The New Order of Global Taxation: Next Steps for BEPS[1] 2.0 and its Pillars for insurers

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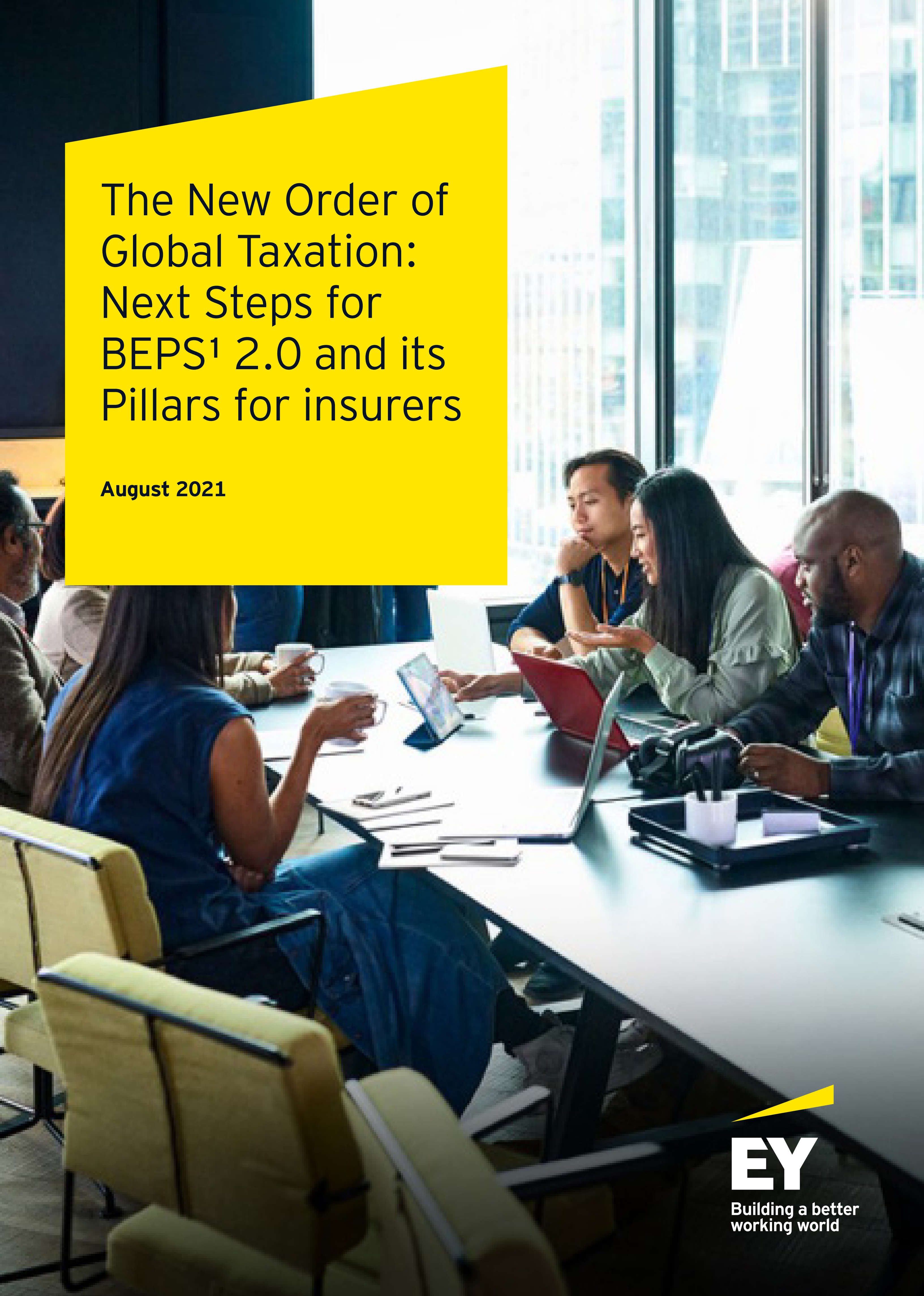

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In early 2019, the OECD[2] invited comments on a public consultation document titled, "Addressing the Tax Challenges of the Digitalisation of the Economy." On closer inspection, it became clear that the ambit of the proposals extended beyond digital matters. The proposals came in the form of two Pillars, the first addressed aspects of the digital economy and particularly the need to reallocate taxing rights over some of the value chains involved in the sale of goods and services to the market jurisdictions, where end-users and consumers reside. This proposal would remove the need for individual or bloc-related digital sales taxes, if widely adopted.

