdiction where they operate. This is per the proposal, or “Model Rules,” which are also referred to as the “Anti Global Base Erosion” or “GloBE” rules.

Unlike many current tax systems, the Pillar Two minimum tax would be determined based on financial reporting: financial results reported in a company’s consolidated financial statements, with certain modifications. This would result in a very complex set of calculations that would require new processes, controls, and systems. Among other considerations, a company would have to maintain separate books and records for each jurisdiction — potentially for each consolidated subsidiary — using the accounting framework of the group’s parent entity (US GAAP for most US-headquartered companies).

Because the Pillar Two calculation is by jurisdiction, companies would be required to prepare financial reports on a recurring basis at entity levels that previously may not have been necessary. Specifically, items that may be eliminated in consolidation or recorded only in consolidation and not “pushed down” to the individual constituent entity’s books and records may affect both the ultimate tax due and the jurisdiction in which such tax is payable. These items include intercompany sales, intellectual property transfers, management fees, and transfer pricing charges. Despite similarities, the recently enacted US book minimum tax, which is based on a 15% tax rate and a financial reporting base, is not considered a Pillar Two equivalent tax regime.

What is Pillar Two?

Establishes a global framework of minimum taxation through use of an effective tax rate (ETR of 15%)

- The Pillar Two ETR is calculated on a jurisdictional basis
- Taxes paid on income or profits, as well as any taxes imposed in lieu of an income tax, are included in the ETR
- Financial accounts of the parent are used to calculate the tax base and ETR at an entity level
- An incremental tax liability (top-up tax) arises when the ETR in a jurisdiction is below the agreed minimum rate

Depending on jurisdiction and what legislation has been enacted, the top-up tax is generally expected to be administered via one or both of the following: the Income Inclusion Rule or Undertaxed Profits Rule. In summary:

- The Income Inclusion Rule would impose a tax on an entity within the consolidated group if it has a foreign subsidiary that is taxed at a rate less than 15%.
- The Undertaxed Profits Rule would impose tax on an entity if an affiliate in another jurisdiction is taxed at a rate less than 15%.

Countries may also enact a Qualified Domestic Minimum Top-up Tax on income earned within the country to ensure that it is taxed at a rate of 15%.

Why companies should be preparing now

Pillar Two is here. The OECD continues to finalize the Pillar Two Model Rules and various countries have enacted or progressed domestic Pillar Two tax legislation.

The Model Rules

From December 2021 to as recently as February 2023, the OECD released multiple documents providing guidance for implementing the global minimum tax. The first, and core, set of guidance, the [Model Rules](#), was released in December 2021 and followed by supporting [Commentary](#) in March 2022, the [Safe Harbours and Penalty Relief](#) in December 2022, and the [Agreed Administrative Guidance](#) in February 2023. Each subsequent release built upon the preceding documents, further expanding the guidance provided and addressing questions raised to the OECD. The OECD said it expects to release additional implementation guidance on an ongoing basis.

