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Are We There Yet? A Practical Discussion on Pillar 2 Challenges

Cory Perry, Mary Xu, and Mike Del Medico*
Grant Thornton LLP

MNEs should no longer wait to begin preparations to implement Pillar 2, say Grant Thornton practitioners.

Are we there yet? How about now? Now? Similar to parents with small children in the back seat of a car on a long trip that never seems to end, taxpayers have been impatiently waiting (and also dreading) for the Pillar 2 trip to reach its destination. Some taxpayers have experienced angst and trepidation, concerned by the ever-increasing burden placed on tax departments, while others eagerly await the new rules designed to provide for a coordinated system of taxation for large multi-national enterprise ("MNE") groups. Whatever your feelings may be towards this monumental global tax renaissance, we may finally have reached our first destination – albeit perhaps not in as coordinated fashion as many had hoped.

Now that we have arrived, and aspects of Pillar 2 are applicable in many jurisdictions, taxpayers must now ready themselves for the formidable challenge that lies ahead – implementation. Undoubtably, there will be bumps in the road. However, well-prepared taxpayers can avoid common implementation foot-faults, busy season compressions, resource constraints and other common side effects of significant tax reform. In this article, we will set the stage with a high-level background on Pillar 2, discuss why it's important to start implementation now, and highlight some of the practical challenges that taxpayers are likely to face during the implementation phase.

The US has yet to enact Pillar 2 legislation. The US does have its GILTI system, but there are major differences between the two regimes. Although various US legislative proposals have been put forth to bridge the gaps, so far, none have garnered enough support to make it through the legislative process. It remains uncertain whether the US will ultimately adopt Pillar 2 legislation. It has been a notable part of President Biden's platform, but consensus (both on one side and across the aisle) has so far been elusive. Given that the Joint Committee on Taxation estimated in a June 2023 report that failing to enact Pillar 2 legislation would only cost

* Cory Perry is a partner in the International Tax group in Grant Thornton LLP's Washington National Tax Office in Washington, D.C. Mary Xu is a managing director in Boston and Mike Del Medico is a senior manager in Cleveland.

the US $122B in lost revenue over the next 10 years, one might reasonably question whether Pillar 2 will ever become law in the US – at least in the foreseeable future.

Background

In October 2021, over 135 countries and jurisdictions participating in the OECD's Inclusive Framework preliminarily approved a two-pillar plan to reform international taxation rules. Pillar 1 of the plan deals with the allocation of taxing rights based on sales into a country and covers a more limited number of taxpayers—generally only companies with a global turnover above 20 billion euros and a profit margin above 10%. However, Pillar 2 and the Global Anti-Base Erosion (GloBE) rules, apply to a much wider base of taxpayers. These rules generally seek to impose a 15% minimum tax on the earnings of MNE groups with revenues of at least 750 million euros. The implementation dates for the first jurisdictions to enact the GloBE rules are generally accounting periods beginning on or after December 31, 2023, for the income inclusion rule ("IIR") and December 31, 2024, for the undertaxed profits rule ("UTPR") (*See* Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two) (July 2023)). The OECD designed a safe harbor to provide transitional relief to parent entities in jurisdictions with a corporate income tax rate of at least 20%, which includes the United States. For ultimate parent entities in these jurisdictions, the UTPR will be deemed zero for fiscal years which run no longer than 12 months and that begin on or before December 31, 2025, and end before December 31, 2026.

The objective of Pillar Two is to ensure that taxpayers pay a minimum rate of tax of 15% on their global income, no matter the jurisdiction in which the income is earned. A minimum level of tax at 15% would, in theory, deter base erosion and profit shifting as no matter where an MNE group earns income, it will be subject to at least 15% tax. To achieve this goal, the Pillar 2 rules create a coordinated system of minimum taxation intended to ensure that MNE Groups pay a minimum level of tax on their income arising in each jurisdiction in which they operate.

An in-scope MNE Group must calculate its effective tax rate in each jurisdiction in which it operates using the Pillar Two rules. The effective tax rate under Pillar Two is Adjusted Covered Taxes divided by GloBE income or loss. If the effective tax rate for a jurisdiction is below the 15% minimum rate, a top-up tax may be imposed and collected under one of the three following interlocking rules aimed at reducing profit shifting and base erosion:

- Income inclusion rule (IIR): Imposes a top-up tax at the parent-entity level that effectively allows countries to "top up" the tax on earnings of foreign subsidiaries with effective tax rates below 15%.

