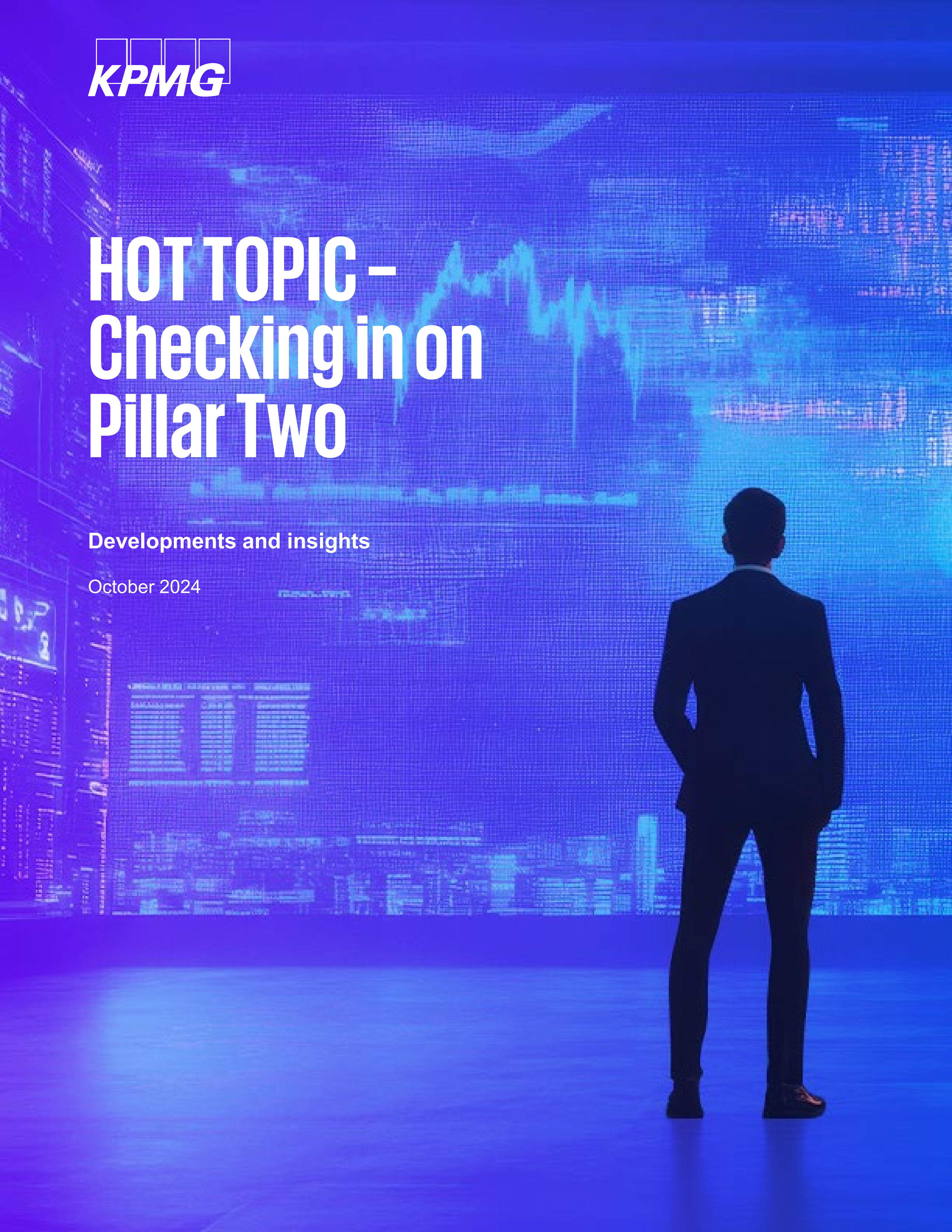


HOT TOPIC – Checking in on Pillar Two

Developments and insights

October 2024

It's been more than six months since aspects of the Organization for Economic Cooperation and Development's (OECD) Pillar Two rules went into effect in many jurisdictions around the world.[1] In this Hot Topic we dive into what companies are saying about Pillar Two in their public disclosures, what questions we have been getting on the US GAAP considerations, and what implementation steps companies are focusing on in advance of year-end.

