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Global implementation of Pillar Two: Impact on deferred taxes and financial statement disclosures

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Key points

- In December 2021, the Organisation for Economic Co-operation and Development ('OECD') released the Pillar Two model rules to reform international corporate taxation that aim to ensure that applicable multinationals (global revenue exceeding €750 million) pay a minimum effective corporate tax rate of 15%.
- The rules are due to be passed into national legislation based on each country's approach, and some countries have already enacted or substantively enacted the rules. Applying the rules and determining the impact are likely to be very complex, and this poses a number of practical challenges.
- In May 2023, the International Accounting Standards Board (IASB) issued narrow-scope amendments to IAS 12, 'Income Taxes' that provide temporary relief from accounting for deferred taxes arising from the implementation of the Pillar Two model rules. Targeted disclosure requirements were also introduced. Jurisdictions subject to an endorsement process will need to endorse the amendments.

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1 What is Pillar Two?

In October 2021, more than 130 countries – representing more than 90% of global GDP – agreed to implement a minimum tax regime for multinationals, 'Pillar Two'. In December 2021, the Organisation for Economic Co-operation and Development ('OECD') released the Pillar Two model rules (the Global Anti-Base Erosion Proposal, or 'GloBE') to reform international corporate taxation. Large multinational enterprises within the scope of the rules are required to calculate their GloBE effective tax rate for each jurisdiction where they operate. They will be liable to pay a top-up tax for the difference between their GloBE effective tax rate for each jurisdiction and the 15% minimum rate. If the GloBE effective tax rate domestically is 15% or more, no GloBE top-up tax will be payable. It is the ultimate parent entity of the multinational enterprise that is primarily liable for the GloBE top-up tax in its jurisdiction's territory.

The goal is to end the 'race to the bottom' on tax rates worldwide, under which countries had been competitively cutting corporate taxes to attract businesses, with the impact that other countries felt forced to cut taxes to compete.

The GloBE rules include two main components: the Income Inclusion Rule ('IIR'); and the Undertaxed Payment Rule ('UTPR'). Top-up tax is first imposed under the IIR on a parent entity with an ownership interest in a low-taxed subsidiary. The UTPR is a backstop mechanism if there is low-taxed income from an entity within the group that is not brought into charge under the IIR by applying a top-up tax in the jurisdiction that introduced the UTPR.

Top-up taxes calculated under the IIR are to be paid in the jurisdiction of the parent entity of the multinational group, rather than in the low-tax territory that triggers the excess payment. Top-up taxes calculated under the UTPR are to be paid by the entity that operates in a jurisdiction that has enacted the UTPR, even if this entity is not a parent entity of the group. Thus, the Pillar Two rules provide for the possibility that jurisdictions might engage in domestic tax policy reforms and introduce their own qualified domestic minimum top-up tax ('QDMTT') based on the GloBE mechanics to avoid any 'tax leakage' in anticipation of the GloBE rules becoming effective.

Notwithstanding any new local minimum tax regime which might be designed to reduce or eliminate the GloBE top-up tax, additional top-up tax under GloBE might still be due. This will depend on the local effective tax rate calculation according to the specific rules set out in the Pillar Two regulations.

Definitions of terms used in this publication

GloBE effective tax rate = GloBE tax expense/income ÷ GloBE profit/loss

Statutory tax rate = Enacted tax rate

IAS 12 effective tax rate = IAS 12 tax expense/income ÷ IFRS profit/loss

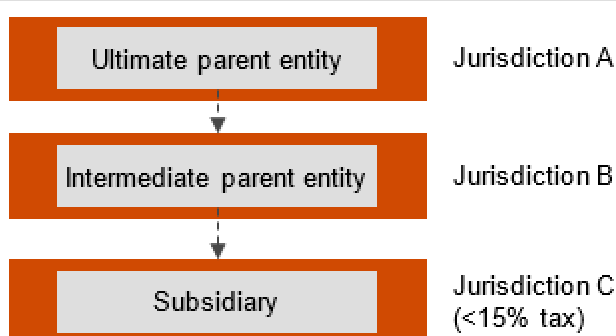
2 Who is impacted?

