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IFRS Developments

International Tax Reform—Pillar Two Model Rules: Proposed amendments to IAS 12

What you need to know

- The ED proposes to amend IAS 12 *Income Taxes* to introduce a mandatory temporary exception from the recognition and disclosure of deferred taxes arising from the implementation of the OECD's Pillar Two Model Rules.
- The ED requires an entity to apply retrospectively the proposed temporary exception immediately upon issuance of the amendments.
- The ED proposes disclosures that give information on the potential exposure to the Pillar Two Model Rules, which are expected to apply for annual reporting periods beginning on 1 January 2023.
- The ED cannot be applied before it is finalised and an amendment to IAS 12 is issued.
- Comments to the IASB are due by 10 March 2023.

Introduction

On 9 January 2023, the International Accounting Standards Board (the IASB or the Board) issued an Exposure Draft ED/2023/1 *International Tax Reform—Pillar Two Model Rules* (the ED), which proposes to provide temporary relief from accounting for deferred taxes arising from the imminent implementation of the Pillar Two Model Rules published by the Organisation for Economic Co-operation and Development (OECD).

The OECD/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) addresses the tax challenges arising from the digitalisation of the global economy. To restore confidence in the international tax system and ensure profits are taxed where economic activities take place and value is created, the Inclusive Framework on BEPS proposes two "pillars":

- Pillar One applies to multinational enterprises (MNEs) with revenue in excess of EUR 20 billion and profitability above 10% (i.e., profit before tax/revenue); and
- Pillar Two applies to MNEs with revenue in excess of EUR 750 million per their consolidated financial statements.

The Pillar Two Global anti-Base Erosion Rules (GloBE or Pillar Two Model Rules) represent the first substantial overhaul of the international tax rules in almost a century. We provided background to the OECD's project in IFRS Developments 203 *OECD BEPS Pillar Two - Global Anti-Base Erosion Rules: Accounting implications*.

In November 2022, the IASB discussed the potential financial reporting issues associated with Pillar Two Model Rules. The discussions at that meeting and tentative decisions are summarised in IFRS Developments 210 *IASB project on International Tax Reform-Pillar Two Model Rules*.

Building a better working world

The GloBE Rules

The GloBE Rules propose three new taxation mechanisms under which MNEs would pay a minimum level of tax: the Income Inclusion Rule (IIR); the Under Taxed Payments Rule (UTPR); and the Qualified Domestic Minimum Top-up Tax (QDMTT) generally propose a minimum tax on the income arising in each jurisdiction in which an MNE operates. Additionally, Pillar Two proposes a Subject to Tax Rule, a tax treaty-based rule that generally proposes a withholding tax levied at source on certain cross-border intercompany transactions that otherwise are not subject to a minimum level of tax in the income recipient jurisdiction.

At the simplest level, the Pillar Two Model Rules impose a Top-up Tax that is calculated and applied at a jurisdictional level involving five steps: 1) determine whether an MNE Group is in scope of the Pillar Two Model Rules; 2) calculate GloBE income or loss for each constituent entity in the MNE Group; 3) calculate adjusted covered taxes for each constituent entity in the MNE Group; 4) based on constituent entities' GloBE income and adjusted covered taxes, compute the GloBE Effective Tax Rate and Top-up Tax at a jurisdictional level, taking into account QDMTT (if any); and 5) determine the entities liable to pay Top-up Tax under the IIR or UTPR.

The proposed Pillar Two Model Rules raise accounting questions, such as:

- Whether the Top-up Tax is an income tax in the scope of IAS 12 *Income tax;*
- Whether the Pillar Two Model Rules create additional temporary differences;
- Whether to remeasure deferred taxes to reflect potential Top-up Tax payable;
- Which tax rate to use to measure deferred taxes as this may depend on a number of factors that are difficult to forecast reliably; and
- Whether the resulting information is useful and the benefits outweigh the costs.

Proposed amendments to IAS 12

Temporary exception from accounting for deferred taxes

The ED proposes a mandatory exception in IAS 12 from recognising and disclosing deferred tax assets and liabilities related to Pillar Two income taxes.

The ED clarifies that IAS 12 applies to income taxes arising from tax law enacted or substantively enacted to implement the Pillar Two Model Rules published by the OECD, including tax law that implements QDMTT. Such tax law, and the income taxes arising from it, are referred to as 'Pillar Two legislation' and 'Pillar Two income taxes'. The ED proposes a mandatory exception in IAS 12 from recognising and disclosing deferred tax assets and liabilities related to Pillar Two income taxes. The temporary exception would not have a sunset date, but would apply until the IASB either removes the temporary exception or makes the temporary exception permanent.

The ED notes that the temporary exception provides entities with relief from accounting for deferred taxes in relation to a complex tax law allowing stakeholders time to assess the implications. It also avoids entities developing diverse interpretations of IAS 12 that could result in inconsistent application of the standard.