But first a refresher…here are the top five things companies should know about Pillar Two

01 Companies will pay a minimum tax rate of 15% in every jurisdiction in which they do business

For every jurisdiction (generally, every country), companies must calculate a new effective tax rate (ETR), referred to as the 'GloBE ETR'. If the GloBE ETR in any given country is less than 15%, companies will need to make up the shortfall by paying a 'top-up tax'.[2]

02 Calculating the GloBE ETR in each jurisdiction is hard

The Pillar Two rules require complicated and data-intensive calculations based on a unique hybrid of tax and financial accounting concepts, which will effectively require companies to create a third set of books. The numerator – Adjusted Covered Taxes[3] – and the denominator – GloBE Income[4] – start with amounts recorded in the financial statements but then require their own unique set of adjustments and calculations.

03 There are three different mechanisms for enforcing payment of the minimum tax

The three enforcement mechanisms work together, like a net, to ensure payment of top-up taxes doesn't escape the system. At times, the entity that triggers the top-up taxes (i.e., because it causes the GloBE ETR in its jurisdiction to be less than 15%) is not the entity that actually pays those taxes. It all depends on how a company is organized and which enforcement mechanisms have been implemented by which jurisdictions.

Qualified Domestic Minimum Top-up Tax (QDMTT)
If a multinational has operations in a jurisdiction but has not met the 15% minimum tax rate, the 'home country' can collect the top-up tax.

Income Inclusion Rule (IIR)
If the 'home country' has not implemented a QDMTT, the parent entity's jurisdiction can collect the top-up tax.

Undertaxed Payments Rule (UTPR)
If neither the QDMTT nor IIR have been implemented, as a last line of defense any other jurisdiction in which the company has a taxable presence can collect the top-up tax.

04 The rules are effective now…but can be deferred

Many jurisdictions, particularly in the EU, implemented the Pillar Two rules effective January 1, 2024. However, the legislative landscape is dynamic. Not only have additional jurisdictions implemented throughout 2024 but the rules themselves have continued to evolve with the OECD releasing its fourth tranche of Administrative Guidance in June 2024.[5] Our Pillar Two tracker is updated real time as things change so you can quickly assess the impact on your organization.

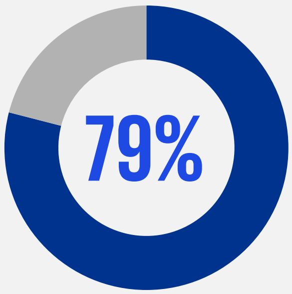
One of the most important things to know about the Pillar Two rules is that they contain certain transitional safe harbors that can delay the effects of the new rules for up to three years. Qualifying for these safe harbors – which come with their own set of conditions – can save a significant amount of time.

05 The implementation efforts are rigorous

Make no mistake, implementing Pillar Two is much bigger than just a tax compliance exercise. It requires a cross-functional team of tax, accounting, IT, internal audit and legal professionals. Couple that with the fact that most companies require new, Pillar Two-specific technology models to fully quantify the impacts, and many are looking at this as a significant finance transformation opportunity.

For a more comprehensive overview of the rules, check out the KPMG Pillar Two Gameplan publication.

What are companies saying about Pillar Two?



of registrants have disclosed that Pillar Two is not expected to have a material impact on their financial results.

Of the nearly 400 quarterly filings reviewed that mentioned Pillar Two, the vast majority indicated that Pillar Two is not expected to have a material impact on financial results. This was either because the registrant was not in the scope of the new rules or does not currently operate in any jurisdictions with a lower than 15% ETR.

KPMG Observations

Even if a company is not currently in scope of Pillar Two or does not expect it to have a material impact on its operations, it is important to continuously monitor changes in both the tax laws and the company's own structure. As more jurisdictions enact Pillar Two laws, companies that were previously not in scope may become so. In addition, as certain Pillar Two rules expire, such as transitional safe harbors, the impact to a company's financial statements may become material. Lastly, changes in a company's legal entity structure or geographical operations could impact its Pillar Two exposure.

89% of those impacted did not quantify the effects of Pillar Two

Surprisingly, only 11% of registrants that are in the scope of Pillar Two and expect to be impacted actually quantified the effects on their financial results. Those that did generally disclosed it in the form of either an increase to the overall ETR or income tax expense. While the magnitude of the impact varied from registrant to registrant, we observed disclosures indicating that Pillar Two could impact the overall ETR by up to 5%.

