EasyChair Preprint

№ 14377

Accounting for Pillar 2

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August 10, 2024

Title- Accounting for Pillar 2

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Abstract:

This research aims to explore the implementation and impact of Pillar 2, a novel framework in international tax law designed to address tax base erosion by establishing a global minimum tax rate of 15%. The study examines the collaborative effort of 140 countries amidst global geopolitical tensions to adopt this framework and analyzes its implications for multinational corporations (MNCs). It investigates the legislative modifications required in host countries, the challenges posed to tax and financial reporting, and the operational provisions of the Global Anti-Base Erosion (GloBE) Rules. The research further delves into the intricacies of compliance, the role of tax professionals, and the integration of tax and financial accounting systems to optimize compliance and risk management. By assessing the effects of Pillar 2 on tax strategies, financial reporting, and state and local taxes, the article aims to provide comprehensive insights into the operational and strategic adjustments necessary for MNCs in the evolving international tax landscape.

Keywords: State and local tax , Accounting , Corporate Taxation , OECD, BEPS, Pillar 2, International Taxation

Introduction

Pillar 2 is a novel approach to international tax law that appears to be a very effective and innovative idea to combat tax base erosion. In a world with multi-polar complex geopolitical space with several ongoing turmoils in Ukraine, Russia, Israel, and the Middle East, getting 140 of the 195 countries to get on board with implementing a global minimum tax framework is remarkable. Despite the fact that conflict seems to be tearing the world apart, everyone has agreed on a tax framework that simplifies the tax code and creates a level playing field for multinational corporations (MNCs). Although the framework looks simplistic, it still needs to go through legislative modifications in host nations to confirm or adapt to the Pillar 2 tax structure. It also poses a variety of challenges in terms of tax and financial reporting for MNCs.

The Nuances of Pillar 2[1]

1. Taxpayers who have consolidated revenues of less than 750 million euros or who have no presence in other countries are free from paying taxes. Some not-for-profit entities are not eligible for this exemption.

2. The Pillar Two Model Rules, which are also known as the Global Anti-Base Erosion (GloBE) Rules, have been established to ensure that major multinational corporations (MNCs) pay a minimum amount of tax on income generated in each country in which they operate.

3. G20 Finance Ministers and Leaders adopted the guidelines after delegates from the Organization for Economic Co-operation and Development (OECD) and G20 issued an inclusive framework on BEPS. This framework helps jurisdictions incorporate the regulations into their local laws.

4. In terms of organization, the rules laid out for Pliiar 2 are composed of ten chapters that address topics such as scope, operative rules, mergers and acquisitions, tax neutrality regimes, administration, transition, and definitions. These chapters are designed to accommodate a wide variety of tax systems and company forms, such as VAT-based systems and multinational corporations with complex structures.

5. In-scope taxpayers are responsible for calculating their effective tax rate in each jurisdiction and must pay top-up tax for the amount that is the difference between their effective tax rate and the minimum rate of 15%, which is typically charged in the jurisdiction of the ultimate parent corporation.

6. In the operational provisions of Pillar 2 framework, the calculating and billing provisions are broken down in depth in chapters 2–5. The Income Inclusion Rule (IIR) or the Undertaxed Payment Rule (UTPR) is used to identify which entities are liable for top-up tax. This rule ensures that outcomes are coordinated and addresses low-taxed income across regions.

Overcoming Tax Planning Obstacles

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[1] COMMENTARY TO THE GLOBAL ANTI-BASE EROSION MODEL RULES ..., https://www.oecd.org/tax/beps/tax-challenges-arising-from-the-digitalisation-of-the-economy-global-anti-base-erosion-model-rules-pillar-two-commentary.pdf (last visited Apr 16, 2024).

When it comes to figuring out their tax obligations and making sure they comply with regulations, Pillar 2 offers a plethora of challenges and barriers for businesses to overcome from the perspective of tax accounting. Tax professionals have to work within the constraints of the new framework while navigating the intricacies of Pillar 2 laws. Challenges like calculating taxable profits,country-by-country reporting, handling tax credits and incentives, and maximizing tax planning strategies with the new framework must be addressed.