- Qualified domestic minimum top-up tax (QDMTT): Is a domestic "top-up" tax that will take precedence over either an IIR or UTPR and tax domestic entities up to 15% before another country's UTPR or IIR applies.

- Undertaxed profit rule (UTPR): Will generally deny deductions with respect to members of a group or otherwise impose mechanisms that will impose additional tax on income subject to an effective tax rate below 15% that is not otherwise subject to an IIR or QDMTT.

Presently, there are no enacted laws incorporating Pillar 2 in the US In 2020, President Biden introduced the Build Back Better Plan ("BBB"), which included tax legislation that would more closely align US international tax rules with the Pillar 2 rules. Most significantly, BBB would have increased the effective tax rate on GILTI to be in excess of 15% and imposed the regime on a country-by-country basis. These changes were expected to result in the GILTI regime meeting the requirements of a qualifying IIR regime. Despite Democrats holding a majority in both the House of Representatives and Senate, at the time, these measures were not passed.

Proposed legislation aimed at aligning the US with Pillar 2 has reached a standstill in Congress. While the implementation of Pillar 2 legislation in the US remains uncertain, the pressure to act may intensify as other countries implement crucial components of Pillar 2 in 2024 and 2025. Despite US inaction, the implementation abroad will affect US MNEs in various ways.

Challenges

Pillar 2 presents numerous challenges that companies must grapple with. These range from the mundane, like data gathering and collections, to the extraordinary, like the need to understand finite details of all the various corporate tax systems that apply to the MNE Group. Here are some of the key challenges the MNE Groups should consider:

1. Understanding the GloBE Rules and Compliance: Taxpayers will need to familiarize themselves with the complex rules of Pillar 2. Compliance with these new rules will require significant effort and understanding of the detailed tax guidance not just addressing Pillar 2, but also its interplay with the various corporate income tax systems that apply to the MNE Group. Treasury has already begun to issue guidance that addresses the interactions, and taxpayers can expect more to come. For example, IRS Notice 2023-80 addresses Pillar 2 and dual consolidated losses as well as circularity issues between the US CFC regime and the Pillar Two IIR regime. This is likely just scratching the surface of the many issues that will need to be hashed out from a US perspective.

2. Increased Reporting and Tracking Requirements: Pillar 2 is likely to increase the reporting and documentation burdens on MNE groups. Many tax departments are already spread thin, and this now adds an entire new dimension that this already constrained resource must now manage.

3. Uncertainty and Transitional Challenges: As countries begin to adopt and implement Pillar 2 rules, there will be a period of uncertainty. Taxpayers will have to navigate these transitional challenges, which might include interpreting guidance from tax authorities and managing any differences in the interpretations from various local taxing authorities. As a result of guidance already issued and future guidance over the next several years, we could see a divergence in systems across countries.

A good analogy could be state and local tax conformity rules in the US, which refer to how state and local tax laws align with, or "conform to," federal tax laws. There are several types of conformity, which vary among states. For example, there is rolling conformity where state tax codes automatically update to reflect changes in the federal tax code, static conformity where states link their tax codes to the federal tax code as of a specific date, and also selective conformity where states conform to certain parts of the federal tax code while decoupling from others. During a transitional period where countries are legislating and regulating Pillar 2, we will likely see various conformity rules regarding Pillar 2. Some jurisdictions may struggle with the fast pace of guidance, and others may not permit retrospective legislation or regulations. These challenges may result in a patchwork system for the first couple of years. This patchwork poses the potential risk of double taxation if different countries apply the rules in varying ways or if there is a lack of coordination between the implementing countries.

4. Cost of Implementation: The administrative burden of complying with Pillar 2 will significantly increase compliance costs. The increased costs may relate to adapting internal ERP systems, seeking outside advice, and taking on new compliance requirements. For many, this new cost could easily swell into the six figures.

5. Strategic Business Decisions: MNE Groups will need to reassess their global operational and tax strategies considering the Pillar 2 rules. This could impact decisions related to supply chain, location of intellectual property, holding companies, and financing arrangements. Beyond this, the impact of Pillar 2 will need to be incorporated into the ongoing process of evaluating changes in the business.

6. Technology and Data Management: Pillar 2 will exponentially increase the volume of data points that MNE Groups need to collect. Some commentators have estimated the number of data points per Constituent Entity may be as high as 350. If an MNE Group has 100 entities, that would mean 35,000 data points that may need to be collected. Some of these data points may already be collected through the tax compliance process, but many will be new. Further exacerbating this challenge is the fact that many of the new data points are proving hard to automate, thus requiring detailed, manual analysis. Taxpayers may also need to invest in new technology solutions to handle these requirements effectively, and perhaps even implement a new tax engine like those offered by Thomson Reuters, Longview, Oracle, and Corptax.

