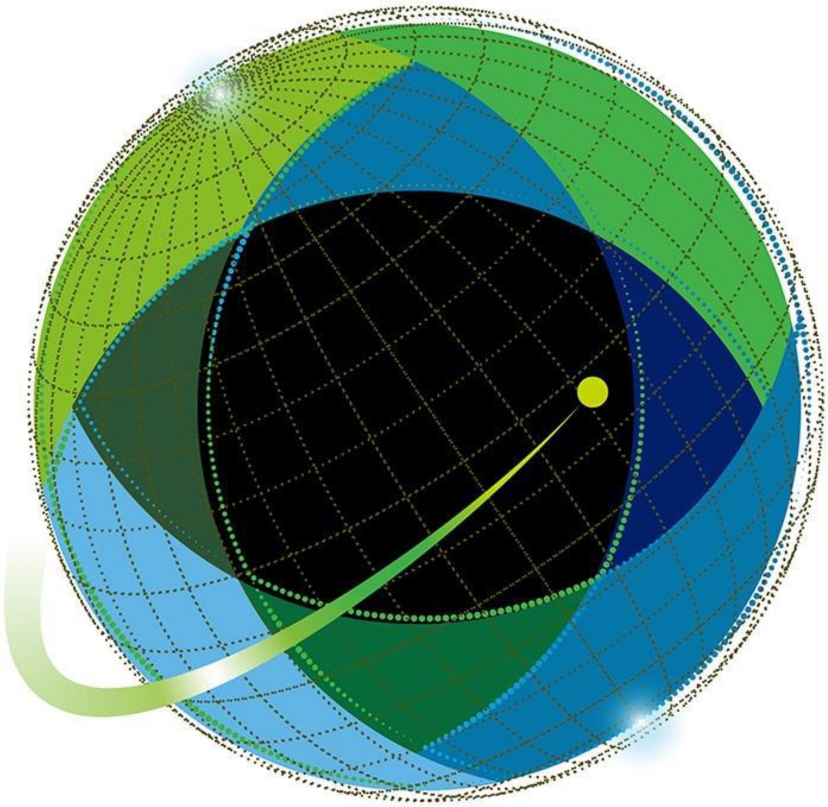

Pillar Two – Is your Country-by-Country Report Qualified? Key considerations and insights

Most MNE Groups intend to apply the Transitional Country-by-Country Report Safe Harbours to ease their compliance burden when transitioning into Pillar Two. This article addresses key considerations for MNE Groups to assess whether their Country-by-Country Report is so-called 'Qualified' and set outs additional considerations closely related to this process.

Introduction

For the majority of MNE Groups, Pillar Two entails a large-scale reporting and compliance challenge: extensive data gathering, setting up new processes and critically assessing their tax-related governance framework, to name a few. Ensuring the current tax, finance, and accounting functions are ready for the upcoming Pillar Two reporting and compliance obligations should – regardless of whether additional Top-up Tax might be due under these new rules – be considered a priority.

Reporting and compliance deadlines

A dangerous pitfall in any Pillar Two readiness journey is taking the extended 18-month filing deadline for the first GloBE Information Return (GIR) as the primary milestone. Instead, MNE Groups should proactively focus on the upcoming FY24 year end audit, as MNE Groups must report the current tax expenses related to Pillar Two separately, as well as a related disclosure note. Given that the Consolidated Financial Statements (CFS) are typically published within 4 months after the end, this deadline is critical to consider in light of Pillar Two readiness.

This also means that the first external review of an MNE Group's reported Pillar Two position will, in principle, be conducted by their auditor. Currently, audit firms are in the process of determining their audit approach concerning Pillar Two. There will likely be increased attention on the accurate and consistent application of the new Pillar Two (local) rules as well as the validity of data sources used as input.

Substantiating the Pillar Two position

Most MNE Groups intend to apply the Transitional Country-by-Country Report (CbCR) Safe Harbour (SH) for eligible jurisdictions and thus aim to substantiate their Pillar Two position (to a large extent) based on those simplified calculations. Therefore, relevant data sources – which (partially) deviate from those required for a full GloBE-calculation – will be the Qualified CbCR and the Qualified Financial Statements (QFS) (as per the OECD's Safe Harbours and Penalty Relief publication of December 2022 and the Administrative Guidance publication of December 2023). In this two-pager, we will discuss relevant considerations that MNE Groups face in meeting the required Qualified CbCR data status for the Transitional CbCR SH testing.

Qualified CbCR

Ensuring the Qualified status of the CbCR is a necessity in light of the Transitional CbCR SH. Ultimately, it involves certain requirements related to the source of the data for the CbCR as well as mandatory adjustments. Establishing a standard for CbCR was somewhat of an inevitability. It was created as a result of the OECD Base Erosion and Profit Shifting (BEPS) project with its primary function being one related to risk assessment; allowing tax authorities to flag certain MNE Groups for further investigation. Now, CbCR is instrumental for Pillar Two compliance and more specifically, has a direct impact on a potential Pillar Two Top-up Tax liability. This increased importance has warranted the need for a standard which would solve some of the issues that CbCR faces, namely: potentially unreliable data, and the use of different data sources for entities within the same jurisdiction.

Data sources for CbCR / Qualified CbCR

Under BEPS Action 13, the CbCR must contain aggregated (or possibly consolidated) data, from any of the following data sources: consolidation reporting packages, stand-alone statutory financial statements, regulatory financial statements and/or financial data from internal management reporting. Although the various abovementioned data sources could be used within the same jurisdiction, they must be applied on a consistent basis and also disclosed in the CbCR in table 3.

