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OECD Public Consultation - Tax Challenges Arising from the Digitisation of the Economy - Global Anti-Base Erosion Proposal - Pillar 2

Dear Sir/Madam

We refer to the "OECD Secretary General tax report to G20 Finance Ministers and Central Bank Governors" dated July 2020 ("G20 Report").[1]

The comments in this letter are additional to our submission in relation to Pillar 2 dated 2 December 2019, on the OECD's public consultation document "Global Anti-Base Erosion Proposal ("GloBE") (Pillar 2)".

We note that the G20/OECD Inclusive Framework has advanced the development of the policy features and technical elements of both Pillar 1 and Pillar 2. We understand from Annex 3 of the G20 Report that further work is being undertaken in relation to the design of potential measures under Pillar 2, and that a framework of rules is currently being formulated. We therefore would appreciate your consideration of our comments provided below, to assist your further work on Pillar 2.

1. General comments

The Pillar 2 concept appears to be simple and straight forward at first sight. However, the actual mechanics required to complete jurisdictional calculations appear complex and there is a significant amount of detail required. For international banks and tax authorities, it will be very onerous to implement this regime. The administrative procedures an international bank will need to implement, and the related audit and compliance activities required from tax authorities will be very complex, irrespective of whether the bank ends up above or below the threshold. On this basis, we would advocate for application of the minimum tax assessment on a global basis, not on a jurisdictional or entity basis. Specifically, where a global bank can demonstrate that its constituent entities are all subject to regulatory regimes in jurisdictions they operate in, and are required to hold regulatory

[1] http://www.oecd.org/tax/oecd-secretary-general-tax-report-g20-finance-ministers-july-2020.pdf

capital – that this would allow for the operation of a simplified calculation to demonstrate compliance with Pillar 2.

We think that any Pillar 2 rules should take into account of the fact that banks must adhere to a unique regulatory framework that impacts how they operate in comparison to other industries, and therefore due to the complexity of these rules we would welcome the opportunity to meet with you to discuss the framework rules (when open for public consultation).

If Pillar 2 were to apply, due to the current economic conditions and their impact on the wider economy, a number of banks can be expected to reflect accounting and/or tax loss positions, and there is an expectation that the new rules should adequately take into account those losses. A simplification measure should be available where a multinational can demonstrate there is a rule in its head office jurisdiction that subjects global profits to tax in that location at a rate equal to or above the minimum tax rate (i.e. that once the parent has an effective IIR rule, there should be no further imposition of tax).

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 (CbC) report 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.

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. Calculating the top-up tax under the GloBE rules

To determine an MNE's effective tax rate (ETR) under the GloBE rules, the MNE first determines its income for GloBE purposes and the covered taxes on that income. The ETR is the amount of such covered taxes divided by the amount of income as determined under the GloBE rules.

Covered Taxes

Covered taxes is 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. Further guidance is required in relation to those taxes and levies imposed on banks in the context of an ETR calculation, as in many cases, the justification for their introduction was that they were required to make banks make a fair tax contribution. We would advocate for financial services taxes and levies to be included within the scope of covered taxes as they result in a real financial cost of operating in a country and should be considered in lieu of corporate tax.

All covered taxes, wherever and however paid in respect of branch operations should be taken into account in establishing the effective tax rate both for the relevant year and any excesses be fully available to address timing items.

Tax Base by reference to financial accounts

The starting point for determining the GloBE tax base is the profit (or loss) before income tax as determined using the relevant financial accounting standard, which may include items previously included in other comprehensive income. Certain items of income are removed from and certain items of expense are added back to arrive at the GloBE tax base.

We agree in principle with the use of IFRS or the equivalent financial accounting standard (including country GAAP) accepted in the ultimate parent jurisdiction to determine the income base in the calculation.

Permanent Differences

- Whilst there can be complexity in recognition of deferred tax balances, banks may also have significant non-deductible and/or non-taxable permanent differences which are taken into account when calculating the current tax expense. These include:
  - Effect of different tax rates in other countries
  - Expenses not deductible for tax purposes
  - Tax exempt dividend income
  - Non-taxable interest income (for example on government bonds commonly held to satisfy regulatory requirements relating to liquid asset buffers)
  - Other income not subject to tax
  - Items that are capital in nature

Intragroup Dividends

- As a general principle, intra-group dividends paid out of previously taxed profits (retained earnings) should not be included as income again and be subject to potential double taxation.
- We note the differing treatment of taxable and exempt portfolio and non-portfolio dividends globally. Banks should not be placed at a relative disadvantage to other industries in treatment of dividend income.
- In any case, recognition for tax paid in relation to income giving rise portfolio dividends in another country needs to be taken into account if they are to be included within the GloBE tax base.