The Pillar Two rules apply to multinational enterprises that have consolidated revenues (which, as defined by the OECD, include any form of income and are therefore not limited to revenue recognised in accordance with IFRS 15) of €750m in at least two of the last four years.

Pillar Two applies if a jurisdiction in which the group operates has passed the rules into national legislation – this could be the jurisdiction of the ultimate parent entity or, if the IIR Pillar Two legislation is not yet in effect in the ultimate parent entity's jurisdiction, an intermediate parent entity in the multinational enterprise that is subject to top-up tax. For UTPR, this could even just be a subsidiary in the multinational enterprise. Enacted QDMTT rules could also increase the tax liability of the group.

A multinational enterprise might therefore be subject to Pillar Two taxes, and within the scope of the IAS 12 disclosure requirements, even if the jurisdiction of the ultimate parent entity has not yet enacted the Pillar Two rules.

Illustrative example where the jurisdiction of the ultimate parent entity has not enacted the Pillar Two rules



Assume that the group has recorded consolidated revenue (as defined by the OECD) of €750m in at least two of the last four years, which would result in the group being within the scope of the Pillar Two rules. The GloBE effective tax rates in jurisdictions A, B and C are 25%, 22% and 5% respectively.

The status of Pillar Two rules implementation for each of the jurisdictions is as follows:

- jurisdiction A has not enacted the Pillar Two rules;
- jurisdiction B has enacted the Pillar Two rules; and
- jurisdiction C has not enacted the Pillar Two rules.

Question
In this scenario, is the consolidated group in jurisdiction A considered to be impacted by the Pillar Two rules for purposes of the disclosure requirements under IAS 12?

Answer
Yes. The Pillar Two rules do not apply to the ultimate parent entity, and so no GloBE top-up tax is collected in jurisdiction A. Instead, the jurisdiction of the next intermediate parent entity (jurisdiction B in this example) applies the IIR and imposes top-up tax on the intermediate parent entity for the low-tax jurisdiction C.
Since the group has been impacted by the Pillar Two rules, the disclosure requirements of IAS 12 would be applicable to the consolidated financial statements prepared by the ultimate parent entity.

3 What is the issue?

Applying the Pillar Two rules and determining the impact are likely to be very complex, and this poses a number of practical challenges. Additionally, how to account for the top-up tax (whether GloBE or a GloBE qualifying domestic minimum top-up tax) under IAS 12 was not immediately apparent.

On 23 May 2023, the IASB issued narrow-scope amendments to IAS 12. The amendments provide a temporary exception from the requirement to recognise and disclose deferred taxes arising from enacted or substantively enacted tax law that implements the Pillar Two model rules published by the OECD, including tax law that implements QDMTT described in those rules.

The amendments to IAS 12 make it clear that entities subject to Pillar Two rules must ignore the deferred tax implications of enacted or substantively enacted Pillar Two legislation in their IFRS® financial statements. However, for annual reporting periods beginning on or after 1 January 2023, these entities will need to provide some additional disclosures about current taxes in their annual financial reports, as described below.

4 What is the impact?

As explained above, the one impact is that entities are prohibited from recognising or disclosing deferred tax implications arising from Pillar Two. A second impact is that the narrow-scope amendments to IAS 12 introduced targeted disclosure requirements for affected companies. They require entities to disclose:

- the fact that they have applied the exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes [IAS 12 para 88A];
- their current tax expense (if any) related to the Pillar Two income taxes [IAS 12 para 88B]; and
- during the period between the legislation being enacted or substantively enacted and the legislation becoming effective, entities will be required to disclose known or reasonably estimable information that would help users of financial statements to understand an entity's exposure to Pillar Two income taxes arising from that legislation. If this information is not known or reasonably estimable, entities are instead required to disclose a statement to that effect and information about their progress in assessing the exposure. [IAS 12 paras 88C-88D].

Due to the complexity of the Pillar Two rules, we expect that it will take time for some entities to carry out their impact assessments following the legislation's announcement. As a result, management might be unable to quantify and therefore disclose the detailed effects. However, an entity might be able to provide qualitative information – for example, if a material portion of its business operates in relatively low-tax jurisdictions that are likely to be impacted.

