You and the Taxman

Tax accounting and BEPS 2.0 Pillar Two: Is it business as usual for multinationals?

Released in June 2024, the OECD's fourth Administrative Guidance on BEPS 2.0 Pillar Two could reshape MNEs' approach to tax accounting in the post-GloBE world.

The Base Erosion and Profit Shifting (BEPS) 2.0 Pillar Two framework heralds a new chapter in tax accounting for multinational enterprises (MNEs) that are within its scope and calls for a strategic overhaul of deferred tax practices.

Part of the two-pillar solution developed by the Organisation for Economic Co-operation and Development (OECD) to address the tax challenges arising from the digitalised economy, BEPS 2.0 Pillar Two establishes a global minimum tax rate of 15%. The tax applies to MNEs with an annual consolidated revenue of at least €750 million in at least two of the four preceding fiscal years. It has been implemented in several major economies.

The principles underlying the global minimum tax are embedded in the Global Anti-Base Erosion Model Rules (GloBE Rules). While the GloBE Rules were finalised in December 2021, the OECD Secretariat has been releasing additional administrative guidance to ensure their consistent global application. The fourth Administrative Guidance on BEPS 2.0 Pillar Two (June 2024 AG) has significant clarifications that can reshape MNEs' approach to tax accounting in the post-GloBE world.

This article discusses the clarifications in the June 2024 AG concerning divergence between GloBE and accounting carrying values, and deferred tax liability (DTL) recapture rule.

Divergence between GloBE and accounting carrying values

The GloBE Rules require certain adjustments to accounting profits to determine the GloBE income or loss, which serves as the denominator in the effective tax rate (ETR) computation. Additionally, Article 6.3 and Article 9.1.3 of the GloBE Rules dictate the GloBE carrying values to be adopted for intra-group asset transfers, which may lead to differences between GloBE and accounting carrying values.

The June 2024 AG clarifies that, for BEPS 2.0 Pillar Two purposes, the deferred taxes, which form part of "adjusted covered taxes" in the numerator of the ETR computation, must be determined using the GloBE carrying values.

This requires MNEs to keep distinct records to track the GloBE carrying values for calculating GloBE income or loss and deferred taxes in compliance with the GloBE Rules. Due to GloBE adjustments, deferred tax computations currently prepared for financial reporting may not be admissible for Pillar Two purposes. Failure to understand this clarification, along with inadequate processes and internal controls to address the requirements, may result in incorrect Pillar Two filings and hefty penalties. As the errors can be carried forward onto subsequent years, such systematic errors can readily compound into a multiyear problem.

Complying with the DTL recapture rule

The DTL recapture rule aims to remove the impact of DTLs from the jurisdictional ETR calculation when the corresponding tax remains "unpaid" after five years. Notably, certain categories of low-risk DTLs that are likely to reverse over time are exempted from this recapture rule. Additionally, MNEs may elect to exclude a particular DTL accrual or DTL for a general ledger (GL) account and their subsequent reversal from the computation of adjusted covered taxes (i.e., Unclaimed Accrual election).

To comply with the DTL recapture rule, MNEs must identify which categories of DTLs are subject to this rule. They also need to determine the year and the extent to which each identified DTL accrual will reverse. This entails putting in place tracking and monitoring mechanisms to determine whether the relevant DTL accrual has been paid or reversed within the five-year period.

MNEs may have traditionally computed and aggregated deferred taxes by GL account or balance sheet items, rather than determining deferred taxes on an asset-by-asset or liability-by-liability basis. To provide guidance on how MNEs can compute and aggregate their deferred taxes to comply with the DTL recapture rule, three DTL aggregation categories and associated principles are detailed in the June 2024 AG: the aggregate DTL category basis, the GL account basis and the item-by-item basis. Each method presents its own unique criteria and exclusions, and operational demands. Additionally, the June 2024 AG sets out the first-in, first-out and last-in, first-out mechanisms to determine recapturing of DTLs, and certain simplifications for DTL tracking applicable to short-term DTLs (i.e., DTLs that fully reverse within five years).

