OECD Pillar Two – Consultation on Implementation

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UK Finance is the collective voice for the banking and finance industry. Representing over 300 firms across the sector, we act to enhance competitiveness, support customers and facilitate innovation. Our members include businesses that are large and small, national and multinational, corporate and mutual, retail and wholesale.

1. Introduction

We recognise that the OECD Pillar Two rules have been developed and agreed by delegates from all Inclusive Framework member jurisdictions to ensure large multinational enterprises ('MNEs') pay a minimum level of tax on the income arising in the jurisdictions in which they operate. We support coordinated international action to address perceived tax challenges, and provide the following technical analysis to facilitate the proportionate implementation of the rules, in a manner which will simplify the compliance burden of this new regime.

We welcome the opportunity to respond to the HM Treasury ('HMT') and HM Revenue and Customs ('HMRC') 'OECD Pillar Two – Consultation on Implementation' ('the Consultation'). We are also grateful for the sessions that have been run by HMT and HMRC with business stakeholders and the individual sessions held with us and with some of our members.

Given the amount of detail that has, until recently, been outstanding and that the implementation framework is still under consultation at the Inclusive Framework, our comments are only preliminary observations. We therefore welcome ongoing engagement with HMT/HMRC.

As HMT will be aware, Pillar Two effectively introduces a new tax applying to every jurisdiction in which MNE's operate. The rules are extremely complex, taking into account the significant number of adjustments required to reach both the amount of GloBE income or loss and the covered tax amount and country by country elections. This will require the extraction and processing of data that is not currently available in a group's financial architecture. Therefore, it is expected that implementation of end-to-end processes to comply with the rules will be a complex, costly, and lengthy exercise for large banking multinationals. It will require firms to develop new compliance processes and build and maintain new systems, requiring input from multiple teams (involving group and local tax and finance teams) and a significant number of data points. HMT should appreciate that it is not expected that these processes will easily align to existing group reporting or tax compliance processes, so early clarity on detailed requirements, simplifications or certainty on implementation timing will be important.

In addition to the uncertainties concerning the final design and the systems impact for taxpayers and HMRC, the competitive position of the UK noted below, raises significant concerns over the UK introducing Pillar Two in advance of its fellow members of the Inclusive Framework. We would urge that the UK closely monitor and mirror delays in the passage of Pillar Two implementation by other Inclusive Framework members, particularly, EU Member States and the US and other major economies. Coordinating the start date will reduce any competitive disadvantage to the UK, improve consistency of UK legislation with the evolving Pillar Two framework, but should also allow the UK to remain a key standard setter in the global implementation. Given Pillar Two fundamentally applies to multinational groups operating in many jurisdictions, compliance with and administration of the rules will be far simpler if countries agree on a consistent start date.

2. Main concerns of UK Finance

UK business competitiveness

We welcome HMT's recognition that Pillar Two will create a significant compliance burden for affected businesses and we welcome measures intended to reduce this compliance burden. In particular, we propose a simplified Country by Country Reporting ("CbCR") safe harbour and a secondary safe harbour where a local jurisdiction operates a Qualifying Domestic Minimum Top Up Tax ("QDMTT"). Both would need to be agreed at the level of the Inclusive Framework to be effective. In combination we consider these measures would have the potential to provide significant simplification or avoid duplication of compliance effort and would allow HMT/HMRC to accommodate some features of the UK tax code within the UK QDMTT.

We would welcome proposals for a UK QDMTT that simplifies the application of the Undertaxed Profits/Payments Rule (UTPR) to UK headquartered groups, subject to ensuring that the UK tax treatment of Investment Entities and securitisation vehicles is respected. We propose that this is applied to all multinationals operating in the UK within the scope of Pillar Two to ensure a level playing field.

Additionally, the QDMTTs should ideally be aligned at the IF level, otherwise, there could be additional complexity in managing variations in local calculations and a potential risk of double taxation if there are differences in basis of calculation between countries.

We note HMT's cautious approach to reforming existing BEPS measures in UK domestic law and the reasons given. However, we consider HMT should be bolder, particularly for MNE's within the scope of Pillar Two In particular HMT should consider whether Diverted Profits Tax ('DPT') and Controlled Foreign Companies ('CFC') rules which could be simplified or removed in entirety where their objectives are wholly, or even partially, met by Pillar Two. This could help to put the UK on the same footing as other jurisdictions in terms of tax competitiveness.

Timing of implementation

The proposed implementation timeline is extremely short and creates a significant implementation risk for MNE groups. Whilst the extended deadline for the filing of the first Pillar Two tax return is welcome, the key deadline for tax reporting purposes will be the

substantive enactment and start date of the Pillar Two rules. By this time, MNE groups will need to be able to accurately forecast and report the impact of Pillar Two in their financial reporting. A deferral of the start date to 1 January 2024 would be extremely welcome.