Proposed disclosures

The ED proposes disclosures to compensate users for the potential loss of information that would result from the introduction of the mandatory temporary exception as explained above. The proposed disclosures are based on the needs of the users of the financial statements, when: (a) Pillar Two legislation is enacted or substantively enacted but not yet effective; and (b) once Pillar Two legislation is effective.

The ED proposes to require that an entity discloses that it has applied the temporary exception both before and after the legislation becomes effective.

A majority of Board members believes that the disclosure would be useful to users of financial statements in providing an indication of an entity's potential exposure.

Disclosures in periods before legislation is in effect

The ED proposes to require the following disclosures for periods in which Pillar Two legislation is (substantively) enacted but not yet effective, but comparative information would not be required:

(a) Information about Pillar Two legislation enacted or substantively enacted in jurisdictions in which the entity operates;

(b) The jurisdictions in which the entity's average effective tax rate (calculated as specified in paragraph 86 of IAS 12) for the current period is below 15%;

(c) The tax expense (income) and accounting profit for these jurisdictions in aggregate, as well as the resulting weighted average effective tax rate; and

(d) Whether assessments the entity has made in preparing to comply with Pillar Two legislation indicate that there are jurisdictions:

- identified in (b) and (c) above in relation to which the entity might not be exposed to paying Pillar Two income taxes; or
- not identified in (b) and (c) above in relation to which the entity might be exposed to paying Pillar Two income taxes

The information described in (b) and (c) above would be prepared in accordance with IAS 12 rather than the requirements in the Pillar Two Model Rules that differ from IAS 12. A majority of Board members believes that the disclosures would be useful to users of financial statements in providing an indication of an entity's potential exposure to paying Top-up Tax and the jurisdictions in which that potential exposure might exist.

Disclosures in periods after the legislation is in effect

For the periods in which Pillar Two legislation is in effect, the ED proposes to require an entity to disclose separately the current tax expense (income) related to Pillar Two income taxes. The Board believes that disclosing such current tax information would help users of the financial statements understand the magnitude of Pillar Two income taxes relative to an entity's overall tax expense.

Transition and effective date

The ED proposes to require that immediately upon issuance of the amendment an entity should apply the mandatory exception from recognising deferred tax assets and liabilities and disclosing information about such deferred tax assets and liabilities. The ED requires that the mandatory exception must be applied retrospectively in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*.

The proposed requirement to disclose that the mandatory exception has been applied is effective immediately upon issuance of the amendment. The remaining proposed disclosures are applicable for annual reporting periods beginning on or after 1 January 2023.

Considerations regarding Pillar Two legislation issued before the IAS 12 amendment is finalised

The IASB is planning to issue the final amendments in the second quarter of 2023 and the mandatory exception would be effective immediately upon issuance. However, certain jurisdictions might (substantively) enact Pillar Two Model Rules before the IASB issues the amendments to IAS 12 as proposed in the ED. Even if the effective date of such legislation might be after the amendment is expected to be issued, MNEs operating in such jurisdictions need to consider the application of IAS 12 including recognition and measurement of deferred tax assets and liabilities arising from the Pillar Two Model Rules in the annual or interim financial statements. Key aspects that must be considered in such situations are:

- The ED cannot be applied before it is finalised and an amendment to IAS 12 is issued, nor can the provisions in the ED be applied using the hierarchy in IAS 8;
- IFRIC 23 *Uncertainty over Income Tax Treatments* would apply to the recognition and measurement of deferred tax assets and liabilities arising from the Pillar Two Model Rules; and
- IAS 1 *Presentation of Financial Statements* requires disclosures about judgements and estimates that need to be made regarding the application of the Pillar Two Model Rules in the financial statements.

How we see it

We welcome the mandatory temporary exception to avoid inconsistent application of IAS 12 that would not result in useful information for the users of the financial statements. Entities should carefully consider the proposed disclosure requirements and respond to the IASB with any comments that they may have on those and other requirements.

Entities need to monitor the developments around the implementation and (substantive) enactment of the Pillar Two Model Rules in the relevant jurisdictions and, if appropriate, engage with advisors to determine the impact of Pillar Two Model Rules on their financial statements, audit and tax filings. We encourage entities to start considering whether they have established appropriate processes and procedures to obtain information, on a timely basis, necessary to present disclosures required in the proposed amendment.

If the Pillar Two Model Rules have not yet been (substantively) enacted in the jurisdictions in which an MNE operates before the end of the reporting period, there is, nevertheless, a requirement under IAS 10 *Events after the Reporting Period* to disclose changes in tax laws enacted or announced after the reporting period that have a significant effect on current and deferred tax assets and liabilities. In addition, entities may wish to consider whether to provide some or all of the information described in the section 'Proposed disclosures' above in financial statements for annual periods ending before the issuance of the proposed IAS 12 amendment if they have a significant exposure to paying Top-up Taxes.

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