Consolidation adjustments

Due regard must be made in the rules to cross border intercompany transactions. We expect arm's length intra-group transactions to be appropriately recognised, even where transactions are between a head office and its offshore permanent establishment.

Temporary Differences

Temporary differences can be addressed under the GloBE rules either using a carry-forward approach or a deferred tax accounting approach, however we understand the rules may proceed with a carry-forward approach.

Carry forward tax mechanism

The GloBE loss carry-forward is intended to prevent taxation in excess of economic income and gives recognition of prior period losses. The carry-forward rules may result in a smoothing of the ETR of the jurisdiction over a period of time, however, from a tracking and compliance perspective, carry forward rules will be a more complicated method than using deferred tax accounting. Steps to address timing differences as a result of losses would be welcome but, as noted below, losses are not the only matter giving rise to substantive timing differences for banks. Any such mechanism for losses will need to be carefully developed and extended to other significant timing differences if the policy objective is to be delivered. Further in this regard, we would note the need for transitional rules to address opening timing differences (including losses) at the point of introduction of GloBE rules.

Deferred tax accounting

Deferred tax accounting is the favoured option by Banks. Some of our observations are set out below.

- 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 a taxpaying 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.
- Banks have significant deferred tax balances. Some of the key balances, generating both assets and liabilities relate to:
    - Provisions for impaired loans and expected credit losses
    - Losses from prior years and current year
    - Revaluation, mark to market of certain financial assets and liabilities including derivative contracts
    - Various provisions (such as staff bonuses and leave pay) and provision for pensions and other post-retirement benefits
    - Cash flow hedges not taken to Other Comprehensive Income (OCI)
    - Share-based payment liabilities and other deferred compensation
    - Leasing (including the impact of IFRS 16)
    - Capital and Property allowances

- Global banks are currently experiencing significant impairments arising from inability for customers to meet loan repayment obligations and have provided additional support through deferrals and payment holidays. The full extent of losses is unknown at this juncture. Bad debt provisions will be important for banks reporting their financial results.
- The net effect is that banks will (to a material extent) pay tax on the profits recognised in the accounts of a period in a different accounting period. Thus, for example, a bank which sets up a bad debt reserve in Year 1 will deduct that reserve for financial reporting in that year. However, it will not generally recognise a tax deduction for the write off attributable to that reserves until later years.
- We note that that timing differences will not always unwind within a short period. Time limits on mechanisms to deal with temporary differences should be avoided in favour of open-ended carry forwards/credits.
- As noted for the carry forward mechanism, there will be a need to carefully focus on opening deferred balances to provide transitional rules to ensure that the policy objective is delivered.

Calculating an effective tax rate

The effective tax rate for a jurisdiction is equal to:

Adjusted Covered Taxes / Adjusted GloBE income

Where:

a. Adjusted Covered Taxes means the covered taxes assigned to the jurisdiction, except taxes attributable to income excluded from the GloBE tax base, increased by the lesser of the total local tax carry-forward or the amount of the local tax carry-forward necessary to achieve an ETR that equals to minimum rate; and

b. Adjusted GloBE Income means the combined income and loss of all Constituent Entities located in the jurisdiction for the year decreased by the loss carry-forward for the jurisdiction.

We make the following observations:

- 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 an CbC 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%).
- Some banking groups include other business lines such as insurance, funds management, superannuation etc. We would support an approach that factors in separate taxation rates applying to different business lines of a banking group (in comparison to the headline corporate tax rate).

