Accounting for Pillar Two: Frequently asked questions

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At a glance

Pillar Two tax legislation has been implemented in over 35 countries, with certain provisions becoming effective as of January 1, 2024. The objective of Pillar Two is for large multinational enterprises to pay a minimum level of tax (a threshold effective tax rate of 15%) on the income arising in each jurisdiction where they operate. This global minimum tax brings significant complexity in determining impacts on the income tax provision for interim and annual financial reporting in calendar year 2024 for many multinational reporting entities.

This *In depth* includes our responses to frequently asked questions on US GAAP accounting considerations related to the implementation of Pillar Two, including interim considerations applicable for calendar year end companies beginning in the first quarter of 2024, valuation allowance impacts, and other questions, and supplements In depth 2023-03, *OECD Pillar Two: Time to act on the global minimum tax*.

New questions on valuation allowance considerations have been added as of May 15, 2024. New questions are marked with the date added.

Overview

The Organisation for Economic Cooperation and Development (OECD) Pillar Two framework is here. While guidance has been released by the OECD, the OECD cannot legislate local country tax law, and therefore each country is required to implement the OECD guidance into its own local tax legislation. With many countries having enacted certain aspects of the Pillar Two framework with effective dates in 2024, reporting entities with a footprint in countries where Pillar Two has been enacted will need to estimate any Pillar Two top-up tax obligations for interim and annual reporting periods beginning in the first quarter of 2024.

The Pillar Two top-up tax can be administered in several ways, adding to the complexity of this model. While each approach may be calculated using a similar methodology, the approaches will differ depending on the enacted tax law governing which jurisdiction collects the tax and the mechanisms by which the tax is collected. Further complicating the calculation, additional jurisdictions are expected to enact Pillar Two legislation throughout the remainder of 2024 with the potential for retroactive application to the beginning of the year. In addition, the OECD continues to issue implementation guidance. Finally, while various safe harbors exist that may temporarily simplify a reporting entity's Pillar Two calculations, reliance on these safe harbors may be challenging given both the entity-level detail that is required to be assessed and the very specific data qualification thresholds that must be met to be eligible for the transitional safe harbors.

In 2023, the FASB staff concluded that for US GAAP, the minimum tax described in the Pillar Two Global Anti-Base Erosion (GloBE) rules is an alternative minimum tax per ASC 740, *Income taxes*. As such, reporting entities do not recognize or adjust deferred tax assets and liabilities for the estimated future effects of Pillar Two taxes as long as enacted legislation is consistent with the OECD's GloBE Model Rules and associated commentary. Any Pillar Two top-up taxes are accounted for as a period cost impacting the effective tax rate in the year the GloBE minimum tax obligation arises.

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Pillar Two background

The objective of Pillar Two is for large multinational enterprises to pay a minimum level of tax (a threshold effective tax rate of 15%) on the income arising in each jurisdiction where they operate. The GloBE rules would apply to any "Constituent Entity" that is a member of a multinational group with annual revenue of €750 million or more in the consolidated financial statements of the Ultimate Parent Entity (UPE) in at least two of the four fiscal years immediately preceding the tested fiscal year.

- Constituent Entity - an entity included in a "Group" that is subject to the GloBE rules (i.e., a multinational enterprise)

- Group - comprises entities (including those that prepare separate financial accounts, such as partnerships or trusts) that are related through ownership or control and generally included in consolidated financial statements of a UPE, including any permanent establishments (i.e., a taxable presence in another taxing jurisdiction) of a Constituent Entity

As noted, the guidance must be adopted into local country tax law to be effective. Some countries have implemented Pillar Two Model Rules to apply to their own domestic income so they can collect and administer the taxes attributable to income generated within their jurisdictions, which is referred to as a Qualified Domestic Minimum Top-up Tax (QDMTT). Many countries have enacted QDMTTs with an effective date beginning in 2024. (Note that although the US enacted both the Global Intangible Low-Tax Income (GILTI) regime as part of the Tax Cuts and Jobs Act and the Corporate Alternative Minimum Tax (CAMT) as part of the Inflation Reduction Act, neither is a qualified QDMTT for Pillar Two purposes.)