Additionally, the proposed implementation timeline gives organisations an extremely challenging timeline for making decisions on IT design and expenditure to accommodate Pillar Two compliance and reporting requirements. The outcome of the implementation framework consultation, which at this stage is unknown, may significantly change the scope of the final system requirements. The time between finalising the implementation framework and the rules going live as they are proposed now is simply too short.

If a deferred start date of 1 January 2024 is possible it is important that this is co-ordinated at an OECD level, so no jurisdiction is permitted to adopt Pillar Two prior to that date. We think this ought to be feasible and in particular we note the recent draft Directive in the EU proposes a "deferral" of the IIR until periods starting on or after 31 December 2023 with other jurisdictions also contemplating a similar timeframe. For many banking groups operating within the UK and Europe different timescales for EU and UK would cause significant additional complexity on what are already complex rules with no overall policy benefit. From the perspective of cost to banks operating in the UK (who nearly always would have significant EU operations) we would strongly recommend that if the EU defers then the UK should do so too on the same timeline. A similar point arises in relation to the US, where the policy response to Pillar Two is at present highly uncertain.

Transition

We recommend that the GloBE rules should commence for UK purposes for accounting periods (APs) beginning on or after the agreed respective commencement date (which we suggest should be 1 January 2024) without any straddling periods.

We understand that HMT is considering where an accounting period straddles the proposed commencement date (1 April 2023) two approaches, either:

1. The affected group should calculate Pillar Two GloBE income and taxes for a deemed period from 1 April to (say) 31 December 2023 (including commencement attributes such as Deferred tax balances as of 1 April); or
2. Calculate the GloBE income and taxes for the period to (say) 31 December 2023 and then apportion the amount of top up tax for the 9 months from 1 April 2023.

In our view, the additional compliance burden of both proposals is disproportionate to the benefit to be obtained therefrom. We do not perceive any significant policy advantage to the UK for MNE groups to be within the Pillar two rules slightly earlier or later in 2023, relative to the challenges of split period reporting. We also understand that it could still be an option for the new regime to apply to accounting periods beginning on or after 1 April 2023 and this would certainly represent an improvement and represent a cleaner result. However, the simplest, and our preferred, approach would be to legislate UK rules to commence for accounting periods beginning on or after 1 January 2024, which would better address our concern.

US interaction

We appreciate HMT's focus on the US developments as they relate to Pillar Two. Noting that US engagement was an important factor in securing international political agreement to the

principles of Pillar Two, it is unclear how other jurisdictions, including the UK, intend to proceed in the absence of alignment of, for instance, the US GILTI and BEAT regimes with the Pillar Two framework. We would welcome HMT & HMRC's clarification, in due course, of how taxes paid under GILTI and BEAT will be treated and interact with the Pillar Two rules.

Simplification and Qualifying Domestic Minimum Tax

We propose two primary simplification measures:

1. **QDMTT Safe Harbour:** This would apply to jurisdictions applying a qualifying domestic top up tax (which is certified as qualifying by the OECD). In that case no GloBE calculation would be required for that jurisdiction as part of the Ultimate Parent Entity ("UPE") calculation (i.e., following UPEGAAP or UPE implementation of GloBE rules) and the calculation of top up tax (if any) would be performed under the local jurisdiction's implementation of the GloBE rules. This might allow individual jurisdictions, including the UK, to cater for specific aspects of local law whilst ensuring that the DMTT is qualifying This would need to be agreed at the level of the IF – we think it is consistent with the policy intention of the Pillar Two but some inconsistences (e.g., differences between UPE and local GAAP) would need to be accepted. We note in particular Para 20 of the guidance on Art 5.2.3 which suggests that both UPE GAAP and local GAAP calculations would be still be required under the application of a QDMTT. We strongly suggest that the UK resists this at the level of the IF and proposes a QDMTT safe harbour as set out above. We believe developing this approach would be capable of delivering real reduction in administrative complexity, with little risk of material tax loss. Such an approach would also encourage jurisdictions to apply a QDMTT rather than additional covered taxes.

2. **CbCR safe harbour**. We are awaiting detail from the Inclusive Framework as to how an CbCR safe harbour would work, but current consensus is that a safe harbour based on a CbCR-derived ETR with a small number of adjustments to the CbCR reported profit or loss before tax and taxes accrued would be preferred over a simple annual ETR derived straight from CbCR data. Our main concern with a CbCR safe harbour is that adjustments under local law that would artificially reduce the CbCR ETR so that a company would not benefit from the safe harbour even if those adjustments are permitted within the GloBE rules (e.g., a large exempt gain, use of tax losses). Therefore, we suggest a few approaches are worth exploring:

   - One approach would be to adjust CbCR data for: (1) deferred tax (at actual rates, not revalued to 15%); (2) impairments of investment in subs (which would be excluded equity gain or loss); (3) investments in associates. This has the attraction of allowing ETR smoothing that is permitted within the GLoBE rules but without the high complex requirement to keep an additional set of GloBE deferred tax books.