Tax accountants are required to meticulously analyze country-specific reports, incorporate Pillar 2 exposure into their estimates, and make necessary adjustments to ensure compliance with the regulations. For instance, in India, the "Global Minimum Tax" (GMT), which will increase the firm's tax burden, will replace the "Equalization Tax" of 6% on international digital transactions of USD 1200 (INR 1 lac), also known as the "Google Tax." [2]

Even though it is predicted that the impact of pillar 2 on state and local taxes will be minimal, there is a minute degree of vulnerability that may fall through federal taxable income.

The purpose of the GloBE laws, which are intended to maximize the efficiency of transfer pricing arrangements, is to ensure that multinational corporations are subject to equitable taxation across all of the various jurisdictions in which they conduct business. The Pillar 2 guidelines, which look at the global profit allocation of these corporations, determine the effective tax rate (ETR) of these firms in each jurisdiction. To prevent profit shifting to regions with lower tax rates, GloBE stipulates those intercompany transactions between different nations that should be taxed in accordance with the arm's length principle (ALP). This principle is analogous to the principles that govern local tax regimes.

GloBE recognizes unilateral adjustments made by one jurisdiction when transaction prices are in dispute between jurisdictions, reducing the possibility of double taxation on the same income. However, within a single jurisdiction, transaction pricing adjustments are generally unnecessary unless there's a loss or specific entities are involved.

To optimize tax outcomes under GloBE, multinational corporations must ensure that their intercompany transactions comply with the ALP. Additionally, they should be equipped to handle any potential disputes in accordance with OECD guidelines, which

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[2] EQUALISATION LEVY - INDIAN VERSION OF 'GOOGLE TAX'!, https://database.taxsutra.com/articles/274c6bbeb88d3bd5fb14d7d7a7d21e/expert_article (last visited Apr 16, 2024).

oversee GloBE implementation. By adhering to these regulations and proactively addressing disputes, corporations can minimize the likelihood of facing increased tax liabilities or penalties in the future.

The Global Anti-Base Erosion (GloBE) rules introduce a top-up tax mechanism to ensure multinational corporations pay a minimum effective tax rate of 15% in each jurisdiction. The process involves identifying eligible groups and constituent entities, determining GloBE income, assessing covered taxes, calculating effective tax rates, and imposing top-up taxes. GloBE rules exclude certain entities and provide for de minimis exclusions. Adjustments are made for temporary differences and prior-year losses. Top-up tax liability is determined based on jurisdictional excess profits and is applied to parent entities under the Inclusion Inclusive Rule (IIR) and the Undertaxed Payment Rule (UTPR). Special provisions address allocation, offsets, and backstop mechanisms. Safe harbors and limitations ensure compliance and minimize the administrative burden.

As different countries roll out pillar 2 legislation, tax accounting needs to be prepared for compliance, make necessary changes, and communicate mitigation plans with executives so apt business decisions can be framed.

Depending on whether or not the United States makes certain modifications to the Global Intangible Low-Tax Income (GILTI), considering pillar 2, tax accountants should be prepared to accept the possibility of changes in the application of the GILTI measure. To assess whether revenue from controlled foreign corporations (CFCs) should be included, the GILTI system requires computations that are quite thorough. The Internal Revenue Code (IRC) Section 951A provides specific guidelines for calculating GILTI. These requirements require the determination of tested income and qualified business asset investment (QBAI), among other things.

Modifications to the Accounting Procedures for State and Local Taxes In addition to the federal tax considerations, Pillar 2 also influences the accounting procedures for state and local taxes. As an illustration, nations can establish conformance or decoupling measures in relation to GILTI and other international tax provisions. Companies operating in multiple jurisdictions must carefully assess the impact of state tax legislation on their tax accounting procedures before implementation. Additionally, modifications to state apportionment laws and nexus standards have the potential to significantly complicate the process of tax accounting for transactions belonging to Pillar 2. For example,more states may decide to implement market-based sourcing standards for service income, which would require businesses to change their apportionment calculations in accordance with the new regulations.

