Accounting for income taxes implications of Pillar Two GloBE top-up taxes

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The Organisation for Economic Cooperation and Development (OECD) continues to implement the Base Erosion and Profit Shifting (BEPS) 2.0 framework, an international tax reform initiative designed, in part, to ensure large multinational enterprise groups pay a minimum level of tax on the income arising in each of the jurisdictions where they operate. Its release of model rules in December 2021 provides a template for countries to implement a top-up tax through the global anti-base erosion (GloBE) rules. Many countries have amended local laws to introduce a top-up tax as part of the initiative, with certain laws becoming effective January 1, 2024.

Background of the GloBE rules

Under the model rules, multinational enterprises with consolidated group revenue exceeding €750 million in at least two out of the last four years would be required to pay a top-up tax on excess profits in any jurisdiction in which the GloBE effective tax rate (GloBE ETR) for the jurisdiction is below a 15% minimum rate.

Top-up taxes differ from taxes that arise under traditional income tax regimes. Traditional income taxes are generally based on specified tax rates applied to a company's taxable profit whereas GloBE top-up taxes will arise only if a group pays an insufficient amount of income taxes at the jurisdiction level. The GloBE top-up taxes may be implemented through an income inclusion rule (IIR), an undertaxed profits rule (UTPR) or a qualified domestic minimum top-up tax (QDMTT).

IIR	UTPR	QDMTT
The IIR is imposed at the ultimate parent entity or an intermediate parent entity within the multinational enterprise group that would pay the top-up tax in its jurisdiction of tax residence.	The UTPR would operate as a backstop to the IIR where a parent entity jurisdiction has not adopted an IIR. The UTPR would deny deductions or provide for a similar adjustment for group entities to the extent that there is top-up tax that has not been taxed under an IIR.	A QDMTT is a minimum tax imposed by a country to increase taxes within that jurisdiction. Any QDMTT taxes incurred are creditable when applying the IIR or UTPR.

The determination of whether top-up taxes are required is based on a complex calculation of the GloBE ETR for a jurisdiction. The IIR, UTPR and QDMTT are collectively referred to within this document as GloBE top-up taxes.

For additional information and background on GloBE top-up taxes, refer to KPMG's Pillar Two Hub.

Complexities in accounting for the GloBE top-up taxes

Unlike traditional income tax regimes, the GloBE top-up taxes are an additional tax based on the difference between a minimum 15% rate and the jurisdiction's GloBE ETR. Additionally, because the tax is based on the accounting framework used in the consolidated financial statements, it may result in basis differences that do not exist under local tax law, and local tax law basis differences may not exist for GloBE purposes.

Implementing the new rules and determining the appropriate accounting impacts may be challenging, especially given the volume of GloBE regimes enacted and the recent effective date of many GloBE top-up taxes in a number of jurisdictions. The areas that may frequently arise when accounting for GloBE top-up taxes includes scope considerations, valuation allowance considerations, intra-entity transfers of assets, presentation, accounting for income taxes in interim periods, forthcoming administrative guidance related matters, and disclosure.

Accounting for GloBE top-up taxes

Scope

Because the GloBE top-up taxes are based on financial statement net income with certain adjustments, GloBE top-up taxes are in the scope of ASC 740.

Consistent with the FASB staff's comments at the February 1, 2023 Board meeting, GloBE top-up taxes are alternative minimum taxes (AMTs) because the regimes are separate but parallel systems for a company to pay a minimum level of tax, but an entity will never pay less than it would under local regular income tax systems.

Because GloBE top-up taxes are AMTs, companies will not record GloBE-specific deferred taxes or remeasure existing deferred taxes to the GloBE rate. Instead, the incremental effect of GloBE top-up taxes will be recognized as incurred.

For a general discussion of accounting for AMTs, see section 3 of KPMG Handbook, *Accounting for income taxes*.

