Comments on EC proposal for implementation of Pillar 2 tax rules

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Contact person:	Michele Tadi Policy advisor, life insurance & taxation	E-mail:	tadi@insuranceeurope.eu
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Insurance Europe welcomes the opportunity to provide feedback through the "Have your say" tool. As the on-going discussions at Council-level will be key for the implementation of the rules, Insurance Europe wishes to raise some critical concerns and highlight the need for clarifications of some key elements of the European Commission's work on the implementation of the OECD Model Rules, and in particular the proposal for a Directive on ensuring a global minimum level of taxation for multinational groups in the EU.

Due to the considerable compliance effort for companies both at the time of introduction of the new rules and afterwards, further simplifications are necessary: eg regarding "safe-harbour rules".

The industry calls on the EC to clarify the following points, which are of vital importance to Europe's insurers:

- **Interaction of Pillar 2 with certain domestic tax treatment**
  There is uncertainty with regards to proposed rules that would override some domestic tax exemptions, despite the fact that there may be sound reasons for them to be in place. For instance, in the Netherlands, healthcare insurance companies and certain other pension insurance companies are exempt from corporate income tax. These subjects would not be exempt under Pillar 2. Countries may also have specific rules under which income from portfolio investments (eg the US DRD provisions) is exempt, but such rules do not seem to be aligned with Pillar 2 rules in respect of short-term portfolio investments.
  This represents a rather material issue for insurance companies which invest on a large scale.

- **Definition of insurance investment funds**
  The definition of insurance investment funds does not reflect the reality of the insurance business.
  The "wholly-owned" requirement raises the question of whether a fund whose participations are held by different entities within one group may be seen as an insurance investment fund. Furthermore, the requirement that the fund is established "in relation to liabilities under an insurance or annuity contract" should be interpreted as including investments not only for life insurance, but any type of insurance contracts.

- **Treatment of investment funds**
  Another concern relates to the fact that the beneficial domestic tax treatment of investment funds would trigger a top up tax due to the limited scope of the elections provided by Article 40 (7.5 of OECD Model Rules) and 41 (7.6 of OECD Model Rules). Usually, under domestic tax law, investment funds

Insurance Europe aisbl • rue Champ de Mars,23 B-1050 Brussels
Tel: +32 2 894 30 00 • Fax: +32 2 894 30 01
E-mail: info@insuranceeurope.eu
www.insuranceeurope.eu

are exempt from tax to ensure a single layer of tax on income that an investor derives through an investment fund. Such tax exemption is consistent with the GloBE rules (see paragraph 79 of the Pillar 2 blueprint report). Consequently, GloBE rules should not trigger top-up tax on income of an investment fund. However, the envisioned rules do not achieve this goal and could result in an unintended top-up tax.

Both elections essentially aim to attribute the income of an investment fund to the investor where it is then subject to an Effective Tax Rate (ETR) computation. In circumstances where investment income is taxed at the level of the investor the ETR computation would normally produce adequate results. However, in many instances, neither election is available.

First, the tax transparency election under Article 40 has a very narrow scope. According to Article 40, investment funds may be treated as transparent for ETR purposes. The election is available for an investment entity or an insurance investment entity, provided that the constituent-owner is subject to tax in its location under a regime based on the taxation of the annual changes in the fair value of its ownership interests in the entity. In some countries, such as Germany, changes of the fair value of the ownership interest in the investment entities are not taxed. In others, such as France, some investors are taxed on changes of the fair value as required but others are not and are taxed on the historic value of their ownership interests. Therefore, this election is either not applicable in some jurisdictions or only on a few investment entities or insurance investment entities in others.

Therefore, Insurance Europe calls for a widening of the scope for Article 40 so that investors in continental European jurisdictions may avail themselves of the election.

Secondly, the taxable distribution method election according to Article 41 also has a very narrow scope. Under this election the fund's distributions or deemed distributions are included in the ETR calculation of the investor. The scope of the election for the taxable distribution is currently prohibitively restrictive for two reasons:

- The current wording limits the election to an investment entity. insurance investment entities are not within the scope of the provisions.
  The reason why insurance investment entities are excluded from the provisions of Article 41, while being included in those under Article 40, is unclear.
  In order to avoid double taxation, insurance investment entities must be included in the scope of the taxable distribution method election under Article 41.

