

Financial Reporting Implication of OECD Pillar Two GloBE Rules

Extract, IFRS® Discussion Group Report on the Meeting – September 21, 2022

In October 2021, 137 of 140 countries in the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework on Base Erosion and Profit Shifting (“Inclusive Framework”) reached a landmark agreement to implement a two-pillar solution to reform the international taxation rules in response to challenges relating to the taxation of the digital economy. The two-pillar solution introduces a new global corporate minimum tax.

In December 2021, the OECD released the Pillar Two model rules (also known as the Global Anti-Base Erosion Rules (GloBE Rules)), which provide pivotal information on how the minimum tax works. While each jurisdiction needs to decide whether to adopt the GloBE Rules and when, the OECD has announced the GloBE Rules should be enacted by the various jurisdictions into domestic legislation in 2022, to be effective in 2023.

The Group discussed the following questions:

- (a) What are the GloBE Rules, at a high level?
- (b) What are the potential financial reporting implications of the GloBE Rules?
- (c) What action might management want to take now?

Issue 1: What are the GloBE Rules, at a high level?

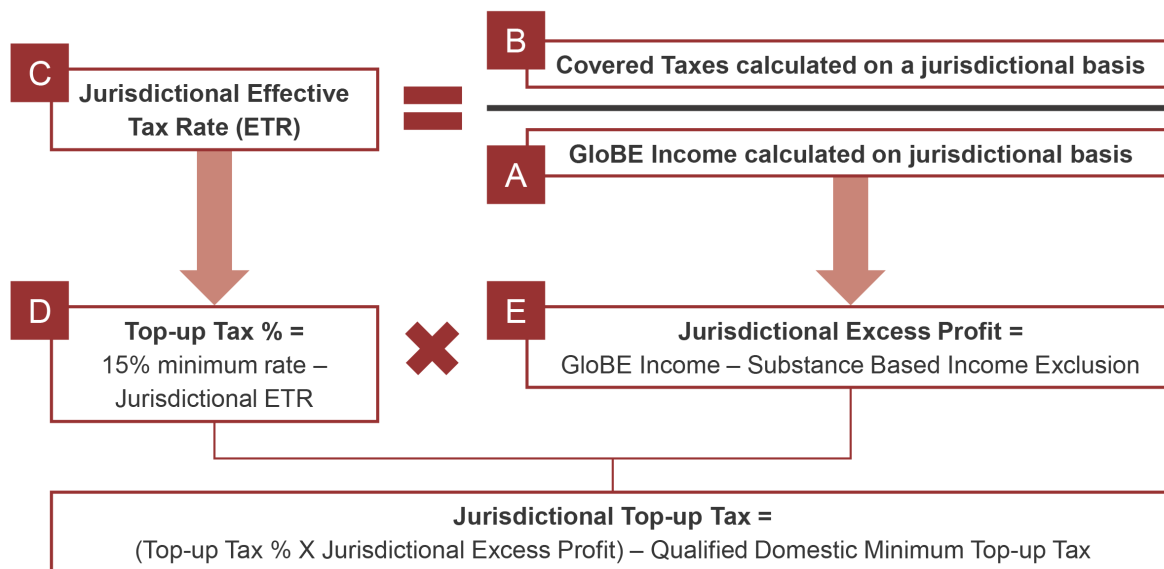
Analysis

The GloBE Rules are proposed international tax rules designed to ensure that large multi-national enterprises (MNEs) within the scope of the Rules pay a minimum level of tax of 15 per cent on the income arising in each jurisdiction in which they operate. If a MNE has an effective tax rate that is less than 15 per cent in a jurisdiction, it will have to pay a top-up tax for the difference. In general, it is expected that the top-up tax will be paid by the MNE’s ultimate parent entity, with the tax being due to the parent entity’s local tax authority.

The goal of the GloBE Rules is to end the ‘race to the bottom’ where certain countries have been reducing their corporate tax rates to attract foreign investment which has led to other countries feeling compelled to reduce their corporate tax rates to remain competitive.

