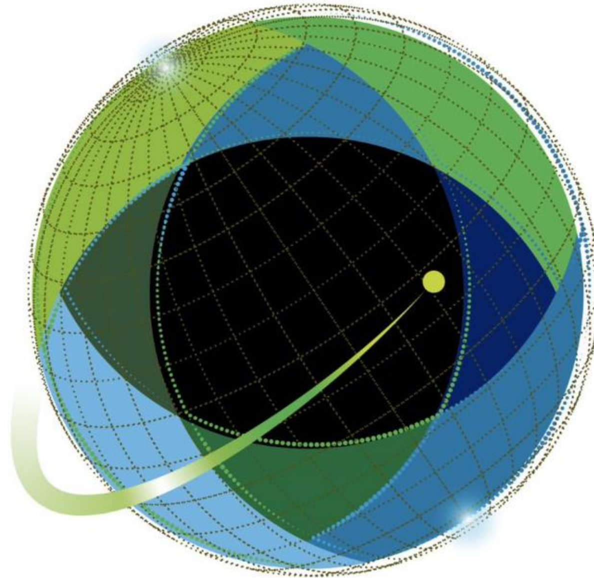
Deloitte.





# Responding to Pillar Two

## New taxation management and financial reporting challenges

The Pillar Two 'top up' tax seeks to impose a minimum 15% tax on multinational entities with global revenues exceeding €750 million (approximately A$1.2 billion). The Pillar Two reforms are scheduled to commence for income years beginning on or after **1 January 2024**, leaving little time for entities to get ready for its implementation. With Australian legislation not expected until late 2023 at the earliest, and some parts still moving, the management challenge for entities with revenue over €750 million (~A$1.2 billion) is immense.

The top up tax is based on accounting information of the global parent entity and the calculation process results in numerous financial reporting issues, including scope and **deferred tax** questions under AASB 112 *Income Taxes*.

In response to these financial reporting challenges, the International Accounting Standards Board has introduced amendments that have **immediate effect** and prohibit the recognition and disclosure of deferred taxes arising from Pillar Two taxes. The amendments also require **immediate disclosure** of the use of the exception and introduce **new disclosures** about the expected impacts of Pillar Two for annual reporting periods beginning on or after 1 January 2023.

The message is clear: larger entities need to urgently respond to Pillar Two – even in the absence of enabling legislation – and tax and financial reporting teams need to work together. Smaller entities also need to respond to the new disclosures.

"Pillar Two is an important development in international taxation that will require significant effort by entities within its scope"

**David Watkins**
**Partner – Tax Insights & Policy**

## Background

### What is Pillar Two?

In October 2021 Australia and over 130 other countries endorsed proposed international corporate tax reforms to address the challenges arising from the digitalisation of the economy. The reforms consist of two 'pillars' that were developed by the Organisation for Economic Co-operation and Development (OECD) Inclusive Framework on Base Erosion and Profit Shifting (BEPS).

Pillar One would reallocate taxing rights to countries where goods and services are consumed. This reallocation would only apply where a multinational has global revenues exceeding €20 billion per annum and also has a profit-before-tax to revenue ratio exceeding 10 per cent. Extractives and regulated financial institutions would not be subject to this pillar and it was originally anticipated the Pillar One reforms would be implemented in 2024[1].

Pillar Two is designed to operate to ensure a minimum rate of taxation of 15% and applies to entities that have global revenues of €750 million (approximately A$1.2 billion) or more. This means that where entities have operations operating in low tax jurisdictions, the ultimate parent entity would be subject to additional 'top up' tax on low or zero taxed profits.

Pillar Two consists of three components:

1. An optional domestic minimum top-up tax (DMTT), which effectively applies the top up tax at the country level
2. The Income Inclusion Rule (IIR), which is the default rule, applied at the ultimate parent level
3. Undertaxed Profits Rule (UTPR), applied where an entity's ultimate parent is domiciled in a jurisdiction that doesn't have an Income Inclusion Rule

There are numerous complexities and exceptions, and many of the tax calculations rely on accounting information included in the ultimate parent entity's financial statements.

