

Analysis

Profit recognition under GloBE and domestic rules: it's all in the timing

Speed read

The OECD published model minimum tax rules on 20 December 2021. An interesting aspect – which has evolved since previous iterations – is the approach to adjusting for differences between when profits are recognised under the GloBE and domestic rules. The rules now smooth out such differences by allowing businesses to include deferred tax expenses when calculating their effective tax rate. This addresses business concerns but makes the rules more complex. There are also limits on when deferred tax may be taken into account, which may lead to unexpected GloBE charges in some situations, especially those involving intangibles.

On 20 December 2021, the OECD published model global anti-base erosion (GloBE) rules. The rules, which are the main component of pillar two of the BEPS 2.0 initiative that has been endorsed by 137 countries, aim to ensure that large multinationals pay an effective tax rate (ETR) of at least 15% on their profits arising in each jurisdiction.

The rules are 70 pages long and analysing them will keep practitioners busy over the coming weeks and months. This article focuses on one fundamental aspect: the mechanism for dealing with differences between when a company's profits are recognised for domestic tax purposes and for the GloBE rules (referred to here as 'timing differences'). It explains the thinking behind the approach the OECD has ultimately taken and the implications for businesses.

Background

The GloBE rules ensure that groups pay a minimum ETR by:

- measuring the ETR that a group pays in each jurisdiction;
- calculating how much additional tax would be required to bring those ETRs up to the minimum; and
- allocating to countries the right to collect that top-up tax.

Ordinarily the group's parent jurisdiction will collect the top-up tax under the income inclusion rule (IIR), which is akin to a traditional controlled foreign company (CFC) rule, albeit very broad in scope. There are also backup rules for allocation in situations where the parent jurisdiction does not implement the GloBE rules.

What is ETR?

$$\text{ETR} = \frac{\text{Tax paid}}{\text{Profit measure}}$$

Unlike a country's headline tax rate, an ETR compares the tax paid by a company to an objective measure of its profits. In doing so it attempts to measure the 'true' rate



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of tax being paid by a company: even where a country's headline tax rate is high, the tax burden on companies may be low because of the way the tax base is defined, including any allowances, exemptions, or credits. Defining taxable profits in an objective way controls for these factors.

To measure groups' ETRs, the OECD has developed a GloBE tax base which will be applied uniformly by implementing countries. That base is a company's accounting profit, adjusted for a handful of things that reflect countries' consensus views about what things are legitimate features of a tax system (and not devices for competition). For example, the GloBE tax base exempts dividends and gains from participation shareholdings, recognising that participation exemption is a mainstream feature of countries' tax systems and has a legitimate policy rationale. In contrast, it does not recognise patent boxes, which are aimed at attracting or retaining IP using low tax rates.

What's the problem with timing differences?

After pillar two has been implemented countries will continue to tax groups using their domestic tax rules, with the results then being tested by the GloBE rules. Domestic rules may differ from the GloBE rules in two ways:

- **Permanent differences:** whereby domestic tax rules include or exclude items of income or expenditure that are not included or excluded in the GloBE base. For example, the UK disallows expenditure on business entertainment while GloBE does not. Those permanent differences will increase or decrease the ETR of the business in question; for example, allowing entertainment expenses under the GloBE rules decreases the denominator of the ETR fraction, thereby increasing the resulting rate. That is the right outcome: these things are not adjusted for in the GloBE base because they speak to the generosity of the tax system in question.
- **Timing differences:** whereby domestic tax rules recognise income and expenditure at different times to the accounts (and therefore the GloBE base), but in the long run the overall profit is the same. An obvious example of a timing difference is a loss, which is recognised in a company's accounts but may only be tax effective in a later profitable year when it can be relieved. Timing differences can also arise for profit-making companies. For example, accelerated capital allowances will change the timing of a profitable company's tax payments compared to what might be expected from the depreciation in its accounts.

Timing differences present a problem. They could affect a group's ETR as much as permanent differences do, but often that would be inconsistent with pillar two's policy rationale and lead to disproportionate top-up charges.