Failure to accurately track DTLs can result in inaccurate ETR computations, surprise top-up tax liabilities, as well as expose MNEs to associated penalties, among other things. The DTL accruals may also be disregarded altogether for purpose of computing the adjusted covered taxes.

Navigating June 2024 AG

MNEs can consider the following steps:

1. **Comprehensive understanding and evaluation**
   - Peruse the GloBE Rules and the June 2024 AG. This includes the specifics of the DTL recapture rule, the criteria of the DTL aggregation categories and the requisite tracking mechanism to support compliance with the DTL recapture rule.
   - Understand the profile of existing DTLs in the organisation that fall within the scope for the DTL recapture rule, such as accrual and reversal patterns of the DTL.
   - Determine transactions within the organisation that may lead to divergence between GloBE and accounting carry values.
   - Assess existing tax accounting practices and reporting tools related to deferred tax to identify gaps in meeting the compliance requirements of the GloBE Rules and the June 2024 AG. This evaluation should consider how deferred taxes are currently computed, tracked, and reported.
   - Determine the categorisations of existing DTLs within the organisation and assess the merits of DTL tracking mechanisms that may be adopted to meet the DTL recapture rule.

2. **Election decisions to mitigate compliance burden**
   - Evaluate the potential benefits and impacts of making certain elections under the GloBE Rules, such as the GloBE Loss Election and Unclaimed Accrual Election. For jurisdictions with overall losses and immaterial timing differences, MNEs can consider opting for GloBE Loss Election, thereby creating a "GloBE Loss Deferred Tax Asset" via a simplified off-the-books calculation. However, this one-off election should not be made lightly as it disregards the effect of deferred taxes in computing the jurisdictional ETR.
   - MNEs may also consider the feasibility of the Unclaimed Accrual Election to remove certain DTL accruals in the computation of adjusted covered taxes. This allows the excluded deferred tax expense to be recognised as covered taxes upon payment in subsequent years.

3. **Enhance tax accounting processes and capabilities**
   - Develop a detailed plan to align their tax accounting practices with the GloBE Rules. This plan should include timelines, responsibilities, and the resources needed for implementation.

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- Build capabilities to support the preparation of separate deferred tax computations for Pillar Two purposes, including adherence to the DTL tracking methods outlined in the June 2024 AG.
- Design and implement a DTL tracking system, taking into consideration the appropriate choice of applicable DTL tracking methods. Consider segregating short-term DTLs from long-term DTLs to utilise the applicable exceptions.
- Maintain a deferred tax reconciliation report in preparation for future tax audits.

4. Training, documentation and monitoring

- Ensure that internal stakeholders, such as in-house tax and finance teams tasked with Pillar Two responsibilities, are well-trained on the new rules and the specific processes for tracking and calculating deferred taxes for Pillar Two purposes.
- Maintain detailed documentation of tax policies and procedures for Pillar Two deferred tax computations to guide staff and meet regulatory scrutiny.
- Continuously review and refine the tax accounting processes, staying updated with OECD guidelines and changes in tax laws.

5. Consult with tax professionals

- Collaborate with tax professionals on BEPS 2.0 Pillar Two to strengthen the MNE's Pillar Two compliance strategy and tax accounting governance framework.

MNEs must address the tax accounting challenges arising from the June 2024 AG’s clarifications on differences between GloBE carrying value and accounting carrying value, as well as the DTL recapture rule. Meticulous tracking and making informed strategic elections are required to ensure compliance. Professional guidance and a commitment to adaptability are key to navigating this complex tax landscape. By adopting these proactive steps, MNEs can manage risks, avoid surprise top-up taxes and penalties, and maintain a favourable tax position.

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Chai Wai Fook
EY Asean Government & Public Sector Tax Leader
wai-fook.chai@sg.ey.com

Teo Ying Quan
Partner, International Tax and Transactions Services
Ernst & Young Solutions LLP
yingquan.teo@sg.ey.com

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