### Pillar Two quick facts

Model rules to be implemented by more than 130 countries globally

Applies where global revenue exceeds €750 million

Imposes top up tax on jurisdiction profits with less than 15% effective tax rate

Based on accounting information in ultimate parent financial statements

### Implementation in Australia

In October 2022, Treasury consulted on Australian implementation of the two-pillar solution with the objective that it would "help ensure that multinationals pay their fair share of tax in the jurisdictions in which they operate".

The 2023-2024 Federal Budget subsequently confirmed that the Australian Government will proceed with implementation of Pillar Two minimum tax, with the IIR and a DMTT applying to income years beginning on or after 1 January 2024, and the UTPR applying a year later (income years beginning on or after 1 January 2025).

Draft legislation is expected in the second half of 2023, with a view to the final enabling legislation being implemented prior to commencement of the IIR and DMTT.

The $1.2 billion revenue threshold will likely capture many ASX listed entities, large privately held entities and investment entities

[1] A Treasury consultation on the implementation of the BEPS pillars released for comment in October 2022 noted that "Treasury estimates that no Australian headquartered multinationals currently fall into the scope of Amount A" (i.e. the amount of taxing rights to be redistributed under Pillar One). Pillar One taxes are not considered further in this publication.

## Understanding financial reporting perspectives

### Problematic interaction with accounting standards

The Pillar Two top up taxes are based on accounting information included in the consolidated financial statements of the ultimate parent entity, and apply a top up tax based on effective tax rates in each jurisdiction in each year based on those numbers. The base accounting information is adjusted for various rules, exceptions and requirements in deriving the ultimate amount of top up tax payable.

Because of the linkage to accounting information and the complexity of the top up tax calculation methodology, constituents raised many accounting issues around the application of IAS 12 *Income Taxes* to Pillar Two taxes with the International Accounting Standards Board (IASB), including:

- Whether Pillar Two taxes are an income tax for group entities, given that the IIR operates at the ultimate parent entity level (unless a DMTT is in place, and acknowledging that top up taxes in the consolidated financial statements at the ultimate parent level would generally be considered to be income taxes)
- Whether the Pillar Two rules create temporary differences in respect of jurisdictions where the top up tax may apply (due to the way in which the top up tax amounts are calculated by reference to accounting information), and if so, what rate should be applied
- The usefulness of any deferred tax information based on tax rates expected to apply in future periods, and the predictability of those rates given the way in which they are calculated.

As many countries, including Australia and New Zealand, are in the process of implementing the Pillar Two rules by 2024, the IASB acknowledged the urgency of addressing these issues and undertook a fast-tracked project to address constituent concerns.

### The IASB's solution: a temporary recognition exception whose use is disclosed

The IASB amendments to IAS 12 in *International Tax Reform – Pillar Two Model Rules* prohibit the recognition or disclosure of information about deferred taxes related to Pillar Two income taxes. This exception to the recognition and disclosure of deferred taxes **applies immediately on issue** on a retrospective basis.

In addition to this exemption, an entity is **required to disclose** that it has applied the exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes. This requirement also applies immediately on issue.

Accordingly, once the AASB has made equivalent amendments, entities will need to include this disclosure in their financial reports, including at 30 June 2023.

To meet this disclosure requirement, once the AASB has made equivalent amendments, entities need to state that it has applied the exception in the notes to the financial statements. This applies even if enabling legislation has not been substantively enacted in the participating jurisdictions where the entity operates.

In addition, entities would need to update any relevant accounting policy disclosure to be consistent with the exception being applied.

The prohibition on recognition and disclosure of deferred taxes arising from Pillar Two applies with immediate effect and requires disclosure

## The trade-off: additional disclosures

IAS 12 adopts a comprehensive balance sheet approach to the recognition of current and deferred taxes. Users of financial reports use deferred tax balances to understand the future tax consequences the entity faces.

Accordingly, without the recognition exception being in place for deferred taxes associated with Pillar Two top up taxes, entities would indirectly disclose the expected impacts of those taxes in their financial reports through recognised deferred taxes and associated disclosures. However, the calculation of deferred taxes arising from Pillar Two would be difficult because of the linkage of the Pillar Two calculations to accounting information and the need to forecast future effective tax rates to determine the top up tax rate to apply to temporary differences arising.