Valuation allowance considerations

QDMTT

As a result of GloBE top-up taxes operating as minimum taxes, certain deductible temporary differences and carryforwards that exist under regular tax systems may not result in future cash tax savings to the group when they reverse. For instance, certain tax credit carryforwards may not reduce future cash tax savings if the group is subject to GloBE top-up taxes; instead, utilization of the tax credit carryforwards may result in a reduction in regular taxes that is offset by an increase in the amount of GloBE top-up tax incurred. This has raised questions as to if GloBE top-up taxes should be considered in the assessment of whether a valuation allowance should be recognized.

In 2018, in response to the enactment of the U.S. federal base erosion and anti-abuse tax (BEAT), the FASB provided guidance on an entity assessing the realizability of its deferred tax assets under the regular tax system and any impact BEAT may have on such assessment, noting that an entity would not need to evaluate the effect of potentially paying the BEAT in future years. As such, we believe that while an entity does not need to consider its BEAT status for valuation allowance assessments related to deferred tax assets under the regular tax system, it may elect to do so as an accounting policy election. A similar approach is generally applied in assessing the impact the U.S. federal corporate alternative minimum tax (CAMT) may have on the realizability of deferred tax assets under the regular tax system.
Similarly, as QDMTTs are administered and applied by a local taxing authority, they may impact the realizability of certain deferred tax assets under the regular tax system. We believe that the policy election that exists under other AMT regimes (such as BEAT and CAMT) applies to the application of QDMTTs; as such, we believe an entity may either consider or disregard its QDMTT status in assessing the need for a valuation allowance on its deferred tax assets under the regular tax system in the jurisdiction

assessing the QDMTT. We would expect an entity to apply a consistent policy to each type of AMT; in other words, an entity may have different policies for BEAT, CAMT and QDMTTs, but it must apply the policy consistently amongst all instances of the application of the specific regime.

IIR and UTPR

As it relates to the application of the IIR and UTPR, one approach would be to exclude the interaction of these taxes from the assessment of the realizability of deferred tax assets under the regular tax system in the low-taxed jurisdiction. As ASC 740-10-30-5 requires that deferred taxes are determined separately for each tax-paying component in each tax jurisdiction (including the identification of temporary differences, measurement of deferred tax assets (liabilities) and assessment of the realizability of deferred tax assets), it would be inconsistent to assess the realizability of deferred tax assets due to cross-jurisdictional income taxes imposed by a separate tax jurisdiction. Accordingly, under this approach, an entity would not consider a potential IIR or UTPR imposed in another jurisdiction in assessing the realizability of deferred tax assets in a low-taxed jurisdiction. Other approaches that consider a tax in another jurisdiction in assessing the need for a valuation allowance may also be acceptable.

Additionally, since an IIR will generally have no effect on the regular taxes incurred in the jurisdiction imposing the IIR, we would not expect an IIR to affect realizability or the valuation allowance judgement for deferred tax assets under the regular tax system in the jurisdiction imposing the IIR.

For a general discussion of accounting for valuation allowances, including the effect of AMT status on the valuation allowance judgment, see section 4 of KPMG Handbook, *Accounting for income taxes*.

Intra-entity transfers of assets

An intra-entity sale or purchase of assets, such as the sale of inventory or amortizable assets between tax jurisdictions, is generally a taxable event for the seller and establishes a new tax basis for those assets in the buyer's tax jurisdiction. As a result, there often will be a taxable gain in the seller's jurisdiction and a difference in the buyer's tax jurisdiction between the new tax basis and the carrying amount of those assets as reported in the consolidated financial statements. However, in accordance with ASC 810, *Consolidation*, intra-entity balances, transactions, and intra-entity profit or loss on assets remaining within the group are eliminated. Accordingly, no pretax gain (loss) is recognized in the consolidated financial statements on transactions among entities within a consolidated group.

Intra-entity transfers of inventory

An intra-entity sale or purchase of inventory between tax jurisdictions is generally a taxable event for the seller that generally results in a taxable gain in the seller's jurisdiction. ASC 810-10-45-8 requires that for intra-entity transfers of inventory, income taxes paid on intra-entity profits in the seller's tax jurisdiction be deferred and ASC 740-10-25-3(e) prohibits recognition of a deferred tax asset for the tax effect of the difference between the tax basis of the inventory in the buyer's tax jurisdiction and its carrying amount in the consolidated financial statements. The deferred effects of an intra-entity transfer of inventory generally are calculated by applying a with-and-without approach by assessing the difference between income tax expense (benefit) of the seller with and without the intra-entity transfer.

