Tax in tech: Prepare for Pillar 2

Transcript

CHRISTOPHER SUMMER: My name is Chris Summer. I'm a partner in Grant Thornton focused in the technology industry for our tax clients. I'm joined here today by fellow partner in our Washington National Tax Office, Cory Perry. Cory and I are going to talk through some of the implications of the new Pillar 2 rules, to companies in the industry. Cory, thanks for taking some time today to join.

CORY PERRY: Absolutely. Thanks for having me, Chris. Excited to be here. Maybe I'll just set the stage, Chris, with a little bit of background on what Pillar 2 is. The Organisation for Economic Cooperation and Development or the OECD introduced Pillar 2 as a global minimum tax and what it's designed to do is to ensure that all companies, no matter where they earn their profits, are subject to a minimum effective tax rate of at least 15%. The idea being that there's less incentive to base erode and shift profits if those profits are subject to 15% tax, no matter where they are earned globally. It operates through a relatively complex three-pronged system that involves a qualified domestic minimum top-up tax — think of that as like an extension of the local tax. In Ireland, for example, you may be at less than 15%. A QDMTT would top that up locally, followed by an income inclusion regime. That's a top-down approach where a parent would tax a subsidiary not at that desired 15% effective rate. And finally, an under-tax profit rule — consider that like a backstop rule. If anything under either of those other two rules has not been taxed up to 15%, the UTPR will kick in to ensure that that income is taxed at that 15% effective rate.

SUMMER: Thanks for that overview. I mean there is definitely a big sea change, I think, Corey. There’s definitely been a big effort by the OECD to get countries on board with this and to work out a framework that's possible to even be implemented and it's starting to get implemented by a lot of these countries. When we're looking through some of these rules and thinking about how they impact technology companies, specifically, what are you seeing? What are you thinking about?

PERRY: So there's sort of general impact that all companies are facing and I would describe that in sort of 2 buckets. Its client and administrative and cash tax expense. Certainly this is going to be an extreme effort. This is like no other tax. As you noted, the entire world has changed and has looked to implement a cohesive system which requires new data points that have never needed to be collected before or different types of data, different cuts of data, and

is really going to require a rework in many cases, of how we think about preparing and collecting tax data. So, a large administrative burden is certainly going to be placed on taxpayers. The next is cash tax, particularly in the tech industry I believe the days of low and no tax jurisdictions are behind us. And the OECD released an assessment report where they expected corporate income tax to increase as a result of Pillar 2 annually by 155 to 192 billion U.S. dollars. So a pretty sizable impact of this new system and likely to hit the bottom line of tech companies. As for some specific ways in which these rules might interact or impact tech companies directly? Well, there's some factors that tech companies have that are perhaps a little unique. They often have complex delivery systems involving intellectual property. They often have historically operated in low tax environments, particularly because of the portability of assets and operations like you wouldn't see in other industries like manufacturing. That, combined with diverse workforce involvement of oversea entrepreneurs, JVs and the fact that tech companies are often highly acquisitive will make these rules particularly challenging because there's special carve out, special rules, special adjustment that's needed for all of those types of different fact patterns that are not going to be as easy to automate as your typical adjustments might otherwise be. The last point I'll make is that the tech industry is quite IP heavy and benefits from a number of incentives as far as reductions to corporate income tax in various jurisdictions. There's the foreign, direct and tangible income deduction in the U.S., there's patent boxes abroad that might otherwise drive you below 15% that are going to be negated by this top-up tax. There's also a number of tax incentives through credit systems that if they're not “qualifying refundable credits,” reduce the effective rate and require a top-up. A big one to mention is the US R&D credit that's obviously not refundable like some other countries are, for example the UK, and likely would not be a qualified tax, so it could reduce U.S. effective tax rates, requiring top-up tax. Now that in many ways upsets the policy behind these credits because they're intended to incentivize certain behaviors by driving down costs to incentivize those behaviors. If that's otherwise topped up under this system, it sort of upsets the original policy that the credit intended. So we'll have to wait and see how that plays out. Maybe there'll be legislative changes or other changes, perhaps even to the Pillar 2 rules, to accommodate some of these benefits that tech companies often look to enjoy.

SUMMER: Yeah, certainly a big sea change. And so really for a lot of these companies, it's active tax planning, active cash planning because your tax liability globally two years ago may have been zero even with a non-exotic structure from taking advantage of some of these patent boxes like you mentioned, accelerated amortization, capitalization of IP, where going forward you're not going to be able to take advantage of those globally as much. So, Corey, what are some things you're seeing companies do to lessen the burden of the Pillar 2 implementation?

PERRY: There are certainly a couple of things companies can think about. I think the biggest and most important low hanging fruit that tech companies should be thinking about is the transitional Safe Harbor rules. They only will apply for the first couple of years, but if the transitional Safe Harbor rules apply, companies will be exempt from going through some of the more onerous and detailed calculations that are required. And effectively what these rules are is they're a system of tests that are designed to determine whether a jurisdiction is of a low risk of producing a low taxed outcome, so it's expected based on the profile, either to produce little or no tax under the Pillar 2 system. And it does this through a series of tests that are focused on de minimis operations, effective tax rates and and whether there's a sufficient level of substance in a country. So focusing on these safe harbors can significantly eliminate the amount of work needs to be done to comply and calculate Pillar 2 exposure in the first couple years. And what we're finding in practice is that this can often eliminate, I would say, 80 to 90% of the jurisdictions that are in scope that require detailed calculations. And if you think about it, that makes sense because many of the jurisdictions in your structure, particularly sales and distribution entities, might be in what are ordinarily high-tax jurisdictions, Germany, Japan, and so on and so forth, and not going to need to be subject to a top-up tax and only a few where there may be an effective rate that requires the top-up. And using these safe harbors would limit your effort and focus it to those jurisdictions where there's a risk of low tax. There are certainly some traps to look out for. I mean the benefit of this transitional safe harbor is you're using country-by-country reporting data, something companies already have readily available and already collect. But the rules require it to be a qualified country-by-country report and it also needs to be a quality country-by-country court for that matter. So some attention needs to be put particularly proactively on country-by-country reporting going forward. So certainly a lot to think about but they really have a extreme opportunity here to take advantage of these country-by-country reporting transitional safe harbors that would exempt the need to do some of these calculations. The other point I'll make is that preparation is key. You will need all these additional data points that I mentioned. Some of those could be automated upfront collected. You could bifurcate an account and have people account for things a little bit differently. That would be a little bit of work on the front end, but would eliminate a ton of account analysis and detailed digging through that may be needed on the back end if you didn't do it proactively. So there's quite a bit that taxpayers could start doing now to become compliant and to ensure that they're on the right foot and don't trip over some of these stumbling blocks that are presented in the guardrail.

SUMMER: Yeah, it's good walk through. I mean, I think a lot of U.S.-based multinationals maybe want to put this off a little longer, but it's 2024 now. It's here. It's time for Pillar 2 and full speed ahead. So, Cory, thank you for your time today. We appreciate it and hope you have a great day.