The IASB decided that users would seek to understand an entity's exposure to Pillar Two top up taxes, particularly prior to its implementation by the entity. However, in order to provide an appropriate trade-off between costs and benefits of disclosing information, disclosure of the known expected impacts of Pillar Two are required in financial reports prepared in the period between enabling legislation being enacted or substantively enacted[2] and when the Pillar Two top up taxes are in effect for entities.

The amendments require disclosure of **known or reasonably estimable** information that helps users understand the entity's exposure to Pillar Two top up taxes. Where information is not known or reasonably estimable, the entity would instead disclose a statement of that fact and disclose information about the entity's progress in assessing its exposure.

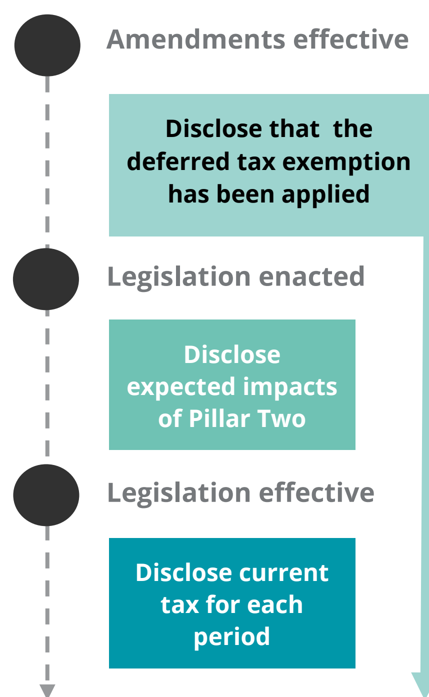
Both qualitative and quantitative information should be disclosed. Quantitative information is not required to reflect all of the specific requirements of Pillar Two and can be provided in the form of an indicative range. The amendments include the following examples illustrating how the overall disclosure objective might be met:

- Information about how the entity is affected by enacted or substantively enacted legislation and the main jurisdictions in respect of which Pillar Two exposures might exist
- An indication of the proportion of an entity's profits that might be subject to Pillar Two top up taxes, and the average effective tax rate applicable to those profits
- An indication of how the entity's average tax rate would have changed if Pillar Two legislation had been in effect.

Disclosures about the impact of Pillar Two legislation is not required once the Pillar Two legislation is effective and is being applied by the entity. Instead, the entity is required to disclose the current tax amount arising from Pillar Two legislation in each reporting period.

The Pillar Two impact disclosures apply for annual reporting periods beginning on or after 1 January 2023, but disclosures are not required in any interim period that ends on or before 31 December 2023[3].

## Disclosure timeline




The focus on known and estimable information seeks to find balance between user needs and entity preparedness for Pillar Two

[2] See FAQ *We have operations in many countries. What if one or more of these countries substantively enact the Pillar Two model rules before Australia?* on page 10 for more information.
[3] Because Australian Accounting Standards are legislative instruments under the *Corporations Act 2001*, the applicable date of the equivalent AASB standard to be made by the AASB will likely be expressed in a different way to meet Australian legal requirements. However, the effect will be to implement the requirements for an equivalent period.

## What do Australian entities need to do?

### Pillar Two preparations underwrite the disclosures required

All entities that might be potentially impacted by Pillar Two need to ensure they are ready for the broader implementation of Pillar Two, particularly as the documentation requirements from a taxation perspective might be expected to be significant. Entities might reasonably expect that the Australian Taxation Office will seek well documented position papers confirming positions as part of its compliance program, especially given Federal Government interest in multinational taxation and legal compliance.

Preparing for Pillar Two will necessitate close liaison between accounting and tax teams and the information obtained will ultimately form the basis of disclosures made under the IASB amendments. In other words, the disclosure objectives arising from the IASB amendments rely on known or reasonably estimable information which will be directly obtained from the Pillar Two preparation process.

Maintaining high-value communication and cooperation between financial reporting and tax teams will make the disclosures more meaningful, easy to prepare and provide most benefit to users of the financial statements seeking to understand the impact of Pillar Two. For instance, judgement will be required to determine whether information is sufficiently 'known or reasonably estimable', or the result of uncertain preliminary investigations that do not meet the threshold for inclusion in the disclosures.