However, the companion proposals in Pillar 2 are not about the digitalization of the economy, but what are termed "residual BEPS concerns." The initial BEPS program already addressed the concerns related to base erosion and profit shifting in the list of 15 Action Items, but many of those measures are yet to be implemented by signatories. They were not given adequate time to take effect as well. Furthermore, Pillar 2 addresses more than base erosion, as it makes provision for a global minimum tax. Some OECD Inclusive Framework members see this minimum tax going beyond remediating the impact of perceived base erosion and profit shifting, to extend to an anti-competition measure. Large, resource-rich and diverse economies complain about the unfair nature of low corporate income-tax rates, asserting that they unlevel the playing field. On the other hand, jurisdictions with small and less diverse economies with fewer resources say otherwise.

The Blueprints of the principles behind the two Pillars of the BEPS 2.0 program have been subject to significant review and revision as the various Working Parties examined the details and consulted with industry, as well as conducting public consultation. The OECD Secretariat aimed to get consensus from all 139 members of the Inclusive Framework in 2021, with a view to provide Model Rules later in the year, as a framework for individual jurisdictions, to implement legislation and bring the Pillar Two into effect. In a meeting in June 2021, the G7 finance ministers announced their broad agreement to the two Pillar proposals. The OECD Inclusive Framework released a Statement in July 2021 indicating that 132 members out of 139 had indicated support.

- So where do things stand now?
- What is likely to happen next?
- What will the impact be on the insurance industry?

[1] Base Erosion and Profit Shifting (BEPS)
[2] Organisation for Economic Co-operation and Development (OECD)

Impact on the insurance industry

Pillar 1, which allocates increased taxing rights to market jurisdictions in relation to certain transactions concluding through digital means, was initially conceived as focusing on business-to-consumer transactions. The US was a more cautious participant in this process, seeing it as focusing excessively on technology businesses headquartered in the US. The Biden administration then proposed a potentially simpler approach – consider the world's largest companies measured by revenue and profitability and reallocate some amount (say 20% to 30%) of their profits, over a margin of 10% to the market jurisdictions using agreed-upon allocation keys.

Financial services business in general and insurance specifically do not ordinarily engage directly with customers across borders. Regulatory constraints and the need for capital to align to the acceptance of risk mean that, in most cases, the appropriate amount of tax is paid in market jurisdictions, either in the form of tax on a subsidiary or branch operation or through compensation to an intermediary in the market jurisdiction. Furthermore, in some jurisdictions, such as Australia, there are specific rules that deem a portion of insurance premiums paid to an offshore insurer or reinsurer to be sourced in Australia and subject to tax in Australia at the corporate rate. A carve-out for financial services was therefore considered in the initial approach. The US does not believe carve-outs are generally appropriate in the revised formulation. There is an expectation that some industries, including extractives and financial services can be properly excluded if policy mismatches or administrative concerns aren't resolved. It appears that certain regulated financial services are likely to be excluded.

However, Pillar 2 presents the more significant challenge technically and there are several grounds of concern. Essentially, Pillar 2 requires a calculation of the effective tax rates experienced in each jurisdiction, at which a multinational enterprise operates. If that rate is below the global minimum rate (currently undetermined, but likely to be at least 15%, then any shortfall has to be collected through one of two mechanisms. The primary mechanism is an Income Inclusion Rule (IIR), similar in broad terms to anti-deferral rules like controlled foreign company rules or the US Global Intangible Low Taxed Income (GILTI) provisions. A parent entity which has implemented the IIR will then collect any shortfall in respect of subsidiary jurisdictions which have an effective tax rate lower than the minimum. However, if the parent jurisdiction does not implement these rules, a secondary mechanism known as the Undertaxed Payment Rule (UTPR) may apply to deny deductions in subsidiary jurisdictions for base erosion payments made to low-taxed jurisdictions in the group, and potentially beyond, as a way of causing incremental tax to be paid. In both cases, no additional tax is paid in the low-tax jurisdiction; that shortfall is imposed as a penalty on other group members.

The first concern here is with the computation of the effective tax rate for a given jurisdiction, since this is the figure against which the global minimum tax rate is compared to determine whether or not corrective action is required. As things stand, that calculation does not take full account of deferred taxation but includes only timing differences in relation to depreciation, amortization and cost recovery; in other words, timing differences related to fixed assets and even then where those differences may reverse in a relatively short time. Insurers, along with businesses in the pharmaceutical and extractive industries, may experience much longer-term timing differences, as exposures arise long after the receipt of the premium paid to cover the related risk. Examples of this, depending on the jurisdiction, may be the treatment of deferred acquisition costs, amounts accepted for tax as policy liabilities versus actual potential claims payments, catastrophe reserves and regulatory pooling requirements. There are similar and related concerns with investments. Without a proper means of taking the deferred tax into account, long-term insurers may experience artificially depressed or elevated effective tax rates under Pillar 2, which could cause incremental tax payments and may never be recovered. An incremental tax payment arising under Pillar 2, as a result of unrealized gains (for which a deferred tax liability is raised), can be a good example, especially where ultimately the gain never crystallizes due to market movements. Alternatively, certain US life insurance businesses require very conservative reserves to be held against some policies, with the excess being held for the term of the policy. Since this is a regulatory requirement only, it is reflected in regulatory returns and not under GAAP.