- As a result of the current economic downturn, due to the COVID 19 pandemic, this has also led to situations where both permanent and timing differences (e.g. foreign exchange movements) have become more pronounced. These could have an impact to either increase or reduce the current or future effective tax rate. A careful consideration of the impact of these issues, including deferred tax liabilities and asset balances at the point of introduction will be required to ensure that the policy objective is appropriately delivered. This may mean that appropriate transitional rules must be formulated to ensure banks are not disadvantaged from the outset. An open-ended look back rule for losses would be preferred.
- Under the jurisdictional blending approach, covered taxes are assigned to the jurisdiction of the Constituent Entity that earned and recorded the related income. It is proposed that one should seek to match covered taxes with the income to which they relate for purposes of the jurisdictional ETR computations. Although we support the idea, assigning taxes in respect to branches, CFCs, and WHT is expected to be complex and burdensome.
- In relation to jurisdictional blending and withholding tax / CFC tax charged at rates in excess of the minimum rate, we understand the OECD is considering an approach that excludes such tax and associated income entirely from the GloBE base and covered taxes. Only if the withholding or CFC tax is below the minimum rate does it get included in covered taxes for the jurisdiction in which the underlying income is generated (and the income left in the GloBE base). This is intended to stop withholding tax and CFC tax from subsidising the covered tax base in a low tax jurisdiction. Whilst the proposal appears simpler, we would advocate for all withholding tax and CFC tax to be allowed to be attributed as covered tax to whatever location the profits which gave rise to it belonged. This is particularly given that high withholding and CFC tax has been suffered, so should be included in the covered tax pot with all other tax suffered by that entity. Alternatively, we request that the definition of passive income exclude income derived by a bank in the ordinary course of its banking business. That approach should be consistent with the policy underlying the rule, which is intended to discourage shifting passive income from high to low tax countries for the purpose of using withholding taxes and top-up taxes to increase overall ETR in the low-tax country.
- There needs to be careful consideration as to the attribution of anti-avoidance taxes incurred by an affiliate within a MNE Group. Where should these be rightfully attributed? For instance, where an affiliate pays tax as a result of hybrid rules or as a result of the operation of the EU blacklist. Anti-avoidance rules may be in part to influence behaviour, however tax is only one factor taken into account in commercial decisions.

4. Mechanics for applying the GloBE

Income inclusion rule (IIR)

The IIR requires a taxpayer that is the parent of the multinational group to pay top-up tax on its proportionate share of the income of any low-tax Constituent Entity in which that taxpayer has a direct or indirect ownership interest.

In principle, we do not disagree with this approach, however would strongly advocate for an exclusion for the group (by way of simplified operation) where the parent country already has a rule in place to ensure tax is paid at the same or similar rate as the parent country in respect to its offshore operations, i.e. that once the parent has an effective IIR rule, there should be no further imposition of tax.

We would also note that split ownership structures may result in the top up tax being recorded in more than one entity which again would be extremely complex and burdensome.

Switch-over rule

The switch-over rule can apply where the multinational parent derives branch income that benefits from a tax exemption under the laws of the parent jurisdiction. The income of that exempt branch should be apportioned between the branch jurisdiction and the parent jurisdiction (together with any tax on that income) in order to accurately calculate the jurisdictional ETR in the parent jurisdiction.

The specific case of branches, widely used by the banking sector, raises questions about the relationship between the switch-over rule and the income inclusion rule, in relation to the effects of the latter. It could thus be explained that the switch-over rule is designed for the sole purpose of removing any conventional obstacles to the application of the inclusion rule, and that it cannot constitute a stand-alone rule. In addition, the right of parent country to tax the profits of the foreign branch should be limited only to the supplement required to reach the minimum tax rate.

Rules around the taxation of branches differ among jurisdictions and legal systems and will be a source of considerable complexity. For example:

- In In numerous EU countries, especially France and Germany, under normal rules based on a territoriality concept, neither branches nor foreign subsidiaries should be taken into account when determining the tax result of a company in an EU-Member State (subject to the application of specific CFC rules).
- In Australia, branches are not considered functionally separate for tax purposes and offshore banks branch profits are generally exempt (where they have been comparably taxed in the foreign location), as are foreign non-portfolio dividends from subsidiaries.
- Switzerland applies a tax exemption method where income and taxes paid by foreign branches are exempt from the tax base in Switzerland. No tax credit system is applicable in Switzerland. In general, Switzerland does not apply any particular treatment of offshore subsidiaries.
- The US poses some difficult questions regarding inclusion of branch income and availability for credits that may reduce the tax liability and ETR. We understand alternative proposals have been considered by industry to address the US position.
- South African resident financial institutions with foreign branches are subject to tax in South Africa and the foreign jurisdiction. Foreign tax credits are however usually claimable in South Africa in relation to foreign taxes paid, limited to the corporate tax rate of South Africa.
- Japanese resident financial institutions with foreign branches are subject to tax in Japan and their foreign jurisdictions. Foreign tax credits are claimable in Japan within the extent of the percentage of foreign taxable income to total taxable income.
- The UK taxes foreign branch profits and provides for foreign tax credit unless an election has been made (and conditions satisfied) for the exemption regime to apply.