Possible changes for financial reporting

Pillar 2 has significant implications for the procedures and disclosures that are involved with financial reporting. These implications are significant when it comes to the subject of financial accounting. To evaluate the impact that Pillar 2 will have on financial statements, income tax provisions, cash flow estimates, and earnings per share computations, tax executives and financial professionals need to work closely together. By way of illustration, Pillar 2 may result in changes to deferred tax assets and liabilities, which in turn may have an impact on the valuation of these items on financial statements. Furthermore, the disclosure of risks and uncertainties connected to Pillar 2 is of the utmost importance to provide investors and stakeholders with transparency and insight into the tax status of the firm.

Taxes are included in statutory financial statements, individual financial accounts, and group consolidated financial statements through BEPS Pillar Two implementation. To accomplish this, it is necessary to incorporate tax concepts into the processes of financial close and consolidation.

As a means of addressing the issues that are provided by GMT, businesses are increasingly investigating organizational models that maximize tax efficiency while still assuring compliance with regulatory obligations. The development of regional holding companies is one example of such a structure. These firms have the potential to facilitate centralized management of tax affairs and streamline reporting procedures, among other benefits. Businesses can take advantage of attractive tax regimes and reduce their exposure to global trade and investment by consolidating their operations within a single jurisdiction. Furthermore, the utilization of hybrid organizations and financing arrangements makes it possible to further improve tax outcomes while simultaneously fitting with the objectives of Pillar 2.

Significance of Integrating Tax and Financial Accounting

Establishing seamless integration between tax and financial accounting systems within multinational corporations is crucial for aligning tax strategies with financial objectives and ensuring compliance with regulatory changes, rather than brining in the tax department after the financial close.

A seamless integration of tax accounting and financial accounting systems within multinational corporations is one of the most significant issues that tax executives and experts face. To connect tax strategies with financial objectives and to ensure compliance with the ever-changing regulatory landscape, it is vital for the departments of finance and tax to collaborate with one another. When it comes to developing cross-functional collaboration, facilitating the harmonious integration of tax and financial

accounting procedures, and providing board members and senior management with strategic direction, tax executives play a vital role in all these areas, considering the materiality of the taxes paid.

Interventions for Risk Management

There are a variety of risk management factors that are introduced in Pillar 2, which encompass both the financial and tax aspects. Tax executives and practitioners are tasked with identifying and mitigating various tax risks, including disputes, audits, and financial hazards. The implementation of rigorous risk management methods is necessary to limit detrimental consequences for financial performance and shareholder value. For instance, tax professionals are required to evaluate the potential impact that Pillar 2 could have on the effective tax rate and cash flows of the firm. In addition, tax executives are required to maintain vigilance in the monitoring of legislative developments and developing tax risks, and they must proactively modify strategies and procedures to protect themselves from future penalties and ensure compliance.

Optimization to Improve Operations

It is necessary for tax executives and professionals to conduct an analysis of the effects that Pillar 2 will have on the accounting systems, practices, and controls that multinational corporations (MNCs) use. When it comes to achieving operational excellence in the face of ever-changing regulatory obstacles, it is necessary to make use of technological solutions, improve data management skills, and streamline compliance procedures. Tax executives play a crucial role in promoting operational optimization, building resilience, and enabling the organization to adjust to changes in regulatory requirements in a timely and efficient manner.

In conclusion, the advent of Pillar 2 represents a watershed moment in international tax law, ushering in a new era of compliance and transparency for multinational corporations. Tax executives, lawyers, accountants, and CEOs must navigate the complexities of Pillar 2 with diligence, foresight, and strategic acumen. By embracing innovation, collaboration, and proactive compliance strategies, tax professionals can steer their organizations towards sustainable growth, regulatory compliance, and enhanced competitiveness in the global marketplace. Furthermore, staying informed about updates and changes to Pillar 2 regulations will be crucial for ensuring ongoing compliance and minimizing risks. Organizations must proactively adapt their tax strategies and compliance measures to navigate the ever-evolving international tax landscape and maintain a competitive edge in the global market.

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