

BEPS Pillar Two Calculating Top-up Tax

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Overview



Step 1: Assign income and taxes

Identify which entities are in a jurisdiction

- Opaque entity
 - Place of tax residence
 - Non-tax resident entities: place of creation
- Permanent establishment: PE jurisdiction
- Flow-through Entities: stateless unless UPE
 - Tax Transparent Entity
 - Reverse Hybrid
- Dual resident entities
 - Apply tax treaty tie-breaker
 - If no tiebreaker: greater amount of Covered Taxes / substance



Step 1: Assign income and taxes

Calculate each Constituent Entity's GloBE Income

- Start with accounting income – use UPE's financial standard
- Adjustments include:
 - Net Taxes Expense
 - Excluded Dividends
 - Excluded Equity Gains / Losses
 - Policy Disallowed Expenses
 - Accrued Pension Expenses
- Qualified Refundable Tax Credits treated as income
- Arm's length adjustment
- Exclude International Shipping Income



Step 1: Assign income and taxes

Assignment of income to special entities

- Permanent Establishments
 - Allocate to PE the income allocated to PE in accounts
 - Adjust by reference to tax treaty / domestic law etc
- Tax Transparent Entities
 - General rule: allocate Tax Transparent Entity's income to Constituent Entity owners in proportion to ownership interests
 - Tax Transparent Entity that is UPE: allocate income to Tax Transparent Entity
- Reverse Hybrids
 - Allocate income to Reverse Hybrid



Step 1: Assign income and taxes

Calculate each Constituent Entity's Adjusted Covered Taxes

- Starting point: current tax expense in financial statements
- Strip out any taxes that aren't Covered Taxes
- Reductions
 - Tax related to uncertain tax positions / tax not expected to be paid in 3 years
 - Tax on income that isn't GloBE Income
- Additions
 - Total Deferred Tax Adjustment Amount
 - Covered Taxes recorded elsewhere in accounts

Covered Taxes

- a) Taxes recorded in the financial accounts of a Constituent Entity with respect to its income or profits or its share of the income or profits of a Constituent Entity in which it owns an Ownership Interest;
- b) Taxes on distributed profits, deemed profit distributions, and non-business expenses imposed under an Eligible Distribution Tax System;
- c) Taxes imposed in lieu of a generally applicable corporate income tax; and
- d) Taxes levied by reference to retained earnings and corporate equity, including a Tax on multiple components based on income and equity.

Step 1: Assign income and taxes

Assignment of Covered Taxes

Type of Tax	Entity to whom Tax is allocated
Taxes on GloBE Income attributed to a PE	PE
Taxes in Tax Transparent Entity's accounts on income allocated to Constituent Entity Owner	Constituent Entity Owner
CFC taxes	Entity that earned income
Tax on Hybrid Entity income in Constituent Entity Owner's accounts	Hybrid Entity
Tax on distributions in Constituent Entity Owner's accounts	Distributing entity
Withholding taxes	Entity that earned income



Step 2: Calculate ETR

- Jurisdictional blending
 - Add together GloBE Income / Losses for Constituent Entities in jurisdiction to get Net GloBE Income / Loss
 - Add together Adjusted Covered Taxes for Constituent Entities in jurisdiction
- Divide aggregate Adjusted Covered Taxes by Net GloBE Income
- ETR of Minority Owned Constituent Entities and Investment Entities calculated on stand-alone basis
- No ETR calculation for jurisdictions that have Net GloBE Losses

$$\text{ETR} = \frac{\text{Aggregate Adjusted Covered Taxes}}{\text{Net GloBE Income}}$$

Step 3: Calculate Top-up Tax

Calculate Top-up Tax Percentage

- Minimum Rate: 15%
- ETR of 15% or more doesn't automatically mean no top-up tax payable

$$\text{Top-up Tax Percentage} = \text{Minimum Rate} - \text{ETR}$$

Step 3: Calculate Top-up Tax

Calculate Excess Profit

- Mechanism to exclude fixed return on substantive activities in jurisdiction
- Substance based Income Exclusion
 - 5% of Eligible Payroll Costs in jurisdiction; and
 - 5% of carrying value of Eligible Tangible Assets
- Applies by default – can elect out
- Higher fixed return for transitional period
- Tax Transparent Entities – issues with allocation of Eligible Payroll Costs and Eligible Tangible Assets