This is not an exhaustive list but provides an overview of what lies ahead for many MNE Groups. Given the breadth of this list, it's important that companies start this Pillar 2 journey to preparedness now. We will now discuss some practical insights that we have learned while working with MNE Groups implementing Pillar 2.

Implementation

To successfully implement Pillar 2, and avoid many of the risks highlighted above, taxpayers will need a combination of process and system improvements. These two items are critical to an MNE Group's success. Pillar 2 is unlike any other tax change – its goal of global coordination also means taxpayers must have global coordination when compiling data and analyzing implications.

The calculation will require data points from all jurisdictions in which the MNE Group operates, information from HR systems, tax outputs, financial data and more. All of this may be spread across the organization's systems, some of which may not communicate with each other (at least currently). Moreover, much of the data required may be in an unusable format, so some level of data cleaning will be required. These calculations will need to be run multiple times a year including, quarterly or annually for income tax provisions, at least once a year for compliance, and perhaps even more frequently for ad hock modeling. To prepare for the data needs, there are three key actions that taxpayers can take: (1) assess the overall impact of Pillar 2, (2) adjust "back-end" systems and processes to accommodate data requirements, and (3) determine whether to outsource or implement a "front-end" system to enable the calculations and reporting. We will address each of these below.

Assess the overall impact of Pillar 2. For many MNE Groups, Pillar 2 may have little to no cash tax impact, but these companies will still be required to comply with the complex rules requiring calculations and local country reporting. The complexity also scales with the global reach of the MNE Group. During this phase, the taxpayer should understand the application of the transitional country-by-country safe harbors ("CbCR Safe Harbors," discussed further below), which entities are in and out of scope, which entities are subject to the IIRs (or UTPRs in later years), and begin to understand the potential impact on cash taxes and financial statements. At this stage, its crucial to understand the impacts of the Pillar 2 rules, not only from a financial perspective, but also from aspects of disclosure, reporting, and processes. To navigate these challenges, many taxpayers have developed a comprehensive roadmap that lays the groundwork for the implementation process. A high-level example of such a roadmap can be found in the final section of this article.

Undoubtedly, this will be a global exercise that will include stakeholders across the company as well as outside service providers. The need for data from multiple sources requires coordination between tax, accounting, HR, finance, IT and other groups. Based on the experiences of these authors, it's important to identify those stakeholders early in the process. Although great strides in remote working have made global coordination common in the workplace, it still takes considerable time when dozens of professionals, spread across many countries, need to come together.

Assessing the impact of the CbCR Safe Harbors should also be performed as part of the initial, overall assessment. Transitional CbCR Safe Harbors will be an MNE Group's best friend during the first couple of years. The CbCR Safe Harbors are short-term tests performed to exclude an MNE Group's operations in lower-risk countries from the computation. The CbCR Safe Harbors identify lower-risk jurisdictions through the application of three quantitative tests taking information primarily from a business' country-by-country report. In effect, if a jurisdiction maintains a low-risk profile under these tests, the more detailed and onerous calculations will not be required for the tax year in which the test(s) are satisfied. With some minor exceptions, these safe harbor tests are done using CbCR data and other data the company should already have readily available. In practice, we have observed that MNE Groups are often able to eliminate 80-90%+ percent of the jurisdictions requiring the more detailed calculations with use of these safe harbors.

Give the newfound importance of CbCR, it's critical that more attention is paid to this area. Companies should evaluate the quality of data being used, and also ensure the report is a "qualified country by country report" under the Pillar 2 administrative guidance, which is not as simple as it may seem. Although a discussion of the detailed Pillar 2 rules is beyond the scope of this article, for a CbCR to be a "qualified country by country report" it generally must be prepared using certain approved financial statement data. Further, the OECD has more recently installed additional guard rails on when the CbCR safe harbors can be applied, including guidance that would disqualify the CbCR for transactions and arrangements that take advantage of differences in accounting treatments (referred to as "hybrid arbitrage arrangements.") and places limitation on "post-year end transfer pricing adjustments." (*See* Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two) (Dec. 2023)).