The GloBE Rules apply to MNE groups if the revenue in their consolidated financial statements exceeds EUR 750 million, in two of the last four fiscal years. The GloBE Rules do not apply to government entities, international organizations and non-profit organizations nor do they apply to entities that meet the definition of a pension, investment or real estate fund. These entities are excluded even if the MNE group they control remains subject to the rules.

The following diagram outlines at a high-level the process for calculating the jurisdictional top-up tax. The components of the diagram are described in the paragraphs that follow. This report does not address all of the detailed steps and requirements in the GloBE Rules for determining the top-up tax which are detailed, nuanced and based on specific defined terms in the GloBE Rules.



To know if they owe top-up tax, MNEs need to calculate the jurisdictional effective tax rate (ETR) for each jurisdiction in which the MNE group operates. This requires a calculation of the GloBE income or loss, and the covered taxes on such income for each constituent entity in the group.

[A] The GloBE income or loss: A constituent entity starts by taking its financial accounting net income or loss for the fiscal year that is used for preparing consolidated financial statements of the ultimate parent entity prior to elimination of intragroup items. Adjustments are then made to eliminate common book-to-tax differences including those relating to dividends, equity method income, stock-based compensation, accrued pension expense, revaluation gains and losses, and certain foreign currency gains and losses.

[B] The covered taxes: A constituent entity starts with its current tax expense for the fiscal year that is used in preparing the consolidated financial statements of the ultimate parent entity. Adjustments are made to current tax expense for various items including uncertain taxes and refundable tax credits. Adjustments are also made to consider temporary differences using an entity's deferred tax expense (income) as a starting point to which various adjustments are made for GloBE purposes. For instance, there is an adjustment to recast deferred tax expense using a tax rate of 15 per cent, where a tax rate higher than 15 per cent was used. This is a unique use of deferred taxes in a tax calculation.

[C] The jurisdictional ETR: An MNE Group is required to determine the ETR for each jurisdiction in which it operates which is the amount of covered taxes with respect to a jurisdiction divided by the GloBE Income for such jurisdiction. When the ETR for the jurisdiction is less than the minimum rate of 15 per cent, then the top-up tax percentage must be calculated.

[D] The top-up tax percentage: This is the minimum rate of 15 per cent less the ETR for the jurisdiction (e.g., if the ETR is 10 per cent, the top-up tax percentage is 15%-10%=5%). The jurisdictional top-up tax is calculated by applying the top-up tax percentage to the excess profit for the jurisdiction (i.e., the GloBE Income for the jurisdiction less a substance based income exclusion).

[E] The substance based income exclusion: This is a reduction to the profit subject to the minimum tax for substantive activities in the jurisdiction. It is calculated as a percentage of payroll costs incurred and tangible assets located in the jurisdiction. Finally, the top-up tax is reduced by any applicable qualified domestic minimum top-up tax.

Once the amount of the top-up tax is calculated it is necessary to determine which entity(ies) in the MNE group is liable to pay such tax. Under the income inclusion rule (IIR), the minimum tax is paid at the level of a parent entity, in proportion to its ownership interests in those entities in low-taxed jurisdictions. Generally, the IIR is applied at the level of the ultimate parent entity and works its way down the ownership chain. If there is any residual top-up tax that remains unallocated after the IIR is applied, the under taxed payment rule (UTPR) applies to allocate the tax to other members of the group (e.g., a sister subsidiary in respect of a low-taxed subsidiary).

The GloBE Rules contemplate the possibility that countries may introduce their own domestic minimum top-up tax regime. If countries implement a domestic minimum top-up tax regime that fully complies with the GloBE Rules and increases the domestic tax liability for entities within the jurisdiction to at least 15 per cent, no incremental top-up tax would be due under the GloBE Rules. However, if such domestic tax regimes do not fully comply with the GloBE Rules, additional top-up taxes under GloBE may still be due.

Implementation and timing

The GloBE Rules are intended to be implemented as part of a ‘common approach’, as agreed by the OECD members. This means that jurisdictions are not required to adopt the GloBE Rules, but if they choose to do so, they will adopt them consistently with the model.

