EFRAG

[Draft] Comment Letter

You can submit your comments on EFRAG's draft comment letter by using the 'Express your views' page on EFRAG's website, then open the relevant news item and click on the 'Comment publication' link at the end of the news item.

Comments should be submitted by 27 February 2023.

International Accounting Standards Board
7 Westferry Circus, Canary Wharf
London E14 4HD
United Kingdom

[XX March 2023]

Dear Mr Barckow,

Re: Exposure Draft International Tax Reform – Pillar Two Model Rules

On behalf of the European Financial Reporting Advisory Group (EFRAG), I am writing to comment on the Exposure Draft ED/2023/1 *International Tax Reforms - Pillar Two Model Rules,* issued by the IASB on 9 January 2023 (the 'ED').

This letter is intended to contribute to the IASB's due process and does not necessarily indicate the conclusions that would be reached by EFRAG in its capacity as advisor to the European Commission on endorsement of definitive IFRS Standards in the European Union and European Economic Area.

EFRAG welcomes the IASB's efforts to address the concerns of stakeholders about the implications for income tax accounting arising from the implementation of Pillar Two model rules.

EFRAG supports the IASB's proposal to provide a mandatory temporary exception to the requirements in IAS 12 under which an entity should neither recognise nor disclose information about deferred tax assets and liabilities related to Pillar Two income taxes.

However, EFRAG encourages the IASB to clarify whether top-up tax based on the Pillar Two model rules are in scope of IAS 12 in situations outside the context of consolidated financial statements of the ultimate parent entity. This is especially relevant if the entity which is required to pay differs from the one that reports and could impact both consolidated financial statements at sub-group level and separate financial statements.

Furthermore, EFRAG supports the efforts of the IASB to define a disclosure approach that would provide information to the users to assess an entity's exposure to paying top-up tax that would not involve undue cost or effort. EFRAG appreciates that the IASB is trying to find a compromise, considering the urgency of the project.

However, at this stage it remains unclear whether this information is useful for users of financial statements. EFRAG will seek views from its constituents on the usefulness of the proposed disclosures, as due to the nature of the information required, the necessary data may not be available nor easily reconcilable with the internal records.

EFRAG agrees with the transition provisions included in the ED.

In addition, EFRAG highlights that the timing at which the amendments will be published by the IASB is critical. Indeed, given the timing at which some jurisdictions are expected to enact or substantively enact the Pillar Two model rules, it could impact interim reporting and annual reporting periods ending before 31 December 2023.

Finally, given the absence of an end date for the exception introduced by these proposed amendments, EFRAG recommends that the IASB schedules in its workplan, from now, an activity of review, so that the exception may be terminated at the appropriate moment.

EFRAG's detailed comments and responses to the questions in the ED are set out in the Appendix.

If you would like to discuss our comments further, please do not hesitate to contact Juan José Gómez, Monica Franceschini or me.

Yours sincerely,

Wolf Klinz
President of the EFRAG FRB

Appendix - EFRAG's responses to the questions raised in the ED

Question 1- Temporary exception to the accounting for deferred taxes (paragraphs 4A and 88A of the ED)

Notes to constituents – Summary of proposals in the ED

1 *The Organisation for Economic Co-operation and Development (OECD) published the 'Pillar Two model rules' in December 2021. These rules aim to address the tax challenges arising from the digitalisation of the economy and were agreed by more than 135 countries. These rules:*

   (a) *aim to ensure that large multinational groups pay a minimum amount of tax on income arising in each jurisdiction in which they operate;*

   (b) *would achieve that aim by applying a system of top-up taxes that results in the total amount of taxes payable in each jurisdiction representing at least a minimum rate of 15%; and*

   (c) *typically require the ultimate parent entity of the group to pay top-up tax (in the jurisdiction in which it is domiciled) but, in some circumstances, intermediate parent entities may be liable.*

2 *The rules generally apply to multinational groups with revenue in their consolidated financial statements exceeding €750 million.*

3 *Jurisdictions may also introduce a qualified domestic minimum top-up tax. This top-up tax is computed on a basis similar to the Pillar Two model rules but would be charged in the jurisdiction in which the profit arises rather than in the ultimate parent entity's jurisdiction.*

4 *Stakeholders informed the IASB of concerns about the implications for income tax accounting resulting from jurisdictions implementing the Pillar Two model rules within a short period of time. Those concerns related to:*

   (a) *How to apply IAS 12 to account for top-up tax. The IASB's stakeholders generally agree that the top-up tax is an income tax in the consolidated financial statements of the ultimate parent entity of a group subject to the Pillar Two model rules. However, it remains unclear whether top-up tax is an income tax in other circumstances like in the financial statements of a group's subsidiaries – for example if the entity that triggers the top-up tax is not part of the reporting group. They also noted that it is unclear how an entity accounts for deferred taxes related to top-up tax. In this regard, it is unclear whether the Pillar Two model rules create additional temporary differences, whether entities are required to remeasure existing deferred taxes and which tax rate has to be used to measure deferred taxes.*

