Amendments to the HKFRS for Private Entities

International Tax Reform—

Pillar Two Model Rules

Entities are required to apply the temporary exception to the requirements in the HKFRS for Private Entities to account for deferred taxes related to Pillar Two income taxes immediately upon the issuance of the Amendments, and to provide the disclosures as set out in the Amendments for annual reporting periods beginning on or after 1 January 2023.

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CONTENTS

Amendments to the *HKFRS for Private Entities*

Section 29
Income Tax

Paragraphs 29.3A and 29.42–29.43 (including their related heading) are added.
Paragraph 29.38 is amended. New text is underlined.

Scope of this section

...

29.3A This section applies to income taxes arising from tax law enacted or substantively enacted to implement the Pillar Two model rules published by the Organisation for Economic Co-operation and Development (OECD), including tax law that implements qualified domestic minimum top-up taxes described in those rules. Such tax law, and the income taxes arising from it, are hereafter referred to as 'Pillar Two legislation' and 'Pillar Two income taxes'. As an exception to the requirements in this section, an entity shall neither recognise deferred tax assets and liabilities related to Pillar Two income taxes nor disclose information that would otherwise be required by paragraphs 29.39–29.41 about deferred tax assets and liabilities related to Pillar Two income taxes.

...

Disclosures

29.38 An entity shall disclose information that enables users of its financial statements to evaluate the nature and financial effect of the current and deferred tax consequences of recognised transactions and other events (including the enactment or substantive enactment of tax rates and tax laws, such as Pillar Two legislation).

...

International tax reform—Pillar Two model rules

29.42 An entity within the scope of Pillar Two legislation shall disclose that it has applied the exception to recognising and disclosing information about deferred tax assets and liabilities related to Pillar Two income taxes (see paragraph 29.3A).

29.43 An entity shall disclose separately its current tax expense (income) related to Pillar Two income taxes.

Section 35
Transition to the HKFRS for Private Entities

Paragraph 35.10(h) is amended. New text is underlined.

...

Procedures for preparing financial statements at the date of transition

...

35.10 An entity may use one or more of the following exemptions in preparing its first financial statements that conform to this Standard:

...

(h) deferred income tax. A first-time adopter may apply Section 29 *Income Tax* prospectively from the date of transition to the *HKFRS for Private Entities*<u>, while applying the exception in paragraph 29.3A retrospectively</u>.

Appendix A
Effective date and transition

Paragraph A4 is added. For ease of reading this paragraph has not been underlined.

...

A4 *International Tax Reform—Pillar Two Model Rules*, issued in November 2023, added paragraphs 29.3A and 29.42–29.43, and amended paragraphs 29.38 and 35.10(h). An entity shall apply:

(a) paragraphs 29.3A, 29.38, 29.42 and 35.10(h) immediately upon the issue of these amendments. Paragraphs 29.3A, 29.38 and 29.42 shall be applied retrospectively in accordance with Section 10 *Accounting Policies, Estimates and Errors*.

(b) paragraph 29.43 for annual reporting periods beginning on or after 1 January 2023.

Amendments to the Basis for Conclusions on *International Financial Reporting Standard for Small and Medium-sized Entities*

This Basis for Conclusions accompanies, but is not part of, the Standard.

Paragraph BC1BA is added. Paragraphs BC273–BC301 and their related headings are added. For ease of reading these paragraphs have not been underlined.

Introduction

...

BC1BA In September 2023 the IASB issued *International Tax Reform—Pillar Two Model Rules—Amendments to the* IFRS for SMEs *Standard*. The IASB's considerations in developing these amendments are discussed in paragraphs BC273–BC301.

...

Basis for Conclusions on 2023 Amendments to the Standard (International Tax Reform)

BC273 In September 2023 the IASB issued *International Tax Reform—Pillar Two Model Rules—Amendments to the* IFRS for SMEs *Standard*. The amendments:

(a) introduced a temporary exception to the requirements:

(i) to recognise deferred tax assets and liabilities related to Pillar Two income taxes; and

(ii) to disclose information that would otherwise be required by paragraphs 29.39–29.41 of the *IFRS for SMEs* Standard about deferred tax assets and liabilities related to Pillar Two income taxes;

(b) introduced targeted disclosure requirements for affected SMEs in periods when Pillar Two legislation is in effect; and

(c) clarified that 'other events' in the disclosure objective in paragraph 29.38 of the Standard include the enactment or substantive enactment of tax rates and tax laws, such as Pillar Two legislation.

