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OECD Centre for Tax Policy and Administration
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OECD Public Consultation - Tax Challenges Arising from Digitisation – Report on Pillar Two Blueprint

Dear Sir/Madam

We refer to the OECD's Pillar 2 Blueprint dated 12 October 2020 ("the Blueprint"),[1] and your request for submissions in relation to aspects of the Blueprint, detailed in the Public Consultation Document.[2]

We understand that ongoing work is being undertaken in relation to the design of Pillar 2, and therefore would appreciate your consideration of our comments below.

We would be happy to meet with you as part of your consultation process should the need arise.

1. Introduction

The exclusion for financial services detailed in the Pillar 1 Blueprint is welcomed and supported by the IBFed. In relation to Pillar 2, global banks are seeking clear and simple rules that are easy to implement and produce a fair outcome for all multinationals. The proposals outlined in the Pillar 2 Blueprint are complex and therefore we would encourage the rules to be implemented in such a way to minimise any additional compliance burden. Having regard to how global banks arrange their businesses, it is often the case that activities are carried on offshore by branches (in addition to subsidiaries). These offshore operations are highly regulated in each of those locations, which lends to specific issues facing banks. In addition, the treatment of timing differences between accounting and tax, and transitional rules are of importance to our members.

Overall we would favour an approach that limits the extent to which banks must perform computations for each jurisdiction and one that allows a simplified approach where it can be generally demonstrated that income is being included and minimum level of taxes are paid on a global level.

[1] https://www.oecd.org/tax/beps/tax-challenges-arising-from-digitalisation-report-on-pillar-two-blueprint-abb4c3d1-en.htm
[2] http://www.oecd.org/tax/beps/public-consultation-document-reports-on-pillar-one-and-pillar-two-blueprints-october-2020.pdf

Where this can be demonstrated via a simplified approach, it would meet the policy intent behind Pillar 2 while reducing compliance costs for taxpayers and tax authorities.

We welcome the proposals to simplify the Pillar 2 approach and offer comments on them below. We also offer other further suggestions in this response as to ways to achieve simplification.

2. Scope of the GLoBE rules

Internationally operating businesses and their constituent entities will be within scope of the GLoBE rules (broadly consistent with Country by Country report (CbCR) filing). Key to this is the definition of a multinational group and a methodology for identifying the various constituent entities that make-up each multinational group.

Prima facie, the suggested approach to include a global group and its constituent entities within the scope of the rules, appears acceptable.

Multinational banks frequently use permanent establishment bank branches to conduct their offshore operations. We support the recognition of the separate nature of these operations as important for tax purposes. It is also important to note that these branches are also subject to regulation in their ultimate parent entity jurisdiction in addition to licencing and local requirements in their country in which they operate. See our comments below at 3 in relation to branches.

Whilst countries largely adopt a control test for grouping purposes, tax groups can differ. Some countries use financial accounting definitions, others a percentage or complete ownership of the legal entities to form a tax group. A difference between tax law grouping and accounting grouping can result in complexity in applying a consistent rule to multinational banks.

We are broadly supportive of the idea that investment funds are considered as an excluded entity as the fund itself is not exposed to tax, as they are established, to put the investors in the same position as if they had invested in the underlying assets of the fund directly, rather than through an investment fund vehicle. It is therefore appropriate to preserve the tax neutrality policy, by ensuring that fund vehicles are not exposed to the GLoBE rules.

3. Treatment of bank branches

Global banks are required to hold/attribute capital for their offshore branches. Subject to the rules in each county, this may be done at the parent level and potentially in country where the branch is located. This allocation of capital is an important issue for banks, and can impact profits in those jurisdictions. The OECD has considered the basis on which capital is treated as attributed to branches for the purposes of restricting funding costs for tax purposes. Accordingly, when computing the effective tax rate based on profits in those jurisdictions, the attribution of capital for the purposes of accounting and tax should be appropriately factored in for banks with offshore branches. That is, there is a cost of funding disallowed from attributing capital to a branch for tax purposes that may not always be reflected in a branch's income and profits. It should be noted that capital attribution is not consistent worldwide, which is especially relevant when seeking to attribute taxes incurred at the Head Office to branches.