When a QDMTT does not exist at the local level, if the UPE is located in a jurisdiction that has adopted the Pillar Two Model Rules, any required top-up tax on lower tier subsidiaries would generally be collected from the UPE by the UPE's tax jurisdiction, which is addressed in Pillar Two's Income Inclusion Rule (IIR). If the UPE is located in a jurisdiction where the Pillar Two Model Rules have not been adopted, generally the jurisdiction of the highest tier intermediate parent with an enacted IIR may collect top-up tax on lower tier subsidiaries. Many countries' IIRs are effective beginning in 2024.

However, if the UPE is not located in a taxing jurisdiction that has adopted the Pillar Two Model Rules (and no other intermediate parent of a low-taxed subsidiary has an enacted IIR), and no QDMTT is present in the low-taxed jurisdiction, then the responsibility for applying the Pillar Two rules may flow to other lower tier or brother-sister subsidiaries under the Undertaxed Profits Rule (UTPR). UTPRs are generally effective beginning in 2025.

The ability to apply and collect (or otherwise enforce) this tax may vary among the three methods (QDMTT, IIR, or UTPR). Additionally, actual tax legislation enacted in the various jurisdictions will require coordination to minimize double taxation.

For additional background on the OECD and mechanics of the Pillar Two computations under the model rules, see *OECD Pillar Two: Time to act on the global minimum tax*.

1. Interim tax accounting

The Pillar Two tax is accounted for as a period cost which will impact the effective tax rate in the year the Pillar Two tax obligation arises. This means that beginning in the first interim period a Pillar Two tax is effective (i.e., the first quarter of 2024 for reporting entities with a calendar year end), a reporting entity must include an estimate of its full-year Pillar Two taxes in its estimated annual effective tax rate. Consistent with general interim provision rules, the estimate of the Pillar Two taxes will be updated at each interim reporting date based on new information that arises in the period.

As countries continue to implement Pillar Two and adopt OECD guidance, reporting entities will need to monitor the changes and update their Pillar Two estimates as needed. ASC 740 requires recognition of the tax effects of changes in tax laws in the period the law is enacted.

Basic method of computing an interim tax provision

At each interim period, a reporting entity is required to estimate its forecasted full-year effective tax rate (ETR). That rate is applied to year-to-date ordinary income or loss to compute the year-to-date income tax provision. To compute the annual ETR, a reporting entity needs to estimate its full year ordinary income and its total tax provision, including both current and deferred taxes. When a reporting entity is subject to tax in multiple jurisdictions, one worldwide estimated annual ETR is developed and applied to consolidated ordinary income/(loss) for the year-to-date period, with certain exceptions and limitations.

Exceptions to the use of the worldwide estimated annual ETR

When a reporting entity has a tax-paying component in a particular jurisdiction and that tax-paying component has generated ordinary losses on a year-to-date basis, or anticipates an ordinary loss for the full fiscal year, and no benefit can be recognized on those losses, ASC 740-270-30-36(a) requires the entity to exclude that tax-paying component's income (or loss) in that jurisdiction from the overall estimate of the ETR. A separate ETR should be computed and applied to ordinary income (or loss) for that tax-paying component in that jurisdiction. In effect, any tax-paying component within a jurisdiction that has losses for which no benefit can be recognized are removed from the base calculation of the ETR. If the reason that no benefit can be recognized is because the resulting net operating loss deferred tax asset is subject to a full valuation allowance, the separate ETR for that jurisdiction will often be zero.

