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IFRS Developments

Accounting for Pillar Two income taxes before IAS 12 is amended

What you need to know

- The IASB is expected to publish the final amendments to IAS 12, which will take effect immediately, in the second half of May 2023.
- Until the IAS 12 amendments are published (or endorsed in jurisdictions where this is required), it is considered acceptable for an entity to apply judgement and conclude - in accordance with paragraphs 10 and 11 of IAS 8- that not accounting for deferred taxes related to Pillar Two income taxes would result in the most relevant and reliable accounting policy.
- Entities need to get ready to provide the additional disclosures, required by the amendments to IAS 12, that help users of financial statements understand the entities' exposure to Pillar Two income taxes.

Introduction

The Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework on Base Erosion and Profit Shifting (BEPS) addresses the tax challenges arising from the digitalisation of the global economy. BEPS Pillar Two model rules apply to multinational enterprises (MNEs) with revenue in excess of EUR 750 million per their consolidated financial statements. We provided background to the OECD's project in IFRS Developments 203 *OECD BEPS Pillar Two - Global Anti-Base Erosion Rules: Accounting implications*.

In 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 proposed to clarify the application of IAS 12 *Income Taxes* to income taxes arising from tax law enacted or substantively enacted to implement the Pillar Two model rules (Pillar Two income taxes). The ED proposed a mandatory temporary exception from accounting for deferred taxes in respect of Pillar Two income taxes and proposed certain additional disclosure requirements.

On 11 April 2023, the Board held a supplementary meeting in which it discussed the feedback received on the ED. The Board decided to finalise the amendments to IAS 12, which will introduce:

- A temporary exception to the accounting for deferred taxes arising from the jurisdictional implementation of the Pillar Two model rules; and
- Disclosure requirements for affected companies to help users of the financial statements better understand an entity's exposure to Pillar Two income taxes arising from that legislation, particularly before its effective date.

The final amendments to IAS 12, which will take effect immediately, are expected to be published in the second half of May 2023.

Building a better working world

Accounting for Pillar Two income taxes before IAS 12 is amended

Some jurisdictions have enacted, and others are expected to enact, tax legislation to implement the Pillar Two model rules in the first half of 2023. Consequently, the final amendments to IAS 12 may not be published (or endorsed) until after an MNE becomes subject to Pillar Two income taxes. Entities that need to prepare IFRS annual or interim financial statements before these amendments are published (or endorsed in their jurisdiction), will therefore need to develop their own accounting policies to account for Pillar Two income taxes.

Developing an accounting policy for Pillar Two income taxes

IAS 12 does not offer specific guidance on accounting for Pillar Two income taxes and the ED does not constitute part of the authoritative IFRS literature. IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires that, in the absence of an IFRS that specifically applies to a transaction, other event or condition, an entity is required to use its judgement in developing and applying an accounting policy that results in information that is relevant and reliable.

In the Basis for Conclusions to the ED, the IASB noted that stakeholders had said that it is unclear whether the Pillar Two model rules create additional temporary differences, whether to remeasure deferred taxes for the Pillar Two model rules and which tax rate to use to measure deferred taxes. It should be further noted that the tax rate that will apply to an entity's excess profit in future periods depends on a number of factors that are difficult, if not impossible, to forecast reliably.

It is considered acceptable for an entity to apply judgement and conclude … that not accounting for deferred taxes related to Pillar Two income taxes would result in the most relevant and reliable accounting policy.

The application of the current requirements of IAS 12 to Pillar Two income taxes is unclear. Therefore, it is considered acceptable for an entity to apply judgement and conclude – in accordance with paragraphs 10 and 11 of IAS 8 – that not accounting for deferred taxes related to Pillar Two income taxes would result in the most relevant and reliable accounting policy.

Such an accounting policy results in an approach that is consistent with the temporary exception in the forthcoming amendments to IAS 12 and would avoid otherwise unnecessary changes in accounting policies within the same annual accounting period. While not directly relevant to the analysis under paragraphs 10 and 11 of IAS 8, it should be noted that the accounting would also be consistent with the US Financial Accounting Standards Board Technical Inquiry on Pillar Two tax.

While the above accounting policy choice is considered acceptable, it would not preclude an entity from developing an accounting policy that does result in the recognition of deferred taxes in respect of Pillar Two income taxes. However, it should be noted that, in this case, an entity will be required to change its accounting significantly once the IAS 12 amendments are published (or endorsed), which will prescribe a mandatory temporary exception from accounting for deferred taxes in respect of Pillar Two income taxes.