We note that MNEs with branches may be subject to either a worldwide or a territorial basis of taxation and that there may be exemptions, credits or other methods that provide for relief from double taxation. We note that some countries exempt or credit foreign branch income in their domestic law, and others through their treaty network. The coordination of mechanisms for how branch profits are to be allocated, and for relieving any double tax is important given the different tax systems in each jurisdiction. Implementing changes through only tax treaties will not serve to resolve all issues of tax allocation, and amending treaties themselves can be problematic.

Due to the complex nature of bank branch calculations, exemptions, allocations etc., we would advocate for a simplification measure that considers particularly where the head office jurisdiction adopts a worldwide system of taxing branches. Such a worldwide system acts as a suitable income inclusion rule (IIR), thereby precluding the need to attribute profits and taxes to branches. Conditions may be required to permit such a simplification e.g. that the income is subject to the minimum rate of tax at a worldwide level, but we believe that this may provide for considerable simplification while respecting the policy objective of Pillar 2.

The hybrid mismatch rules under BEPS action 2 introduced a branch rule where differences in income and expense arise between branches and their head office would be addressed and negated, but only where the taxpayer obtained a benefit. Further the hybrid mismatch rules can apply to timing differences, which introduces further complexity for measures to address tax charges introduced by Pillar 2 as a result of timing differences. We would advocate that the hybrid mismatch rules be disabled via the application of the Pillar 2 proposals to result in a simplified application across all countries.

4. Regulatory capital instruments

Prudential regulators require banks to hold minimum levels of capital corresponding to their risk weighted assets. In addition to common equity such as share capital, banks issue loss absorbing capital in the form of Additional Tier 1 (AT1) and Tier 2 instruments. The treatment of regulatory capital (and in particular, AT1 capital) may have differing tax and IFRS accounting treatments. AT1 instruments can be in the form of preference shares or the form of debt securities (typically convertible contingent securities). Regulatory requirements vary between jurisdictions. Under IFRS AT1 instruments are typically equity accounted by the issuer, but treated as income in the P&L of the payee.

As the GloBE rules are currently framed, AT1 instruments in the form of debt appear to fall outside the special rules for dividend treatment and therefore, without a special rule, the GloBE treatment would follow the accounts, meaning that the coupon payment would not reduce GloBE income of the payer (because it is equity accounted), but the coupon would be treated as GloBE income of the payee (because it is part of the income statement income). This distortion could be further exacerbated if the instruments pass through a chain of legal entities in different jurisdictions within an MNE group e.g. if AT1 instruments are routed via the legal entity structure and therefore pass through more than one jurisdiction before reaching the ultimate destination – in each jurisdiction this would result in accounting income, with no corresponding accounting expense. From a tax perspective, many jurisdictions permit tax deductions for AT1 or hybrid capital instruments which results in symmetrical treatment (deductible/taxable). Rather than applying the special rule for dividends to AT1 in the form of debt securities, the preference would be to allow deductible AT1 coupons to be treated as <u>reducing</u> GloBE income of the payer and to remain part of the GloBE income of the recipient (applying the dividend treatment to deductible AT1 would be less appropriate as it would result in the tax effect of the instrument being allocated to the "wrong" jurisdiction – i.e. it would exclude income that is normally taxed, and not take into account an expense that is normally deductible).

This treatment also is of particular relevance for the head office jurisdiction as many FS groups have a single point of entry resolution strategy, meaning that all regulatory capital instruments of such FS groups will be issued by the ultimate parent entity before being down-streamed to local subsidiaries. This makes the group more resolvable in the case of stress, and the strategy is agreed with regulators. Where such a strategy applies, if the GloBE rules do not recognise the deductible nature of the AT1 instruments issued by the top holding company (ultimate parent entity), the ETR in the UPE jurisdiction could be materially impacted. As the IIR is not proposed to be applied to the UPE jurisdictions own position, this results in a risk that the UPE jurisdiction could inadvertently trigger the highly complex UTPR regime, despite being a relatively high taxed jurisdiction (for example, this situation could arise if, in a particular year, the MNE makes an accounting profit that is no larger than its AT1 deduction in the UPE jurisdiction). A GloBE rule specifically recognising the deductibility of AT1 debt securities would address this risk.

