

GFIA comments on draft UK Pillar Two legislation

Introduction

On 20 July 2022, the UK Government published several documents as part of its ongoing commitment to the OECD's two-pillar initiative in relation to the tax challenges of digitalisation ("Pillar 2"), including draft legislation and explanatory notes on aspects of Pillar 2 and a summary of consultation responses to the UK's Pillar 2 consultation, which was issued in January 2022.

GFIA welcomes the UK's broad commitment to these initiatives in accordance with the Inclusive Framework ("IF") agreement reached in October 2021, and the opportunity to provide feedback and engage on these developments.

However, since the October 2021 IF statement and the Model Rules being published in late 2021, GFIA has observed delay and divergence from the Pillar 2 initiatives, both from the UK's major economic trading partners and more generally globally.

The Model Rules are complex and are leading to considerable uncertainty for in-scope groups. Furthermore, they are already increasing compliance costs and raising potential double taxation issues in their current form. The OECD acknowledges significant work remains to be undertaken through the IF process and through administrative guidance to address a myriad of technical issues in the Model Rules.

Considering this, GFIA asks that the UK Government announce a delay in legislating for the Pillar 2 rules and a further delay in the implementation of these rules until further international agreement is obtained, a common approach becomes clear and the timeline for adoption of these rules is feasible.

OECD common approach and the importance of the UK to global insurance

The UK is a significant insurance market, both domestically and internationally in terms of the insurance products offered and the premiums underwritten by insurers and reinsurers. It is a significant UK export sector and a key part of the UK's strategically important financial services sector.

The UK Government's approach to the insurance market, including in the field of taxation, is, therefore, important, as it has a significant impact on both British and overseas consumers and economies, by providing certainty and consistency in the legislative framework within which market participants operate.

The IF timeframe for adoption of the Pillar 2 rules is challenging and the UK has been exemplary in attempting to adhere to those timelines. However, for a variety of reasons, other major economies, including both the US and EU, have struggled to move as robustly as the UK in putting legislative processes in place. As such, the UK finds itself ahead of most world economies in advancing this legislation.

Developments in key jurisdictions and major UK trading partners

It is quite likely that most major markets will not be able to implement Pillar 2 Income Inclusion Rule (“IIR”) legislation in line with the IF’s originally anticipated timeline to be effective by 2023, with Undertaxed Payment Rule (“UTPR”) legislation to be effective by 2024. We are seeing the inclusion of Pillar 2 initiatives in budgetary and consultation processes in some jurisdictions (for example Canada, Malaysia, South Korea and Switzerland): however, as of writing, the UK appears to be one of the most advanced legislatively.

The most recent version of the draft directive to implement Pillar 2 in the EU remains in draft and is subject to agreement between member states. While it anticipates an IIR in tax years beginning on or after 31 December 2023 and a UTPR in tax years beginning on or after 31 December 2024, the timing and likelihood of adoption remains in question and is likely to slip. The draft directive diverges from the Model Rules where necessary to ensure compatibility with existing EU law and provides scope for deferral of the rules where there are a minimal number of UPE’s based in a member state.

The US has recently passed legislation that includes a new 15% corporate minimum tax (“US Corporate AMT”). While the US Corporate AMT shares some similarities with the Pillar 2 effective tax rate (ETR) calculation, the technical design of the minimum tax deviates in significant ways from Pillar 2. Given these differences, it seems unlikely that the US Corporate AMT would be considered a Qualified Domestic Minimum Top-Up Tax (as it relates to its application to domestic US income) or a Qualified IIR (with respect to its application to foreign income) under Pillar 2.

Accordingly, developments in the US and EU currently suggest degrees of divergence from the Pillar 2 framework and, therefore, uncertainty and complexity in interaction with Pillar 2 prospectively.

Unresolved technical issues

There continue to be unresolved technical issues that arise from the Pillar 2 Model Rules in relation to insurance business that are replicated in the draft UK legislation. These technical issues must be given appropriate consideration by the OECD secretariat and IF members (including the UK) as they continue to work on further refinements to the Pillar 2 rules.

Treatment of investment entities

Most important in this regard is the treatment of investment entities. The Model Rules do not sufficiently reflect the transparent tax treatment of investment funds. Top-up-tax can be triggered because these vehicles themselves suffer little or no tax, although the investment income is sufficiently taxed in the hands of the investor. The Model Rules attempt to respond to the tax transparent nature of investment entities by offering the Investment Entity Tax Transparency Election under Article 7.5. and the Taxable Distribution Method Election under Article 7.6. as a solution. However, in many jurisdictions neither option is available. In particular, this is the case for jurisdictions that do not tax the investor under a mark-to-market tax regime. The absence of such fair value taxation effectively rules out the Investment Entity Tax Transparency Election. The resulting Top-up tax does not seem to be in line with the policy objective of the minimum taxation concept, since tax exemption of investment funds is consistent with Global Anti-Base Erosion (“GloBE”) rules.

As noted, these issues are mirrored in the UK's legislation. The Tax Transparency Election under Paragraph 74 is only available on the condition that the investment entity owner is subject to tax in its location on the annual changes in the fair value of its ownership interests in the entity. This is not the case for all insurance investment entities.