- Furthermore, the requirement in Article 41(2) whereby the funds (deemed) distributions must be subject to a minimum tax rate of 15% leads to conflicts with domestic tax laws. It seems to presuppose that investment income is only taxed when it is distributed by the fund. However, this is not always the case. In some jurisdictions, the design of a domestic tax system may ensure tax neutrality of a fund by taxing investment income at the level of the fund but exempting such income from tax when it is distributed or deemed to be distributed. According to German investment tax law, for instance, distributions made by a fund are partially tax free to avoid a second layer of taxation on the same income. In a scenario like this, the election cannot be used simply because the 15% minimum tax rate requirement only takes into account the tax on (deemed) distributions. In France, some investment funds allow for a derogatory low tax regime open for the investor in the first years of the investment. Therefore, the requirement should be amended to consider most tax regimes available in Europe.

Also, according to the rules of Article 41(2), tax incurred by the fund cannot be used as covered taxes since, according to Article 41(2), the fund's taxes are excluded from all ETR computations. In other words, whereas the income of the fund (provided it is distributed or deemed to be distributed) is attributed to the investor, the tax incurred by the fund is not, thus separating income and the corresponding tax for ETR purposes. As a consequence, under the rules of Article 41 a top-up tax is likely to be triggered where the investor is resident in a jurisdiction which exempts (deemed) distributions in order to achieve tax neutrality of the fund. Again, similar to the industry's conclusion regarding Article 41(1), the provisions in Article 41(2) should be amended or interpreted so that tax incurred by the fund may be included in the adjusted covered taxes amount of the investor.

Finally, the period until the income of the fund has to be distributed should not be strictly limited to three years, as it may run counter to tax policies of jurisdictions with regard to undistributed income. For example, Germany leaves certain items of undistributed income by investment funds untaxed for a 15-year period.

- **Deferred taxes**

Insurers take the view that a fundamental policy concept of Pillar Two is to look at ETR over a period of time to neutralize the consequences stemming from the application of the annual accounting concept. The requirement that deferred tax balances be recast at the minimum rate undermines the ability of the rules to achieve the policy objective of smoothing the ETR noted immediately above and does not appear to be justified. Recasting deferred tax amounts at the minimum rate does not provide recognition of the actual rate of tax that will be borne in respect of the relevant underlying timing difference when looking at the annual ETR and will result in a top-up tax both in respect of timing and permanent differences. This will arise notwithstanding that the true ETR borne by the Multi National Entity (MNE) over time is higher than the minimum rate. For example, the top-up tax will arise in circumstances where there are loss carry-back rules under local legislation or where tax losses are being utilised and there is a permanent difference, regardless of the materiality of that permanent difference or its impact on the effective tax rate, and regardless of the level of tax paid by an MNE over time. The outcome of this calculation is double taxation.

Regarding the deferred taxes, the industry also has serious concerns with the level of aggregation. In financial statements, the deferred taxes are computed on an aggregate basis. The gathering of these data would be tremendously burdensome. Therefore, the industry recommends that computing deferred taxes on an aggregate basis is accepted, where such aggregation would not undermine ETR computation rules.

Also, it is important for insurers that contingency reserves (safety reserves) get the same treatment under Article 21 (8) (g) as other insurance reserves and that should be made clear in the Directive. Due to the insurance business model, insurers must make assumptions about the future. Contingency reserves are a legitimate way for insurers to cater for factors that are random or otherwise difficult to assess.

The specific provisions for insurance companies relating to insurance provisions are most welcome, but these do not include the tax treatment of derivatives related to these provisions. In many cases, substantial deferred tax positions exist in relation to these derivatives. The EC should also confirm that these deferred tax positions, based on paragraph 4.4.5(e), are treated the same as insurance reserves and insurance policy deferred acquisition costs. If not, the scope for the special treatment for insurance provisions should be extended to derivatives that relate, are linked to these provisions.
If a 3.2.5 election is made, it should be confirmed that deferred tax related to these excluded gains or losses attributable to fair value or impairment accounting are excluded from the covered taxes.

- **Calculation of ETR**

  With regards to the proposal of calculating the ETR position on a yearly basis without compensation over the years, the general basic assumption in financial and tax accounting is that taxes payable should, at the lifetime of a company, be based on the total profit concept, being the sum of all yearly profits. To meet this basic principle, the introduction of a carry forward or averaging instrument would be appropriate. One could think of a recalculation of the five-years average of the ETR's in a country with the potential of a refund.

