What you need to know about Pillar Two taxation 1/7/23


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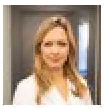
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Pillar Two is a tax scheme that will be applied in the EU and OECD countries in addition to their national corporate tax systems. This was developed to make multinational enterprises (MNEs) pay a minimum 15% tax in their home country on income arising in each country they operate in.

What this is about and what companies are affected

The global minimum tax applies to MNEs with consolidated revenues of more than EUR 750 million a year – that's an estimated 8,000 companies worldwide according to the OECD. Pillar Two aims to ensure an MNE's income in countries it operates in is taxed at a minimum rate of 15% by means of a top-up tax.

While some details of Pillar Two rules still need to be worked out, it's clear that introducing a global minimum tax will cause substantial changes to international tax law.

How Pillar Two will affect companies

It's very difficult to enforce the global minimum tax rules, and it's clear that the relevant tax compliance and accounting measures as well as the time frame will be considerable and will require the involvement of the MNE's entire financial function.

A comprehensive supplementary tax information return must be filed for each qualifying group company and permanent establishment, with considerable penalties for late filing. The affected companies are now wondering about what impact the introduction of Pillar Two rules in their country might have on the movement of financial data and accounting processes and how to ensure compliance. This also raises centralised questions about the collection of information and data (IT), data structuring and data analysis to guarantee compliance with the new rules and the filing of relevant reports by 2024.

How Pillar Two rules work

The top-up tax will be collected in either the ultimate parent company's country or a country in which companies enjoy a lower rate if that country has adopted a top-up tax at national level. The rules aim to ensure an MNE pays at least a 15% effective tax rate (ETR) for each of the countries it operates in.

The first step is to identify units within the group covered by Pillar Two and their role in applying the minimum tax.

Next, the total income or loss of the company or companies in each country is measured. This will be based on their financial accounting data using the standards applicable to financial statements in the parent company's country and considering a number of adjustments required by the Pillar Two directive.

Thirdly, the covered taxes recognised by each unit within the group are calculated, considering any specific adjustments (deferred taxes in particular). A special Deemed Distribution Tax Recapture Account will be set up for the expected tax on distributed profits.

The next step is to calculate the ETR for each country. This involves dividing the adjusted covered tax of all the companies by the relevant amount of income in each country.

After that, the country's ETR is compared with the 15% minimum tax rate and the top-up tax rate is calculated. For example, if the ETR is 12%, the top-up tax rate will be 3%.

Before charging the top-up tax rate, a substance-based carve-out will be deducted from taxable income – 8% on tangible assets and 10% on payroll, which will shrink to 5% on each of these categories in subsequent years.

Finally, taxable income is multiplied by the top-up tax rate (3% in our example).

Things MNEs in Latvia need to consider

Most of the companies in Latvia covered by Pillar Two are subsidiaries of large groups, so their CFOs will have to provide the ultimate parent company with information from a different aspect than usual.

The impact of Pillar Two should be identified early to be able to adapt your systems, set up new processes and understand which of the directive's optional rules are essential.

There will also be subsidiaries in Latvia with their parent in a country that is not yet applying Pillar Two (i.e. countries outside the EU/OECD). Those Latvian companies will have to pay a top-up tax not only for themselves but also for all other group companies from 2025.

To help MNEs gear up for the upcoming changes and to outline steps that should be taken now, we invite you to attend a PwC Academy webinar on 16 March.