The second election under Paragraph 75 (Taxable Distribution Method Election), that is also supposedly intended to account for tax transparent treatment of investment entities, excludes insurance investment entities. In addition, this election fails to achieve its objective in cases where investment income derived by the fund is taxed partially at fund level and partially at investor level. Since tax paid by the fund is not allowed to be used as covered tax for the ETR calculation for the investor, top-up tax may be triggered even if the aggregate tax burden on the investment income on both levels exceed the 15 % minimum tax.

These problems could be solved or at least mitigated by the following:

- The scope of the Investment Entity Tax Transparency Election in the OECD Model Rules and under Paragraph 74 of the draft UK legislation, is widened so that it can be used for jurisdictions where the owner is subject to taxation on value changes of the ownership interest in the investment entity only on realisation.
- The scope of the Taxable Distribution Method Election under Article 7.6 of the Model Rules and Paragraph 75 of the draft UK legislation is made available for insurance investment entities.
- Under the rules of the Taxable Distribution Method Election, any taxes on the investment income paid by the investment entity are included in the Covered Taxes of the Constituent Entity-owner.
- The allocation of taxes from the constituent entity-owner to the constituent entity under 4.3.2. e) of the model rules (Paragraph 53 of the draft UK legislation) is adapted to account for the differences with investment funds. This could be done by extending the provision to deemed distributions.

It is paramount for the insurance industry, which relies heavily on investments through funds, that appropriate solutions are developed which accommodate for the peculiarities of investment funds.

Other unresolved technical issues

1. GloBE loss election for investment entities

According to 4.5.1. of the Model Rules (Paragraph 57 draft UK legislation -placeholder) the GloBE loss election may be made per jurisdiction. Although the ETR of investment entities is calculated separately from other constituent entities in a jurisdiction, the Model Rules do not provide for a separate GloBE loss election.

The rules should be amended so as to allow all investment entities within one jurisdiction to separately make a GloBE loss election.

2. IFRS 17 - Calculation of GloBE base if IFRS accounting standard prescribes future cashflows as basis for profit calculation

Insurance companies will have to account for insurance contracts under International Financial

Reporting Standards (IFRS) 17 — Insurance Contracts from 2023 onwards. According to this, in simplified terms, the profits of a life/health insurance company are calculated on the basis of the future net cashflows at the insurance company. The future profits based on net cash inflows are realised over the term of the insurance contracts (technically the calculated future profits are in the so-called “contractual service margin (CSM)” that is released over the term of the insurance contract).

The future cash inflows of the insurance company also include tax-free dividend income from fully consolidated companies (being potentially situated in other countries), so that the income from the release of the CSM also includes dividends (from foreign entities) realised as the CSM is released. For companies operating in countries where the tax base is determined under IFRS, this could result in inappropriate taxation under Pillar 2. GloBE rules generally exclude dividend income except from short-term portfolio shareholdings from the GloBE base (Model Rules Article 3.2.1 (b); UK draft legislation Paragraph 21). Therefore, the UK’s Pillar 2 implementation should include an adjustment to exclude subsidiary dividends that are included in the accounting determination of profitability under IFRS 17.

3. Restricted Tier 1 Capital (RT 1)

Under Solvency II regulations, insurers can issue Restricted Tier 1 Capital (RT1). This is contingent convertible subordinated debt and includes a contractual trigger to convert to equity on specified events. In some countries RT1 is treated as equity for accounting purposes, but coupons are deductible for tax. This treatment is identical to Additional Tier 1 Capital in the banking sector.

Given the similarity between RT1 and Additional Tier One Capital, it should be clarified that section 3.2.10 of the model rules (Paragraph 34 of draft UK legislation) is also applicable to the insurance sector.

Conclusion

The Pillar 2 rules are complex. GFIA anticipates that there will be significant costs of compliance, and reporting for in-scope groups and the rules may have a detrimental effect on business through double taxation where the rules are adopted inconsistently or to non-aligned commencement dates. There is significant work to be done via the IF through administrative guidance both to clarify areas that are creating uncertainty and to develop agreement in areas such as the application of safe harbours.

The UK Government acknowledged in its statement on 14 June 2022 that implementing Pillar 2 rules ahead of other countries would compromise the long-term success and sustainability of the regime and put UK business at a competitive and administrative disadvantage. This logic led to a delay for implementation of rules initially from 1 April 2023 to periods beginning on or after 31 December 2023.

GFIA takes the view that this logic remains sound and suggests that the UK announce an intention to further defer the implementation of these rules until the IF and administrative guidance process has been more thoroughly completed and until there is more clarity on the timeline for and substance of international adoption, including regarding the unresolved technical issues noted above. To mitigate UK businesses suffering a competitive disadvantage, GFIA asks that the UK government announces that it does not intend to implement the Pillar 2 rules before other comparable jurisdictions.



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About GFIA

The Global Federation of Insurance Associations (GFIA), established in October 2012, represents through its 40 member associations and 1 observer association the interests of insurers and reinsurers in 65 countries. These companies account for 89% of total insurance premiums worldwide, amounting to more than \$4 trillion. GFIA is incorporated in Switzerland and its secretariat is based in Brussels.