   (b) *The usefulness of the information that could result from accounting for deferred taxes related to top-up tax. The IASB's stakeholders said that, in some cases, the recognition of deferred taxes related to top-up tax could be extremely complex and, therefore, the costs of doing so might outweigh the benefits.*

   (c) *The urgent need for clarity in the light of the imminent enactment of tax law to implement the rules in some jurisdictions. The ED indicates that some jurisdictions are expected to enact tax law to implement the Pillar Two model rules in the first half of 2023. Consequently, stakeholders said that there is little time to resolve the current uncertainties and that, without further clarification, an entity might incur costs in developing and applying their own*

interpretations of the requirements in IAS 12 which could result in diversity in accounting practice and information that is not necessarily useful for users.

5 *As the rules are expected to be implemented in some jurisdictions in the near term, the IASB concluded that it would not be feasible to determine how to apply the principles and requirements in IAS 12 before new tax laws are expected to be enacted.*

6 *Therefore, the IASB proposes to introduce a temporary exception to the requirements in IAS 12 to recognise and disclose information about deferred tax assets and liabilities related to Pillar Two income taxes. This ED does not affect the accounting for current taxes arising from implemented OECD Pillar Two rules.*

7 *The IASB also proposes that the temporary exception will be mandatory. This would result in greater comparability and eliminate the risk of entities developing accounting policies that are inconsistent with IAS 12.*

8 *In addition, the IASB concluded that entities need time to determine how to apply the principles and requirements in IAS 12 to account for deferred taxes related to top-up tax and that they need time to consider whether, for example, any action is needed to support the consistent application of IAS 12. From their point of view it is not possible to determine - at present - how much time such work will require. Consequently, the IASB proposes not to specify how long the temporary exception would be in place.*

Question 1

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.

EFRAG's response

9 EFRAG agrees with the IASB's proposal to provide a mandatory temporary exception to the requirements in IAS 12 under which an entity should neither recognise nor disclose information about deferred tax assets and liabilities related to Pillar Two income taxes.

10 As explained in paragraph BC7 of the ED, jurisdictions may introduce a qualified domestic top-up tax. Qualified domestic top-up tax would also be computed based on the Pillar Two model rules but would be paid in the jurisdiction in which the profit arises rather than in the (ultimate) parent entity´s jurisdiction. EFRAG welcomes the IASB's proposal to apply the exception to the accounting for deferred taxes to qualified domestic top-up tax. Such domestic top-up tax is subject to the same concerns as potential deferred tax that arises from the other Pillar Two rules.

11 Based on the preliminary feedback received, this temporary exception would:

(a) provide relief to entities from applying the complex calculation as required by the new tax law, including that related to the qualified domestic top-up tax, as they do not have to consider future tax effects;

(b) avoid diversity in practice in applying IAS 12 requirements without affecting comparability between entities' financial statements, both before and after the top-up tax applies;

(c) provide more time for entities to better understand the implications of new local tax laws leading to more reliable and useful financial information; and

(d) allow to better understand users' information needs related to top-up tax.

12 EFRAG welcomes that the exception is mandatory. Making this exception mandatory enhances comparability and avoids the risk of accounting inconsistencies as referred to in paragraph BC16(b) of the ED. In addition, disclosing that the entity has to apply the exception provides transparency about the fact that the entity might be impacted by top-up tax.

13 However, EFRAG notes that extending such a mandatory exception to the disclosure about deferred tax assets and liabilities related to Pillar Two income taxes could lead, in future periods, to a potential loss of some relevant information. The currently proposed mandatory exception can be understood that even in future periods when companies are able to provide this information, it will not be allowed to provide it in the notes to the financial statements.

14 Furthermore, EFRAG supports the IASB's approach not to include a sunset clause for the application of the exception. It would grant additional time to impacted entities and tax specialists to assess the effects of the new tax law and, consequently, to provide more useful and accurate financial information. In addition, taking into account that the OECD Pillar Two rules might be implemented at a different point in time in the various jurisdictions, a uniform timeline would not be appropriate. In addition, it gives time to the IASB to engage with stakeholders and to carefully consider any need for standard-setting.

15 Nevertheless, EFRAG encourages the IASB to monitor the forthcoming enactment process, to coordinate with other standard setters, to already define a specific work plan and envisage a timeline to analyse the impacts of the Pillar Two rules and to assess whether an additional standard-setting activity is required.

16 EFRAG also highlights that the timing at which the amendments will be published by the IASB is critical. Indeed, given the timing at which some jurisdictions are expected to enact or substantively enact the Pillar Two model rules, it could impact interim reporting and annual reporting periods ending before 31 December 2023.