A Qualified CbCR has to be prepared based on the QFS, which are the CFS of the MNE Group or the stand-alone statutory financial statements, prepared in accordance with an authorized/ acceptable OECD accounting standard (generally this is any OECD members' GAAP or globally recognized accounting standards like IFRS). This means that data source requirements for the Qualified CbCR are stricter and as a result, forces MNE Groups to embed CbCR into their financial reporting process. In contrast to CbCR under BEPS Action 13, it is the case that the same data source must be used per jurisdiction. As the data sources can potentially vary per jurisdiction, the Qualified status of the CbCR will also have to be determined per jurisdiction. This is a very important feature of the Transitional CbCR SH rules considering that one jurisdiction may use a Qualified CbCR and thereby have access to the Transitional CbCR SH whereas another may not.

CbCR under BEPS Action 13

Over 120 jurisdictions have implemented CbCR under BEPS Action 13 – with some jurisdictions closely sticking to the OECD implementation guidance publications, whereas other jurisdictions have diverged from the legislative blueprints to varying extents. As a prerequisite to achieving the Qualified status for the CbCR, MNE Groups should ensure their CbCR adheres to local CbCR (i.e., BEPS Action 13) rules. The key factor here being where the Ultimate Parent Entity (UPE) is located given its obligation to submit the CbCR to the tax authorities. In the subsequent section, we will outline a key example of why understanding local CbCR rules are of critical importance.

Dividends and (un)realised capital gain income of Constituent Entities

Within the CbCR framework (as well as within Pillar Two in general), the OECD has specifically stated that (non-hybrid) dividends received from other Constituent Entities should not be 'double-counted' and hence be excluded from Revenue and PBT in the receiving jurisdiction. However, most participation exemption regimes also exempt capital gains realised on the sale of Constituent Entities, which would result in increased Revenue and PBT, without a commensurate increase in the Simplified Covered Taxes. Therefore, such sales negatively impact the Simplified ETR. Local CbCR legislation may deviate – e.g., the Dutch CbCR implementation guidance states that it is '*at the discretion of the reporting entity whether to include other participation results from group entities in PBT*', seemingly opening the door to exclude share sales proceeds.

"Depending on where MNE Groups are required to file their CbCR, the local implementation of CbCR requirements may impact the presentation of figures in important items such as PBT."

Net unrealized fair value loss

Unrealised capital gains (or losses) under fair value accounting are generally also exempted under local participation exemptions, giving rise to a similar Simplified ETR deflation issue. The OECD seems to be well-aware of such effects, as it decided that a Net Unrealised Fair Value Loss shall be excluded from PBT if that loss exceeds € 50m in a given jurisdiction. These rules protect the integrity of the Simplified ETR in a loss situation, which would otherwise be overstated. However, for positive unrealised capital gains no correction can be made, which would result in the risk of an overstated Simplified ETR. Further, it should be noted that this Net Unrealised Fair Value Loss adjustment should not be made in the CbCR itself, but in the Transitional CbCR SH calculations.

Purchase price accounting

Specific rules with regard to mandating purchase price accounting (PPA) adjustments form part of the requirements to achieve the Qualified status of the CbCR. In short, if an MNE Group has submitted a CbCR for a FY beginning after December 31, 2022, with PPA adjustments, the MNE Group can continue to include PPA effects (i.e., the so-called consistent reporting condition). If it has not, then PPA adjustments may not be incorporated in future CbCRs. This means that the FY23 CbCR is the last window of opportunity to include PPA effects going-forward. In addition, a goodwill impairment adjustment must be applied. This would require a reduction to a Constituent Entity's income attributable to an impairment of goodwill which relates to transactions entered into after November 30, 2021, to be added back to PBT when the Transitional CbCR SH tests are performed. These PBT corrections are performed outside the Qualified CbCR.

Transfer pricing adjustments

In contrast to obligatory adjustments, achieving the Qualified status for the CbCR may also prohibit MNE Groups from making certain adjustments. Key to this topic is transfer pricing (TP) adjustments, whereby the timing thereof is the leading factor. Whilst incorporating post-year-end TP adjustments may ensure a more accurate representation of the data, doing so may very well render the CbCR disqualified based on the OECD's Administrative Guidance publication of December 2023.

Closing remarks

With the deadline for filing the FY23 CbCR quickly approaching (for FYs aligned to the calendar year, the deadline in the Netherlands falls on December 31, 2024), it is imperative for MNE Groups to revisit their CbCR preparation process. This is all the more apparent given that CbCR is becoming part of the year end audit process and the potential significant impact it may have on determining a given MNE Group's FY24 Pillar Two Top-up Tax liability. Whilst the Transitional CbCR SH may aid in mitigating the Pillar Two compliance burden, MNE Groups should be aware of the likelihood that the Qualified nature of the CbCR will be scrutinized by tax authorities and auditors alike.

Contact us

Carla van der Merwe
Director
Mobile: +316 2259 0557
E-mail: carvandermerwe@deloitte.nl

Charlie Symonds
Senior Consultant
Mobile: +316 2967 8497
E-mail: csymonds@deloitte.nl

Robin Tulp
Senior Consultant
Mobile: +316 2965 3024
E-mail: rtulp@deloitte.nl