Financial Reporting Council

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Exposure Draft ED/2023/01 *International Tax Reform—Pillar Two Model Rules*

Dear Andreas,

I am writing on behalf of the UK's Financial Reporting Council (FRC) in response to the above Exposure Draft. We agree there is an urgent need for clarity in accounting standards in the light of the imminent implementation of the Pillar Two model rules in some jurisdictions and we encourage the IASB to finalise its amendments as soon as possible.

This response draws on the FRC's experience in developing UK and Ireland accounting standards. The FRC's overriding objective in setting accounting standards is to enable users of accounts to receive high-quality understandable financial reporting proportionate to the size and complexity of the entity and users' information needs. In achieving its overriding objective, the FRC aims to provide succinct financial reporting standards that, amongst other things, have consistency with global accounting standards through the application of an IFRS-based solution unless an alternative clearly better meets the overriding objective.

The FRC's accounting standards include FRS 102 *The Financial Reporting Standard applicable in the UK and Republic of Ireland*. The requirements in FRS 102 are based on the *IFRS for SMEs* Accounting Standard, modified in terms of the scope of entities eligible to apply it, the accounting treatments provided, and the required disclosures.[1] Those modifications include, when appropriate, incorporating requirements that are consistent with IFRS Accounting Standards.

[1] For details, refer to the *Significant differences between FRS 102 and the IFRS for SMEs Standard* available at: https://www.frc.org.uk/accountants/accounting-and-reporting-policy/uk-accounting-standards/significant-differences-between-frs-102-and-the-if

The FRC anticipates that some entities applying FRS 102 will be within the scope of Pillar Two legislation and is considering amending that standard in response to concerns about the potential implications for income tax accounting. In developing potential amendments to FRS 102, the FRC is considering the IASB's project 'International Tax Reform—Pillar Two Model Rules' and it is in this context that I am responding to the above Exposure Draft. The views expressed in this submission do not reflect the FRC's final decisions on the development and maintenance of UK and Ireland accounting standards in respect of this issue.

The UK Endorsement Board (UKEB) is responsible for adopting IFRS Accounting Standards for application by UK companies and will respond to you with its own perspectives on the Exposure Draft.

The specific matters the FRC has commented on in response to your questions are included in the Appendix. If you have any queries or would like to discuss our comments in more detail, please do not hesitate to contact Stephen Maloney (Senior Project Director) or Adrian Wallis (Project Director) at ukfrs@frc.org.uk.

Yours sincerely,

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Appendix: Specific matters for comment

Question 1—Temporary exception to the accounting for deferred taxes (paragraphs 4A and 88A)
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 qualified domestic minimum top-up taxes described in those rules. The IASB proposes that, as an exception to the requirements in IAS 12, an entity neither recognise nor disclose information about deferred tax assets and liabilities related to Pillar Two income taxes. The IASB also proposes that an entity disclose that it has applied the exception. Paragraphs BC13–BC17 of the Basis for Conclusions explain the IASB's rationale for this proposal. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you would suggest instead and why.

Pillar Two transactions as income taxes

A1. Proposed paragraph 4A states that IAS 12 *Income Taxes* will apply to income taxes arising from 'Pillar Two legislation'. However, we think it may be unclear whether all transactions arising as a result of Pillar Two legislation meet the definition of income taxes – for example, in separate financial statements when an entity is charged a top-up tax that relates to the taxable profits of a different entity. We encourage the IASB to clarify which standard would apply to each type of top-up tax transaction.

Definition of 'Pillar Two legislation'

A2. The proposals define 'Pillar Two legislation' as tax law enacted or substantively enacted to implement the Pillar Two model rules published by the OECD, including tax law that implements qualified domestic minimum top-up taxes.