Where AT1s are in the form of preference shares it would be more appropriate that the proposed treatment for "dividends" applies as such instruments are typically taxed as dividends (non-deductible/non-taxable).

5. Cross jurisdictional taxes and anti-avoidance rules

Many countries in which banks operate have CFC regimes in place. These are for the most part effective and well understood in bringing to taxation offshore operations that are not comparably taxed, to a minimum level of parent country taxation. Typically, passive income is taxed under CFC rules, and these rules recognise the particular nature of financial institutions transactions. With the introduction of the GloBE, the fair allocation of these taxes across jurisdictions will be important, particularly where existing CFC rules are taxing offshore operations at a higher rate than the minimum rate under GloBE.

Following on from the BEPS Actions, countries have enacted specific anti-avoidance regimes such as those dealing with hybrid instruments and entities, reporting and transparency requirements, multinational profit shifting activities and also more broadly general anti-avoidance rules. This could result in a conflict between how the country rules and the new Pillar 2 proposals will interact. Pillar 2 is the ultimate BEPS measure, looking only to effective tax rate and not to the nature of transactions. Clarity is required in the ordering and application of these overlapping rules. For instance a broader Pillar 2 anti-avoidance rule could be drafted to replace existing unilateral measures adopted by some countries. In any event the interaction of Pillar 2 and other BEPS measures needs clarifying to ensure that taxes incurred are appropriately matched to income. For instance for Pillar 2 to work effectively, BEPS measures based on the statutory tax rate applicable to the recipient rather than their effective tax rate should be considered as UTPRs and subsidiary to IIRs.

Existing CFC and anti-avoidance measures in each country can be administratively complex to monitor and comply with therefore we would favour a consistent anti avoidance approach to supplement the GloBE proposal.

6. Temporary differences

Banks have significant deferred tax balances which will be unrecognised under the current proposals. Our preferred option is to utilise deferred accounting principles as these are well understood. Banks preparing financial statements under IFRS and other commonly used GAAP already apply deferred tax accounting as part of their financial reporting process. Therefore, using deferred tax accounting is the preferred method for addressing temporary differences. Deferred tax assets and liabilities attributable to temporary differences are computed on an entity-by-taxpaying entity basis. Therefore, large multinationals that prepare financial statements pursuant to IFRS and other commonly used financial accounting standards are already computing financial income and tax expense on an entity-by-entity basis for deferred tax accounting purposes.

While deferred tax accounting would represent a simpler method, any deferred tax balance approach would need to accommodate unrecognised deferred tax balances (e.g. tax losses that do not meet asset recognition criteria) to avoid unintended outcomes.

Given that the Pillar 2 Blueprint does not use deferred accounting balances to manage temporary differences, we note there will be a potential misalignment of how banks account for deferred assets and income tax expense and how the ETR calculation (together with a loss carry forward mechanism) operates. In this regard this results in banks having to manage multiple calculations for their loss positions, which is not a desired outcome.

7. Transitional rules – losses and timing items

We support the comments in the Blueprint which highlight the need for transitional rules to accommodate MNEs that become subject to the GloBE rules for the first time, to take into account both pre-regime losses and timing differences. We also support the need for simplicity (rather than an approach that would require detailed GloBE calculations to be performed for a number of previous years).

It is important that banks obtain recognition for current tax losses when transitioning into Pillar 2. Many global banks, and no doubt multinationals in a variety of industries, have experienced losses in some countries where they operate, therefore those losses should be acknowledged and factored into transitional rules. In the banking industry, substantial losses were sustained as a result of the financial crisis of 2007-2008, and more recently as a result of the Covid-19 pandemic. The quantum of the losses generated from the financial crisis are such that they are still being utilised today.

