Position Paper

Insurance Europe position on Pillar Two of the OECD's Programme of Work on the Tax Challenges Arising from the Digitalisation of the Economy

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General comments and summary

The OECD consultation document on Pillar Two provides detailed consideration of several aspects of the Global Anti-Base Erosion (GloBE) proposal but does not discuss a number of other relevant aspects, such as rule co-ordination. This raises significant challenges when attempting to adequately comment on the overall design of the proposal. Nevertheless, given the information available to date, Insurance Europe has the following concerns and views:

1. The use of financial accounts as a starting point for determining the tax base under the GloBE proposal and different mechanisms to address timing differences:
   - Global consolidated financial accounts are likely to be the most appropriate starting point.
   - The deferred tax approach to capturing temporary differences is likely to be the most appropriate approach, however this will require careful application and some adjustments to avoid unfair or adverse outcomes.
2. The level of blending under the GloBE proposal and the extent to which a multinational enterprise (MNE) can combine high-tax and low-tax income from different sources, taking into account the relevant taxes on such income to determine the effective (blended) tax rate:
   - Worldwide blending is the most practical approach to an income inclusion rule, this is particularly the case where global consolidated financial accounts are the starting point.
3. The ordering and interaction of the income inclusion rule with other existing base erosion rules:
   - The GloBE proposal should lead to a mechanism that ensures the fair treatment of MNEs regardless of the accounting standards used and existing local tax provisions with a similar objective. As long as this principle is not compromised, carve-outs should be considered for MNEs subject to an existing approved regime.
   - It will be critical that the ordering and interaction of the income inclusion rule with any under-taxed payment, switch-over or "subject to tax" rules is carefully documented and fully considered.
   - Built-in and effective dispute prevention and resolution schemes must be considered in the GloBE proposal to avoid disputes resulting from divergent analysis between local tax authorities or mismatch between international and domestic rules.

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Insurance Europe will detail these points below. Once the Inclusive Framework has made more policy choices and agreed on more of the technical and design aspects of the GloBE proposal, Insurance Europe will consider these and fine-tune its response accordingly.

1. Use of financial accounts to determine the tax base

Insurance Europe believes that group consolidated financial statements are likely to be the most appropriate starting point for determining the tax base. The minimum acceptable frameworks for the purposes of the GloBE proposal should not only be IFRS and US GAAP, but all national GAAP used by the ultimate parent company for preparing its financial consolidated statements. Insurance Europe does not believe that there is a high risk of accounting framework arbitrage because a) external commercial and regulatory factors are likely to be more significant than any tax drivers and b) accounting frameworks are subject to regular updates and improvements. Over time, accounting frameworks are likely to converge, thereby limiting the expected long-term benefit of any arbitrage.

The income determined from consolidated accounts after agreed adjustments seems to be the appropriate denominator for the effective tax rate fraction. Regarding the numerator in the effective tax rate fraction, we consider that this should include all relevant profit-based taxes and their equivalent, including withholding taxes on income that is included in the tax base. The IAS 12 definition could be used to ensure relevant local taxes and withholding on cross-border interest/dividend payments is correctly included to show the true overall tax burden imposed. The computation of this ratio should lead to a fair treatment of all MNEs, regardless of the accounting standards used and the various types of taxes to which they are liable.

<u>Adjustments</u>

- <u>Dividends and capital gains/losses:</u> To avoid double taxation, many jurisdictions do not tax certain profits or losses that have already been taken into account at a different level or entity. Therefore, dividends and capital gains or losses in connection with affiliated entities that fulfil certain criteria are usually exempted. Because the avoidance of double taxation should be a fundamental principle, Insurance Europe recommends reducing the tax base for these items.
- <u>FX and translation differences:</u> FX and translation differences shown in group accounts do not reflect economic gains or losses on trading activities. They often occur only upon consolidation, rather than reflecting local profits or losses. Therefore, these should be excluded from any calculation.
- <u>Investment tax credits:</u> Additional tax credits available under many tax regimes (in particular, for R&D) should be excluded from the computation of the tax base or of the expenses, as applicable. Where investment credits (including R&D regimes) operate, these are generally predicated on substance and local economic activity.

<u>Deferred tax and temporary differences</u>

One of the possible approaches to addressing temporary differences is to use deferred tax accounting as the basis for identifying the effective tax rate applied. The deferred tax approach is the least bad approach because the other alternatives do not deal well with differences that arise over the longer term. A multi-year blending may not appropriately reflect the creation or reversal of the difference. Carry-forward of excess taxes or attributes will create an overly complex compliance burden. This could also result in blending of permanent and temporary differences, thereby blunting the policy intent.

<u>Insurance is particularly exposed to large long-term timing differences</u>

Insurance groups will often have temporary differences that will have an impact over the long term. Some of these reflect the business model of the insurance industry, while others reflect the long-term nature of insurance contracts.