A3. We think that linking the definition directly to a specific publication risks having unintended consequences. For example, we think that EU Member States implementing the relevant EU Directive[1] may extend the scope of the Income Inclusion Rule (IIR) to large groups operating exclusively in one jurisdiction, which is not contemplated by the Pillar Two model rules. We do not think it is the IASB's intention that an IIR extended in this way should be outside the scope of the proposed temporary exception or of the proposed disclosure requirements. We think the IASB should consider defining top-up taxes in general and giving transactions arising from the OECD Pillar Two model rules as an example of such top-up taxes. A similar approach was taken for amendments to address interest rate benchmark

[1] Council Directive (EU) 2022/2523 of 14 December 2022 on ensuring a global minimum level of taxation for multinational enterprise groups and large-scale domestic groups in the Union

reform, where the concept was defined in general (the market-wide reform of an interest rate benchmark), alongside an explanation that the definition includes the specific recommendations set out in the Financial Stability Board's July 2014 report *Reforming Major Interest Rate Benchmarks*.[2] For top-up tax this approach might be implemented as follows:

> *4A This Standard applies to income taxes arising from <u>top-up tax. Top-up tax refers to a co-ordinated system of taxation intended to ensure groups pay a minimum level of income tax on income arising in each of the jurisdictions in which they operate. An example is</u> tax law ~~enacted or substantively enacted to~~ <u>that</u> implement<u>s</u> the Pillar Two model rules published by the Organisation for Economic Co-operation and Development, including tax law that implements qualified domestic minimum top-up taxes described in those rules….*

A4. Implementing the proposal above may allow the IASB to replace the terms 'Pillar Two legislation' and 'Pillar Two income tax' with generic terms, such as 'top-up tax legislation' and 'top-up income tax'. We have not reflected this possibility in the rest of this comment letter, and continue to use the terms that are defined in the Exposure Draft.

<u>Temporary exception to the accounting for deferred tax</u>

A5. We agree with the proposal to introduce a temporary exception to the requirements to recognise and disclose information about deferred tax assets and liabilities related to Pillar Two income taxes and that the temporary exception should be mandatory.

<u>Measurement of deferred tax balances</u>

A6. Paragraph BC10(b) of the Exposure Draft indicates that stakeholders told the IASB that it is unclear whether an entity would remeasure deferred taxes recognised under domestic tax regimes to reflect potential top-up tax payable under the Pillar Two model rules. The temporary exception in proposed paragraph 4A is from recognition and disclosure, not measurement. We think it may be unclear if the fact that the reversal of deferred tax balances recognised under domestic tax regimes may give rise to a top-up tax charge, or eliminate one that would otherwise have been due, means the tax rate used to measure those balances should reflect Pillar Two legislation. We think the IASB should consider including a further exception within the 'Measurement' section of IAS 12, for example as follows:

> *<u>47A As an exception to the requirements in this Standard, an entity shall not take into account the effects of Pillar Two legislation when measuring deferred tax assets and liabilities.</u>*

<u>Disclosure that the temporary exception has been applied (paragraph 88A)</u>

A7. We think it may be unclear whether the IASB intends that the disclosure in proposed paragraph 88A would be made in all cases, or only if the exception has had a material impact on the entity[3]. If the disclosure is intended to be made in all cases this may not be useful information in addition to the explicit and unreserved statement of compliance with IFRS

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[2] Refer to paragraph 6.8.2 of IFRS 9 *Financial instruments*.

[3] As required by paragraph 31 of IAS 1 *Presentation of Financial Statements*, an entity need not provide a specific disclosure required by an IFRS if the information resulting from that disclosure is not material.

Accounting Standards required by paragraph 16 of IAS 1. If the disclosure is intended only to be made if the exception has had a material effect, then for the same reasons set out in paragraph BC10 of the Exposure Draft, we think it may be unclear to a preparer whether or not the exception has had a material effect. We think that the IASB should consider deleting or replacing the disclosure requirement in proposed paragraph 88A.