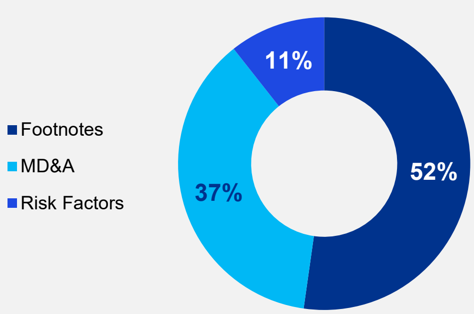
Those that did not quantify the impact generally included qualitative disclosures indicating that the registrant (1) is, or expects to be, in the scope of the new rules and (2) is continuing to evaluate the potential impact on future periods, pending legislative adoption by additional countries. This is despite the fact that Subtopic 740-270 requires these companies to account for the expected impacts of enacted Pillar Two tax laws in their interim period financial statements.

KPMG Observations

The observed diversity in disclosures may be because US GAAP does not require any specific disclosures for Pillar Two. However, Subtopic 740-270 requires disclosure of the effect of significant variations in the ETR in interim periods (e.g., due to application of new tax laws or rates, such as Pillar Two). Further, Topic 740 requires public companies to reconcile the ETR to the domestic federal statutory rate in their annual financial statements.[6] These disclosures require companies to explain the nature of significant reconciling items, of which Pillar Two may be one.

As year-end approaches, we expect registrants to refine their disclosures as they finalize their impact assessments. Examples of disclosures that may be decision-useful to investors include:

- Effects on the ETR or income tax expense;
- Accounting policy elections made regarding Pillar Two top-up taxes, if material; and
- The proportion of profits that may be subject to Pillar Two top-up taxes and the average ETR applicable to those profits.



We observed most of the discussion is in the income taxes notes, even for registrants that indicated there was no impact. However, many also discussed the expected effects of Pillar Two in management's discussion and analysis (MD&A) and a portion talked about it in their risk factors discussion. Given the lack of specific disclosure guidance and the remaining uncertainty, this isn't all that surprising.

As we look ahead to the annual report season, we expect to see additional disclosures in the notes to the financial statements. Additional disclosures in MD&A would also be appropriate to the extent there are material events or uncertainties known to management that may indicate past performance is not indicative of expected future results – e.g., expected increases to the ETR and related cash flows caused by newly enacted tax laws, such as Pillar Two.

What questions are companies asking about Pillar Two?

While we continue to receive many questions about Pillar Two, from interpreting the tax laws to best practices for implementation, this Hot Topic focuses only on the accounting questions that have come up under U.S. GAAP.

Are Pillar Two top-up taxes in the scope of Topic 740?

Yes, the incremental effect of top-up taxes will be recognized as current tax expense as incurred.

Do I need to adjust existing, or record new, deferred taxes as a result of Pillar Two?

No, Pillar Two top-up taxes are alternative minimum taxes (AMTs), which means companies will not record Pillar Two-specific deferred taxes or remeasure existing deferred taxes to the minimum tax rate.

Are liabilities for top-up taxes presented as current or noncurrent in the balance sheet?

We generally believe income taxes payable related to top-up taxes should be classified as current given that they are related to the operating cycle. This is true regardless of whether such taxes will be paid within 12 months.

How is the recapture rule under Pillar Two accounted for?

When an entity recognizes a deferred tax liability (DTL), the corresponding deferred tax expense increases the GloBE ETR and therefore could reduce the amount of top-up tax paid in that year. However, if the DTL does not reverse within five years from that date, it will be “recaptured” potentially resulting in incremental top-up tax being owed in the sixth year (the “recapture rule”).

We have received questions related to the timing of recognizing the additional top-up tax arising from the recapture rule. That is, should the additional top-up tax expense be recognized in ‘year one’ (i.e., when the deferred tax expense is initially included in the computation of the Globe ETR) or in ‘year six’ (when the recapture actually occurs)?

We believe that an entity should recognize the additional top-up tax in year one if it does not expect the DTL to reverse within five years. Such amount would be recognized as a current tax expense with a corresponding tax liability.