### Illustrative disclosures

Set out below are illustrative disclosures that might be included in financial reports for various time periods before the expected effective date of the Pillar Two for income years beginning on or after 1 January 2024.

#### Full and half-years ending 30 June 2023

Subject to the AASB making equivalent amendments, Australian entities will be required to state in their 30 June 2023 financial reports that they have applied the exception to recognising and disclosing information about deferred taxes arising from Pillar Two income taxes.

Such disclosure might form part of the disclosure of newly applied Australian Accounting Standards, and also updating the relevant accounting policy information included in the financial report.

Entities may wish to *voluntarily* include additional information about the impacts of Pillar Two, particularly where the entity is well advanced in preparations[4].

**Illustrative disclosure**

**Pillar Two top up tax**

The Group is expected to be within the scope of the Pillar Two top up tax being implemented in Australia (as it will apply to entities with revenues exceeding €750 million and the Group's revenues exceed this threshold)[5]. The group has applied the mandatory exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes.

[4] In its focus areas for 30 June 2023 financial reports, ASIC notes that financial reports "should provide information about the impact where a group has operations in countries that have enacted Pillar II tax reforms and the group has operations in low tax jurisdictions".

[5] This first sentence is optional, but is illustrated as best practice.

### Half-years ending on or before 31 December 2023

Entities are **not** required to disclose known or reasonably estimable information about the entity's exposure to Pillar Two taxes in half-year (and other interim) reports for periods ending on or before 31 December 2023, even if the Pillar Two legislation has been substantively enacted. However, as noted above, entities may choose to do provide any known or reasonably estimable information if it is available.

Half-year reports should note that the exception to the recognition and disclosure of deferred taxes arising from Pillar Two has been applied and update any deferred tax accounting policies.

**Illustrative disclosure**

**Pillar Two top up tax**

The Group has applied the mandatory exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes.

### Full-years ending on or after 31 December 2023 (before the Pillar Two regime is effective)

Assuming that legislation has been substantively enacted in Australia and/or another jurisdiction in which the entity operates, an entity will need to be disclose any known or reasonable estimable information about the entity's exposure to Pillar Two income taxes. This would include:

- Qualitative information about how the entity is affected and the jurisdictions where Pillar Two exposures might arise
- Quantitative information such as an indication of the proportion of an entity's profits possibly subject to Pillar Two taxes (and average effective tax rates) and an indication of the impact on the entity's overall effective tax rate of Pillar Two taxes.

To the extent that information is not known or reasonable estimable, the entity would be required to make a statement to that effect and provide information about the entity's progress in assessing its exposure.

**Illustrative disclosure – information is known (June year end)**

**Pillar Two top up tax**

The Group is within the scope of the Pillar Two top up tax that applies in Australia for income years beginning on or after 1 January 2024. The first period for which a Pillar Two return will be required is the income year ending on 30 June 2025. The Group has applied the mandatory exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes.

The Group has a performed the necessary analysis in preparation for complying with the Pillar Two model rules for the income year ending on 30 June 2025. Based on the analysis derived from information in respect of the financial year ended 30 June 2024, the group has identified potential exposure to Pillar Two top up taxes in *[Country 1]*, *[Country 2]* and *[Country 3]*.

The proportion of the Group's profit before tax that is derived in these three countries comprises approximately ___ % to ___ % of the total, based on information for the financial year ending 30 June 2024. The effective tax rate (calculated based on the Pillar Two model rules methodology) for that period is ___ % in *[Country 1]*, ___ % in *[Country 2}* and ___ % in *[Country 3]*.

The proportion of profit before tax and effective tax rates that will apply in the first year of complying with the Pillar Two model rules will depend on a number of factors, including customer demand in each country, costs and exchange rates (among others).

### Illustrative disclosure – some information is known (June year end)

**Pillar Two top up tax**

The Group is within the scope of the Pillar Two top up tax that applies in Australia for income years beginning on or after 1 January 2024. The first period for which a Pillar Two return will be required is the income year ending on 30 June 2025. The Group has applied the mandatory exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes.

The Group is in the process of the necessary analysis in preparation for complying with the Pillar Two model rules for the income year ending on 30 June 2025. Based on the analysis derived from information in respect of the financial year ended 30 June 2024, the Group has identified potential exposure to Pillar Two top up taxes in *[Country 1]*, *[Country 2]* and *[Country 3]*.