Excess Profit = Net GloBE Income – Substance based Income Exclusion

Step 3: Calculate Top-up Tax

Substance based Income Exclusion: Eligible Payroll Costs

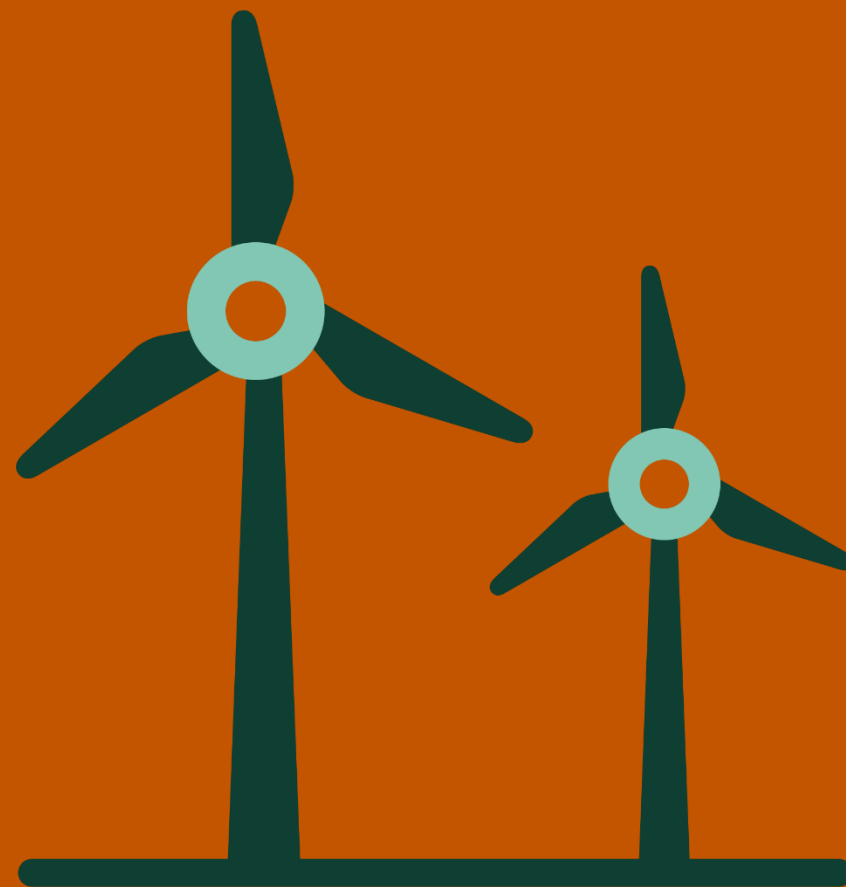
- Eligible Payroll Costs: salaries, bonuses, stock-based compensation, medical insurance, payroll taxes, employer social security contributions
- Eligible Employees: employees and contractors working in jurisdiction
- Must determine:
 - Eligible Employees
 - Location of Eligible Employees
 - Eligible Payroll Costs for Eligible Employees in jurisdiction



Step 3: Calculate Top-up Tax

Substance based Income Exclusion: Eligible Tangible Assets

- Eligible Tangible Assets: property, plant and equipment, natural resources
- Must be located in jurisdiction
- Average of carrying value in fiscal year
- Assets held for sale / lease / investment excluded



Step 3: Calculate Top-up Tax

Calculate Jurisdictional Top-up Tax

- Multiply Excess Profit by Top-up Tax Percentage
- Add any Additional Current Top-up Tax
- Minus any Domestic Top-up Tax

- Additional Current Top-up Tax: Top-up Tax due as a result of recalculation of prior fiscal year ETR

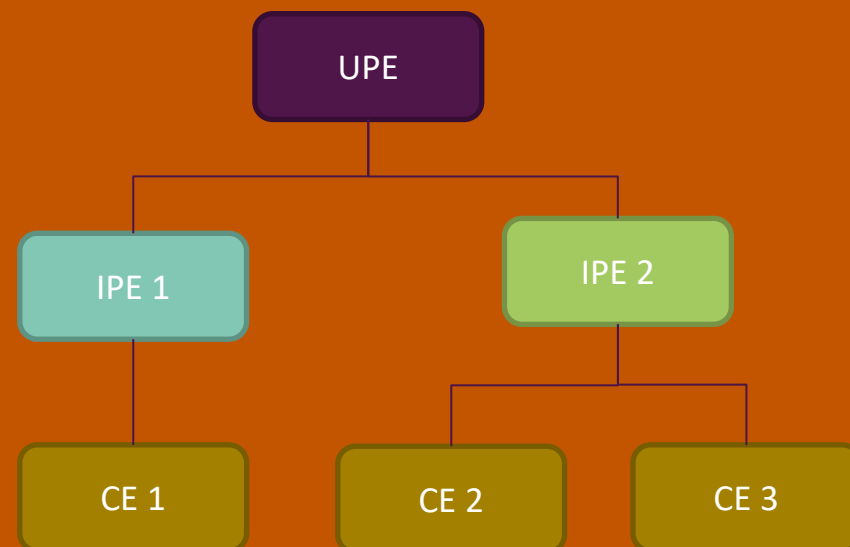
- Domestic Top-up Tax: additional tax levied to prevent IIR or UTPR charge