  In addition, to alleviate from the burden of having to perform ETR recalculations, the materiality threshold of €1 mln in Article 24 should be raised.

- **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 Article 15 paragraph 11 is also applicable to the insurance sector. Without this alignment the EU Directive would negatively impact insurers efficient access to capital markets.

- **Consolidation Scope**

  According to 1.2.2. (b) of the OECD Model Rules and Article 3 paragraph 3 letter a of the Directive the MNE group definition for Pillar 2 also includes related entities which are excluded from the consolidated financial statements of the ultimate parent entity solely on size, materiality grounds or on the grounds that they are held for sale. Currently, these insignificant entities are often not connected to the reporting infrastructure and the accounting standard used for the entity regularly deviates from International Financial Reporting Standards (IFRS) or another accounting standard used in the preparation of the consolidated financial statements of the ultimate parent entity. For that reason, the data required for the ETR computation is not easily available and a reconciliation of the financial statements under local GAAP for these entities would be necessary.

  The exclusion of insignificant related entities from the consolidated financial statements of the ultimate parent entity follows the materiality principle. Given the policy rationale of Pillar 2 to limit the scope of the global minimum tax to large multinational companies it seems exuberant to include insignificant entities. Due to their small size, a possible minimum tax for these entities would be marginal and disproportionate to the resulting administrative burden.

- **Substance-based income exclusion**

  Article 27 provides for a substance carve-out based on a formula, which aims to reduce the impact of Pillar 2 on MNE groups in a jurisdiction, where they are carrying out real economic activities. In this respect, companies with significant human capital and tangible asset benefit of a carve out on the basis on return on those assets. Workforce and tangible assets are key assets only for certain industries, such as the manufacturing sector. Conversely, for insurers, real economic activities are not only measured on the basis of human capital and tangible assets, but especially on the level of financial capital which can be considered their key asset base. By nature, insurance industry is capital intensive.

Holding and managing sufficient capital for an insurer is key for success and a key indicator of substantive activities within a jurisdiction. Per se, financial capital is a scarce commodity and comes at a cost, hence, moving capital in regulated environment is costly and therefore less likely to be susceptible to BEPS risks.

The carve-out proposed, based only on expenditures for payroll and tangible assets, provides little benefit to the financial services industry which will favour one set of industries over another. Therefore Insurance Europe calls on the EC to include in the formulaic carve out a fixed return on the economic/regulatory capital for the financial services industry which will ensure more neutrality between different industries.

- **Definition of group and constituent entity**

  Article 2 defines the group and therefore the constituent entities for the purposes of the GloBE rules as the "entities which are related through ownership or control as defined by the acceptable accounting framework for the preparation of consolidated financial statements by the ultimate parent entity, including any entity that may have been excluded from the consolidated financial statements of the ultimate parent entity solely based on its small size, materiality grounds or on the grounds that it is held for sale". Including the immaterial entities would mean huge operational and manual effort for an MNE group for low-risk entities without adequate value added for the tax administrations.

  Insurance Europe suggests adopting a more risk-based approach by excluding immaterial entities in the GloBE scope which may result in a significant reduction of compliance costs for the MNE group, while continuing to ensure the effectiveness of the GloBE rules.

- **GloBE Safe Harbours**

  The OECD model rule (and Article 30a of the compromise text) provides for the possibility of safe harbours to limit compliance and administration burden for jurisdiction of an MNE's group that are likely to be taxable at or above 15% on a jurisdictional basis. The final design of any safe harbours will be reflected in the implementation framework to be released early this year.

  Insurers welcome the development of elective simplification measures and safe-harbours and it is of extreme importance to develop such simplification measures and for these to be applied already during the transitory years to avoid unnecessary administrative cost and compliance burden for jurisdictions with ETR above 15%.

- **Review of the directive**

  Given the various open questions from the insurers' perspective member states should be able to revise the rules. To this end, the Directive should be time-limited, for instance through a sunset clause whereby all or a set of provisions in the Directive cease to have effect after a certain period (eg two years). This would allow a fine-tuning and further simplification adjustments of the Pillar 2 rules.

The insurance industry would like to highlight that there are several other aspects of the proposed rules that remain to be clarified, for instance the implications for the recognition of pre-regime losses or the treatment of joint ventures under the new rules and they should be properly addressed either via implementation guidelines or via clarification of the proposal for a Directive.

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