ASC 740-270-30-36

If an entity that is subject to tax in multiple jurisdictions pays taxes based on identified income in one or more individual jurisdictions, interim period tax (or benefit) related to consolidated ordinary income (or loss) for the year to date shall be computed in accordance with the requirements of this Subtopic using one overall estimated annual effective tax rate with the following exceptions:

a. If in a separate jurisdiction an entity anticipates an ordinary loss for the fiscal year or has an ordinary loss for the year to date for which, in accordance with paragraphs 740-270-30-30 through 30-33, no tax benefit can be recognized, the entity shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (or benefit). A separate estimated annual effective tax rate shall be computed for that jurisdiction and applied to ordinary income (or loss) in that jurisdiction in accordance with the methodology otherwise required by this Subtopic.

b. If an entity is unable to estimate an annual effective tax rate in a foreign jurisdiction in dollars or is otherwise unable to make a reliable estimate of its ordinary income (or loss) or of the related tax (or benefit) for the fiscal year in a jurisdiction, the entity shall exclude ordinary income (or loss) in that jurisdiction and the related tax (or benefit) from the overall computations of the estimated annual effective tax rate and interim period tax (or benefit). The tax (or benefit) related to ordinary income (or loss) in that jurisdiction shall be recognized in the interim period in which the ordinary income (or loss) is reported. The tax (or benefit) related to ordinary income (or loss) in a jurisdiction may not be limited to tax (or benefit) in that jurisdiction. It might also include tax (or benefit) in another jurisdiction that results from providing taxes on unremitted earnings, foreign tax credits, and so forth.

We believe that if a reporting entity can record any benefit (e.g., carryback of current-year losses to offset income in prior years), the worldwide ETR approach should be used unless another exception applies. While the application of the exception is straightforward for a single tax-paying component in a separate jurisdiction with a single tax regime, questions arise as to how to apply the exception when the anticipated ordinary losses in that jurisdiction impact taxes incurred by other tax-paying components.

QUESTION 1-1

Company ABC (Parent), a US entity, has a wholly-owned subsidiary, Subsidiary B, with operations in Jurisdiction B. Subsidiary B has generated ordinary losses on a year-to-date basis and anticipates an ordinary loss for the full fiscal year, and no benefit can be recognized on those losses (i.e., Subsidiary B has recorded a full valuation allowance). Based on the exception in ASC 740-270-30-36(a), Subsidiary B is excluded from Company ABC's worldwide AETR.

Due to differences between local taxable income and GloBE income, Subsidiary B's earnings will result in a top-up tax. Jurisdiction B has enacted a QDMTT.

Should Subsidiary B's top-up tax obligation to Jurisdiction B resulting from the QDMTT be excluded from Company ABC's estimated worldwide AETR?

PwC response

Yes. In this fact pattern, Subsidiary B is both the tax-paying component responsible for the top-up tax obligation and the tax-paying component whose financial results are driving the top-up tax. The operations of Subsidiary B are excluded from the worldwide ETR as the exception in ASC 740-270-30-36(a) applies. As such, Subsidiary B's obligation to Jurisdiction B would also be excluded from the worldwide ETR estimate and included in the separate calculation of tax on Subsidiary B's loss from continuing operations.

QUESTION 1-2

Company ABC (Parent), a US entity, has a wholly-owned subsidiary, Subsidiary C, with operations in Jurisdiction C. Subsidiary C has year-to-date ordinary income and anticipates ordinary income for the full year. Subsidiary C has a wholly-owned subsidiary, Subsidiary B, with operations in Jurisdiction B. Subsidiary B has generated ordinary losses on a year-to-date basis and anticipates an ordinary loss for the full fiscal year, and no benefit can be recognized on those losses (i.e., Subsidiary B has recorded a full valuation allowance). Based on the exception in ASC 740-270-30-36(a), Subsidiary B is excluded from Company ABC's worldwide AETR.

Jurisdiction B has not enacted Pillar Two legislation, but Jurisdiction C has enacted an IIR. Due to differences between local taxable income and GloBE income, Subsidiary B's earnings will result in a top-up tax in Jurisdiction C under the IIR.

Should the top-up tax imposed on Subsidiary C with respect to Subsidiary B's income be excluded from Company ABC's estimated worldwide AETR?

PwC response

We believe there are two acceptable alternatives. The method chosen should be consistently applied.

Alternative A: Include the top-up tax imposed on Subsidiary C with respect to Subsidiary B's income in the worldwide AETR.