Disclosure example – legislation substantively enacted but not in effect

A parent entity might be in a jurisdiction where the Pillar Two legislation is substantively enacted, but not yet in effect at the group's reporting date. For example, as of 31 December 2023 the jurisdiction of the parent entity might have substantively enacted the Pillar Two legislation that will become effective from 1 January 2024.

To meet the disclosure requirements of IAS 12 above, an entity that is within the scope of the Pillar Two rules should disclose qualitative and quantitative information about its exposure to Pillar Two income taxes in its annual financial statements as of 31 December 2023. That information need not necessarily reflect all of the specific requirements of the legislation and could be provided in the form of an indicative range.

Disclosures that might be considered are as follows:

- Qualitative information such as how the group is affected by Pillar Two legislation and the main jurisdictions in which exposures to Pillar Two income taxes might exist.

Disclosure example – legislation substantively enacted but not in effect

For example, if the parent has subsidiaries that operate in low-tax jurisdictions, it might consider disclosing the name and the current legislative or average effective tax rates of those jurisdictions.

- Quantitative information such as:
  - an indication of the proportion of the entity's profits that potentially might be subject to Pillar Two income taxes and the average effective tax rate applicable to those profits; or
  - an indication of how the entity's average effective tax rate would have changed if Pillar Two legislation had been effective.

To the extent that information is not known or reasonably estimable, the entity should instead disclose a statement to that effect and information about its progress in assessing its exposure. Management will need to be able to support any statement that Pillar Two will not have a material impact.

An illustrative example of what an entity might consider disclosing in its financial statements for the year ended 31 December 2023 is as follows.

OECD Pillar Two model rules

The group is within the scope of the OECD Pillar Two model rules. Pillar Two legislation was enacted in country X, the jurisdiction in which the company is incorporated, and will come into effect from 1 January 2024. Since the Pillar Two legislation was not effective at the reporting date, the group has no related current tax exposure. The group applies the exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes, as provided in the amendments to IAS 12 issued in May 2023.

Under the legislation, the group is liable to pay a top-up tax for the difference between its GloBE effective tax rate per jurisdiction and the 15% minimum rate. All entities within the group have an effective tax rate that exceeds 15%, except for one subsidiary that operates in jurisdiction A.

For 2023, the average effective tax rate (calculated in accordance with para 86 of IAS 12) of the entity operating in jurisdiction A is:

	Group entity operating in jurisdiction A TCHF
Tax expense for year ending 31 December 2023	250
Accounting profit for year ending 31 December 2023	3'000
Average effective tax rate	8.3%

The group is in the process of assessing its exposure to the Pillar Two legislation for when it comes into effect. This assessment indicates for jurisdiction A that the average effective tax rate based on accounting profit is 8.3% for the annual reporting period to 31 December 2023. However, although the average effective tax rate is below 15%, the group might not be exposed to paying Pillar Two income taxes in relation to jurisdiction A. This is due to the impact of specific adjustments envisaged in the Pillar Two legislation which give rise to different effective tax rates compared to those calculated in accordance with paragraph 86 of IAS 12.

Due to the complexities in applying the legislation and calculating GloBE income, the quantitative impact of the enacted or substantively enacted legislation is not yet reasonably estimable. Therefore, even for those entities with an accounting effective tax rate above 15%, there might still be Pillar Two tax implications. The group is currently engaged with tax specialists to assist it with applying the legislation.

Entities might consider disclosing the expected impact of Pillar Two if the local jurisdiction has not yet announced or enacted the changes before the financial statements are authorised for issue. [IAS 1 para 17(c)].

Disclosure example – legislation not substantively enacted

In December 2021, the Organisation for Economic Co-operation and Development (OECD) issued model rules for a new global minimum tax framework (Pillar Two), and various governments around the world have issued, or are in the process of issuing, legislation on this. In [Country X], the government released draft legislation on Pillar Two in [July 2023]. The group is in the process of assessing the full impact of this.

The cash tax impact of the Pillar Two rules on going concern should be reflected in that assessment once the local legislation is announced rather than from when it is substantively enacted. This is because the going concern assessment includes all ‘expected’ future cash outflows and takes into account all available information about the future. [IAS 1 para 26].