Given the complexity and difference in treatment of branches, it would appear to be practical for the charge under the ETR calculation to be applied at the parent level to avoid issues around credits and charges offshore. Additionally, where the parent country has integrity rules built into its exemptions system (for example where the foreign branch is in a comparably taxed jurisdiction), this should reduce the need for further adjustment under a GloBE. To safeguard this rule, a percentage of the parent country tax rate could be used.

Similarly, where the branch income is taxed in the parent jurisdiction equivalent challenges and complexities will arise, such as appropriate attribution of tax. We are also aware of proposals to use a simplified method for taxation of branch income where the parent location taxes the income like its other worldwide income at the parent tax rate. This may avoid considerable complexity regarding both different permanent and timing adjustments and allocation of tax payments and attributes.

Undertaxed payment rule (UTPR)

The UTPR requires a taxpayer that is a member of an MNE Group to make an adjustment in respect of any top-up tax that is allocated to that taxpayer from a low-tax constituent entity of the same group.

The UTPR operates as a back-stop to the IIR (the IIR takes precedence) while also providing jurisdictions with a tool to protect themselves from the effect of base eroding transactions. The rule can operate by way of a limitation on the deduction of intra-group payments or through an equivalent incremental adjustment.

An undertaxed payment rule should be targeted such that other BEPS measures have been taken into account, for example where hybrid mismatch rules are in place in a country.

Additionally, double tax agreements (including to the extent they are updated by multi-lateral instruments) differ between jurisdictions. The new rule should specifically consider the current application of treaty benefits to the financial sector to ensure that it operates in line with the current agreements, which are important to enable efficient access to global funding.

5. Subject to tax rule (STTR)

As noted by the OECD, the subject to tax rule complements the above GloBE rules, but focuses on the bilateral context of tax treaties and the ability of source jurisdictions to protect themselves from the risks posed by BEPS structures which take advantage of low tax outcomes in the other contracting jurisdiction. It applies to payments between connected entities. Typically, this rule targets arrangements that use certain types of deductible intra-group payments as a mechanism to shift profits from source countries to jurisdictions where those payments are subject to no or low rates of nominal taxation.

The subject to tax rule will apply to a defined list of payments that the OECD suggests present a greater risk of base erosion. This list will consist of interest, royalties, and a defined subset of payments for services payments.

Payments within scope are payments that global banks would make intra-group. However, multinational banks do not typically seek to make transfer payments to shift profit to low tax jurisdictions.

We are supportive of the fact that materiality thresholds are proposed and the additional STTR tax will be taken into account in determining the effective tax rate under the GloBE rules.

A key point on STTR may be on the ordering and coordination with IIR/UTPR. We suggest the STTR be applied after application of IIR/STTR so that its application (which will be operationally complex) will be more the exception than commonplace.

It is not entirely clear how tax payable in a 3rd country permanent establishment jurisdiction would be taken into account. It would seem inappropriate for this rule to result in a withholding tax on payments made to 3rd county branches where the recipient entity is tax resident in a jurisdiction with a branch exemption regime but the branch jurisdiction imposes a suitable level of taxation. This is a particular concern for financial services given the prevalence of branches.

6. Implementation and rule co-ordination

Banks should in no way be tasked to administer elements of the proposed GloBE rules as this will apply a significant financial and complex administrative burden. We reiterate that if there is an avenue for banks to be excluded (or subject to simplified application of the rules) under Pillar 2 based on the unique regulatory framework that banks must adhere to, then we would welcome such an approach.

We are supportive of the fact model legislation will be developed setting out the detailed rules for the IIR and UTPR.

There are established transfer pricing concepts, guidance and treaties currently applying to multinational banks to determine intra-group arm's length transfer pricing. We do not expect that the Pillar 2 proposals would invalidate those established transfer pricing concepts.

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

Yours sincerely,

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