This view is based on the general principle that the ASC 740-270-30-36(a) exception is applied on a tax-paying component basis within a jurisdiction, and that the tax is related to the tax-paying component that bears the responsibility for the top-up tax obligation. The top-

up tax is imposed on Subsidiary C. Subsidiary C has ordinary income and anticipates income for the full year, and therefore the related tax effects should be included in the worldwide AETR. Since Subsidiary C's ordinary income in Jurisdiction C is included in the worldwide AETR, its top-up tax obligation to Jurisdiction C (under the IIR collection mechanism) should also be included in the worldwide ETR calculation.

Alternative B: Exclude the top-up tax imposed on Subsidiary C with respect to Subsidiary B's income from the worldwide AETR.

This view is based on the general principle that the ASC 740-270-30-36(a) exception is applied on a tax-paying component basis within a jurisdiction, and that the tax is related to the tax-paying component whose financial results are driving the top-up tax. Although the top-up tax is imposed on Subsidiary C, the top-up tax is related to Subsidiary B's ordinary losses in Jurisdiction B. Since Jurisdiction B's ordinary loss in Jurisdiction B is excluded from the worldwide AETR, the top-up tax expense related to Subsidiary B's earnings in Jurisdiction B should also be excluded from the worldwide AETR calculation and included in the separate ETR calculation for Subsidiary B.

QUESTION 1-3

Company ABC (Parent), a US entity, has a wholly-owned subsidiary, Subsidiary C. Subsidiary C operates in Jurisdiction C, has year-to-date ordinary losses, and anticipates ordinary losses for the full year for which no benefit can be recognized (i.e., Subsidiary C has a full valuation allowance). Based on the exception in ASC 740-270-30-36(a), Subsidiary C is excluded from Company ABC's worldwide AETR. Subsidiary C has a wholly-owned subsidiary, Subsidiary B, with operations in Jurisdiction B. Subsidiary B has generated ordinary income on a year-to-date basis and anticipates ordinary income for the full fiscal year.

Jurisdiction B has not enacted Pillar Two into its local country legislation, but Jurisdiction C has enacted an IIR. Subsidiary B's income will result in a top-up tax in Jurisdiction C under the IIR.

Should the top-up tax imposed on Subsidiary C with respect to Subsidiary B's income be excluded from Company ABC's estimated worldwide AETR?

PwC response

We believe there are two acceptable alternatives. The method chosen should be consistently applied.

Alternative A: Exclude the top-up tax imposed on Subsidiary C with respect to Subsidiary B's income from the worldwide AETR.

This view is based on the general principle that the ASC 740-270-30-36(a) exception is applied on a tax-paying component basis within a jurisdiction, and that the tax is related to the tax-paying component that bears the responsibility for the top-up tax obligation. The top-up tax is imposed on Subsidiary C. Subsidiary C has ordinary losses and anticipates ordinary losses for the full year for which no benefit can be recognized, and therefore the related tax effects should be excluded from the worldwide AETR. Since Subsidiary C's ordinary loss in Jurisdiction C is excluded from the worldwide AETR, its top-up tax obligation to Jurisdiction C should also be excluded from the worldwide ETR calculation.

Alternative B: Include the top-up tax imposed on Subsidiary C with respect to Subsidiary B's income in the worldwide AETR.

This view is based on the general principle that the ASC 740-270-30-36(a) exception is applied on a tax-paying component basis within a jurisdiction, and that the tax is related to

the tax-paying component whose financial results are driving the top-up tax. Although the top-up tax is imposed on Subsidiary C, the top-up tax is related to Subsidiary B's ordinary income in Jurisdiction B. Since Jurisdiction B's ordinary income is included in the worldwide AETR, the top-up tax expense related to Subsidiary B's earnings in Jurisdiction B should also be included in the worldwide AETR calculation.

Significant, unusual, or infrequent items

ASC 740-270-30-12 provides guidance related to specific items that should be excluded from the annual effective tax rate calculation. Per ASC 740-270-30-8, no effect should be included in the estimated effect tax rate for the tax related to significant, unusual, or infrequently occurring items that will be reported separately. The tax effects of such events are accounted for discretely in the interim period in which they occur.

ASC 740 defines unusual and infrequent items as follows.