Given that the OECD does not have the power to implement tax legislation in any country, each country will need to determine if and when the GloBE Rules will be enacted. The OECD has announced the rules should be brought into domestic legislation in 2022, to be effective in 2023 with the UTPR coming into effect in 2024¹. Canada proposes to implement the Pillar Two Rules, along with a domestic minimum top-up tax and IIR that would be effective in 2023, and the UTPR effective not before 2024.²

The following are some initial observations on implementation:

- (a) The GloBE Rules are detailed and complex and it will likely take time to assess their impact.
- (b) It will be necessary to determine how the GloBE Rules interact with any domestic minimum top-up tax regimes to be enacted, and existing regimes such as the US Global Intangible Low Taxed Income (GILTI) regime.
- (c) If some countries choose to adopt the GloBE Rules, but others choose not to adopt at all, or choose not to adopt them at the same time, this could create additional complexity.

¹ OECD, “Statement on a Two-Pillar Solution to Address the Tax Challenges arising from the Digitalisation of the Economy”, October 8, 2021, 5

² Canada 2022 Budget, *A Plan to Grow our Economy and Make Life More Affordable*, Chapter 9, 210

- (d) Entities will need to obtain a refreshed understanding of their tax and legal structures around the world.
- (e) The finance and tax departments would need to work closely in assessing the impacts of the GloBE Rules – which includes identifying entities operating in jurisdictions which are potentially taxed below the 15 per cent minimum rate.

The Group's Discussion

Group members agreed with the analysis, noting that the GloBE Rules are detailed and complex and will require significant effort to implement.

One Group member observed that some multi-national organizations in Canada expect the rules will be substantively enacted in Canada and have already initiated the process to assess the impact of the rules on their operations.

Some Group members noted that given the calculation of GloBE income and loss starts with the financial accounting income or loss used in preparing the ultimate parent entity's consolidated financial statements, it is based on the accounting standard used in the ultimate parent's consolidated financial statements (e.g. IFRS Accounting Standards). The standard used in such consolidated financial statements may be different from that used in a subsidiary's statutory financial statements, unless an exception is met. As a result, some entities may need to maintain another set of financial records for GloBE purposes, in addition to their existing records for financial accounting and tax reporting under the rules in their local jurisdictions. These Group members noted such effort can be significant to MNEs.

Issue 2: What are the potential financial reporting implications of the GloBE Rules?

The proposed GloBE Rules raise several accounting questions, such as whether the top-up tax is an income tax in the scope of IAS 12 *Income Taxes*, and if so, when and how entities should account for the new taxes. As the GloBE Rules are not yet effective, discussion of the potential accounting implications is still underway. The following are key questions an entity might consider when adopting the GloBE Rules.

Question 1: Are the top-up taxes imposed by the GloBE Rules in scope of IAS 12?

Analysis

IAS 12 applies to taxes that are based on taxable profits. At the highest level, the top-up taxes are based on financial accounting income or loss, with various adjustments. Therefore, one might view the top-up taxes as income taxes in the ultimate parent entity's consolidated financial statements.

However, as the OECD noted, the top-up taxes imposed by the GloBE Rules do not operate as a typical direct tax on income of an entity. They apply to excess profits calculated on a jurisdictional basis and only apply to the extent those profits are subject to tax in a given year below the minimum rate. As a result, rather than a typical direct tax on income, the tax imposed under the GloBE Rules is closer in design to an international alternative minimum tax. This raises the question on whether these taxes are in the scope of IAS 12, in particular the UTPR which may result in top-up taxes being allocated among various entities in the group including those outside of the jurisdiction. Therefore, a detailed assessment of these taxes and an understanding of how these rules are enacted in each jurisdiction is necessary before concluding whether and how IAS 12 may apply to the group financial statements and separate entity financial statements.

Question 2: When are the changes in tax laws considered to be substantively enacted?