In the banking industry, the manner in which expected credit losses are accounted for under IFRS9 also has a significant impact, creating substantial volatility in accounting profits. Depending on the tax rules in each jurisdiction, the accounting treatment may either be followed for tax purposes (creating the possibility of significant pre-GloBE losses, particularly in light of the Covid-19 pandemic) or a deduction for expected credit losses may be denied until a later stage of impairment or write-off, leading to substantial book-tax timing differences.

Paragraph 300 of the blueprint explains that the approach to carry-forward losses (once within the regime) has been crafted so that it is effectively unlimited in duration. This approach is appropriate, the Blueprint explains, as it gives appropriate recognition to business cycles of different lengths. We strongly support applying a similar principle when setting the transitional rules and we therefore support an indefinite look back period for carry forward losses at the time of transitioning into the GloBE rules. To ensure the rule is as simple as possible to calculate and administer, we would support an approach where the opening carry forward loss balance is taken from the most recent tax return position – and therefore the calculation of the opening carry forward loss position for each jurisdiction would be calculated under each jurisdiction's rules. A transitional approach that adopts the carry forward losses under local tax rules is appropriate, as these losses are available from the first GloBE year to reduce the covered taxes paid. If losses available for tax return purposes are not given appropriate recognition due to (for example) a restrictive look back period, this could have a material impact on the GloBE tax liability of multinationals. We also note that a tax return approach to calculating transitional carry forward loss balances is preferable to a deferred tax asset approach due the challenge presented by unrecognised deferred tax assets.

It is equally important that the transitional carry forward balances are recognised. As mentioned, IFRS9 can result in significant timing differences. There is scope for a significant distortion in GloBE ETR if insufficient transitional measures are put in place. In particular, IFRS9 ECL impairments that are booked pre-GloBE, may result either in a post-GloBE tax deduction or an accounting reversal of the ECL impairment without a corresponding amount of taxable income. Both scenarios would reduce ETR for GloBE purposes.

Another pre-GloBE timing difference that is of relevance is decelerated depreciation – i.e. the depreciation of capital assets at a slower rate than the accounting depreciation. We would welcome appropriate recognition be given to decelerated depreciation in any transitional adjustments.

Any approach which adopts deferred tax accounting concepts should also give appropriate recognition to unrecognised deferred tax assets.

8. Excess taxes

We understand that excess taxes in a jurisdiction for a year may create an IIR tax credit, a local tax carry-forward, or both. We support a transitional rule that includes the calculation of a day one excess tax balance or carry forward loss position, depending on the prior profitability of the group. This is important to minimise the risk of application of the Under Taxed Payment Rule (UTPR) in year 1 by taking into account excess taxes paid in prior years.

9. Covered Taxes and the ETR calculation

Covered taxes are understood to mean any tax on an entity's income or profits (including a tax on distributed profits), and includes any taxes imposed in lieu of a generally applicable income tax. Covered taxes also includes taxes on retained earnings and corporate equity. Banks are subject to various regimes of taxation that may fall outside the scope of covered taxes. We note that banks may also incur charges such as financial services taxes, bank levies, liquidity charges etc. which may not be calculated by reference to income or profits. Financial institution taxes (e.g. bank levies) should be included in covered taxes as they are a material impost on banking operations. In many jurisdictions these taxes are levied in place of additional or as a top up of corporate tax and therefore need to be factored into the covered tax base. Similarly, some countries have high VAT rates, which represent a significant tax cost for banks.

We make the following additional observations in the relation to the ETR calculation:

- When determining the ETR for multinationals, regard should be made to which part of the tax is paid by the shareholders/partners/beneficiaries of the parent entity due to its legal structure. Additionally, uncertainty relating to the application of company law exists, in particular regarding the presence of minority shareholders in the subsidiaries.
- When formulating the minimum tax, the minimum tax rate should preferably be calculated using income tax expense (current tax and deferred tax) as a proportion of accounting profits, as opposed to current tax only (which would require significant adjustment).
- We would agree with a safeguard by way of a CbCR report ETR safe harbour to be provided for simplification.
- Insofar as the rate is concerned, we would advocate for the minimum rate under Pillar 2 to be at the lower end of the likely range (ie. closer to 10% than 15%).