Definitions from ASC 740-270-20

Infrequency of occurrence: The underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates (see paragraph 225-20-60-3).

Unusual nature: The underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates (see paragraph 225-20-60-3).

QUESTION 1-4

In Q2, Subsidiary B had a significant, unusual, or infrequently occurring item which will be reported separately. As required by ASC 740-270-30-8, the income and the related tax effect will be accounted for discretely and excluded from the Subsidiary B's AETR.

If the significant, unusual, or infrequently occurring item affects the top-up tax calculation, how should the tax effect to be excluded from the estimated AETR be measured?

PwC response

One approach to measure the tax effect of the significant, unusual, or infrequently occurring item would be to perform a calculation of the expected tax provision with and without the significant, unusual, or infrequently occurring item. Any change in top-up tax resulting from the significant, unusual, or infrequently occurring item would therefore be included in the measurement of the discrete tax effect. There may be other acceptable approaches.

For more on accounting for income taxes in interim periods, see Chapter 16 of our *Income taxes* guide.

2. Valuation allowance considerations

The GloBE minimum tax is considered an alternative minimum tax under ASC 740 and therefore should not be considered in the measurement of deferred taxes.

While ASC 740-10-30-11 is clear that deferred taxes should not be measured at the lower alternative minimum tax rate even if a reporting entity expects to always be an alternative minimum tax taxpayer, there is no specific guidance that addresses whether the entity should anticipate future alternative minimum taxes in the valuation allowance assessment for its regular deferred tax assets.

ASC 740-10-30-2(b) establishes the basic requirement to reduce the measurement of deferred tax assets by the amount not expected to be realized. ASC 740-10-30-17 provides guidance on considering "all available evidence" in determining whether a valuation allowance is needed.

ASC 740-10-30-17

All available evidence, both positive and negative, shall be considered to determine whether, based on the weight of that evidence, a valuation allowance for deferred tax assets is needed. Information about an entity's current financial position and its results of operations for the current and preceding years ordinarily is readily available. That historical information is supplemented by all currently available information about future years. Sometimes, however, historical information may not be available (for example, start-up operations) or it may not be as relevant (for example, if there has been a significant, recent change in circumstances) and special attention is required.

QUESTION 2-1

Company ABC (Parent), a US entity, has a wholly-owned subsidiary, Subsidiary B, with operations in Jurisdiction B. Subsidiary B has deferred tax assets for regular tax purposes in Jurisdiction B. Subsidiary B expects its earnings to be subject to a top-up tax for the foreseeable future under the QDMTT legislation enacted in Jurisdiction B. As such, when Subsidiary B's deferred tax assets reverse for regular tax purposes in future years, Subsidiary B does not expect to realize the full benefit as it will be subject to the top-up tax on its GloBE income.

Should Subsidiary B's future top-up tax be considered when assessing the realizability of Subsidiary B's deferred tax assets under the regular tax system?

PwC response

We believe that a policy choice to either consider future QDMTT or not would be allowed when the alternative minimum tax is administered and collected within the same jurisdiction as the regular tax (i.e., the jurisdiction has enacted a QDMTT). The policy choice should be consistent with prior policy elections for other domestic taxes that are considered alternative minimum taxes under ASC 740.

If the election is made to consider the impact of a QDMTT in assessing the realizability of Subsidiary B's regular deferred tax assets, we believe one approach would be to consider the expected benefit of a deferred tax asset (e.g., an NOL) on a with-and-without basis. This approach would compare an estimate of the total tax due considering utilization of the NOL (the "with" calculation) to one in which the NOL does not exist (the "without" calculation). A valuation allowance would be recorded for the difference between these two amounts.

QUESTION 2-2 (added May 15)

Company ABC (Parent), a US entity, has a wholly-owned subsidiary, Subsidiary B, with operations in Jurisdiction B, which has implemented a QDMTT. The QDMTT on Subsidiary B's GloBE income results in additional US foreign tax credits (FTCs) for Company ABC in the general basket. The additional FTCs that Company ABC expects to generate from Subsidiary B's future QDMTT are expected to cause Company ABC's existing deferred tax assets for US FTC carryforwards to expire unutilized.

