

GFIA comments to the OECD on the Global Anti-Base Erosion Proposal (GloBE) (Pillar 2) “Tax Challenges Arising from the Digitalisation of the Economy”

The management of risk in the insurance industry relies on global capacity that is subject to local regulation. It requires the flexibility of operations in key locations around the world and cross border transactions in order to provide the necessary insurance cover that both individual consumers and businesses require. There are many factors that contribute to this structure including the availability of underwriting expertise in order to price risks appropriately, the support of international capital providing capacity for local insurance companies to accept risks they would not otherwise be able to and robust local regulatory requirements providing comfort to stakeholders including policyholders and ratings agencies.

Summary

It is important that Pillar 2 implementation works effectively for all industries including insurance and GFIA is concerned that nothing detailed has been made publicly available since December 2019. The process for developing detailed Pillar 2 proposals is currently opaque, without public stakeholder consultation. GFIA is concerned that this could lead to policy recommendations that will cause tangible harm to the insurance industry, including the impacts of double taxation. GFIA therefore requests that a public consultation take place before the proposed blueprint documents are presented for approval.

GFIA is concerned that a complicated carry-forward mechanism could be used to deal with the issue of temporary differences and that this could lead to a disproportionate compliance burden on the insurance industry. The complexity and unpredictability of the impact of such rules could lead to the disruption of the global insurance sector leading to poorer policyholder outcomes through reduced coverage options and increased costs. Insurance is particularly exposed to large long-term differences due to the business models undertaken, the long-term nature of some policies and the specific tax regimes that are applied to insurers.

As noted in earlier public consultations on Pillar 2, the proposed income inclusion rule, under-taxed payments rule and subject to tax rule all interact. Double taxation is a real concern if co-ordination of these rules is not adequately addressed upfront with clear prioritisation of rule applicability and safeguards being put in place. The public consultation late last year made clear that the objective of Pillar 2 is to apply a minimum rate of taxation, not to impose double taxation. Indeed, references are made to the income inclusion rule applying to top up to the minimum rate i.e. profits should not be subject to double taxation. It is key that the interaction with other rules does not compromise this position.

GFIA understands that substance carve-outs are still being considered. It is important to recognise that substance for financial services is not necessarily correlated to physical assets, R&D expenditure, and payroll in the same way that it is for manufacturing or similar industries. As a result, any substance carve out for insurance should take into account key factors such as capital and regulation.

Mechanism for dealing with temporary differences, losses, and cyclicity

The OECD Public Consultation on Pillar 2 last year identified three possible options to address temporary differences. A carry-forward of excess taxes and other tax attributes, deferred tax accounting or multi-year averaging.

GFIA understands that the OECD is leaning towards recommending a jurisdictional based carry-forward approach and have therefore focussed comments upon that approach. Notwithstanding, a jurisdictional approach, is more likely to increase permanent and temporary differences for insurance than taking the global blending approach which GFIA would prefer.

The insurance industry is one that typically has relatively larger temporary differences than most others and these can arise from a number of sources:

- Although insurance companies and groups aim to make a profit every year, incurring significant losses in some years is an integral part of the insurance cycle due to exposure to underwriting risks such as catastrophes and market movements. This means there is more likelihood of distortive impacts from utilising tax loss and tax attribute carry-forward/back mechanisms
- Each country has different tax rules for insurers and different economic exposures. The tax base of insurers is often aligned to local GAAP or local regulatory requirements rather than to the Group financial statements. Determining the tax base using Group financial statements can result in different valuation bases being applied to investment assets (e.g. based on cost rather than market value) and insurance liabilities (e.g. to incorporate additional prudence into technical provisions so liabilities on a regulatory basis are higher than those included in the Group financial statements). As these are the two significant components of an insurers balance sheet, the taxable result is often not aligned with accounting profits over the short to medium term.
- Some very significant items are included in consolidated accounts, such as value of in-force business, which is often represented on Group balance sheets but not within individual company balance sheets.

As a result, insurers are more likely than other industries to experience large disparities between Group-level accounting and locally calculated tax outcomes, resulting in the likelihood of large temporary/timing differences and/or tax losses arising, with different rules applicable in every jurisdiction.

GFIA therefore has concerns over proposals that could require multiple carry-forwards across every jurisdiction that an insurer operates in. This is likely to create unnecessary administrative cost and a very significant compliance burden. A carry-forward model as being envisaged could also result in worse tax outcomes for insurers due to the relative size of potential losses and timing differences leading to more adjustments being required under Pillar 2. Insurers could also suffer due to comparatively longer time periods for those adjustments to reverse due to the nature of insurance business models, policies and taxation regimes as noted above. Distortions would be particularly severe where carry-forwards were time-limited.

Given these concerns, GFIA reiterates our comments that Pillar 2 proposals including deferred tax accounting would be preferable to including complicated multiple carry-forward mechanisms.

Interaction of Pillar 2 rules

Ordering

There is current uncertainty of the ordering of the income inclusion, under-taxed payments and subject to tax rules. GFIA understands that the fundamental objective of Pillar 2 is to ensure that all profits are subject to a minimum rate of tax. It is therefore inconsistent with the objective of Pillar 2 to subject taxpayers to double taxation through ineffective integration of the rules.

The insurance industry would be particularly susceptible to double taxation should the rules be drafted in an ineffective way due to the cross-border arrangements required to provide efficient and comprehensive insurance coverage. It is easy to see how the interaction of the proposed Pillar 2 rules could give rise to multiple taxation – for example an income inclusion rule (or undertaxed payments rule) could operate on a reinsurance company in Country 1 if that country taxes profits below the Pillar 2 minimum rate, while a second country's subject to tax rules require withholding on reinsurance premiums paid to the Country 1 reinsurance company. Where there is not a clear prioritisation of the rules or some form of credit system, then there would be double taxation.