Where the tax return is based on the regulatory figures a low effective tax rate may arise based on accounting principles. Furthermore, returns on investments could be accelerated in a marked-to-market approach which is normally corrected through deferred tax. Work continues on this matter with the hope to introduce an appropriate mechanism, that reconciles the need for insurers to be treated fairly and equitably with the OECD's concerns around the vagaries of deferred tax accounting and its potential of giving credits where no tax is ultimately paid, together with its subjective nature. A further complication arises in terms of transition and what period of reversals are appropriate, in order to bring an existing position into the new rules.

Secondly, although companies with significant tangible assets and human capital are permitted to carve out an agreed return on those assets, no corresponding relief is afforded to insurers, whose asset base is the financial capital. In a bid to combat the widespread exploitation of intellectual property through certain structures, it seems all intangible assets are considered to be inappropriate drivers of value in the Pillar 2 environment.

Thirdly, the allocation of any tax collection requirement remains undecided, and could at best be difficult to predict and at worst quite arbitrary. This is naturally a concern for regulated insurers who may experience difficulty having surplus reductions be required at the end of a year. This could happen simply because an affiliate has been deemed to experience a lower than appropriate effective tax rate. This can require additional capital, which has further knock-on effects on future flows.

Finally, without a very tight set of model rules, and a clear set of principles for the interaction of rules between jurisdictions, and priorities for the application of these rules, there is a risk of great complication and double taxation. This could be as simple as two different jurisdictions disagreeing on the correct computation of effective rates, with one regarding the third country as low-taxed and the other seeing a rate above the global minimum. Unless there is a strict coordination of rules, mismatches may arise between those jurisdictions which adopt and those which do not. For example, a jurisdiction which does not adopt Pillar 2 fully, but has a domestic anti-base erosion provision could apply that provision irrespective of the operation of an income inclusion or anti-deferral rule by the adopting parent entity. Although we expect the OECD to focus on the need for collective enforcement, either through a multilateral instrument or otherwise, it remains unclear whether such measures would be universally adopted.

What's next for insurers

It is no understatement that there is a lot that needs to happen for the Pillar 1 and Pillar 2 proposals to be seamlessly implemented and to be operated on a consensual basis within the next two to three years. There are several moving parts to how things will progress.

The first of these is whether the US is able to implement domestic law changes so that GILTI can be aligned with Pillar 2. As noted above, the effective tax rates to be applied under Pillar 2 are determined on a jurisdiction-by-jurisdiction basis. Global blending (where the overall rate is for the consolidated group as a whole) was rejected as an alternative during the Pillar 2 discussions, as it was perceived that it allows low-tax jurisdictions to benefit from the excess taxes paid in other locations. GILTI, however, currently operates on a globally blended basis and it would not be compatible with Pillar 2, unless amended. Further, the US SHIELD[3] proposal, which denies deductions for payments to low-taxed affiliates, would need to be incorporated appropriately into a Pillar 2 compliant form. That means it would not apply in circumstances where another country has collected any tax shortfall in respect of the low-taxed affiliate in question. The current US administration does not enjoy a sufficient majority in Congress to make the enactment of these changes a foregone conclusion and the matter is tied up in parts of a significant set of budget proposals, that may encounter resistance at a number of levels.

Next is the matter of where the EU stands in relation to Pillar 1. The EU is likely to agree with the withdrawal of existing digital levies, if Pillar 1 is implemented. However, there is a draft

[3]Stopping Harmful Inversions and Ending Low-Tax Developments

pan-EU digital levy proposal in the event of Pillar 1 being stalled. Similarly, the EU might implement the changes required by Pillar 2, through a Directive. That Directive might be structured to operate on a standalone basis, should Pillar 2 struggle to obtain consensus.