Further, when the additional top-up tax is paid, it may provide a U.S. taxpayer the ability to amend its year one tax return to claim these taxes as foreign tax credits (FTCs), resulting in a refund for the overpaid taxes. In such cases, we believe it is appropriate for the U.S. entity to record a current tax benefit with a corresponding receivable in year one, assuming it has the intent and ability to amend its year one tax return.

What impact, if any, does Pillar Two have on valuation allowance assessments?

It depends.

Low-taxed jurisdiction subject to a QDMTT
Policy choice to either consider or disregard Pillar Two status in assessing the need for a valuation allowance on deferred tax assets (DTAs). This policy must be applied consistently across all jurisdictions.

Low-taxed jurisdiction subject to an IIR or UTPR
We believe the low-taxed jurisdiction generally disregards the incremental top-up taxes imposed by other jurisdictions in assessing the need for a valuation allowance on its DTAs. However, we are aware of other acceptable approaches in certain circumstances.

In addition to assessing the direct effects of Pillar Two on the realization of a jurisdiction's regular DTAs, companies also may need to consider its indirect effects on DTAs in other jurisdictions. For example, paying a top-up tax in a foreign jurisdiction may create additional FTCs in the US. These anticipated additional FTCs may cause the company's existing temporary differences or FTC carryforward DTAs to not be realized.

Similar to the discussion above for a low-taxed jurisdiction subject to a QDMTT, we believe companies have a policy choice when assessing the need for a valuation allowance as a result of anticipated future FTCs generated from Pillar Two top-up taxes. One acceptable approach is to consider all FTCs expected to be generated in the future, which may result in a valuation allowance being necessary for existing temporary differences and FTC carryforward DTAs. Another acceptable approach is to follow the same policy discussed above regarding the effect of a QDMTT on a jurisdiction's regular DTAs. Therefore, if a company adopts a policy to disregard its Pillar Two status when assessing the need for a valuation allowance on regular tax DTAs, it would also disregard any future FTCs generated as a result of Pillar Two top-up taxes.

Will Pillar Two affect the accounting for intra-entity transactions?

Potentially.

For intra-entity transfers of inventory, Topic 740 and Topic 810 require income taxes paid by the seller to be deferred in consolidation. To determine the amount of income taxes to defer (i.e., the amount of income taxes associated with the intra-entity sale of inventory), many companies perform a hypothetical calculation referred to as the 'with-and-without approach'. This approach requires (1) recomputing the amount of income taxes a company would have owed had the intra-entity sale not occurred (the 'without calculation') and (2) comparing this amount to the actual amount of income taxes it owed, inclusive of the intra-entity sale (the 'with calculation').

When top-up taxes are paid in the seller's jurisdiction (e.g., because of a QDMTT), we believe those top-up taxes should be included in the with-and-without approach to calculate the amount of income taxes to be deferred – like any other tax paid on the sale in the seller's jurisdiction.

However, when top-up taxes are paid outside the seller's jurisdiction (e.g., due to an IIR or UTPR), we believe there are multiple acceptable approaches on how to measure the amount to be deferred.

- Exclude the top-up taxes paid under an IIR or UTPR from the deferral amount given that such taxes were not actually paid in the seller's jurisdiction.
- Include the incremental top-up taxes paid in other jurisdictions in the deferral amount by performing a worldwide with-and-without calculation that includes the tax effects of all income taxes, including top-up taxes, and compares the result with and without the intra-entity transfer of inventory.

Other approaches may also be acceptable. A company should consistently apply its policy choice and consider disclosure of the policy in the notes to financial statements, if material.

For intra-entity asset transfers other than inventory, the related income tax expense (benefit), including the impact of any top-up taxes, is recognized immediately in the consolidated financial statements.

How is the intraperiod tax allocation guidance applied to cross-jurisdictional top-up taxes?

Total income tax expense (benefit), including top-up taxes, is allocated to components of comprehensive income and shareholders' equity using a step-by-step approach.[7] This step-by-step approach is generally performed by each tax paying component, which calls into question how to allocate cross-jurisdictional top-up taxes (e.g., due to an IIR or UTPR). That is, are those top-up taxes allocated based on the facts of the tax-paying component that triggered them or the tax-paying component that is legally responsible for paying them?