17 Lastly, EFRAG acknowledges that IAS 12 applies to income taxes arising from tax law enacted or substantively enacted to implement the Pillar Two model rules. However, it is unclear whether Pillar Two income taxes are in the scope of IAS 12 in situations outside the context of consolidated financial statements. For example, in separate financial statements where the standalone entity is liable to pay the top-up tax, but the tax was triggered by another entity of the group. Similar questions may arise in consolidated financial statements at sub-group level. Therefore, we encourage the IASB to clarify which standard would apply in such situations (or to explore alternative accounting treatments), providing that the issuance of these urgent amendments is not delayed.

Questions to Constituents

18 Do you support the IASB's proposal to introduce a temporary mandatory exception to the accounting for deferred taxes arising from the implementation of the Pillar Two model rules, including the qualified domestic minimum top-up tax?

19 Do you support the IASB's proposal to extend a temporary mandatory exception also to the disclosures about potential deferred taxes arising from the implementation of the Pillar Two model rules?

20 Do you think it is necessary to encourage the IASB to clarify whether and how paragraph 4A of the ED is applicable in situations outside the context of consolidated financial statements of the ultimate parent entity (e.g., subsidiary's separate financial statements level or sub-group consolidated financial statements level)?

Question 2 – Disclosure (paragraphs 88B-88C of the ED)

Notes to constituents – Summary of proposals in the ED

21 In introducing new disclosure requirements, the IASB considered the needs of users of financial statements when Pillar Two legislation is enacted or substantively enacted, but not yet in effect and when it is in effect.

22 In periods before Pillar Two legislation is in effect, the IASB sought to identify what information would provide users of financial statements with insights into an entity's potential exposure to paying top-up tax but that would not involve undue cost or effort. Considering this balance of costs and benefits, the IASB proposed to require an entity to disclose, for the current period only:

(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 for the current period is below 15% (calculated in accordance with IAS 12); and*

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

23 The majority of the IASB members considered it being more costly to require disclosing information based on the requirements of the Pillar Two legislation compared with disclosing information for the current period prepared in accordance with IAS 12.

24 As indicated in paragraph BC22 of the ED, some IASB members were opposed to requiring entities to disclose information prepared in accordance with IAS 12. In their view, such information would not be useful to users of financial statements because it would not be based on the requirements in the Pillar Two model rules and would relate to periods in which the rules are not yet in effect. They also raised the concern that such information could be misleading or commercially sensitive. However, a majority of IASB members were of the view that this information would still be useful to users 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.

25 The IASB also proposes to require an entity to disclose whether assessments the entity has made in preparing to comply with Pillar Two legislation. According to these assessments, an entity would indicate whether there are additional (or fewer) jurisdictions in which the entity might be exposed to paying Pillar Two income taxes compared to those with an average effective tax rate of less than 15% based on the

requirements in IAS 12. This information would not involve undue cost or effort because it would be required only if an entity has made such assessments.

26 *In periods when Pillar Two legislation is in effect, the IASB proposes to require an entity to disclose separately the current tax expense related to Pillar Two income taxes. This information would help users understand the magnitude of Pillar Two income taxes relative to an entity's overall tax expense.*

Question 2

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.

EFRAG's response

Disclosures before legislation is in effect

27 EFRAG supports the efforts of the IASB to define an approach that would provide information to the users to assess an entity's exposure to paying top-up tax that would not involve undue costs or effort. EFRAG appreciates that the IASB is trying to find a compromise, considering the urgency of the project. EFRAG will seek views from its constituents on the usefulness of the proposed disclosures, as due to the nature of the information required, the necessary data may not be available nor easily reconcilable with the internal records.

28 EFRAG encourages the IASB to clarify in paragraph 88C (a) of the ED what type of information entities should disclose when Pillar Two model rules are enacted or substantively enacted in jurisdictions in which an entity operates. The proposal raises the question whether this should be understood that entities should provide

information on all the jurisdictions where an entity operates and Pillar Two model rules are enacted or substantively enacted. At this stage, we have some doubts that this is decision-useful information for the users.

29 EFRAG also encourages the IASB to clarify the disclosure requirement included in paragraph 88C (b) of the ED. In EFRAG's view, it is unclear what the IASB means by the accounting profit of a jurisdiction:

(a) Is it the sub-consolidated accounting profit, as defined by IAS 12, of all entities existing in a given jurisdiction; or

(b) is it the aggregated accounting profit of all entities existing in a given jurisdiction?

30 As this is an example of what readers of the ED might interpret, there might be other interpretations of the accounting profit of a jurisdiction. The lack of clarity on this aspect might lead to diversity in the fulfilment of this disclosure requirement. It may also bring complexity depending on the interpretation made by entities.