Analysis

IAS 12 requires that income tax assets and liabilities are measured using the tax rates (and tax laws) that have been enacted or “substantively enacted” by the end of the reporting period. While IAS 12 is not explicit as to when “substantive enactment” occurs, it is generally at the stage of the legislative process when the remaining steps will not change the outcome.

In Canada, a proposed change in income tax laws or income tax rates is generally not considered to be “substantively enacted” until detailed draft legislation has been tabled for first reading in Parliament. If there is a minority government, proposed amendments to the Income Tax Act would not normally be considered as “substantively enacted” until the proposals have passed third reading in the House of Commons.

MNEs will need to monitor the legislative developments with respect of substantive enactment of the GloBE Rules in all of the jurisdictions in which they operate either through wholly or partially-owned subsidiaries, joint ventures, flow-through entities or permanent establishments. Different countries may substantively enact the rules on different dates and with variations to the GloBE Rules, which will result in additional complexity in accounting for the GloBE Rules.

Question 3: Would the GloBE Rules affect the accounting for deferred taxes?

Analysis

Determining the deferred tax effects of the GloBE Rules can be complex. For example, there may be some expenses recognized in financial accounting net income or loss that are not deductible under the GloBE Rules and, therefore, are added back to arrive at GloBE income. However, those expenses may be deductible for GloBE purposes in future when paid. This raises a question on whether this gives rise to deferred taxes under IAS 12 (i.e., whether this is a temporary difference). If it does, entities should consider what tax rate should be used to measure the deferred tax. This determination can be complex as the top-up tax rate applicable to the reversal of GloBE income items will be contingent on future events, including:

- permanent differences related to local tax laws;
- aggregate future accounting income or loss of all entities in a particular jurisdiction; and
- other items that are difficult to forecast reliably.

Question 4: What should an entity consider disclosing in their interim and annual financial statements regarding the GloBE Rules?

Analysis

Paragraph 88 of IAS 12 requires that “where changes in tax rates or tax laws are **enacted or announced after the reporting period**, an entity discloses any significant effect of those changes on its current and deferred tax assets and liabilities (see IAS 10 *Events after the Reporting Period*).” (emphasis added)

Given the complexity of the GloBE Rules, it is expected that some entities will need time to assess how the rules affect their financial statements. This is complicated by the fact that, as noted in

Question 3, it is not immediately apparent how to account for the top-up tax under IAS 12. Therefore, if local legislation is announced or enacted between the reporting period end and the date the financial statements are authorized for issue, an entity may not be able to fully determine the quantitative impact of the GloBE Rules on its current and deferred taxes. However, it would be reasonable that an entity should provide qualitative disclosure of the expected effects of the GloBE Rules on the entity's business, and quantitative disclosure to the extent possible. Where entities are still in the process of assessing the effect of the rules, they should make a statement to that effect.

Even if the local legislation to implement the GloBE Rules is not announced or enacted before the financial statements are authorized for issue, an entity should consider providing qualitative disclosures of how the GloBE Rules could reasonably affect the entity in accordance with the requirement of paragraph 17(c) of IAS 1 *Presentation of Financial Statements*. This paragraph requires an entity to provide additional disclosures when compliance with the specific requirements in IFRS Accounting Standards is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance. This disclosure requirement applies to both annual and interim financial statements. Such disclosure is also consistent with the fact that the GloBE Rules are unique in that the OECD has published model rules, which local tax authorities are expected to use when developing GloBE Rules-compliant legislation. As a result, investors may expect companies to assess the potential impacts of GloBE Rules before changes in local tax legislation are finalized.

Entities should exercise judgment when considering the nature and extent of disclosures, incorporating their circumstances and users' expectations. These disclosures may include the following information about the group (some of which is based on quantitative information, which companies might consider providing, when it is reasonably determinable):

- (a) whether a material portion of its business operations is in relatively low-tax jurisdictions that are likely to be impacted;
- (b) Those operations in low-tax jurisdictions with an ETR lower than 15 per cent;
- (c) Those operations in jurisdictions where the government provides support through tax incentives, tax exemptions or additional deductions, resulting in an ETR lower than 15 per cent;
- (d) Information about expected enactment of tax laws and their effective dates;
- (e) Information about management's assessment of the possible impacts, indicating they are not yet known or reasonably estimable.

