Building a better working world

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Dear Board members,

Invitation to comment – Exposure Draft ED/2023/1 *International Tax Reform—Pillar Two Model Rules (Proposed amendments to IAS 12)*

Ernst & Young Global Limited, the central coordinating entity of the global EY organisation, welcomes the opportunity to offer its views on the Exposure Draft ED/2023/1 *International Tax Reform—Pillar Two Model Rules (Proposed amendments to IAS 12)* (the 'ED').

We welcome the Board's proposal to introduce a mandatory temporary exception to the requirements in IAS 12 *Income Taxes* regarding the recognition of deferred tax assets and liabilities related to Pillar Two income taxes.

We understand that the information required by paragraph 88C(b)-(c) is intended to provide users of financial statements with insights about the entity's potential exposure to paying top-up tax. However, we set out various alternative approaches to developing disclosure requirements in Appendix 1.

Nevertheless, we would like to stress that timely publication of the amendments should take precedence over perfecting the disclosure requirements, as some jurisdictions are currently expected to (substantively) enact Pillar Two model rules in the first quarter of 2023, which could affect interim and annual reporting periods ending well before 31 December 2023.

Should you wish to discuss the contents of this letter with us, please contact Michiel van der Lof at the above address or on +31 88 407 1030.

Yours faithfully

Ernst & Young Global Limited

Ernst & Young Global Limited is a company limited by guarantee registered in England and Wales No. 4328808.

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Appendix 1 – Detailed comments

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.

We agree, for the reasons noted in paragraphs BC10 and BC15, with the IASB's proposal to introduce a mandatory temporary exception to the requirement in IAS 12 that requires an entity not to recognise deferred tax assets and liabilities related to Pillar Two income taxes.

Whilst it is proposed that an entity should disclose whether it has applied the exception, we believe that the disclosure proposed in paragraph 88A would be more helpful if entities were required to state explicitly whether they expect to be affected by Pillar Two legislation. This is because the application of the exception will be mandatory, but not all entities and groups will be affected on account of their size or location of their operations.

The opening sentence of paragraph 4A states that "This standard applies to income taxes arising from tax law enacted or substantively enacted to implement Pillar Two model rules…". We believe that wording is ambiguous, as it is unclear whether or not all taxes arising from the Pillar Two model rules are income taxes. For the application of the IAS 12 deferred tax recognition requirements, it makes no difference whether a top-up tax under the Income Inclusion Rule (IIR) and the Under Taxed Payments Rule (UTPR) are deemed to be income taxes subject to the mandatory exception or are deemed not to be income taxes at all. However, the same would not apply to the IAS 12 current tax disclosure requirements. We recommend that the IASB clarifies that top-up taxes under IIR and UTPR are deemed to be income taxes for current tax disclosure purposes.

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.

We appreciate the IASB's efforts to try to identify information that provides 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. We would like to stress that timely publication of the amendments should take precedence over perfecting the disclosure requirements.

In our internal discussions, the following views, in the order of our preference, emerged on addressing the matter of disclosures:

- *Disclosure approach similar to the interest rate benchmark reform* – Our preference would be for the IASB to follow a disclosure approach similar to that in paragraph 24I of IFRS 7 *Financial Instruments: Disclosures*, which provides the objectives of the disclosures (i.e., enable users of financial statements to understand the effect of the reform by providing information about the nature and extent of risks to which the entity is exposed) and then require quantitative information on a basis selected by the reporting entity. As noted in paragraph BC35JJJ of IFRS 7, permitting entities to select a basis on which to provide relevant quantitative information to achieve the disclosure objective would allow entities to leverage information that is already available and, therefore, would reduce the costs of providing the information;

- *Separate the mandatory exception from the disclosure requirements* – Under this approach, the IASB would first finalise the mandatory exception as it is required urgently and then take additional time to develop disclosure requirements that better meet the needs of users of the 2023 financial statements;

- *Proceed with the approach taken in the ED* – If the IASB does not believe the above suggestions are appropriate or workable, then we would recommend several improvements to the proposals in the ED, as set out below.

Current tax disclosure (paragraph 88B)

We believe that separate disclosure of current tax expense (income) related to Pillar Two income taxes as proposed in paragraph 88B, could provide useful information while not requiring undue cost or effort. However, as noted in our response to Question 1, we recommend that the IASB clarifies that top-up taxes under IIR and UTPR are deemed to be income taxes for current tax disclosure purposes.

Information about legislation (paragraph 88C(a))

We also support the disclosure proposed in paragraph 88C(a) requiring information about Pillar Two legislation (substantively) enacted in jurisdictions in which the entity operates.

Disclosure of jurisdictions with low ETR (paragraph 88C(b)-(c))

We understand that the information required by paragraph 88C(b)-(c) is intended to provide users of financial statements with insights into an entity's potential exposure to paying top-up tax. However, based on our internal outreach, we have the following comments:

Relevance in sub-groups and individual entities

The disclosure requirements would apply to all entities in a group that produce IFRS financial statements and would reflect tax information for entities in which they have a direct or indirect ownership interest. However, attribution of current tax under the IIR and, especially, the UTPR are not based on ownership interest. In addition, the IIR operates on a top-down approach starting with the ultimate parent entity, meaning that the top-up tax will not be allocated to most entities lower down in a group. Therefore, we believe that the proposed disclosures are less likely to provide a meaningful proxy for the potential exposure to paying top-up tax at lower levels in a group.

Given the particular issues that exist in the context of sub-groups and individual entities, we believe the Board should consider scope restrictions such as those that exist in IFRS 8 *Operating Segments*, which limit the application of disclosure requirements to entities with traded debt or equity instruments, as this will reduce the cost of the proposals.

Accounting profit for jurisdictions

Preparing consolidated or aggregated information for a group of jurisdictions raises complex questions on how to deal with intercompany transactions between such jurisdictions and with the rest of the group. In particular, should intercompany profits be eliminated and is it necessary to reassess the nature of transactions such as intercompany financing arrangements (i.e., debt/equity classification), share-based payments transactions (i.e. cash- or equity-settled), and sale/leaseback arrangements for the purposes of the paragraph 88C(b) disclosures. We would recommend that the Board states explicitly that such adjustments should not be made, as this will reduce the cost of the proposals.

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.

We support the IASB's proposal to require the exception to be applied immediately upon issuance, but would recommend adding the wording from paragraph BC27 that the exception is applicable "… to any financial statements not yet authorised for issue at that date." We further support the retrospective application upon issuance of the amendment.

As noted in our response to Question 1, we believe that the disclosure proposed in paragraph 88A would be more helpful if entities were required to state explicitly whether they expect to be affected by Pillar Two legislation, because the application of the temporary exception will be mandatory, but not all entities and groups will be affected on account of their size or the location of their operations.

We agree that information that provides an indication of an entity's potential exposure to Pillar Two model rules should be disclosed in the annual financial statements for periods beginning on or after 1 January 2023.

Some jurisdictions are currently expected to (substantively) enact Pillar Two model rules in the first quarter of 2023. Therefore, we would like to stress that timely publication of the amendments is the highest priority as Pillar Two model rules could affect interim and annual reporting periods ending well before 31 December 2023.