Background

Pillar Two model rules

BC274 In October 2021 more than 135 jurisdictions agreed to the Organisation for Economic Co-operation and Development (OECD)/G20 Inclusive Framework on Base Erosion and Profit Shifting's *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*. Since then, the OECD has published model rules and other documents related to the second pillar of this solution (Pillar Two model rules).

BC275 The Pillar Two model rules provide a template that jurisdictions can translate into domestic tax laws and implement as part of an agreed common approach. The 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 on excess profit in each jurisdiction representing at least the minimum rate of 15%; and

(c) typically require the ultimate parent entity of a group to pay top-up tax—in the jurisdiction in which it is domiciled—on profits of its subsidiaries that are taxed below 15%.

BC276 The rules apply to multinational groups with revenue in their consolidated financial statements exceeding €750 million in at least two of the four preceding fiscal years. The rules specify inclusion thresholds for some jurisdictions and exclude some types of entities from their scope.

Potential implications for income tax accounting

BC277 Stakeholders informed the IASB of concerns about the implications for income tax accounting—and specifically deferred tax accounting—resulting from jurisdictions implementing the Pillar Two model rules within a short period of time. Those concerns related to entities affected by Pillar Two legislation and applying IAS 12 *Income Taxes*.

BC278 Because the requirements for accounting for income taxes in Section 29 of the *IFRS for SMEs* Standard are based on those in IAS 12, the IASB considered whether to amend Section 29.

Relevance to SMEs

BC279 In considering whether to amend the *IFRS for SMEs* Standard, the IASB first determines whether a new or amended full IFRS Accounting Standard is relevant to SMEs. The IASB determines relevance to SMEs by assessing whether the problem addressed by a new requirement in full IFRS Accounting Standards would make a difference in the decisions of users of financial statements prepared applying the *IFRS for SMEs* Standard.

BC280 The staff consulted the SME Implementation Group (SMEIG) and other stakeholders to obtain evidence about the relevance of the Pillar Two model rules (and the IASB's proposals in the Exposure Draft *International Tax Reform—Pillar Two Model Rules—Proposed amendments to IAS 12*) to SMEs. The feedback provided evidence that the Pillar Two model rules could have a material effect on the financial statements of a subset of SMEs, particularly some subsidiaries of large multinational groups.

Urgency

BC281 The IASB undertakes periodic reviews of the *IFRS for SMEs* Standard, during which the IASB considers whether, and if so how, to align the Standard with any new and amended full IFRS Accounting Standards. In undertaking its reviews, the IASB decided that it should not consider any new and amended full IFRS Accounting Standards until they have been issued because its views remain tentative and subject to change until that time.[1]

BC282 Furthermore, paragraph P16 of the Preface to the *IFRS for SMEs* Standard states that urgent matters may need to be considered outside the periodic reviews of the Standard. That said, such occasions are expected to be rare.

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1 Paragraph BC190 of the Basis for Conclusions on *International Financial Reporting Standard for Small and Medium-sized Entities*.

BC283 Given the expected timing of the third edition of the *IFRS for SMEs* Accounting Standard—the product of the Second Comprehensive Review of the *IFRS for SMEs* Accounting Standard—and considering stakeholders' concerns, the IASB decided to amend the *IFRS for SMEs* Standard to align the Standard with the amendments to IAS 12 relating to the Pillar Two model rules outside its periodic review.

BC284 After considering the relevance to SMEs and the urgency of the matter, the IASB set out its proposals and published the Exposure Draft *International Tax Reform—Pillar Two Model Rules—Proposed amendments to the* IFRS for SMEs *Standard* in June 2023 (Exposure Draft).

Temporary exception to deferred tax accounting

BC285 The IASB agreed that SMEs affected by the Pillar Two legislation need time to determine how to apply the principles and requirements in the *IFRS for SMEs* Standard to account for deferred taxes related to top-up tax. The IASB also needs time to engage further with its stakeholders and to consider whether any action is needed to support the consistent application of the Standard. The IASB concluded that it was not feasible to complete these activities before jurisdictions enact new tax laws and, thus, before SMEs are required to reflect those laws in accounting for deferred taxes.