10. Interaction with GILTI

We are of the view that multinationals should not be subject to double taxation in the event that GILTI or an equivalent tax are imposed and the GloBE also applies to taxpayers on the same income. Therefore we support an exclusion for income captured by regimes such as GILTI.

11. Associates

The proposed treatment of associates both adds considerable complexity, and also risks disadvantaging MNE investors compared to other investors (which sits at odds with the rationale for the joint ownership rule). Accordingly, we would ask for further consideration to be given to whether it is appropriate for the GloBE tax to be charged on investments in associates, particularly in cases where the associate is itself an MNE entity within the scope of the GLoBE rules in its own right, including the UTPR.

If a rule for associates is to remain, we would recommend that dividend withholding tax on dividends paid by an associate to the MNE group be included in the associate's ETR calculation. The MNE group will know how much withholding tax has been withheld from dividends paid to it, and therefore this information will not be unavailable to the MNE. This is consistent with the general principle that dividend withholding tax should be part of the covered tax of the entity which pays the dividend – however this principle doesn't seem to have been incorporated in the "simplified" IIR that will apply to associates. The withholding tax expense is not booked as a tax expense of the associate, so it should not be included in its income tax expense line.

12. Liquid assets

There are regulatory requirements to hold high-quality liquid assets (HQLA) such as government/sovereign debt and in some jurisdictions the tax-exempt treatment of HQLA is a significant driver of a lower jurisdictional ETR. This could result in top up tax being imposed due to factors banks do not control and due to rules which have been introduced by FS regulators globally in order to preserve the soundness of the global FS system. There is an inherent contradiction (we think) if we have a regulatory framework calling for a course of action designed to improve the safety and soundness of the financial system that global tax authorities will effectively make economically unattractive through the imposition of a minimum tax. In any normal market the return on exempt instruments is typically less than the return on a taxable equivalent by an amount that is broadly the same as the tax benefit.

13. Simplification

In an increasingly complex regulatory and reporting environment, global banks are strongly of the view that simplification measures should be available to the extent possible.

We make the following comments on simplification for Pillar 2:

- We support a white list concept – either as a simplification measure or a stand-alone "feature" – of parent entity countries that are excluded from the UTPR. This is on the basis that ultimate parent entities located in high-tax countries can be excluded from the UTPR without undermining the policy of using the UTPR to discourage inversions. The UTPR would still serve as a backstop to the IIR in low-tax countries.
- In principle, adopting existing CbCR reporting as an ETR safe harbour seems to be a reasonable approach, although we note that adjustments will be necessary to rely on the

CbCR information. To the extent that the adjustments are complex and onerous (such as those proposed in the Blueprint) this would counteract the purpose of simplification and decrease any benefits.

- We reiterate that global blending eliminates the need to do endless ETR calculations and use of deferred items eliminates the need for complex transitional rules and carry forwards, and IIR credits.
- For the simplification measures to be effective, the result of failing a threshold should be addressed. The effective tax rate as measured by Pillar 2 is capable of being significantly distorted by timing items. This is particularly the case for banks, e.g. where the time of recognition for significant items of expense under tax and accounting treatment can differ. When a simplification ceases to apply, to accurately determine the Pillar 2 tax liability, taxpayers will need to establish the historic position to determine any carry forward attributes, which are designed to address timing items. Unless an acceptable alternative is determined, taxpayers will need to accept reconstructing prior years from the beginning or will need to establish and record the relevant information each year. This achieves simplification for neither taxpayers nor tax authorities. We would urge that measures be developed and introduced to ensure that the simplifications continue to apply where a threshold is failed by reason of a timing item and when carry forward attributes are required to be determined that they be established by reference to the deferred tax balance items, both recognised and unrecognised recorded in the accounts.

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Should you have any questions or require additional input please contact us.

Yours sincerely,

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