$$\begin{aligned} \text{Jurisdictional Top-up Tax} = & \\ & (\text{Top-up Tax Percentage} \times \text{Excess Profit}) \\ & + \text{Additional Current Top-up Tax} \\ & - \text{Domestic Top-up Tax} \end{aligned}$$

Step 3: Calculate Top-up Tax

Allocate Jurisdictional Top-up Tax

- Must allocate Jurisdictional Top-up Tax between Constituent Entities in the jurisdiction
- Not the entity which pays the Top-up Tax
- Allocated in proportion to share of GloBE Income
- Nothing allocated to loss-making entities in jurisdiction

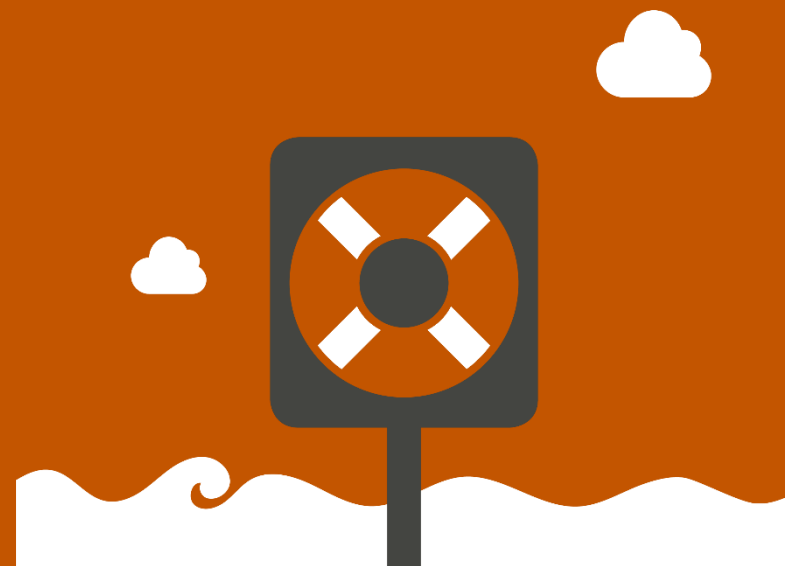


$$\text{Top-up Tax of CE} = \text{Jurisdictional Top-up Tax} \times \frac{\text{GloBE Income of CE}}{\text{Aggregate GloBE Income}}$$

Step 3: Calculate Top-up Tax

De minimis exclusion

- Annual election
- Conditions
 - Average GloBE Revenue for jurisdiction less than €10m
 - Average GloBE Income / Loss for jurisdiction less than €1m
- Effect
 - Top-up Tax for Constituent Entities in jurisdiction deemed to be zero
 - No requirement to calculate ETR for jurisdiction



Worked Example

1. Calculate ETR

- Net GloBE Income = $2000 + 1000 - 500 = 2500$. Aggregate Adjusted Taxes = $180 + 120 = 300$
- ETR = $300 / 2500 = 12\%$

2. Calculate Top-Up Tax Percentage

- Top-up Tax % = $15\% - 12\% = 3\%$

3. Calculate Excess Profit

- Return on Eligible Payroll Costs = $20 + 10 + 10 = 40$. Return on Eligible Tangible Assets = $30 + 5 + 25 = 60$. Substance Based Income Exclusion = $40 + 60 = 100$
- Excess Profit = $2500 - 100 = 2400$

4. Calculate Jurisdictional Top-up Tax

- Jurisdictional Top-up Tax = $(2400 \times 3\%) = 72$

5. Allocate Jurisdictional Top-up Tax

- CE 1: $2000 / 3000 = 66.66\% \times 72 = 48$
- CE 2: No allocation (loss making)
- CE 3: $1000 / 3000 = 33.33\% \times 72 = 24$

