THE UK'S IMPLEMENTATION OF PILLAR TWO

Background

The OECD's "Two-Pillar Solution", which is intended to reform the international tax framework to address challenges arising from increased digitalisation and globalisation, was agreed by almost 140 jurisdictions in October 2021. Since that time, considerable work has been undertaken around the world to refine the detailed proposals and to move them towards implementation.

"Pillar One" is – initially at least – intended to apply only to the very largest multinational enterprises, and will require certain profits to be reallocated between jurisdictions on the basis of where products and services are sold. This is currently some way off being implemented.

"Pillar Two" is much further along the path to implementation, and legislation is now in place in the UK to bring the key elements of this approach into effect.

"Pillar Two" is intended to ensure that large multinational enterprises (MNEs) pay a minimum level of tax on profits from each jurisdiction in which they operate. It is designed to operate through two distinct rules:

1. The Income Inclusion Rule (IIR) – This is the primary "top-up" tax mechanism. In most cases, any tax due under this rule will be assessed on the ultimate parent company of an MNE group and payable to the tax authority of the jurisdiction in which that company is located. The tax due will be the amount required to ensure profits from each jurisdiction in which the group operates are taxed at a minimum rate of tax (currently 15%).
2. The Undertaxed Profits Rule (UTPR) – This rule will apply where the effective tax rate on a group's profits from a particular jurisdiction is below 15% but where the IIR has not been fully applied. Where this is the case, relevant "top-up" amounts will be calculated and allocated between jurisdictions that have a UTPR.

In addition to these rules, the OECD also permits tax jurisdictions to apply a Qualified Domestic Minimum Top-Up Tax (QDMTT), under which those jurisdictions can collect tax on profits from their jurisdiction which would otherwise be collected elsewhere in the world under an IIR or UTPR.

UK Application

Finance (No.2) Act 2023 introduced a Multinational Top-Up Tax (MTT) and a Domestic Top-Up Tax (DTT), which are based on the OECD's IIR and QDMTT respectively. Both the MTT and the DTT will apply for accounting periods commencing on or after 31 December 2023.

Draft legislation has now been published to introduce the OECD's UTPR to the UK. This is due to be in place for accounting periods commencing not before 31 December 2024.

UK Multinational Top-Up Tax (MTT)

The MTT (the UK's IIR) will apply to UK parent companies of multinational groups with annual revenues in excess of €750m in at least two of the previous four accounting periods (subject to handful of exemptions).

In outline terms, those UK parent companies will need to follow these broad steps to calculate their MTT liability for a particular period:

1. Calculate the adjusted accounting profit or loss of each entity in each jurisdiction in which the group operates, then aggregate these by jurisdiction;
2. Calculate the aggregate "covered tax balance" for each jurisdiction;
3. Using the figures calculated in steps 1 and 2, above, determine the effective tax rate in each jurisdiction;
4. If any jurisdiction's effective tax rate is less than 15%, determine the "top-up percentage" for that jurisdiction (being the difference between 15% and the effective tax rate);
5. For each jurisdiction where the effective tax rate is less than 15%, deduct the "substance-based income exclusion" (an amount based on the tangible assets and payroll expense in that jurisdiction) from the aggregate adjusted accounting profit of that jurisdiction.
6. For each relevant jurisdiction, apply the "top-up percentage" to the amount calculated at step 5 to arrive at the MTT for that jurisdiction.

The rules include a de minimis, under which a jurisdiction can be ignored if revenues from that jurisdiction are less than €10m per year, and profits are less than €1m per year.

UK Domestic Top-Up Tax (DTT)

The DTT (the UK's QDMTT) is relevant to UK entities which have annual revenues, or which are part of a group with annual revenues, in excess of €750m in at least two of the previous four accounting periods.

The DTT is designed to ensure that any "top-up tax" amounts that could otherwise be collected under an IIR elsewhere in the world are instead collected in the UK.

The legislation broadly uses the same definitions, and follows the same approach, as the MTT, although this tax is considered on a company-by-company basis.

Transitional Safe Harbours

The MTT and DTT rules both include "transitional safe harbours", under which, for the first few years of the regime, the results of some simplified calculations can mean that the full rules will not apply to the results of a particular jurisdiction.

Where the MNE group has prepared and submitted a report under the Country-by-Country Reporting regime for the relevant period, it can use the figures included in this report to assess whether the de minimis thresholds (listed above) are met, whether the effective tax rate in a jurisdiction is less than 15% (or 17% from 2026), and whether the "substance based income inclusion" would be greater than the aggregate profit before tax. If any of these tests are met, the company can take advantage of the safe harbour provisions and claim that no top-up tax is due for the relevant jurisdiction(s).

UK Undertaxed Profits Rule (UTPR)

The draft provisions for introducing the UTPR into UK legislation are intended to extend the MTT charge to UK members of multinational groups where one or more members of those groups have "top-up amounts" (essentially amounts which would be subject to the MTT if the ultimate parent company was located in the UK) that are not fully subject to an IIR in another jurisdiction. The provisions will effectively allocate a proportion of those "top-up amounts" to UK members of the group based on the number of employees and the value of tangible assets located in both the UK and in other jurisdictions that have similar UTPRs in place.

Administration

All companies and groups which meet the revenue thresholds set out above, and which are either based in the UK or (if a group) have at least one UK entity, will need to register with HMRC. The responsibility to register will fall on the "filing member" of the group, which will typically be the parent company of the group but which may be another member. The registration must be made within six months of the end of the accounting period in which the thresholds are first met.

In addition to the initial registration requirement, there are two on-going submission requirements:

1. Information Return or Overseas Notification Return. The OECD rules provide that an Information Return – containing details of the group, its members, the effective tax rates in each jurisdiction, and the top-up rates and amounts for those jurisdictions – will typically need to be filed by the ultimate parent company of an MNE group in the jurisdiction in which it is located. Ultimate parent companies located in the UK will therefore need to file an Information Return with HMRC. Where an Information Return has been submitted to a non-UK tax authority, an Overseas Notification Return (providing details of this) will need to be submitted to HMRC.
2. Annual Self-Assessment Return. This provides details of the MTT and/or DTT chargeable on any group member.

The relevant returns will generally be due to be filed with HMRC, and any MTT and DTT liabilities paid, within 15 months of the end of the accounting period to which they relate. These deadlines are extended to 18 months from the end of the first accounting period during with the group is within the scope of MTT or DTT. For a group with an accounting date of 31 December, the first in scope accounting period would be the year ended 31 December 2024, with registration required by 30 June 2025 and subsequent compliance obligations due by 30 June 2026.

The legislation relating to the introduction of Pillar Two in the UK is complex and this flyer only provides an outline of the rules. If you have any questions or would like to discuss any elements of the rules further, please get in touch with our specialist tax team at Moore Kingston Smith.

CONTACT US

Call:
+44 (0)20 4582 1000

Or email:
pd@mks.co.uk

MOORE Kingston Smith

www.mks.co.uk