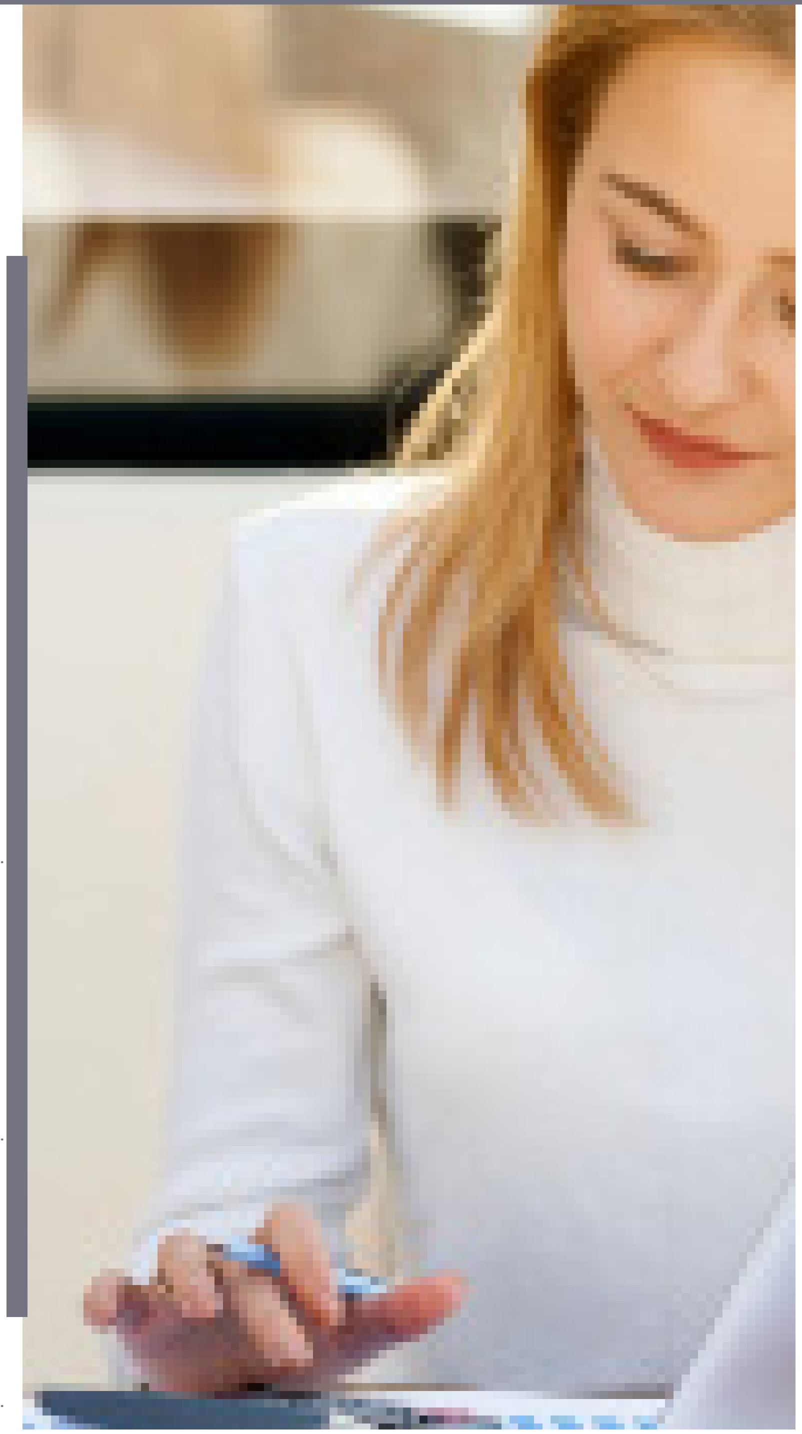
The timeframe for implementation would need to take into account not only the development of suitably tight draft laws and guidance, but also consultation and legislative processes of the Inclusive Framework members. In several jurisdictions, it is not difficult to see that consultation and drafting stages could take at least a year, with the enactment and effective implementation being yet further out. It is also possible that if some design aspects prove unduly complex to agree, such as the proper application of the UTPR secondary collection mechanism, a phased approach could be taken under which a more straightforward Income Inclusion Rule is brought in ahead of the UTPR.

Key actions for insurers

We would expect that if the OECD is able to release public drafts of the proposed rules in the autumn, there is sufficient material together with what is already known, to enable groups to start to model the potential impact of the rules. At this stage, although there are variable aspects to the modeling, it is possible to construct a high-level impact assessment and we would strongly encourage groups to do so. As the rules get refined, the models can be similarly adjusted, and any anomalies that arise can be brought to the attention of the OECD through industry groups, governmental bodies or directly. Although there is a long way ahead before the effective application of rules under the Pillars, the time to start is now, when there is still a runway to consider what sort of action to take to mitigate the impact of the provisions. Groups should stay close to developments over the summer as the proposals go through the G20 and the OECD, and engage where appropriate with legislators and industry bodies.

In summary, groups should consider the following:

1. Begin the process of modeling the impact of the rules to the organization, as currently understood.
2. Based on the initial results, consider the potential impact on the structure or on pricing which may be required together with the associated regulatory and capital implications.
3. Keep management and stakeholders fully informed by establishing a process for reviewing and updating the model, as further details of the rules and guidelines emerge.
4. Consider the potential impact of the rules on projects and initiatives which are already in progress, such as data access and IFRS 17 adoption.
5. Consider potential changes to systems for internal governance and reporting, in order to collect, maintain and track the additional data required to apply the rules, including linkage to existing country-by-country reporting data.



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