Decisions about when to recognise income and

Example 1: 100% FY capital allowance

A company buys plant and machinery for £150 which it depreciates over 10 years on a straight line basis. Under domestic tax rules it receives a 100% first year allowance that reduces the company's ETR to 7% – below the minimum rate – in the first year. This would result in top-up tax being payable, but under the model rules covered tax also includes DTLs, which compensates for the timing difference and bring the ETR back above the minimum rate. Capital allowances on physical assets are on the list of excepted deferred tax adjustments that do not get recaptured after five years.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
	£	£	£	£	£	£
Accounts:						
A. Income	200	200	200	200	200	200
B. Depreciation	-15	-15	-15	-15	-15	-15
C. Profit before tax	185	185	185	185	185	185
D. Current tax expense (per domestic tax computation below)	12.5	50	50	50	50	50
E. Deferred tax expense (per memo below)	20.3	-2.3	-2.3	-2.3	-2.3	-2.3
F. Total tax	32.8	47.8	47.8	47.8	47.8	47.8
G. ETR if used current tax only (D/C)	7%	27%	27%	27%	27%	27%
H. GloBE ETR (F/C)	18%	26%	26%	26%	26%	26%
Domestic tax comp:						
Profit before tax	185	185	185	185	185	185
add: depreciation	15	15	15	15	15	15
less: capital allowances (assume 100% FYA)	-150	0	0	0	0	0
Taxable profit	50	200	200	200	200	200
Domestic tax at 25%	12.5	50	50	50	50	50
Deferred tax memo:						
Timing difference	135	120	105	90	75	60
DTL (timing difference x 15% METR)	20.3	18.0	15.8	13.5	11.3	9.0
Movement in DTL (= DT expense)	20.3	-2.3	-2.3	-2.3	-2.3	-2.3

expenses for tax purposes often reflect legitimate policy choices which the GloBE rules are not intended to constrain (although it is conceivable that long-term deferral of tax, as can occur under systems that only tax a company when it pays dividends, could be used for competition). Countries accept, for example, that a 100% first year allowance for expenditure on plant and machinery is a legitimate way of relieving the cost of capital investment, and not an instrument of undesirable tax competition. But if the GloBE rules were unable to accommodate the decision to relieve this expenditure earlier rather than later, it could depress a group's apparent ETR and lead to it paying top-up tax. That top-up tax would be disproportionate – ultimately the only benefit to the group is a cash-flow advantage, but top-up tax would be charged as if there were a permanent tax saving.

The difficulty is that the GloBE tax base cannot simply be adjusted to avoid timing differences arising; every country has different rules that would be impossible to accommodate under one objective tax base.

What's the solution?

Given the impossibility of catering for all timing differences in the tax base, the OECD has attempted to solve the problem by adjusting the tax in the numerator of

the ETR fraction. Notably the approach has evolved since the original pillar two blueprint was published in October 2020.

The carry-forward approach

The OECD's first proposed solution was described in the blueprint and involved groups being able to carry forward certain tax attributes:

- Firstly, groups that made a loss according to the GloBE base would be able to carry that loss forward and use it to reduce any GloBE profits that arose in the same jurisdiction in the future.
- Secondly, groups that recorded an ETR in a jurisdiction above the minimum rate would be able to recognise the tax paid above the minimum rate as 'excess tax'. To the extent a group recognising excess tax had suffered top-up tax in that jurisdiction previously it could use the excess tax to reduce its future top-up tax liabilities in relation to that jurisdiction or elsewhere (an 'IIR tax credit'). Any excess tax that was not converted to IIR tax credit could be carried forward and included in future years' ETR calculations in that jurisdiction ('local tax carry-forward') for several years.

The carry-forward approach would have reduced the likelihood of timing differences giving rise to permanent top-up tax, but it had limitations. It relied on groups having

Example 2: amortisation of purchased goodwill

A company buys goodwill for £1500. Assume all of it is eligible for tax relief over 10 years on a straight line basis. Under IFRS goodwill is held at cost. The company therefore receives tax relief ahead of when deductions are recognised in the accounts, and accordingly recognises a deferred tax liability (DTL). Initially this keeps the GloBE ETR above the minimum, so no top-up is required. After five years, the DTL is 'recaptured' – because it has not fully unwound – then the company must go back and recompute Year 1 without the DTL. The additional £17.5 of top-up tax is added to Year 6's liability.

	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
	£	£	£	£	£	£
Accounts:						
A. Income	200	200	200	200	200	200
B. Amortisation	0	0	0	0	0	0
C. Profit before tax	200	200	200	200	200	200
D. Current tax expense (per domestic tax computation below)	12.5	12.5	12.5	12.5	12.5	12.5
E. Deferred tax expense (per memo below)	22.5	22.5	22.5	22.5	22.5	22.5
F. Total tax	35	35	35	35	35	35
G. ETR if used current tax only	6%	6%	6%	6%	6%	6%
H. Top-up if used current tax only (C x (15% – G))	17.5	17.5	17.5	17.5	17.5	17.5
I. GloBE ETR (FIC)	18%	18%	18%	18%	18%	18%
Recaptured DT – collected as top-up tax						17.5
Domestic tax comp:						
Profit before tax	200	200	200	200	200	200
less: amortisation relief	-150	-150	-150	-150	-150	-150
Taxable profit	50	50	50	50	50	50
Domestic tax at 25%	12.5	12.5	12.5	12.5	12.5	12.5
Deferred tax memo:						
Timing difference	150	300	450	600	750	900
DTL (timing difference x15% METR)	22.5	45	67.5	90	112.5	135
Movement in DTL (= DT expense)	22.5	22.5	22.5	22.5	22.5	22.5

top-up tax exposures against which to offset their excess tax. That would be the case in situations where a timing difference leads to an increased ETR followed by a reduced ETR. However, groups in the reverse situation – a low ETR followed by a high one – would potentially have had no way of recovering top-up tax charged solely because of a timing difference.