A8. As a potential replacement, we think that whether an entity expects to be within the scope of Pillar Two model rules[4] could be useful information for users of financial statements because Pillar Two legislation may affect the entity's future cash flows in comparison to an entity that is not in scope, irrespective of whether an entity has deferred tax balances that may be affected. In many cases, it could be straightforward to assess because the high-level requirements of the Pillar Two model rules are relatively clear. Therefore, as an alternative to disclosing whether an entity has applied the temporary exception, the IASB might consider requiring an entity that expects to be within the scope of Pillar Two legislation to disclose that fact. For example, as follows:

> *88A* ~~*An entity shall disclose that it has applied the exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes (see paragraph 4A).*~~ <u>*If an entity expects to be within the scope of Pillar Two legislation (see paragraph 4A) it shall disclose that fact.*</u>

[4] An entity that is a member of a multinational group with revenue in its consolidated financial statements exceeding €750 million in at least two of the four preceding fiscal years, and that it is not an "excluded entity" (Refer to Article 1.5 of the OECD Model Rules).

Question 2—Disclosure (paragraphs 88B–88C)
The IASB proposes that, in periods in which Pillar Two legislation is enacted or substantively enacted, but not yet in effect, an entity disclose for the current period only: (a) information about such 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%. The entity would also disclose the accounting profit and tax expense (income) for these jurisdictions in aggregate, as well as the resulting weighted average effective tax rate. (c) whether assessments the entity has made in preparing to comply with Pillar Two legislation indicate that there are jurisdictions: (i) identified in applying the proposed requirement in (b) but in relation to which the entity might not be exposed to paying Pillar Two income taxes; or (ii) not identified in applying the proposed requirement in (b) but in relation to which the entity might be exposed to paying Pillar Two income taxes. The IASB also proposes that, in periods in which Pillar Two legislation is in effect, an entity disclose separately its current tax expense (income) related to Pillar Two income taxes. Paragraphs BC18–BC25 of the Basis for Conclusions explain the IASB's rationale for this proposal. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you would suggest instead and why

<u>Current tax expense (paragraph 88B)</u>

A9. We have no objection to the requirement for an entity to disclose separately its current tax expense (income) related to Pillar Two income taxes. This would allow users of financial statements to understand the scale of an entity's exposure to top-up taxes that are income taxes in the current period. However, we think that when the IASB has done further work to assess whether transactions arising from Pillar Two legislation are income taxes it may be appropriate to re-assess the disclosures that are required to be made about current tax expense. For example:

a. Users may not require a disaggregation of 'income tax' in this manner if information is provided elsewhere, such as the explanation required by paragraph 81(c) of IAS 12.[5]

b. If top-up taxes paid in relation to the profit of other entities are 'income tax' it may be useful to disclose these separately from top-up taxes paid in relation to the profit of

[5] an explanation of the relationship between tax expense (income) and accounting profit.

the entity itself, so that users can understand the extent to which an entity's 'income tax' relates to the operations of other entities.

c. If, over time, top-up taxes become a standard part of the tax landscape, separate disclosure may no longer provide relevant information to users.

<u>Scope of the disclosure requirements (paragraph 88C)</u>

A10. Proposed paragraph 88C would apply in periods in which Pillar Two legislation is enacted or substantively enacted, but not yet in effect. We think that the IASB should consider whether proposed paragraph 88C will apply in the circumstances in which it is intended to apply. For example:

a. *Entities in scope:* as drafted, paragraph 88C would apply to any entity, irrespective of whether it will be affected by Pillar Two legislation. Many entities applying IFRS Accounting Standards will not be within the scope of Pillar Two legislation, for example members of smaller groups. In addition, there may be different interpretations about whether the information is material.

b. *Relevant jurisdictions:* we think that if the intention is that the applicability of paragraph 88C depends on Pillar Two legislation being enacted or substantively enacted, but not yet in effect, *in jurisdictions in which the entity operates*, this could be made clearer.