The potential exposure to Pillar Two top up tax in these countries is not currently known or reasonably estimable, and other jurisdictions where an exposure exists may yet be identified. The Group continues to progress its implementation program, which is expected to be completed by approximately *[provide indication of a date]*.

### Illustrative disclosure – no information is known (June year end)

**Pillar Two top up tax**

The Group is within the scope of the Pillar Two top up tax that applies in Australia for income years beginning on or after 1 January 2024. The first period for which a Pillar Two return will be required is the income year ending on 30 June 2025. The Group has applied the mandatory exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes.

The Group is in the process of the necessary analysis in preparation for complying with the Pillar Two model rules for the income year ending on 30 June 2025. The Group has not yet determined the possibility of exposure to Pillar Two top up tax in the jurisdictions in which the group operates.

The potential exposure to Pillar Two top up tax is not currently known or reasonably estimable. The Group continues to progress its implementation program, which is expected to be completed by approximately *[provide indication of a date]*.

### Illustrative disclosure – no exposure (June year end)

**Pillar Two top up tax**

The Group is within the scope of the Pillar Two top up tax that applies in Australia for income years beginning on or after 1 January 2024. The first period for which a Pillar Two return will be required is the income year ending on 30 June 2025. The Group has applied the mandatory exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes.

The Group has a performed the necessary analysis in preparation for complying with the Pillar Two model rules for the income year ending on 30 June 2025. Based on the analysis derived from information in respect of the financial year ended 30 June 2024, the Group does not expect any potential exposure to Pillar Two top up taxes.

## Half-years ending after 31 December 2023 (before the Pillar Two regime is effective)

Although the amendments do not include any specific amendments to IAS 34 *Interim Financial Reporting*, it is clear from the drafting of the amendments (to provide a temporary exemption from disclosure in interim financial reports for periods ending on or before 31 December 2023) that information about the impacts of Pillar Two should be disclosed in half financial reports ending after 31 December 2023. This would be particularly relevant where the entity is likely to be subject to Pillar Two top up taxes in future periods.

This would also ensure compliance with the general requirements of IAS 34, such as the requirement to explain significant events and transactions needed to understand changes in the financial position and performance of the entity, and the nature and amount of items affecting the financial statements.

Therefore, assuming that legislation has been substantively enacted in Australia and/or another jurisdiction in which the entity operates, for half-years ending after 31 December 2023, an entity should:

- Disclose any new known or reasonable estimable information about the entity's exposure to Pillar Two income taxes
- Update any qualitative or quantitative disclosures made in previous periods in relation to the entity's exposure to Pillar Two taxes.

## Frequently asked questions

Set out below are frequently asked questions about the financial reporting perspectives of the Pillar Two top up tax.

### Do the amendments apply to all entities?

Technically, yes.

It is important to note that the new requirements are not limited to entities that might be exposed to Pillar Two taxes. Accordingly, all entities should consider whether to disclose at least some information about Pillar Two, unless the nature of the entity is such that such information is clearly not material. In other words, investors may expect to know that an entity is *not* expected to be impacted by Pillar Two as much as knowing that it is expected to be impacted, and the extent of those impacts.

Investors and other users of financial statements would appreciate understanding if there is no exposure to Pillar Two top up taxes

For groups that are clearly below the €750 million threshold to fall into the Pillar Two regime, there may be limited benefit in including substantial disclosure in financial reports. It may be simple as including a simple and clear statement in the income tax note or accounting policy note. The example below provides illustrative wording where substantive enactment of Pillar Two has not occurred.

**Example**

**Pillar Two top up tax**

The Group is not in the scope of the Pillar Two top up tax being implemented in Australia (as it will apply to entities with revenue exceeding €750 million).

### What disclosures should be included in Tier 2 financial statements?

It is not known at this stage what specific disclosures may be required in relation to Pillar Two top up taxes in Tier 2 financial statements, as at the date of finalisation of this publication, the AASB has not proposed any amendments to AASB 1060 *General Purpose Financial Statements – Simplified Disclosures for For-Profit and Not-for-Profit Tier 2 Entities*[6]. The AASB is expected to consider the impacts of the IASB amendments on Tier 2 financial statements in due course.