   - Alternatively, an elective regime could be introduced to import a limited range of GloBE adjustments as part of a CbCR simplification). There is some overlap with the first suggestion, but the difference is that, as an elective regime, any added complexity would be at the option of the MNE.

   - A third option is for taxpayers to use a rolling [5 year] average ETR from CbCR data to test whether the safe harbour is met. This would provide for smoothing of volatility in local tax charges and also account for timing and permanent differences between tax and accounting.

> We would be keen to continue a discussion on simplification once the policy parameters are articulated by the OECD. It is premature to recommend what an appropriate CbCR-derived safe harbour ETR should be, but the consensus is that a small number of adjustments would be preferred if this meant keeping the rate as close to 15% as possible.

Overall, we think both measures, i.e., overlying a CbCR safe harbour with a QDMTT safe harbour, can provide genuine simplification for both the taxpayers and HMRC with no or limited compromise to the policy objectives of Pillar Two.

Branches

In general, we agree that the group's consolidated financial statements should be the starting point for the calculation.

We note that there can be significant complexity with branches which particularly impacts multinational banking groups. The recently released OECD Commentary states (para 190) that separate accounts will need to be prepared (where they do not already exist) and then adjusted for tax purposes according to treaty principles. The separate accounts would need to be prepared under parent GAAP.

Practically most branches have UPE-GAAP management accounts which are adjusted for UK GAAP/IFRS differences and then adjusted for tax purposes to reflect the arm's length standard.

Under the rules it is not completely clear how branches will be dealt with where domestic adjustments may not be reflected in the taxation of the Head Office. An example would be the UK CATA adjustment for inbound UK banking branches as more than one approach to the attribution of capital is authorised by the OECD and there is no global consistency.

Assuming the branches in question, fall within paragraph (a) of the definition of Permanent Establishment in Article 10.1, Article 3.4.2 (a) provides for adjustment of each branches' Financial Accounting Net Income or Loss to reflect the income and expense attributable to the relevant branches "in accordance with the applicable Tax Treaty or domestic law" of the jurisdiction of the relevant branch. Para 3.4.4 provides that each branch's Net Income or Loss is not taken into account in the Main Entity (Head Office)'s GloBE income or Loss (unless Para 3.4.5 applies - worldwide taxation at Head Office and branch with loss). A possible view therefore is that under the approach to allocating income or losses between a Head Office and its branches is that the attribution of capital for local tax purposes for each branch should be followed in determining GloBE income of each branch and the Head Office's should be allocated the entity's capital less the total of any capital allocated to its branches under each of their local tax capital attribution rules.

We would welcome further clarification on how branches' s GloBE income should be calculated to ensure no double taxation or double non-taxation under the application of both the Pillar Two and UK tax rules. We will continue to consult with members on any further practical difficulties they face in complying with the GloBE rules on branches. However, given the significance of branches within most MNE banking groups, we would welcome further discussion with HMRC and, in due course, specific examples in UK guidance will be critical for both UK in bound and out bound banks.

Securitisation vehicles

Securitisation vehicles are not explicitly dealt with in the model rules or addressed in the commentaries. Securitisations are a type of structure where investors gain access to pooled assets on a tranched basis. Typically, this is achieved by a special purpose vehicle acquiring the assets which are ultimately financed by issuing tranched debt securities to investors. The vehicles are sometimes consolidated with MNE groups due to control, but the vehicles are typically orphaned, meaning that MNE groups will not own any equity interests in the vehicles. The vehicles are typically structured so that, on a cash basis, the vehicles pay out what they receive in over their life. However, their accounting profits and losses on an annual basis can be more volatile, with the key drivers being fair value accounting and foreign exchange. The vehicles are very sensitive to tax exposure and various countries, including the UK[1], have regimes which allow the vehicles to be taxed on a cash basis. The UK regime recognises 5 types of securitisation vehicle: note issuing company, asset holding company, intermediate borrowing company, warehouse company and commercial paper holding company. Ireland and Luxembourg also have regimes for securitisation vehicles.

We consider there is a strong policy rationale for these vehicles to maintain their tax neutrality and it would be useful if the implementation work could consider how this could be clarified, within the framework of the model rules.