For example:

- The tax base and accounting base of investments can often differ (ie fair value vs amortised cost) and, due to the significant investments they hold, this could prove to be an important issue for insurers.
- The value in-force (VIF) of acquired life business may be recognised on the group balance sheet, but not individual company balance sheets.

Deferred tax is not a magic bullet

- The operation of deferred tax rules is complex and framework dependent. For example, national GAAP and IFRS have differing requirements and exemptions in this respect.
- Material distortions could arise due to consolidation adjustments. For example, intangibles/VIF could be recognised in group consolidated accounts but not be included in local accounting/tax bases.
- Deferred tax asset recoverability and valuation allowances would distort the use of deferred tax to provide a proxy for a smoothed effective tax rate. Therefore, if the deferred tax option is chosen, this must be adjusted to remove recoverability/valuation allowance issues to ensure a fair comparison.
- There will be additional complexity where there are different types of tax gains/losses (eg the difference between trading and capital gains/losses), which will need to be addressed.

Deferred tax rate change adjustments

Changes to local tax rates may impact the carrying value of deferred tax attributes. As these do not reflect the economic result of the group, tax charges or credits as a result of these revaluations should be excluded from the tax base. This is likely to be a significant issue for insurers due to the relative size of deferred tax balances commonly held on the balance sheet.

2. Blending

A worldwide blending approach is likely to be the most practical way of introducing an income inclusion rule. Entity or jurisdictional approaches would be very difficult. As the OECD shows in the consultation paper, a blending at entity or jurisdictional level would lead to a high level of complexity for both taxpayers and tax administrators.

Should an entity or jurisdictional approach be used, it may create a regime that conflicts with business models and — in some cases — with regulatory rules because it would mean extra compliance costs. Under a jurisdictional blending, MNEs that prepare consolidated accounts per business line would have to prepare consolidated accounts per jurisdiction, which would be an additional administrative effort. To a larger extent than under the global approach, timing and other differences would arise. Similarly, withholding taxes on dividends (and credits or exemptions for dividends received that have been subject to tax at lower levels) may also complicate the calculation of the effective tax rate on a per-country basis.

The resulting differences would be even greater in the insurance industry due to the different ways in which insurance reserves and other insurance-specific features are accounted for by different countries and the upcoming introduction of IFRS 17 will bring new changes in the way in which many insurance groups account for insurance contracts. In addition:

- Global blending will help eliminate issues associated with allocating expenses to various tiers of organisations.
- On materiality grounds, elements of deferred tax are often ignored at group reporting level. However, where an entity or jurisdictional approach is taken, this would need to be resolved. Issues result in significant judgements being required around how deferred tax attributes will reverse, and the consequential impacts on double-tax relief.

3. Carve-outs and the interaction of the income inclusion rule with other existing base erosion rules

Carve-outs

Insurance Europe believes it is essential that the GloBE proposal leads to a mechanism that ensures the fair treatment of MNEs regardless of the accounting standards used and existing local tax provisions with a similar objective. As long as this principle is not compromised, carve-outs should be considered for MNEs subject to an existing approved regime such as European controlled foreign corporation (CFC) rules.

Any entities subject to such an approved regime should be deemed to satisfy the GloBE minimum tax income inclusion if the regime applies broadly to certain income generated by a CFC, resulting in an effective minimum tax already being paid. In addition, in order to avoid double taxation, entities should be subject to only a single minimum tax under the income inclusion rule at the level of the ultimate parent company.

Interaction of the income inclusion rule with other existing base erosion rules

The consultation document does not address the ordering and interaction of the income inclusion rule with any under-taxed payment, switch-over or "subject to tax rules". Without careful consideration and documentation of the accepted approach to dealing with this issue, there is a real risk of double taxation and of differences in interpretation that require extended and expensive resolution procedures, resulting in uncertainty for all parties involved. This would add unnecessary and economically damaging friction to legitimate international business operations. Accordingly, if a company's income is subject to a qualifying minimum tax regime under the income inclusion rule, the other Pillar 2 rules should not apply.

Built-in and effective dispute prevention and resolution schemes

Given the various types of tax regulations that may apply to MNEs worldwide, the interaction between such different rules may result in conflict-of-law issues and litigations. Most MNEs already experience such situations and go through existing dispute settlement schemes such as bilateral MAPs. It is very likely that the GloBE proposal, by designing a global minimum income tax, would increase the risk of legal disputes, due to divergent understandings of the said rules by local tax authorities or a mismatch between international and domestic rules. Therefore, robust dispute prevention and resolution schemes should be considered in the GloBE proposal, as well as reasonable timelines in order to allow settlement within timeframes that would not hinder business.