The Group's Discussion

Group members agreed with the analysis.

On Question 1, based on reading the current GloBE Rules, some Group members thought that at a high level, the top-up taxes are based on an entity's financial accounting income or loss. Therefore, they thought that the top-up taxes imposed by the GloBE Rules are in the scope of IAS 12. However, they noted that when the rules are substantively enacted in each jurisdiction, an additional assessment of the GloBE Rules is needed to conclude whether IAS 12 applies. These Group members also observed that determining whether GloBE Rules create temporary differences that give rise to deferred taxes is complex. For jurisdictions that substantively enact the GloBE Rules before the end of 2022, entities should complete this analysis and reflect the accounting impact of the deferred taxes in their 2022 financial statements.

On Question 4, some Group members noted that investors find information related to events that can materially affect the entity's future performance to be valuable. Therefore, entities should consider providing qualitative disclosure of the expected impacts of GloBE Rules on their business, and quantitative disclosure to the extent possible. They noted that the information should be consistent between financial statements and other corporate filings such as the management discussion and analysis.

One Group member also noted that entities should consider providing disclosures on non-adjusting events as required by paragraph 22 in IAS 10 regarding changes in tax rates or tax laws enacted or announced after the reporting period that have a significant effect on current and deferred tax assets and liabilities. Furthermore, this Group member observed that the cash payment related to the top-up tax could be significant and the resulting effect on liquidity may impact an entity's going concern assessment. Entities should consider any potential payment related to the GloBE Rules in the expected cash flow when performing the going concern assessment.

Another Group member noted that given the complexity of the rules, entities should also consider the requirement in IFRIC 23 *Uncertainty over Income Tax Treatments* on how to apply the recognition and measurement requirement in IAS 12 when there is uncertainty over income tax treatments.

Issue 3: What actions might management want to take now?

Analysis

Considering the potentially significant impacts that the GloBE Rules can have on a MNE that is in scope of the rules, management should consider the following action plan to implement the GloBE Rules:

- (a) Determine whether the MNE falls within the scope of the rules as currently set out by the OECD.
- (b) Consider whether group companies operate in low-tax jurisdictions or jurisdictions where they benefit from tax incentives, tax exemptions or significant tax deductions that may result in a low ETR.
- (c) Engage with tax specialists now to help assess the impacts of the GloBE Rules. This may include the following:
 - Delineating between entities that will clearly exceed the minimum ETR threshold versus those that may not.
 - Modelling the effective tax rates in the various jurisdictions.
 - Estimating potential additional GloBE tax liabilities.
- (d) Identify whether there are any challenges to obtaining data necessary to perform the calculations based on the model rules.
- (e) Monitor the implementation of the GloBE Rules in relevant jurisdictions, particularly on when the rules are substantively enacted in their tax laws.
- (f) Engage with users to determine the appropriate level of disclosures for both the 2022 interim and annual financial statements.

Pillar Two is new and the issues associated with its implementation and accounting are evolving. Management of in-scope MNEs should actively monitor developments in the jurisdictions in which they operate and develop an action plan appropriate to their particular circumstances.

The Group's Discussion

Group members agreed with the analysis.

One Group member commented that given the complexity and operational challenges noted in the analysis, the entity may consider building an internal reporting process and management controls to ensure accurate and timely information is reflected in the consolidated financial statements.

Another Group member also noted that entities may need to engage with their auditors and tax professionals in the process of implementing the GloBE Rules.

Overall, the Group's discussion raised awareness of the GloBE Rules and the associated financial reporting issues. An observer commented that the International Accounting Standards Board (IASB) is actively monitoring the development of GloBE Rules and considering whether urgent amendments to IFRS Accounting Standards might be needed concurrent with substantive enactment of tax legislation. Considering the GloBE Rules are expected to be substantively enacted in Canada as early as 2023 and the IASB's activity in this area, the Group will monitor this issue for future developments. No further action was recommended to the AcSB.