31 EFRAG considers it useful to provide users of financial statements with information that tries to provide insights into an entity´s potential exposure to paying top-up as long as the benefit of providing such information outweighs its costs.

32 Even though EFRAG is in favour of a requirement to provide users with information that tries to provide insights about an entity´s potential exposure to paying top-up tax (considering the cost-benefit assessment), there are some doubts whether the information included in paragraph 88C (b) of the ED is useful for users of financial statements. For instance, to identify those jurisdictions that might be exposed to paying top-up tax and for which aggregate figures would then be given, the income tax rate could be used instead of the entity's average effective tax rate. The IASB could also enable entities to provide the disclosure requirement included in paragraph 88C (b) of the ED prepared under Pillar Two model rules as an alternative if an entity has the information already readily available.

33 EFRAG will assess the usefulness of the disclosure requirement included in paragraph 88C (b) of the ED extensively with its constituents together with the expected costs of preparing this information during its outreach activities on the ED.

34 The ED also proposes to require an entity to disclose, if existing, that the entity has made assessments in preparing to comply with Pillar Two legislation and an indication of whether there are additional (or fewer) jurisdictions in which the entity might be exposed to paying Pillar Two income taxes compared to those disclosed under paragraph 88C (b) of the ED. EFRAG considers this disclosure to be useful. However, the way in which the ED is drafted may trigger that some entities may fulfil this disclosure requirement by saying that they have made an assessment that leads to the situations included in paragraphs 88C (c) (i) or (ii) of the ED but without providing further details. Therefore, we encourage the IASB to be more precise on this disclosure requirement.

35 Additionally, EFRAG observes that under Pillar Two rules, an entity might be exposed to paying Pillar Two income tax even if the law is in force in jurisdictions other than that of the ultimate parent entity of the group. Thus, we encourage the IASB to state explicitly in paragraph 88C of the ED that it refers to any jurisdiction in which the entity operates. Even though this is the ED's intention as reflected in paragraph 88C (a) of the ED, we are of the view that this should also be emphasised in paragraph 88C of the ED to avoid any confusion.

36 Lastly, EFRAG indicates that under Pillar Two rules, there might be a difference between the entity liable to pay the top-up tax and the entity that triggers the top-up tax. In case that the IASB clarifies that Pillar Two income taxes are in the scope of

IAS 12 in situations outside the context of consolidated financial statements of the ultimate parent (see paragraph 17 above), we have reservations on whether the disclosure requirements proposed in paragraph 88C (b) in the ED are fit for purpose for separate financial statements (or the financial statements of sub-consolidated subsidiaries).

Disclosures when legislation is in effect

37 EFRAG agrees with the disclosure of an entity´s current tax expense (income) related to Pillar Two income taxes as it would enable users of financial statements to understand the magnitude relative to an entity's overall tax expense and it will not be costly. This is because the entity needs to recognise the current tax in their financial statements anyway. However, EFRAG encourages the IASB to clarify in the Basis for Conclusions the reason why users of financial statements are keener to understand the magnitude of Pillar Two income taxes over other types of income taxes.

Question to Constituents

38 Do you consider that the disclosure requirements included in paragraph 88C (b) of the ED will result in providing users of financial statements with insights into an entity's potential exposure to paying top-up tax? Do you consider that the benefit of providing this disclosure requirement would outweigh the cost of preparing this information? Is there any other indication that could provide users with better insights into an entity's potential exposure to paying top-up tax but that would not involve undue cost or effort?

Question 3 – Effective date and transition (paragraph 98M of the ED)

Notes to constituents – Summary of proposals in the ED

39 The IASB concluded that, for the temporary exception to be effective, it would need to be available to entities immediately upon the issue of the amendments. The IASB decided to propose retrospective application of the temporary exception because such application would result in entities applying the exception from the date Pillar Two legislation is enacted or substantively enacted, even if that date is before the date on which the IASB issues the final amendments.

40 The IASB proposes to require an entity to apply the disclosure requirements in paragraphs 88B–88C of the ED for annual reporting periods beginning on or after 1 January 2023.

Question 3

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.

EFRAG's response

41 EFRAG agrees with the IASB's proposal that entities should 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; and

(b) the disclosure requirements in paragraphs 88B–88C of the ED for annual reporting periods beginning on or after 1 January 2023.

42 Such an approach would not lead to significant additional costs for preparers and would allow entities to apply the mentioned exception retrospectively starting from the date Pillar Two legislation is enacted or substantively enacted (even if that date is before the date the expected amendments are approved).

43 Finally, given the absence of an end date for the exception introduced by these amendments, EFRAG recommends that the IASB schedules in its workplan, from now, an activity of review, so that the exception may be terminated at the appropriate moment.

Question to Constituents

44 Are there any additional questions or issues that should be taken into consideration by EFRAG in its Final Comment Letter?