The intra-entity transfer of inventory may have an impact on GloBE top-up taxes. We believe there are multiple acceptable approaches on how to measure the amount of income taxes to defer when an intra-entity transfer of inventory affects the GloBE top-up taxes incurred by a group. One approach is to compute a worldwide with-and-without calculation which includes the tax effects of all income taxes, including GloBE top-up taxes, and compares the result with and without the intra-entity transfer of inventory. Another approach would be to separately compute the deferred effects as it relates solely to the income arising from the transfer of inventory as if it were the only transaction reported on the tax returns. Other approaches may also be acceptable. An entity should consistently apply its policy choice and consider disclosure of the policy in the notes to financial statements.

Intra-entity transfers of assets other than inventory

For intra-entity transfers of assets other than inventory, the related income tax expense (benefit) is recognized in income in the consolidated financial statements that include both the buyer and seller. As there are no exceptions to the recognition of income tax expense (benefit), the impact of any GloBE top-up taxes is recognized in accordance with the general guidance on accounting for income taxes and will generally be included in income tax expense (benefit).

For a general discussion of intra-entity transactions, see section 2 of KPMG Handbook, *Accounting for income taxes*.

Presentation of GloBE top-up taxes

Balance sheet classification

As countries begin to implement GloBE top-up taxes, entities will recognize the incremental effect of a GloBE top-up tax as incurred, generally within income tax expense (benefit), with a corresponding adjustment to income taxes receivable (payable). Cash tax payments for GloBE top-up taxes may be required within 12 months in certain cases; however, other payments may not be required until the GloBE information return is filed 15 to 18 months following an entity's year-end.

Income taxes receivable (payable) that are anticipated to be settled in cash within a relatively short period (usually 12 months) or that are directly related to the operating cycle are generally presented as current in a classified balance sheet. Income taxes receivable (payable) are otherwise presented as noncurrent. GloBE top-up taxes payable within 12 months will follow these principles and are classified as current income taxes payable within the balance sheet. Additionally, we generally believe an entity with a classified balance sheet would also classify the income taxes payable related to GloBE top-up taxes that are payable in a period greater than 12 months as current given that they are related to the operating cycle.

Intraperiod tax allocations

Total income tax expense (benefit) is allocated to components of comprehensive income and shareholders' equity using a step-by-step approach. Under this approach, an entity first determines the total income tax expense (benefit). It then computes the amount of income tax expense (benefit) allocated to continuing operations and then proportionally allocates the remainder to items other than continuing operations using a with-and-without approach. ASC 740 also sets forth specific provisions about the allocation of some items that represent exceptions to the step-by-step approach.[1]

GloBE top-up taxes should be included in total income tax expense (benefit) and be allocated following the step-by-step approach. Although the intraperiod tax allocation is performed by tax-paying component, we believe the tax effect of pretax income (loss) from continuing operations for each jurisdiction would include the GloBE top-up taxes that would be owed based on the worldwide group's continuing operations. A similar approach would be used for proportionally allocating income tax expense (benefit) to components other than continuing operations. This approach will typically result in any GloBE top-up taxes triggered by an entity's income that is part of discontinued operations being allocated to discontinued operations, even if the entity liable for the payment of the tax has no activity outside of continuing operations.

For a general discussion of intraperiod tax allocations, see section 9 of KPMG Handbook, *Accounting for income taxes*.

[1] The exceptions to the step-by-step approach include, but are not limited to, the tax effects of changes in tax laws or rate, the tax effects of changes in tax status, and changes in the beginning of year valuation allowance for deferred tax assets expected to be realized in future years.