Businesses felt that the carry-forward approach would be burdensome to administer and that it would not fully resolve timing difference issues they expected to see in practice. This was of particular concern to groups in the extractive and insurance sectors, which can both have long business cycles with large timing differences that persist for many years.

The deferred tax approach

Responding to these concerns, the OECD developed the approach contained in the model rules. This smooths out timing differences by including both the current and deferred tax expenses recorded in a company's accounts in the numerator of the ETR fraction. That effectively matches a company's tax payments to the time when profits are recognised in the accounts, taking advantage of

the matching that has already been done for accounting purposes in the deferred tax calculations.

At first glance this might appear to neatly remove the effect of timing differences. However, there are several stings in the tail that mean the deferred tax approach is not as straightforward as it initially seems.

Firstly, the model rules require groups to 'recast' – in other words, revalue – any deferred tax they recognise using the GloBE minimum ETR of 15% where that is lower than the domestic tax rate which will have been used in the accounts. This ensures timing differences are valued consistently (at least for countries with rates above the minimum). Otherwise, a deferred tax item arising to a company in a country with a 15% tax rate would have half of the effect on its ETR as the same item arising to a company in a country with a 30% rate, even though both represent the same difference in taxable profits. See example 1.

Secondly, as noted above the opportunity for tax deferral could be used for tax competition. The rules therefore only allow deferred tax to be taken into account for five years. Other than for certain excepted differences, deferred tax will be 'recaptured' if it has not unwound

after that length of time. This means that after five years the group must re-compute its top-up tax for the year in which that deferred tax was first recognised, exclude the recaptured deferred tax, and then pay any additional top-up tax.

The list of excepted differences is short. It includes differences relating to capital allowances or roll-over relief on tangible assets, fair value accounting, FX gains, and several sector-specific provisions. Notably, it does not include differences relating to the amortisation of intangibles or goodwill. This can lead to some counter-intuitive outcomes, as illustrated in example 2.

Finally, there are various things that affect deferred tax expense that do not relate to timing differences, for example changes in whether deferred tax can be recognised for accounting purposes and changes in the domestic tax rate. They are therefore stripped out of the ETR calculation.

Observations

The deferred tax approach is an innovative solution to a tricky problem. Relying on deferred tax makes it possible to isolate timing differences specifically and deal with them 'up-front' in the ETR calculation. That prevents top-up tax being erroneously charged, rather than trying to compensate for it in the long run.

This precision comes at the price of complexity. Businesses that thought the carry-forward approach was too burdensome will not be heartened by the prospect of having to maintain shadow deferred tax computations, recast at 15%, with some items excluded and the remainder individually tracked for recapture. The rules do allow groups to elect to apply a simpler approach, which only tracks the effect of losses, to individual jurisdictions instead. That simplification may be illusory though – presumably groups will need to model the outcome under the full rules extensively to determine whether the election is worthwhile.

The precision of the deferred tax approach in isolating the effect of timing differences may also leave some businesses at a substantive disadvantage compared to the carry-forward approach. Under the carry-forward approach, groups would recognise excess tax in any situation in which their ETR was above the 15% minimum, irrespective of whether that was because of a timing difference, a permanent difference, or simply because the domestic tax rate was higher than 15%. That would have allowed considerable blending of high- and low-taxed profits over time. In an extreme example, a group taxed at 30% could build up enough excess tax in a country over several years to allow that country to then reduce its tax rate to zero without triggering a GloBE top-up. That is arguably contrary to the GloBE rules' policy aim of ensuring the minimum ETR is always met, and is not possible under the deferred tax approach.

Finally, although the rules do much to arrive at the 'right outcome', the recapture mechanism means groups can still be topped up under GloBE purely because of timing differences, even in benign situations involving high tax jurisdictions. As demonstrated in example 2, this could lead to top-up charges that are hard to justify for IP-heavy businesses such as those in the media, pharmaceutical and consumer goods sectors. This could be an obstacle to groups repatriating IP held in low-tax jurisdictions, which is the sort of restructuring that BEPS 2.0 is trying to encourage. ■

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