Disclosures

Annual financial statements

Entities that publish annual financial statements after they become subject to Pillar Two income taxes, but before the final amendments to IAS 12 are published (or endorsed) would need to disclose in their annual financial statements, the following:

- *Accounting policy information* – IAS 1 *Presentation of Financial Statements* requires disclosure of material accounting policy information, which would be the case as the accounting policy was developed in accordance with IAS 8 in the absence of guidance that specifically applies.

> ***Example accounting policy information disclosure***
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> IAS 12 does not offer specific guidance on accounting for Pillar Two income taxes. As noted in the IASB's Exposure Draft International Tax Reform—Pillar Two Model Rules (Proposed amendments to IAS 12), it is unclear whether the Pillar Two model rules create additional temporary differences, whether to remeasure deferred taxes for the Pillar Two model rules and which tax rate to use to measure deferred taxes. Furthermore, the tax rate that will apply to an entity's excess profit in future periods depends on a number of factors that are difficult, if not impossible, to forecast reliably.
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> The group has, therefore, applied judgement and developed an accounting policy, in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, and concluded that not accounting for deferred taxes related to Pillar Two income taxes would result in the most relevant and reliable information. This policy results in accounting that is expected to be consistent with forthcoming amendments to IAS 12, which the IASB is expected to publish in the second half of May 2023.

- *Judgements and estimates* – An entity is also required under IAS 1 to disclose the judgements and estimates that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements.

- *Additional information* – Paragraph 112(c) of IAS 1 requires an entity to provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them. In disclosing the information relevant to understanding the impact of Pillar Two income taxes, entities may wish to consider the disclosure objective that the Board voted in favour of in its 11 April 2023 meeting.[1] It should be noted, however, that the exact drafting of these requirements will only be known once the IAS 12 amendments are published.

Interim financial statements

Entities that publish interim financial statements after they become subject to Pillar Two income taxes, but before the final amendments to IAS 12 are published (or endorsed), would need to disclose in their interim financial statements:

- *Accounting policy information* – IAS 34 *Interim Financial Reporting* requires, that if accounting policies and methods of computation have been changed, an entity should disclose a description of the nature and effect of the change.

- *Additional information* – In deciding how to recognise, measure, classify, or disclose an item for interim financial reporting purposes, an entity needs to assess its materiality. However, the overriding goal of IAS 34 is to ensure that an interim financial report includes all information that is relevant to understanding an entity's financial position and performance during the interim period.

[1] IASB Staff Paper 12B, Project: International Tax Reform—Pillar Two Model Rules, Topic: Disclosures, IASB meeting, 11 April 2023, paragraph 55. Available at www.ifrs.org.

Estimating the impact of Pillar Two income taxes

In determining the impact of Pillar Two income taxes, an entity is likely to face two sources of uncertainty:

- Uncertainty about the interpretation of the Pillar Two tax legislation, which may give rise to uncertain tax treatments to which entities should apply the guidance in IFRIC 23 *Uncertainty over Income Tax Treatments*; and
- Incomplete information because entities may not keep their books and records in a location and form that allows them to make certain detailed tax calculations at short notice.

When it comes to incomplete information, it is important to note that IAS 8 requires an entity to use reliable information that was available when its financial statements were authorised for issue and could reasonably be expected to have been obtained and taken into account in the preparation and presentation of those financial statements. Changes in accounting estimates that result from new information or new developments are not considered corrections of errors and should be accounted for in the period of the change (and future periods, if affected). Future changes to amounts recognised in the financial statements that result from new information or more experience would generally be treated as changes in accounting estimates.

How we see it

Entities that need to prepare IFRS annual or interim financial statements before the IAS 12 amendments are published (or endorsed in their jurisdiction), will need to develop an accounting policy to account for Pillar Two income taxes.

Entities should get ready to provide the additional disclosures required by the amendments to IAS 12, which will require that an entity disclose information that helps users of financial statements understand the entity's exposure to Pillar Two income taxes. Furthermore, entities should be prepared to provide the known or reasonably estimable qualitative and quantitative information about its exposure at the end of the reporting period, that will be required by the amendments to IAS 12.

Entities need to monitor the developments around the implementation and 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 necessary to present disclosures required in the proposed amendments in a timely manner.

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