c. *Period of effect:* we think that paragraph 88C could be read as starting to apply when *any* Pillar Two legislation is enacted or substantively enacted; and ceasing to apply when *any* Pillar Two legislation becomes effective. This may have unintended consequences, for example:

    i. *effect for groups*: legislation may take effect in different jurisdictions at different times. For example, if legislation is in effect across only a small portion of a group's operations the disclosures that give some indication of an entity's potential exposure to paying top-up tax may continue to be useful, so it would be undesirable for the group to cease making those disclosures.

    ii. *effective in general*: some legislation, including draft legislation for the UK, would come into effect in general on 31 December 2023, and specifically for each entity for its next accounting period beginning on or after that date. If the disclosure requirement is read to apply in general, it may cease to apply earlier than intended;

    iii. *effective in part*: some legislation, including draft legislation for the UK, would bring the Undertaxed Payment Rule into effect at a later date than the IIR. The proposed disclosures may be intended to be useful to users of financial statements until the legislation is fully effective, rather than when only part of it is effective.

A11. For example, the following amendments to the leading sentence of proposed paragraph 88C may address some of the issues noted above:

> *88C If an entity expects to be within the scope of Pillar Two legislation then, in periods in which ~~Pillar Two~~ such legislation is enacted or substantively enacted, but is not yet in effect for the entity, ~~an~~ the entity shall disclose, for the current period only:...*

Disclosure objective

A12. Applying proposed paragraph 88C may require judgement about the information that would be useful to users of financial statements. We think the IASB should consider including a disclosure objective, based on paragraph BC20 of the Exposure Draft, to help preparers of financial statements understand the intent of the requirement. For example, as follows:

> *88BA The objective of the disclosures required by paragraph 88C is to enable users of financial statements to understand an entity's potential exposure to paying top-up tax.*

Information about Pillar Two legislation (paragraph 88C(a))

A13. Proposed paragraph 88C(a) requires disclosure of information about Pillar Two legislation enacted or substantively enacted in jurisdictions in which the entity operates. We think there is a risk that this disclosure becomes onerous because it could require an entity to provide information for many different jurisdictions. There is also a risk that entities will disclose less useful standardised descriptions rather than entity-specific information because proposed paragraph 88C(a) does not require an entity to disclose how the legislation will affect the entity.

A14. We think the IASB should consider deleting proposed paragraph 88C(a). As set out in our response to Question 1, we suggest the IASB considers requiring that if an entity expects to be within the scope of Pillar Two legislation it shall disclose that fact. We think that disclosure would enable users to understand whether the entity is affected and therefore whether the users need to consider pertinent information from sources other than the entity's financial statements.

An entity's exposure to paying top-up tax (paragraph 88C(b))

A15. Proposed paragraph 88C(b) requires an entity to disclose the jurisdictions in which the entity's average effective tax rate for the current period is below 15%, and the tax expense (income) and accounting profit for these jurisdictions in aggregate, as well as the resulting weighted average effective tax rate.

A16. We think the proposed disclosures would not be useful for considering the potential effects of Pillar Two legislation on the entity's recognised or unrecognised deferred tax balances that existed at the end of the current reporting period. This is because the entity is not required to disclose its deferred tax balances associated with the jurisdictions that are relevant for the purposes of paragraph 88C(b).

A17. We also think that the proposed disclosure may be too far removed from the Pillar Two model rules to provide a useful indication of an entity's exposure to paying top-up tax. For example:

a. some effects of Pillar Two legislation are at the entity level not the jurisdictional level, for example some types of entity[6] are excluded from the top-up tax calculation;

b. as stated in paragraph BC22 of the Exposure Draft, the IAS 12 effective tax rate is not the same as the Pillar Two effective tax rate;

c. although perhaps mitigated by the disclosure requirements in proposed paragraph 88C(c):

    i. the effective tax rate in future accounting periods may not be the same as the effective tax rate in the current accounting period;

    ii. top-up tax for a jurisdiction is deemed to be zero if total operations are below the *de minimis* threshold[7]; and

    iii. the 'accounting profit' referred to in proposed paragraph 88C(b) is not the same as 'excess profit' under the Pillar Two model rules (for example, because the Pillar Two model rules deduct the 'substance based income exclusion'[8] in arriving at that figure).