The introduction of new transfer pricing limitations has become a real cause for concern for many MNE Groups. Assume an MNE Group has been diligently preparing its CbCR. It has followed all of the guidelines and collected financial statement data and post-close transfer pricing entries. This is all in line with the process (correctly) applied for all prior years. However, the new guidance from December 2023 states that post year-end adjustments, like transfer pricing adjustments, to the financial statement data used for the CbCR are not allowed under the transitional CbCR Safe Harbor. The guidance provides that "[m]aking adjustments to the data drawn from Qualified Financial Statements in a CbC Report for a jurisdiction would disqualify a Tested Jurisdiction from the Transitional CbCR Safe Harbour, regardless of whether such adjustments were intended to make CbCR data more consistent with the GloBE Rules."

Under current practice, many MNE Groups prepare their CbCRs using numbers that include these very post-year- end adjustments. This means MNE Groups will need to rethink their approach to CbCR preparation and transfer pricing adjustments – and they will need to do so soon. Because if they don't, they could find themselves potentially disqualified from enjoying the CbCR Safe Harbor benefits.

Adjust "back-end" systems and processes to accommodate data requirements. Once a plan is in place, the next step is establishing the "back-end" system changes and related process changes that will be required; the "back-end" being the data management on the taxpayer's ERP system or other databases. In practice, however, some of the data needed will not be available in the form required by Pillar 2. This will require some level of programing and data cleansing to enhance the reliability of the Pillar 2 data analysis and ensure that any Pillar 2 insights derived from the data are based on accurate and consistent information. Assistance from the Information Technology team (either internal or external) will often be required to facilitate this data exercise and identify areas where automation is available. When planning for resource demands, keep in mind that automation may not always be possible, and some level of annual analysis will be required.

Determine whether to outsource the computation or implement a tax engine to enable the calculations and reporting. Once you have collected all the required data points, the next task will be to run that data through a "front-end" engine that will process the data and provide calculations and output that can be used for forecasting, financial reporting, tax reporting, and other requirements such as estimated payments and cashflow management. Some taxpayers are outsourcing this aspect to accounting firms, but many are also turning to software providers that offer an "out-of-the-box" solution. This may also be done in collaboration with an accounting firm in a co-source arrangement or the firm may assist in implementation of any software solution selected. There are several big-name players that offer Pillar 2 software solutions, including Thomson Reuters, Longview, Oracle, and Corptax. However, these solutions may not always perfectly fit the needs of every organization, which is why some customization may still be necessary.

The tax software should be able to seamlessly integrate with your data collection (or your back-end) via application programming interface (API) or other data connections. Without these connections, many man hours may be required to pull data and re-import, so it's critical to ensure any tax software will integrate with your back-end (and also other reporting software such as the income tax provision software).

These authors would recommend against any solution that is excel or Power BI based. These open-ended tools create unnecessary risk, often require significant upkeep, and generally lack controls that are required in modern businesses. Moreover, some of these solutions do not meet internal IT data security requirements.

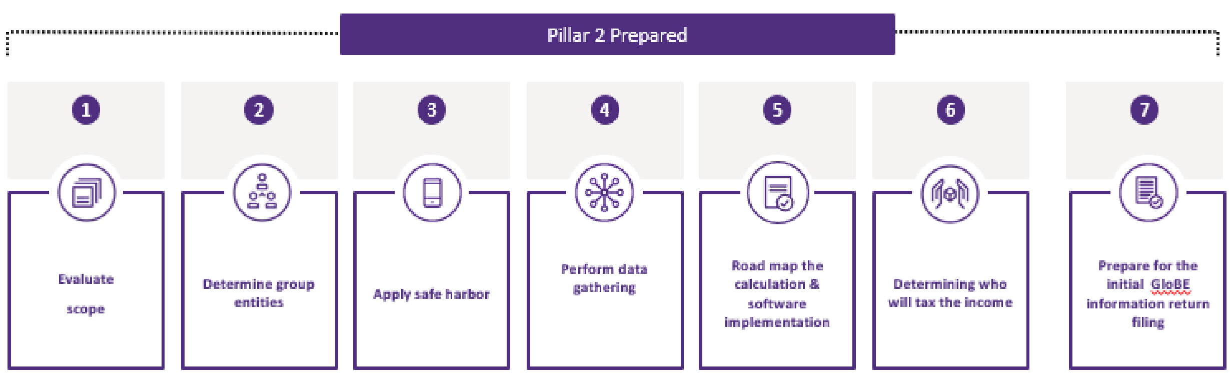
Another item to consider is where within the MNE Group this work will be done. If the work will be performed in the US, then using a US provider makes obvious sense. But, as noted at the onset, the US has not implemented Pillar 2 rules, so the direct reporting may be initially at a foreign subsidiary, and the cash tax consequences may also lie outside of the US Therefore, larger organizations with robust non-US tax departments may consider having this organizational initiative be spearheaded by the tax group that handles the direct reporting and compliance impacted by the rules (i.e., outside of the US). Obviously, US coordination will still be required, for example to accomplish the so-called GILTI push down calculation, but in some cases, it may be better to have these responsibilities reside with the group responsible for the impacted regions (for example, in the EU) (*See* *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two)* (Feb. 2023)). If this is the case, a software provider that supports that local jurisdiction would be advantageous. Such a provider may also be more familiar to those in the organization with ownership of the calculations.