We believe in applying the step-by-step approach for purposes of the consolidated financial statements, top-up taxes are often allocated based on the facts of the tax-paying component that triggered them, particularly when it relates to allocating between continuing and discontinued operations. This approach will typically result in any top-up taxes triggered by an entity's income that is part of discontinued operations being allocated to discontinued operations, even if the entity liable for the payment of the tax has no activity outside of continuing operations.

What are the interim accounting requirements for Pillar Two?

Top-up taxes that a company expects to incur generally should be included in the worldwide estimated annual effective tax rate (AETR) calculation, consistent with other taxes in the scope of Topic 740. There are two situations in which policy elections arise due to certain amounts being excluded from AETR.

Significant unusual or infrequently occurring items

In some instances, a significant unusual or infrequently occurring item, which is excluded from the AETR, may impact the amount of top-up taxes imposed. We generally believe a company has a policy choice as to how to measure the tax effects of such item. For example, an entity could:

- Perform a with-and-without computation where the total worldwide forecasted income tax expense (benefit) includes top-up taxes that would be computed both with and without the significant unusual or infrequently occurring item; or
- Only consider the top-up tax impact of such item in the jurisdiction in which it arises (e.g., a top-up tax that is paid through a QDMTT).

This policy choice should be consistently applied and disclosed, if material.

Loss jurisdictions

Certain jurisdictions may be excluded from the AETR – e.g., when an ordinary loss is anticipated for the fiscal year, or a year-to-date ordinary loss has occurred, for which no tax benefit can be recognized ('loss jurisdictions'). We believe that if a loss jurisdiction is liable for top-up taxes under either the IIR or UTPR, a company has a policy choice to associate the top-up taxes with either (1) the loss jurisdiction or (2) with the low-taxed jurisdiction of the entity that caused the tax.

For example, assume a loss jurisdiction expects to incur a top-up tax under the IIR as a result of a subsidiary that is located in a separate low-taxed jurisdiction. If the low-taxed jurisdiction is included in the worldwide AETR, we believe there is a policy choice to either (1) include the top-up taxes in the loss jurisdiction's separate AETR calculation, in which case they would be excluded from the worldwide AETR or (2) associate the top-up taxes with the low-taxed jurisdiction, in which case they would be included in the worldwide AETR. This policy should be consistently applied and disclosed, if material.

However, this policy choice is not available when a jurisdiction is excluded from the AETR due to an inability to make reliable estimates. In that instance, the top-up taxes would be associated with the low-taxed jurisdiction.

How are top-up taxes accounted for in separate financial statements?

In general, we believe top-up taxes should be included in the separate financial statements of the entity that is liable for paying the taxes (the 'paying entity'), rather than the entity that caused the top-up taxes to be owed (the 'low-taxed entity'). With respect to top-up taxes payable under the IIR and UTPR, the paying entity will be different from the low-taxed entity.

We believe the presentation of top-up taxes in the separate financial statements of the paying entity depends on whether those financial statements include the income from the low-taxed entity (e.g., because it's a consolidated subsidiary or accounted for under the equity method).

Income of low-taxed entity is included

Record a liability for top-up taxes owed with a corresponding entry to income tax expense.

Further, the effect of any uncertainties related to the recognition or measurement of tax positions should be consistent with the consolidated financial statements.

Income of low-taxed entity is excluded

Record a liability for top-up taxes owed with a corresponding entry to equity.

Further, the effect of any uncertainties related to the recognition or measurement of tax positions should be consistent with the consolidated financial statements and recognized in equity.

In some cases, there may be a tax-sharing agreement in place that entitles the paying entity to be reimbursed by its parent or another affiliate outside of its financial statements. We believe such amounts should generally be recorded in equity in the separate financial statements of the paying entity.

What happens if the rules change?

Given the rate at which Pillar Two-related tax laws are changing and being enacted, including Administrative Guidance to the OECD model rules, analysis will be required to assess whether such changes represent changes in tax laws, administrative practice and precedents, or interpretations.(8)

A company is required to reflect the impact of changes in tax laws and rates in the interim period that includes the enactment date, even if the law has a future effective date. Some jurisdictions may automatically apply changes to the Administrative Guidance to the OECD model rules whereas others may require enactment of new laws in the respective jurisdiction to apply such guidance. Further, although a company accounts for its tax positions based on the tax law as currently enacted at the reporting date, administrative practices and precedents of the taxing authority may impact the analysis of the tax positions. Whether administrative practices and precedents may be considered is dependent on facts and circumstances and should be consistently reevaluated to determine if such application remains appropriate.