Status update — Local country and US enactment of Pillar Two

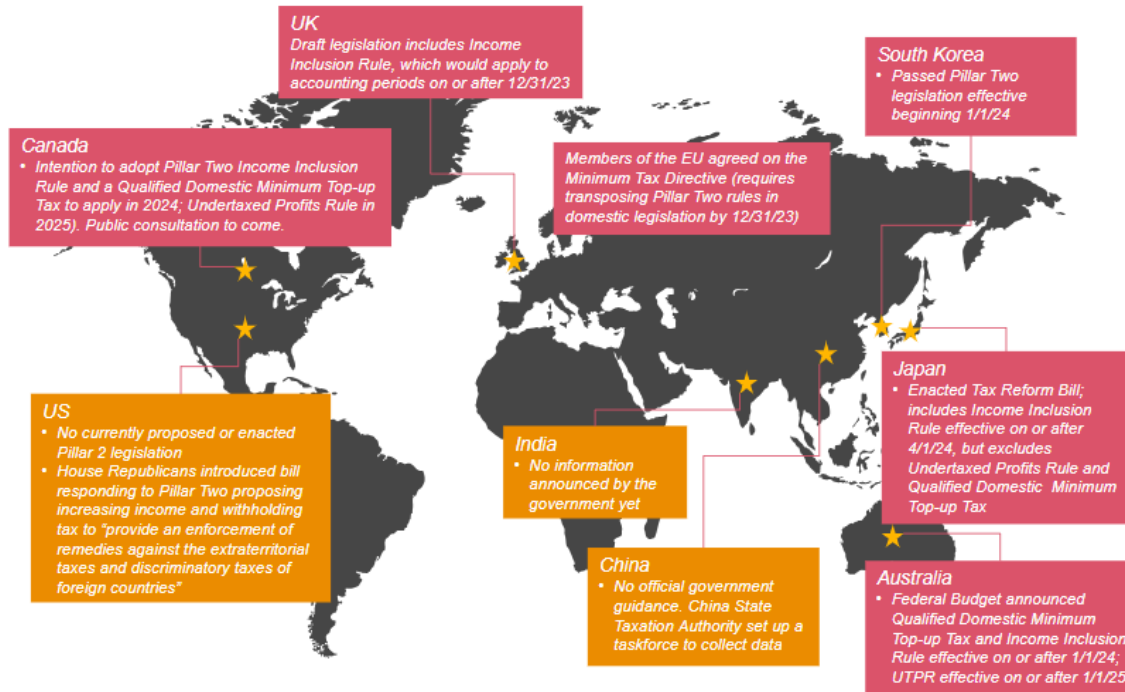
As of June 2023, Japan and South Korea have enacted domestic Pillar Two legislation. The UK, Australia, Ireland, Germany, and the remaining European Union members have made substantial progress in drafting domestic Pillar Two legislation, and all have stated that they will enact legislation during 2023 to be effective beginning in 2024. Additional jurisdictions have publicly announced their intentions to draft and enact domestic Pillar Two legislation.

Companies subject to Pillar Two will need to include an estimate of the Pillar Two taxes in their first quarterly estimated annual effective tax rate calculations in 2024. With the complexity of the calculation, companies are advised to begin the process now.

The implementation of Pillar Two compliant tax legislation in the US is highly uncertain. But regardless of what the US does (or does not do), US companies with operations in foreign jurisdictions that have adopted Pillar Two will be subject to the reporting requirements of Pillar Two. In addition — and perhaps more importantly — because of a potential “top-up” tax, they will be at risk of double taxation if they operate in countries that have enacted Pillar Two.

Given actions already taken in other jurisdictions, it's clear that Pillar Two will have an effect on the majority of multinational companies.

Recent Pillar Two legislative developments



This is not intended to be all inclusive. See [PwC's Pillar Two Country Tracker](#) for the latest developments by country.

What's next?

This is the pivotal question. Given the expected effort involved to obtain information as well as to develop and implement processes and systems to comply with the rules, companies should be preparing now. A common starting point would be to model the impact of the rules on cash taxes and the effective tax rate. This exercise may identify gaps in the systems (including ERP systems) and processes necessary to collect the data — and related internal controls — to determine income and covered taxes at a constituent entity / jurisdictional level.

While there is some time before companies will report the global minimum tax on a tax return, financial reporting is right around the corner. Companies subject to Pillar Two will need to include an estimate of the Pillar Two taxes in their first quarterly estimated annual effective tax rate calculations in 2024. Disclosures and investors' interest in the impact of the global minimum tax are ramping up. Of course, tax payments could also begin in 2024.

What should companies be considering on Pillar Two?

Companies should not wait to evaluate the potential impact of Pillar Two. Potential immediate actions include:

- Perform a modeling and impact assessment
- Perform a “gap analysis” of the data needed for the Pillar Two computations
- Review the tax reporting process and use of technology to automate and streamline the computations
- Consider resource needs for implementation and compliance
- Monitor legislative developments in material jurisdictions

Conclusion

Pillar Two represents a fundamental change to how companies have been taxed on international operations for decades. The fact that Pillar Two leverages financial reporting income by jurisdiction, under the accounting principles of the parent, makes preparing for its implementation a cross-functional effort that requires engagement with the operational and finance organizations well beyond the tax function; early planning and consistent communication will be critical. Proactive leadership and substantive preparations now will make the rapidly approaching transition to a new global tax environment much more efficient.

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For a more detailed discussion of the mechanics of the Pillar Two Model Rules and the accounting impacts, see [OECD Pillar Two: Time to act on the global minimum tax](#), and listen to our podcast, [Tax policy update - OECD and domestic minimum taxes](#).

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