Similarly, it is important that attention is paid to the interaction with existing controlled foreign company (CFC) rules (and other similar rules) to ensure effective co-ordination with these in order to mitigate the risk of double taxation. GFIA therefore requests that the OECD introduces a multi-lateral instrument that sets out the design framework (including rule ordering) for Pillar 2 rules for implementing countries to follow. This would provide certainty for business and avoid the risk of double taxation by ensuring a consistent approach to rule ordering.

Compliance complexity

In addition to double taxation, an additional pitfall of possible Pillar 2 proposals is the significant compliance burden associated with the operation and interaction of the rules. There will be an inevitable increase in administration required to comply with new requirements and appropriate setting of de minimis levels will be important to ensure that this measure is appropriately targeted at only the largest groups.

The increases in compliance burden should be kept to a minimum to avoid impacting commercial insurance structures negatively. Cross-border insurance is often structured into numerous contracts and transactions, with off-setting premiums and claims. It can be seen with the introduction of recent US tax laws aimed at preventing base erosion, that changes to tax law can lead to commercial arrangements being restructured to reduce the impact of double taxation. This is poor tax policy, leading to less efficient commercial transactions while not addressing any harmful or abusive business practices successfully.

It is important that the rules are implemented in a way that does not require transaction-by-transaction assessment of whether the under-taxed payment or subject to tax rules will operate. This could amount to extreme compliance costs. Even where the ordering of the rules is clear, there could be cases where it would be very difficult to determine whether income is taxed below the minimum rate. This is especially so, where payments between independent parties are concerned. The payor may then be required to ascertain whether the recipient's ETR is above the minimum taxation rate. Given the practical difficulties of that exercise they may be inclined to apply withholding tax just to be on the safe side. This again could lead to double or triple taxation. We, therefore, call for the subject to tax clause to be applicable only between related parties.

To offset at least part of the additional compliance burden, the introduction of the rules should be accompanied with a cut back of existing anti-abuse rules with similar policy objectives.

De Minimis Thresholds

Many long-term insurance products include an element of savings and investment assets. Under some GAAPs all such income is recognised as Revenue although it would not be under IFRS. A revenue threshold for inclusion in the regime of €750 million, could result in insurers in some regimes being brought within scope as a result of local GAAP including policyholder related items within revenue that would not be included within the equivalent IFRS revenue.

It is for this reason that revenues of insurance companies under German GAAP for example tend to be relatively high. (Banks on the other hand do not show customer deposits as revenues.)

Metrics applied to insurance groups should therefore adequately reflect the specific nature of the business and exclude policyholder items.

Carve-outs/Substance

GFIA understands there is ongoing consideration of how the rules could give credit for substance in jurisdictions where location choices are made for economic or business reasons rather than tax. Any substance proposals introduced by the OECD need to ensure that substance criteria work for insurance as well as other industries.

For typical manufacturing and trading businesses, substance can be represented largely by payroll and physical assets as proxies and OECD proposals are focussing on these as well as R&D expenditure.

Importance of capital

For financial services substance is often linked to other measures, and for insurance this is particularly so. The OECD has previously noted this in Part IV of the Discussion Draft on Attribution of Profits to Permanent Establishments¹, which acknowledges that an insurance company must have equity capital (or surplus as it is referred to in the report). Sufficient surplus is the pre-requisite to write insurance business, and how much is adequate is defined by the marketplace, rating agencies and regulators. Critically, an insurer will not get regulatory authorisation if it cannot demonstrate sufficient assurance that funds exist to ensure claims will be paid. Capital is therefore an essential part of substance for insurers.

Use of payroll / physical assets in insurance

The OECD report mentioned above identified functions such as product management and sales and marketing, but also acknowledged that the assumption of insurance risk was the key entrepreneurial risk-taking function for

¹ See OECD, 2010 Report on the Attribution of Profits to Permanent Establishments, Part IV (Insurance), p. 171, para. 16 (July 22, 2010)

insurers. However, business to business insurance and reinsurance is often structured into a small number of high value transactions rather than a large volume of low value transactions. Many of an insurer's functions can be done in-house or outsourced to third parties. While underwriting activity and the taking of other key decisions in assuming insurance risk is made by employees or directors where the revenue is recognised, it is not necessarily done in a location with a large physical presence, therefore, apportionments based around payroll may not necessarily be reflective of the true substance of the organisation. Therefore, an exemption based on deemed return on tangible assets or labour would likely exempt a significantly higher portion of profit for non-financial services than for financial services companies.

Implications for OECD substance proposals

Accumulating the points noted above means that focussing on payroll, R&D and physical assets directly held by an insurer does not represent substance appropriately in the way that it does for other industries. Instead, capital and regulation are of critical importance in identifying the location of substance of insurance business and should be taken into account in order to ensure parity in the application of a Pillar 2 minimum tax across both financial and non-financial services industries.

Dispute prevention and resolution schemes

A multilateral minimum taxation scheme as envisaged by the OECD Pillar 2 programme can only be effective with robust dispute prevention and resolution processes, which require reasonable timelines for settlement so as to provide business with fair treatment.

By themselves, tax administration panels or administrative guidance lists are unlikely to be enough to ensure tax certainty for global businesses working across multiple jurisdictions.

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About GFIA

Through its 41 member associations and 1 observer association, the Global Federation of Insurance Associations (GFIA) represents the interests of insurers and reinsurers in 64 countries. These companies account for around 89% of total insurance premiums worldwide. GFIA is incorporated in Switzerland and its secretariat is based in Brussels.