Should Company ABC consider the FTCs that are expected to be generated from Subsidiary B's future QDMTT in Company ABC's realization assessment of its existing US FTC carryforwards?

PwC response

Because US GAAP is not clear on this point, we believe Company ABC should make a policy election as to which of two views to apply.

View A. Company ABC should consider the future US FTCs expected from Subsidiary B's future QDMTT in the realizability assessment of its US FTCs. This view is based on the guidance in ASC 740-10-30-17, which requires that "all available evidence" be considered when determining whether a valuation allowance for deferred tax assets is needed. While the additional US FTCs that will arise from Subsidiary B's future QDMTT in Jurisdiction B are an indirect impact of the foreign jurisdiction's minimum tax, they are a direct consequence of applying US tax law for the US tax paying component.

View B. Company ABC should follow its existing policy choice on whether to consider future QDMTT(s) in assessing realizability of deferred tax assets. This view is based on the US GAAP guidance that a company should make a policy choice as to whether to consider future minimum taxes in its valuation allowance assessment. The FASB staff provided this guidance in a Staff Q&A regarding BEAT tax and in a statement at a Board meeting regarding CAMT. We believe the policy choice as to whether to consider future minimum taxes (as discussed in Question 2-1) could be interpreted to be applied to both the direct and indirect effects of the minimum tax. Therefore, if Company ABC has elected not to consider future QDMTTs in assessing realizability of deferred tax assets, it would not consider the impact of the anticipated US FTCs resulting from Subsidiary B's future QDMTT on its existing US FTC DTA.

QUESTION 2-3 (added May 15)

Company ABC (Parent), a US entity, has a wholly-owned subsidiary, Subsidiary C, with operations in Jurisdiction C. Subsidiary C has a wholly-owned subsidiary, Subsidiary B, with operations (and deferred tax assets for regular tax purposes) in Jurisdiction B. Jurisdiction B has not implemented Pillar Two legislation, but Jurisdiction C has implemented an IIR under Pillar Two, which results in a top-up tax imposed on Subsidiary C with respect to Subsidiary B's income.

Should Subsidiary C's future top-up tax with respect to Subsidiary B's income be considered when assessing the realizability of Subsidiary B's deferred tax assets? What about when assessing realizability of Subsidiary C's deferred tax assets?

PwC response

With regard to Subsidiary B's deferred tax assets, we do not believe that the top-up tax imposed by Jurisdiction C should be considered when assessing the realizability of Subsidiary B's regular deferred tax assets in Jurisdiction B because ASC 740-10-30-5 provides that deferred taxes should be determined separately for each tax-paying component in each tax jurisdiction. This determination includes the recognition and measurement of deferred tax assets and liabilities as well as a valuation allowance assessment. Therefore, the realization of Subsidiary B's deferred tax assets should not consider the effects of applying the tax laws attributable to separate jurisdictions or to other tax-paying components.

With regard to Subsidiary C's deferred tax assets, the IIR top-up tax should not have an impact on the realizability of the deferred tax assets of Subsidiary C. Under the model rules, an IIR is settled through a direct payment to the taxing authority (i.e., not a denial of deduction), and the entity that is liable for the tax cannot use its attributes or tax credits to settle the tax. Therefore, there should be no interaction between the top-up tax and Subsidiary C's deferred tax assets.

For more on valuation allowance assessments, see Chapter 5 of our *Income taxes* guide.

3. Intraperiod allocation and application of the basic model

While ASC 740 does not explicitly state the level of application of the intraperiod allocation rules, the intraperiod allocation rules should be applied

- at the jurisdictional level when there is only one tax-paying component in the jurisdiction, and
- at the tax-paying component level if there is more than one tax-paying component in the jurisdiction.

The potential for cross-jurisdictional taxes under Pillar Two rules raises question about how to apply intraperiod allocation guidance.