Entities preparing Tier 2 financial statements may wish to include information about their exposure to Pillar Two top up taxes where it is considered necessary to give a true and fair view of the financial statements, or where such disclosure is useful to users of the financial statements.

For example, an entity preparing Tier 2 financial statements may wish to provide disclosures where an entity that is a subsidiary of a foreign entity is subject (or expected to be subject) to the Undertaxed Profits Rule as a result of its foreign parent operating in a jurisdiction that has not implemented Pillar Two.

[6] On 1 June 2023, the International Accounting Standards Board (IASB) released Exposure Draft IASB/ED/2023/3 *International Tax Reform – Pillar Two Model Rules (Proposed Amendments to the IFRS for SMEs Standard)*. The Exposure Draft proposes inserting into the *IFRS for SMEs* Standard an equivalent recognition and disclosure exception in relation to deferred taxes arising from Pillar Two deferred taxes. In addition, the Exposure Draft proposes disclosure that the exception has been applied and notes that Pillar Two taxes may inform other disclosures (whilst providing flexibility in the level of disclosure provided).

## We have operations in many countries. What if one or more of these countries substantively enact the Pillar Two model rules before Australia?

The amendments do not differentiate between substantive enactment in the jurisdiction in which the entity preparing financial statements resides and the jurisdictions of its subsidiaries.

Accordingly, if substantive enactment occurs in any jurisdiction in which an entity operates, the disclosures about any known or reasonably estimable information about the entity's exposure to Pillar Two income taxes should be made (or alternatively, a statement to the effect that no known or reasonably estimable information is available and information about progress in assessing exposure should be made).

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited ("DTTL"), its global network of member firms, and their related entities (collectively, the "Deloitte organisation"). DTTL (also referred to as "Deloitte Global") and each of its member firms and related entities are legally separate and independent entities, which cannot obligate or bind each other in respect of third parties. DTTL and each DTTL member firm and related entity is liable only for its own acts and omissions, and not those of each other. DTTL does not provide services to clients. Please see www.deloitte.com/about to learn more.

Deloitte is a leading global provider of audit and assurance, consulting, financial advisory, risk advisory, tax and related services. Our global network of member firms and related entities in more than 150 countries and territories (collectively, the "Deloitte organisation") serves four out of five Fortune Global 500® companies. Learn how Deloitte's approximately 312,000 people make an impact that matters at www.deloitte.com.

Deloitte Asia Pacific

Deloitte Asia Pacific Limited is a company limited by guarantee and a member firm of DTTL. Members of Deloitte Asia Pacific Limited and their related entities, each of which are separate and independent legal entities, provide services from more than 100 cities across the region, including Auckland, Bangkok, Beijing, Bengaluru, Hanoi, Hong Kong, Jakarta, Kuala Lumpur, Manila, Melbourne, Mumbai, New Delhi, Osaka, Seoul, Shanghai, Singapore, Sydney, Taipei and Tokyo.

Deloitte Australia

The Australian partnership of Deloitte Touche Tohmatsu is a member of Deloitte Asia Pacific Limited and the Deloitte organisation. As one of Australia's leading professional services firms, Deloitte Touche Tohmatsu and its affiliates provide audit, tax, consulting, risk advisory, and financial advisory services through approximately 8000 people across the country. Focused on the creation of value and growth, and known as an employer of choice for innovative human resources programs, we are dedicated to helping our clients and our people excel. For more information, please visit our web site at https://www2.deloitte.com/au/en.html.

Liability limited by a scheme approved under Professional Standards Legislation.

Member of Deloitte Asia Pacific Limited and the Deloitte organisation. © 2023 Deloitte Touche Tohmatsu.

## Contacts

**David Watkins**
**Partner – Tax and Legal**
dwatkins@deloitte.com.au

**Amelia Teng**
**Partner – Tax and Legal**
amteng@deloitte.com.au

**Frank Betkowski**
**Principal**
fbetkowski@deloitte.com.au

**Alison White**
**Partner**
aliswhite@deloitte.com.au

**Anna Crawford**
**Partner**
acrawford@deloitte.com.au

**Moana Overton**
**Partner**
moverton@deloitte.com.au