The OECD administrative guidance released in February 2023 includes clarification on the allocation of taxes arising under blended CFC regimes. The guidance explicitly cites GILTI as an example of such blended CFC tax regime, commonly references GILTI within the provided examples, and provides that GILTI is an acceptable CFC tax under the GloBE rules. The treatment of GILTI and CFC tax taxes is applicable only for a limited time, however, for fiscal years beginning on or before Dec. 31, 2025. It will be re-evaluated for fiscal years that end after June 30, 2027.

Finally, these authors would provide a word of caution. Although many of the software packages produce flashy deliverables and promise automation (and one-click type results), keep in mind that many of these programs are still evolving as the rules take final shape. There will be bugs, glitches, and overrides required in the early years. This will be the case with all software providers but should be contemplated when selecting a software and also estimating the number of resources required to operate and implement the software selected.

Next Steps for Multinationals

Multinationals that meet the scope of the Pillar 2 rules may be initially overwhelmed, however, as with any significant undertaking, a proactive approach and thoughtful planning will ease the burden. As the date of enactment of Pillar 2 has already passed for many jurisdictions, it is critical to act now. The following is a high-level roadmap that “in scope” MNE Groups may consider following as they begin their Pillar 2 preparation journey:



1. Evaluate the scope: This will involve a detailed review of the entire organizational structure in order to determine entities in scope of Pillar II. It also requires review of the consolidated financial statements in the context of applying the €750m revenue test.

2. Determine group entities (“Constituent Entities”): MNE Groups should review their structure to identify entities in scope of Pillar II and those which may qualify as excluded entities, subsidiaries of excluded entities or stateless entities under the rules. This step should also include an overview of the specific Pillar 2 rules relating to permanent establishments.

3. Apply safe harbors: Separate calculations are required to determine the applicability of transitional CbCR safe harbors. Under this step, MNE Groups will identify constituent entities which may be excluded from Pillar 2, at least initially.

4. Perform data gathering: MNE Groups should map out the different types of data required under Pillar 2, identify any data gaps, and take action to close such gaps. This exercise generally starts with the MNE Group cataloging all of the data points required, and mapping those to their location within the companies' data ecosystem.

5. Roadmap the calculation and software implementation: MNE Groups should undertake a review of the available Pillar 2 software and tools available on the market and determine offerings that are most suitable based on specific business needs. Alternatively, this step may include determining which outside provider the MNE Group will partner with for outsourced preparation. Once the approach is determined, then the MNE Group should evaluate the data gathered to calculate the GloBE income or loss by making the relevant adjustments to the annual financial accounting net income. This step should also include the development of internal controls and establishing the preparation process.

6. Determine who will tax the income: Evaluate who in the MNE Group will have annual reporting requirements, notification requirements, and what jurisdiction(s) will levy the ultimate tax owed.

7. Prepare for the initial GloBE information return filling: Lastly, the MNE Group should take action to complete the annual GloBE Information Return, domestic top up tax returns, as well as the notification and registration requirements, where required.

Conclusion

Understanding Pillar 2 and its implications is crucial in today's global tax landscape. The introduction of Pillar 2 has significant implications and comes with new risks and burdens. In this evolving tax landscape, MNE Groups should stay informed and adaptable to ensure they navigate the complexities of Pillar 2 effectively. They also need to act timely to avoid traps, such as disqualifying a jurisdiction from using the CbCR safer harbor as a result of post-close transfer pricing adjustments, as highlighted above.

The timeline for implementation will vary by MNE Group, but most should expect it to take no less than 6 months. That means now is the time to prepare for Pillar 2. Although many challenges lie ahead, the prepared taxpayer should be able to navigate Pillar 2 with relative ease. There is no longer a need to impatiently (or anxiously) wait for Pillar 2 – because it does seem that we are "there" (or as close as we are going to get) and the Pillar 2 trip has reached its destination.

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