BC286 The IASB, therefore, decided to introduce a temporary exception to the requirements in Section 29 of the *IFRS for SMEs* Standard to recognise deferred tax assets and liabilities related to Pillar Two income taxes and to disclose information that would otherwise be required by paragraphs 29.39–29.41 about deferred tax assets and liabilities related to Pillar Two income taxes. The IASB concluded that introducing this exception would:

(a) provide affected SMEs with relief from accounting for deferred tax assets and liabilities in relation to complex new tax legislation to be enacted by multiple jurisdictions in a short period;

(b) prevent the development of diverse interpretations of Section 29 and any resulting inconsistent application of that section; and

(c) allow time for stakeholders to assess how the Pillar Two model rules have been implemented in different jurisdictions, for SMEs to assess how they are affected, and for the IASB to consider whether to do further work.

BC287 The IASB also decided to require an SME within the scope of Pillar Two legislation to disclose that it has applied the temporary exception. The IASB concluded that this requirement would:

(a) provide entity-specific information because some SMEs are unaffected by Pillar Two legislation and, therefore, would not apply the exception; and

(b) make the exception's application transparent to users of financial statements during the periods in which it is applied.

BC288 The IASB decided it was unnecessary to expand the scope of the temporary exception to include the measurement of deferred taxes recognised under domestic tax regimes. The IASB concluded that an entity would not remeasure such deferred taxes to reflect Pillar Two income taxes it expects to pay when recovering or settling a related asset or liability because the temporary exception applies to deferred tax assets and liabilities related to such income taxes.

BC289 For the reasons in paragraph BC286, the IASB also decided to make a consequential amendment to paragraph 35.10(h) of the Standard to clarify that if a first-time adopter uses the exemption in paragraph 35.10(h) to apply Section 29 prospectively, the exception in paragraph 29.3A applies retrospectively. The IASB noted that without this clarification, a first-time adopter could incur additional costs applying Section 29 compared to SMEs already applying the Standard.

Mandatory application

BC290 The IASB decided to make the application of the temporary exception mandatory because doing so would:

(a) result in greater comparability between SMEs' financial statements and, therefore, provide more useful information for users of financial statements; and

(b) eliminate the risk that SMEs might inadvertently develop accounting policies that are inconsistent with the principles and requirements in Section 29 of the *IFRS for SMEs* Standard.

Duration

BC291 The IASB concluded that it was not possible to determine how much time the activities described in paragraph BC285 would require because they would depend on how and when jurisdictions implement the Pillar Two model rules. Therefore, the IASB decided not to specify how long the temporary exception will be in place. The IASB will monitor developments related to the implementation of the Pillar Two model rules to determine when to do further work. Any further work would not necessarily coincide with the next periodic review of the Standard.

Disclosures

Periods before legislation is in effect

BC292 When amending IAS 12 in May 2023 the IASB added a disclosure objective. An entity applying full IFRS Accounting Standards is required to disclose—in periods when Pillar Two legislation is enacted or substantively enacted but not yet in effect—information that helps users of financial statements understand the entity's exposure to Pillar Two income taxes arising from that legislation.

BC293 The disclosure objective in paragraph 29.38 of the *IFRS for SMEs* Standard requires an SME to disclose information that enables users of its financial statements to evaluate the nature and financial effect of the current and deferred tax consequences of recognised transactions and other events. The IASB observed that:

(a) paragraph 29.38 (which applies to all income tax consequences) is not the same as the objective developed as part of the IAS 12 amendments (which specifically deals with an entity's exposure to Pillar Two income taxes). Nonetheless, the IASB concluded that the objective in paragraph 29.38 would be expected to result in SMEs affected by Pillar Two legislation disclosing some information about the nature and financial effect of income tax consequences of such enacted (or substantively enacted) legislation in periods before the legislation is in effect (for example, information available from an SME's assessment of its exposure to Pillar Two income taxes). These disclosures would be expected because, in the IASB's view, 'other events' in paragraph 29.38 include the enactment (or substantive enactment) of Pillar Two legislation.

(b) although it is still uncertain when jurisdictions will implement the Pillar Two model rules, feedback on the Exposure Draft *International Tax Reform—Pillar Two Model Rules—Proposed amendments to IAS 12* confirmed that many jurisdictions are expected to enact in 2023 Pillar Two legislation that has effect from 1 January 2024. Consequently, any amendments to introduce new disclosure requirements or to amend existing disclosure requirements for SMEs for periods before such legislation is in effect would be applied for only a relatively short period.