Similarly, if an entity applies post-tax cash flows in a value-in-use calculation of the recoverable amount of an asset or a cash-generating unit when performing an impairment test, the cash tax impact of the Pillar Two rules should be reflected in those cash flows. The timing of this would be based on a market participant’s view which would likely be once the local legislation is announced rather than from when it is substantively enacted. Generally, the inclusion of tax cash flows would not impact the recoverable amount, because the entity would also adjust the post-tax discount rate used (see FAQ 24.87.2).

5 When does it apply?

The Pillar Two rules are intended to be implemented as part of a common approach, as agreed by the OECD members, and to be brought into domestic legislation by 2023. However, each jurisdiction will need to determine if and when the rules will be enacted and effective. In Switzerland, a constitutional amendment was subject to public vote on 18 June 2023, which was positive. QDMTT and IRR are therefore expected to be implemented as from 1 January 2024. The earliest expected implementation for the UTPR is currently 1 January 2025. The EU has issued a Directive to require its Member States to enact domestic legislation for the IIR from 2024 and the UTPR from 2025. For the status of Pillar Two implementation in different countries and regions, visit PwC's Pillar Two Country Tracker.

The amendments to IAS 12 are required to be applied immediately (subject to any local endorsement processes) and retrospectively in accordance with IAS 8, including the requirement to disclose the fact that the exception has been applied if the entity's income taxes will be affected by enacted or substantively enacted tax law that implements the Pillar Two rules. The disclosures relating to the known or reasonably estimable exposure to Pillar Two income taxes are required for annual reporting periods beginning on or after 1 January 2023, but they are not required to be disclosed in interim financial reports for any interim period ending on or before 31 December 2023.

6 Considerations for Swiss GAAP FER

'Swiss GAAP FER' (FER) are Swiss financial reporting standards focusing on accounting for small and medium-sized entities and groups with a national reach[1], but they are also applied by larger groups with international operations. The respective standard setter, the FER commission, has not published any specific guidance on tax accounting impacts from Pillar Two.

EXPERTSuisse, the Swiss Expert Association for Audit, on the other hand, has published an FAQ taking up the practical challenges and the impacts from Pillar Two on financial statements in accordance with Swiss GAAP FER. The publication is structured into three main questions/topics:

1. Are Pillar Two income taxes that are introduced by domestic tax laws in scope of FER 11 'Income Taxes'?
2. How do the Pillar Two model rules impact accounting for deferred taxes?
3. What related disclosures should be included in Swiss GAAP FER financial statements?

Based on all information available to the day, top-up taxes are according to the Q&A likely in scope of FER 11 'Income Taxes'.

The concepts of accounting for deferred taxes in FER 11 are comparable to IAS 12. It is therefore likely that FER preparers have similar challenges when accounting for deferred taxes from Pillar Two as IFRS preparers have. EXPERTSuisse concludes that are two ways how affected FER preparers can approach deferred tax accounting resulting from the effects of the Pillar Two model rules.

> *Approach A: Alignment with IFRS approach*
>
> It appears reasonable for EXPERTSuisse that FER preparers may follow the IASB's approach exempting impacts from resulting from Pillar Two income taxes from accounting for deferred taxes in their financial statements.
>
> *Approach B: Assess and account for deferred taxes arising from the Pillar Two model rules considering FER 11 and the FER Framework*
>
> FER preparers following Approach B have to assess, once the Pillar Two model rules are enacted or substantively enacted in one of the jurisdictions where the entity operates, whether the degree of reliability of the resulting financial statement information is such that a recognition of the related

[1] Swiss GAAP FER 1 – Accounting and Reporting Recommendations, Introduction 3.1

deferred tax positions in the balance sheet is required. If the entity concludes that it is currently not possible to reliably determine the potential future tax consequences, no related deferred taxes should be recognized. Instead, according to FER FW/32, this fact should be disclosed.

FER preparers impacted by the Pillar Two model rules must add a description of the accounting policies applied. Depending on the entity's specific situation, further disclosures may be required to enable the the reader of the financial statements to understand potential future impacts from Pillar Two. To do so, FER preparers may use the disclosure requirements in the IAS 12 amendment as an inspiration.

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