Accounting for income taxes in interim periods considerations

Significant unusual or infrequently occurring items

Income tax expense (benefit) recognized for an interim period is generally based on income tax expense (benefit) related to worldwide ordinary income (loss) that is recognized through the use of an estimated annual effective tax rate applied to year-to-date results, as adjusted for income tax expense (benefit) related to specific events that are discretely recognized in the period in which they occur. Ordinary income (loss) refers to income (loss) from continuing operations before income tax expense (benefit), excluding significant unusual or infrequently occurring items; accordingly, discontinued operations are excluded from such amount.[2] The tax effect of separately reported significant unusual or infrequently occurring items are excluded from the estimated annual effective tax rate and instead recognized in the interim period in which the transaction arises.

Although the codification provides the tax effect of a separately reported significant unusual or infrequently occurring item is excluded from the estimated annual effective tax rate, it does not clarify how the tax effect should be measured. In some instances, a significant unusual or infrequently occurring item that is excluded from the estimated annual effective tax rate may impact the amount of GloBE top-up taxes imposed.

We believe an entity has a policy choice as to how to measure the tax effects of an item excluded from the estimated annual effective tax rate. One acceptable approach to computing the tax effects of the item would be to perform a with-and-without computation where the total worldwide forecasted income tax expense (benefit) includes GloBE top-up taxes that would be computed both with and without the significant unusual or infrequently occurring item. The difference is the amount of income taxes associated with the significant unusual or infrequently occurring item which should be recorded discretely in the interim period in which the event occurs. Another acceptable approach to measure the tax effects of the significant unusual or infrequently occurring item is a computation that excludes taxes imposed in other jurisdictions, essentially taking into consideration only the impact of such item in the jurisdiction it arises. Other approaches may also be acceptable. An entity should consistently apply its policy choice and consider disclosure of the policy in the notes to financial statements.

Jurisdictions excluded from the overall estimated annual effective tax rate

An entity subject to tax in multiple jurisdictions should generally compute one overall worldwide estimated annual effective tax rate related to consolidated ordinary income (loss). However, exceptions to the general rule may arise when an entity operates in certain loss jurisdictions or when there is an inability to make reliable estimates in a jurisdiction.

GloBE top-up taxes are generally expected to be included within the determination of the estimated annual effective tax rate; however, questions may arise as to which jurisdiction GloBE top-up taxes should be associated with when a jurisdiction is excluded from the overall estimated annual effective tax rate due to one of the exceptions.

Ordinary income (loss) and the related income tax expense (benefit) in a jurisdiction should be excluded from the overall estimated annual effective tax rate if an ordinary loss is anticipated for the fiscal year, or a year-to-date ordinary loss has occurred, for which no tax benefit can be recognized. If an entity incurs such a situation in which an ordinary loss for the fiscal year is anticipated or has a year-to-date ordinary loss for which no benefit can be recognized, a separate effective tax rate should be calculated for that jurisdiction and applied to the ordinary loss of that jurisdiction.

When determining the estimated annual effective tax rate, we believe entities have a policy choice to associate an IIR and UTPR with the jurisdiction imposing the tax or with the jurisdiction of the low-taxed entity when a jurisdiction is excluded as a loss jurisdiction.[3] An entity's policy choice should be consistently applied and disclosed, if material. For instance, if an entity in a loss jurisdiction that is

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[2] ASC master glossary, *Ordinary Income (or Loss)*
[3] The same policy election is not expected to be relevant to a QDMTT given any income taxes imposed under such regime is imposed by the same jurisdiction as the low-taxed entity.

excluded from the overall estimated annual effective tax rate is required to pay an IIR related to the ordinary income of a low-taxed entity in a jurisdiction that is included in the overall estimated annual effective tax rate, the GloBE top-up tax may either be associated with the jurisdiction imposing the tax and excluded from the estimated annual effective tax rate since the jurisdiction is excluded or it may be associated with the low-taxed jurisdiction and included in the estimated annual effective tax rate since the jurisdiction that triggered the GloBE top-up tax would be included in the estimated annual effective tax rate.

If the annual effective tax rate cannot be reliably estimated in a foreign jurisdiction or ordinary income (loss) or the related income tax expense (benefit) for a jurisdiction cannot be reliably estimated, the jurisdiction is excluded from the overall estimated annual effective tax rate and the income tax expense (benefit) related to ordinary income (loss) in that jurisdiction is recognized in the interim period the related ordinary income (loss) is recognized.