(c) the information needs of users of SMEs' financial statements might differ from those of users of financial statements of entities applying full IFRS Accounting Standards.[2] Indeed, the absence of any new specific disclosure requirements would allow an SME to retain flexibility in deciding which information to disclose to meet the disclosure objective in paragraph 29.38.

BC294 A few respondents to the Exposure Draft said the amendment to paragraph 29.38 might not result in SMEs providing the disclosures expected in paragraph BC293(a). In their view, in periods before the Pillar Two legislation is in effect no current or deferred tax consequences would arise because the amendments introduce an exception to recognising deferred tax assets or liabilities related to Pillar Two income taxes.

BC295 The IASB observed that this view may have arisen from a narrow reading of the disclosure objective in paragraph 29.38, particularly of 'other events'. The IASB disagreed with this view, noting paragraph 29.38 does not state that 'other events' are *recognised* in the financial statements, nor does it limit the required information to only information about *recognised* current or deferred tax consequences. That is, paragraph 29.38 does not exclude *unrecognised* income tax consequences of other events (even if such other events are not yet recognised in the financial statements).

BC296 After considering responses to the Exposure Draft, the IASB confirmed its conclusion that 'other events' in paragraph 29.38 of the Standard includes the enactment (or substantive enactment) of tax rates and tax laws, which would include, for example, Pillar Two legislation. The IASB decided to amend paragraph 29.38 to provide more clarity about 'other events'.

BC297 The IASB noted that an SME needs to consider its specific circumstances in deciding which information to disclose to meet the disclosure objective in paragraph 29.38 of the Standard. An SME would also consider the disclosure requirements in other sections of the Standard, including:

(a) Section 33 *Related Party Disclosures*, which requires subsidiaries to provide information about transactions and outstanding balances, including commitments, with group entities;

(b) paragraphs 8.6–8.7 of the Standard, which require information about judgements and sources of estimation uncertainty; and

(c) paragraph 3.2 of the Standard, which requires additional disclosures when compliance with the specific requirements in the *IFRS for SMEs* Standard is insufficient to enable users to understand the effect of particular transactions, other events and conditions on the entity's financial position and financial performance.

Periods when legislation is in effect

BC298 The IASB decided to require an SME to disclose separately its current tax expense or income related to Pillar Two income taxes because doing so would:

(a) help users of financial statements understand the magnitude of Pillar Two income taxes relative to the SME's overall tax expense—disaggregation of amounts presented in an SME's financial statements helps users understand those statements; and

(b) not be costly to prepare because the SME would already be required to recognise current tax related to Pillar Two income taxes.

[2] See paragraphs BC76 and BC157 of the Basis for Conclusions on *International Financial Reporting Standard for Small and Medium-sized Entities*.

Effects analysis

BC299 The IASB concluded that the benefits of the amendments outweigh the costs because the amendments would:

(a) provide timely relief for affected SMEs;

(b) avoid diverse interpretations of Section 29 of the Standard developing in practice;

(c) safeguard the usefulness of the information disclosed by an SME applying the *IFRS for SMEs* Standard until questions about how to apply Section 29 of the Standard to Pillar Two income taxes have been resolved; and

(d) improve the information provided to users of SMEs' financial statements before and after Pillar Two legislation is in effect.

Effective date and transition

BC300 The IASB concluded that, for the temporary exception to be effective, it is necessary for it to be available to SMEs immediately upon issue of the amendments. The IASB decided to require retrospective application of the temporary exception in paragraph 29.3A because such application would:

(a) allow an SME to apply the exception from the date the Pillar Two legislation is enacted or substantively enacted, even if that date is before the issue date of the amendments; and

(b) not result in additional costs.

BC301 The IASB decided to require an SME to apply the disclosure requirements in proposed new paragraph 29.43 for annual reporting periods beginning on or after 1 January 2023. The IASB concluded that this effective date would provide an SME with enough time to prepare the required information. The IASB expects that the disclosure requirements in paragraph 29.43 will only be applicable from 1 January 2024, when Pillar Two legislation is expected to be in effect in many jurisdictions.