We would note the following areas of uncertainty in connection with securitisation SPVs:

- Securitisation SPVs are often consolidated in the accounts of the sponsoring group. This is because the sponsoring group controls the SPV, rather than holding any Ownership Interests. Ownership Interests (as defined under the GloBE rules) would typically be held by a charitable trust.
- Because SPVs are often taxed on a "cash basis" it is possible that deriving an ETR based on accounting profits (which can show some volatility) may give rise to top up tax. We don't think that taking account of deferred tax will always be a solution, either because some difference may be permanent differences or the five-year recapture rules could be in point.

It might be expected that SPVs will often be "minority owned constituent entities" (MOCE) and clarification regarding the application of Pillar Two to minority owned constituent entities would be welcomed. For example, it is not entirely clear how the allocable share rules work for MOCE (e.g., "ownership interests" are referenced within these rules, and for securitisation vehicles the ownership interest will usually be 0%). That could mean that SPVs cannot be MOCE's as defined. If top up tax is imposed, the election that is available to tax fair value gains and losses on a realisation basis could help to mitigate the impact for securitisation vehicles, if this election could be made separately from the MNE's main calculation, i.e., the election could be made for the MOCE calculation only. Given a separate calculation is required, this would appear to provide a sensible result.

If Top up tax arises in respect of a SPV, it is not clear that the mechanism for allocating that tax under the IIR (Article 2.2) works as intended. The allocation mechanism seems to be intended to ensure that where Ownership Interests (broadly equity interests) are not held by the consolidating group, that top up tax isn't allocated to the group. However, because SPVs are consolidated by virtue of control and not by virtue of the consolidating group having

[1] The Taxation of Securitisation Companies Regulations 2006 (SI 2006/3296)

Ownership Interests as defined, there would seem to be no provision to reduce the allocation of top up tax to the consolidating group (ideally to nil).

There would be various ways to address this within the GLoBE rules (or their UK implementation). This includes an exemption for SPVs, simplified deferred tax calculations, or non-allocation of top up tax where there is no ownership interest. We recommend that HMRC's securitisation working group are tasked with considering the implication in more detail and helping to identify suitable policy responses. We would be pleased to work with HMRC on possible solutions.

Excluded Dividends

We note the policy rationale for adjusting GloBE income or loss for Excluded Dividends but would note that many Banks will find it difficult to track the holding period of all portfolio shareholdings to be able to determine whether they are categorised as Short-Term Portfolio Holdings. The Commentary does not comment on how a taxpayer would calculate their holding period. Bearing in mind the various types of acquisitions that they might undertake on any given day and the typically high volume of buys and sells any securities dealer would enter into across all of their accounts and business activities, it would be helpful to clarify, or allow taxpayers to choose, a methodology for this – whether based on accounting treatment or other operational methods to minimise compliance costs.

As a simplification/compliance matter, we believe that it would be appropriate to allow banks the option to treat dividends from equities which are held as part of a bank's trading activities as Short-term Portfolio Shareholdings (i.e. not Excluded Dividends) and similarly gains and losses arising from such equities should not be considered Portfolio Shareholdings (i.e. not Excluded Equity Gains or Loss). In the UK, such positions will be subject to tax at the normal corporate tax rate, plus bank surcharge, as trading income and accounts are typically prepared on a mark to market basis. This will minimize the compliance steps for both taxpayers and HMRC to deliver the intended policy.

The OECD Commentary (page 50) notes the definition of Excluded Dividends was not intended to exclude dividends derived by a Constituent Entity as part of its trading activity. We wish to flag that banks may hold trading positions for a year or more and, in exceptional circumstances, can hold an ownership interest of 10% or more in a trading asset.

Joint and Several Liability

Members have a preference for not making UK constituent entities joint and severally liable for any UK (GLoBE) debts and they remain the liability of the UK entity they are charged to, consistent with the corporation and surcharge tax position. Without this, UK banks subject to ring fencing will need to assess, monitor (and potentially mitigate) any cross- ring-fence exposure created and report it to PRA ("RFB 005 – Joint and several liability arising from taxes") thus increasing the already considerable compliance burden.

In conclusion, we welcome the UK taking a leading role amongst OECD members in relation to the Pillar Two initiative. However, we urge for due consideration in relation to aligning the timing of implementation with other major economies, including the EU and the rest of the Inclusive Framework to preserve the UK's competitiveness. As HMT is aware, the banking sector is one of the highest, if not the highest taxed sector in the UK. Whilst Pillar Two may raise further UK tax revenue from banks, it will impose a massively complex and arguably disproportionate compliance burden with significant additional time and cost required by MNEs

affected. Any clarification or simplifications as to its application to banking groups therefore will be welcome.

If you have any questions relating to this response, please contact Sarah Wulff-Cochrane (sarah.wulff-cochrane@ukfinance.org.uk).

Sarah Wulff-Cochrane
Principal, Taxation Policy