The policy choice noted for loss jurisdictions would not be available to GloBE top-up taxes when a jurisdiction is excluded from the overall estimated annual effective tax rate due to an inability to make reliable estimates. In that instance, the GloBE top-up taxes would be associated with the jurisdiction of the low-taxed entity.[4]

For additional guidance on accounting for interim period income taxes calculations, see section 10 of KPMG Handbook, *Accounting for income taxes*.

Forthcoming administrative guidance and changes in tax laws

An entity is required to reflect the impact of changes in tax laws and rates in the interim period that includes the enactment date.[5] Any impact on current year income taxes receivable (payable) are reflected in the estimated annual effective tax rate in the interim period that includes such enactment date, even if the law has a future effective date. If a change in tax law is effective retroactively, the retroactive effect results in a catch-up adjustment for the current year income taxes receivable (payable) recognized in earlier interim periods.

In certain cases, there may be provisions enacted in current tax laws that an entity believes may be modified through future law changes. While these future changes may ultimately impact the analysis of a tax position, an entity should account for its positions based upon the tax law as currently enacted at the reporting date. This analysis may take into consideration administrative practices and precedents of the taxing authority which are those positions that are expected to be accepted, even though the treatment may not be specified by the tax law or the positions may be considered technical violations of the tax law. Whether administrative practices and precedents may be taken into consideration is dependent on facts and circumstances and should be consistently reevaluated to determine if such application remains appropriate.

Given the rate at which GloBE related tax laws are changing and being enacted,[6] including Agreed Administrative Guidance[7] to the OECD model rules, analysis will be required to assess whether such changes represent changes in tax laws, administrative practice or interpretations. Some jurisdictions may automatically apply changes to the Agreed Administrative Guidance to the OECD model rules whereas others may require enactment of new laws in the respective jurisdiction to apply such guidance. For instance, if a jurisdiction automatically adopts new Agreed Administrative Guidance to the OECD model rules without further legislative actions required, the change in tax law may occur at the date in which the Agreed Administrative Guidance is released. Further, through the volume of changes that are anticipated, it may be likely that inadvertent changes in tax laws arise. Generally, the tax law is applied as enacted as of a reporting date; however, if administrative practices exist that provide widely understood guidance on the taxing authority's position, it may be appropriate to consider such practices. In summary, each individual instance will require assessment to ensure the accounting considerations are appropriately incorporated in an entity's financial statements.

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[4] ASC 740-270-30-36(b)
[5] ASC 740-10-25-47
[6] Refer to KPMG's Pillar Two - State of Play for the status of Pillar Two legislation by jurisdiction.
[7] Agreed Administrative Guidance is defined in Article 10.1 as guidance issued by the Inclusive Framework on either the interpretation or administration of the GloBE Rules.

Disclosure considerations

As noted above, GloBE top-up taxes are considered an AMT for US GAAP for which there are no specific disclosure requirements. However, entities should consider if any disclosures are appropriate as well as considering whether the GloBE top-up taxes will impact any of the existing disclosures. For instance, entities may need to consider the impact GloBE top-up taxes will have on the effective tax rate reconciliation disclosure or within the disclosures on accounting for uncertainty in income taxes.[8] Additionally, Securities and Exchange Commission registrants may consider whether to include disclosures in risk factors or management's discussion and analysis as it relates to the impact of GloBE top-up taxes, including whether income tax expense is expected to materially increase in the future.

Conclusion

Although the accounting for GloBE top-up taxes as AMTs simplify much of the accounting for the income taxes, entities will need to be mindful of various challenges they may encounter in accounting for GloBE top-up taxes incurred.

Related content

For additional information and background on GloBE top-up taxes, refer to KPMG's Pillar Two Hub.

For more information, contact a tax professional in KPMG Washington National Tax:

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[8] See KPMG's Hot Topic: Income tax disclosures for considerations on the presentation of GloBE top-up taxes in the rate reconciliation after adoption of ASU 2023-09.