Although ASC 740 outlines the basic model for intraperiod allocation in only a few paragraphs (primarily ASC 740-20-45-1 through ASC 740-20-45-14), application of the guidance can be complex and, at times, counterintuitive. When ASC 740 does not specifically allocate all or a portion of the total tax expense to one or more specific financial statement components, it allocates taxes based on a with-and-without or incremental approach. Intraperiod tax allocation is performed once the overall tax provision is computed; it allocates that overall provision to components of the income statement, OCI, and stockholders' equity but does not change the overall provision. This basic approach can be summarized in the following three steps:

Step 1: Compute the total tax expense or benefit (both current and deferred) for the period.

Step 2: Compute the tax effect of pre-tax income or loss from continuing operations, without consideration of the current-year pre-tax income or loss from other financial statement components. To this amount, add the tax effects of the items that ASC 740 specifically allocates to continuing operations.

Step 3: Allocate among the other financial statement components, in accordance with the guidance in ASC 740-20-45-11 through ASC 740-20-45-14, the portion of total tax that remains after the allocation of tax to continuing operations (the difference between the total tax expense (computed in Step 1) and the amount allocated to continuing operations (computed in Step 2)). If there is more than one financial statement component other than continuing operations, the allocation is made on a pro-rata basis in accordance with each component's incremental tax effects.

US GAAP requires presentation of discontinued operations in financial statements in certain circumstances. A reporting entity with a component that meets the conditions for discontinued operations should report the results of operations of the component, less applicable income taxes (benefit), as a separate component of income. This requires that reporting entities consider the intraperiod allocation rules for all periods presented in the financial statements.

ASC 740-270-45-8 specifies that the amount of tax to be allocated to discontinued operations should be the difference between the tax originally allocated to continuing operations and the tax allocated to the restated amount of continuing operations. Amounts of tax allocated to components of income (loss) other than continuing operations recognized in prior years should not be adjusted in recasting the financial statements for the discontinued operation. This prescribed with-and-without allocation approach will often result in a different amount than would result from a complete reapplication of the intraperiod allocation rules.

QUESTION 3-1

Company ABC (Parent), a US entity, has a wholly-owned subsidiary, Subsidiary C, with operations in Jurisdiction C. Subsidiary C is the parent of Subsidiary B, which operates in Jurisdiction B, a 0% tax rate jurisdiction. Jurisdiction B has not implemented Pillar Two legislation, while Jurisdiction C has adopted an IIR. In the current year, Subsidiary B's income is part of discontinued operations.

Should the top-up tax imposed on Subsidiary C with respect to Subsidiary B's income be allocated to discontinued operations?

PwC response

Yes. We believe that the intraperiod allocation of the top-up tax on Subsidiary B's income should follow the normal with-and-without approach. In Step 2 of the intraperiod allocation approach described above, the top-up tax on Subsidiary B would not be part of the tax effect of pre-tax income or loss from continuing operations as Subsidiary B's income is not included in continuing operations. This would result in the top-up tax being allocated to discontinued operations in Step 3.

For more on intraperiod tax allocation, see Chapter 12 of our *Income taxes* guide.

4. Intercompany inventory sales

Ordinarily, there are tax effects when inventory is sold or transferred between affiliated companies that are consolidated for financial statement purposes but file separate tax returns. In consolidation, however, the seller's pre-tax profit will be deferred for financial statement purposes, and the inventory will be carried at its cost to the seller until it is sold to an unrelated third party or written down.

ASC 740-10-25-3(e) (often referred to as "3(e)") prohibits the recognition of a deferred tax asset for basis differences relating to intra-entity transfers of inventory. This treatment of intra-entity transfers is an exception to the asset and liability approach otherwise prescribed by ASC 740.

ASC 740-10-25-3(e)

A prohibition on recognition of a deferred tax asset for the difference between the tax basis of inventory in the buyer's tax jurisdiction and the carrying value as reported in the consolidated financial statements as a result of an intra-entity transfer of inventory from one tax-paying component to another tax-paying component of the same consolidated group. Income taxes paid on intra-entity profits on inventory remaining within the consolidated group are accounted for under the requirements of Subtopic 810-10.