A18. Paragraph BC24 of the Exposure Draft concludes that the information required by proposed paragraph 88C(c) would not involve undue cost or effort because it would be required only if an entity has made such assessments. However, we think that entities may feel compelled to carry out more detailed assessments to address situations where the information disclosed could be misleading as an estimate of the entity's exposure to paying top-up tax.

A19. Stakeholders have told us they have concerns that proposed paragraph 88C(b) would be burdensome and the benefits of the disclosure for users would not outweigh the costs of preparing it. Overall, we think that feedback from users of financial statements will be crucial in assessing whether the proposed disclosure will provide useful information.

<u>Where more detailed assessments have been carried out (paragraph 88C(c))</u>

A20. Proposed paragraph 88C(c) requires an entity that has carried out more detailed assessments to disclose some indicative information about jurisdictions to which the entity might or might not be exposed to paying top-up tax. We think the drafting could be interpreted in a closed manner (such that an entity discloses the fact that its assessments indicate that there are jurisdictions identified in applying paragraph 88C(b) but in relation to which the entity might not be exposed to paying Pillar Two income taxes, or not identified in applying paragraph 88C(b) but in relation to which the entity might be exposed to paying Pillar Two income taxes, but without disclosing the names of those

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[6] 'Excluded Entities', as defined in Article 1.5 of the OECD Model Rules.

[7] Refer to Article 5.5 of the OECD Model Rules

[8] Refer to Article 5.3 of the OECD Model Rules

jurisdictions, and/or any information about the tax expense (income), accounting profit or effective tax rate in those jurisdictions). It is unclear whether this is the IASB's intention; if not, we think the IASB should consider redrafting the requirement. If, for example, the IASB's intention is that the entity should name the relevant jurisdictions, the requirement could be redrafted as follows:

c) *<u>if</u> ~~whether~~ assessments the entity has made in preparing to comply with Pillar Two legislation indicate that there are jurisdictions:*

   (i) *identified in applying paragraph 88C(b) but in relation to which the entity might not be exposed to paying Pillar Two income taxes; or*

   (ii) *not identified in applying paragraph 88C(b) but in relation to which the entity might be exposed to paying Pillar Two income taxes<u>;</u>*

   <u>an entity shall disclose that fact and identify the relevant jurisdictions</u>.

Question 3—Effective date and transition (paragraph 98M)
The IASB proposes that an entity apply: (a) the exception—and the requirement to disclose that the entity has applied the exception—immediately upon issue of the amendments and retrospectively in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors; and (b) the disclosure requirements in paragraphs 88B–88C for annual reporting periods beginning on or after 1 January 2023. Paragraphs BC27–BC28 of the Basis for Conclusions explain the IASB's rationale for this proposal. Do you agree with this proposal? Why or why not? If you disagree with the proposal, please explain what you would suggest instead and why.

A21. FRC stakeholders have told us that for a temporary exception in FRS 102 to be effective it would need to be available to entities for reporting periods in which Pillar Two legislation is enacted or substantively enacted. By extension, the FRC therefore agrees that the exception proposed for IAS 12 should apply immediately and retrospectively upon issue of the amendments.

A22. We think it is reasonable that the proposed disclosure requirements should only be effective for annual reporting periods beginning on or after 1 January 2023, to provide reporting entities with sufficient time to prepare.

<u>Future removal of the exception and disclosure requirements</u>

A23. We agree that it is not possible to determine at present how much time the IASB's further work on this topic will require and therefore we agree with the approach of not including an end date for the application of the temporary exception. However, we think the IASB should set out its work plan on this topic as soon as possible.