What are companies doing about Pillar Two?

If the first half of 2024 was about big picture impact assessments, the second half is all about fine tuning. Here are the areas where we see companies spending the most time in advance of the year-end reporting season.

Finalizing safe harbor calculations	Companies are diving into the details of their country-by-country reports, with a specific focus on making sure they will be 'qualified' for safe harbor purposes.
Preparing for the GloBE ETR calculations	In our experience, most, if not all, multinational companies impacted by the new Pillar Two rules have at least one jurisdiction that does not qualify for one of the transitional safe harbors. This means the full GloBE ETR calculations, which can be daunting, are likely to be required this year. As a result, companies are diligently working to identify the data sources that will be necessary to perform such calculations, as well as implementing processes and internal controls to ensure the completeness and accuracy of that information.
Testing Pillar Two modeling solutions	Whether home grown or using an outside vendor, companies are performing detailed scenario testing to validate the results being computed by the models.
Monitoring compliance requirements	Pillar Two creates an entirely new layer of tax compliance, including registration forms, globe information return, notification form, and local Pillar Two returns. Companies are now in the process of adding these new requirements into their existing compliance process.
Analyzing the effects of newly issued guidance	At the end of June, the OECD released a fourth round of Administrative Guidance on the Pillar Two framework. To determine the impact of this release on their Pillar Two positions, companies are working through its detailed guidance on the DTL recapture rules, differences between carrying amounts for Pillar Two purposes as compared to financial reporting, and allocation of cross-border taxes and profits/taxes to flow-through entities.
Monitoring enactment of legislation and forthcoming guidance	More and more countries continue to implement the Pillar Two rules into their local tax law. For example, Canada recently enacted Pillar Two legislation. As each country implements the Pillar Two rules and the OECD considers additional Administrative Guidance, companies must diligently monitor the exact language in the tax law to identify whether any differences exist from the model rules.
Coordinating with external auditors	Auditors will likely be keenly focused on safe harbor calculations this year – both in terms of the completeness and accuracy of the information used and compliance with the requirements for Country-by-Country Reports[9]. Companies are continuing to coordinate with their external auditors as impact assessments are finalized, including any changes to internal controls or processes, to avoid surprises at year end.

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Endnotes

[1] 'Pillar Two' as used throughout this publication refers specifically to the Global anti-Base Erosion Rules (GloBE Rules), which are applicable to multinational enterprises with consolidated group revenue exceeding €750 million in at least two of the last four years.

[2] The amount of top-up taxes owed is calculated by multiplying GloBE Income, less qualifying deductions, by the difference between 15% and the GloBE ETR.

[3] Adjusted Covered Taxes are broadly defined as the amount of income taxes recorded in the financial statements, adjusted for certain timing differences, allocations, and other adjustments pursuant to Article 4 of the Model Rules.

[4] GloBE Income is broadly defined as the net income or loss recorded in the consolidated financial statements, which is then adjusted for numerous items pursuant to Article 3 of the Model Rules. Most of the adjustments needed to determine GloBE Income either draw on financial accounting principles or will be driven by how a company maintains its books and records, including how the consolidation process is configured.

[5] Administrative Guidance is defined in Article 10.1 as guidance issued by the Inclusive Framework on either the interpretation or administration of the GloBE Rules.

[6] The FASB's ASU on income tax disclosures requires significant transparency about the drivers of the ETR and income taxes paid, which could put a spotlight on the effects of Pillar Two. For more information about the ASU, check out our Defining Issues.

[7] See paragraph 9.021 of KPMG Handbook, Accounting for income taxes, for further discussion of the step-by-step approach.

[8] If the administrative practices and precedents of the taxing authority are widely understood and reflect positions that are expected to be accepted, they are taken into account even though the treatment may not be specified by the tax law or the positions may be considered technical violations of the tax law.

[9] Companies that are seeking to rely on this safe harbor need to review their process for preparing the Country-by-Country Report to provide that it will meet the 'Qualified' standard under the Pillar Two rules. See the KPMG report: New administrative guidance on Pillar Two rules, initial observations and analysis, for additional information regarding the qualified standard.

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