Similarly, ASC 810-10-45-8 precludes a reporting entity from reflecting a tax benefit or expense from an intra-entity transfer between entities that file separate tax returns until the inventory has been sold to a third party or written down.

ASC 810-10-45-8

If income taxes have been paid on intra-entity profits on inventory remaining within the consolidated group, those taxes shall be deferred or the intra-entity profits to be eliminated in consolidation shall be appropriately reduced.

Taxes paid (if any) by the seller, as well as any other tax consequences (e.g., as a result of temporary difference reversals), are deferred in consolidation.

QUESTION 4-1

When the sale of inventory between members of a consolidated group impacts the amount of top-up tax payable, should the related top-up tax payable be deferred in the financial statements if the inventory has not been sold outside of the consolidated group?

PwC response

Yes. ASC 810-10-45-8 indicates that income taxes paid on intra-entity profits related to inventory remaining within the consolidated group should be deferred. We believe that incremental Pillar Two top-up taxes resulting from intra-entity profits on inventory should generally be deferred until the inventory is sold outside the consolidated group.

QUESTION 4-2

How should a reporting entity determine the amount of top-up tax paid on intra-entity profit that should be deferred?

PwC response

We believe that the profit should generally be the last item to enter into the seller's computation of taxes payable in the period of the sale, and the deferred tax should be calculated as the difference in taxes payable with and without the intra-entity profit. However, if the "without" calculation indicates a top-up tax that exceeds the actual top-up tax paid, the amount deferred should not exceed the actual amount paid based on ASC 810-10-45-8.

5. Deferred tax liability recapture

For the purpose of computing an entity's GloBE ETR, the entity must determine the Constituent Entity's adjusted covered taxes. Adjusted covered taxes are equal to the financial statement current and deferred tax expense of the entity, as adjusted under the relevant Pillar Two rules. As such, covered taxes generally include the impact of financial statement deferred taxes. The creation of a deferred tax liability (DTL) will generally result in an income tax expense in the financial statements, which increases covered taxes, thus increasing the GloBE ETR and minimizing the exposure to a top-up tax liability. The reversal of a deferred tax liability will result in an income tax benefit in the financial statements, which would decrease covered taxes, thus reducing the GloBE ETR and potentially resulting in a top-up tax liability.

The Pillar Two model rules include a "5-year rule." If a deferred tax liability is not paid (or does not reverse) within five fiscal years, the deferred tax expense must be recaptured. The GloBE ETR and top-up tax in the years in which the deferred tax expense was initially recorded must be recalculated to reduce covered taxes.

QUESTION 5-1

Subsidiary A is a Constituent Entity in a multinational group subject to Pillar Two. Subsidiary A previously purchased an intangible asset in an asset acquisition (in a period the GloBE rules are effective). On Day 1, the asset value was equal for book and tax purposes. The intangible is amortized over 3 years for local tax purposes. It is not amortizable for book purposes. As the intangible asset is amortized for tax purposes, a DTL is established under US GAAP. Subsidiary A has no intention of selling or otherwise disposing of the intangible asset.

Because of the Pillar Two 5-year recapture rule, Subsidiary A will be required to recapture the deferred tax expense related to the annual tax amortization. At the time the recapture rule is triggered, Subsidiary A will be required to recalculate the prior years' GloBE ETR and top-up tax.

Should the top-up tax expense that will be incurred upon recapture in the future be recorded in the period that the related deferred tax expense is recognized in financial statement income?

PwC response

Yes. We believe that a tax payable should be recognized in the period that the related deferred tax expense is included in financial statement income. In this example, as of Day 1, Subsidiary A does not expect the DTL to reverse within 5 years (as they do not intend to dispose of or sell the intangible).

This view is based on the facts that are known at the time the deferred tax expense is initially recognized. Subsidiary A knows based on the nature of the temporary difference that the DTL will be recaptured, which will result in incremental tax. We would expect the tax payable to be classified as noncurrent when recognized.

If in a later period, new information arises that would result in the recapture no longer being applicable (e.g., the intangible asset becomes held for sale), the tax payable should be adjusted.

To have a deeper discussion, contact:

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