CLIENT ALERT

Pillar One: Insurance Industry Responds to OECD Consultation

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Introduction

On 26 May 2022, the OECD published the responses to its consultation on the “regulated financial services exclusion” under “Amount A” of Pillar One. The insurance industry responded to the consultation on a number of aspects, most importantly whether reinsurance should be included within the exclusion. This client alert provides some background to Pillar One and a summary of responses to the consultation.

Background

Since 2015, the OECD has been developing its response to addressing the “tax challenges” of an increasingly “digital economy”. The project developed in scope to include multinational enterprises in most industries. By 2019, the OECD had developed two main proposals; Pillar One and Pillar Two.

Pillar One reallocates taxing rights to the jurisdictions where large multinationals have customers, regardless of whether they have an office or any physical presence there. It is currently proposed to apply to groups with revenue of at least EUR 20 billion (although this is intended to fall to EUR 10 billion, seven years following implementation) and relative profitability as measured against revenue in excess of 10%. It principally targets the profits of U.S.-based digital giants to reallocate them to “user” jurisdictions. The OECD estimates that globally, Pillar One would reallocate taxing rights to USD 125 billion of profits.

Pillar Two would allow jurisdictions to collect taxes in respect of associated companies that have paid tax on profits at a rate below 15%.

The Pillar One Blueprint, published in 2019, included a proposed financial services exclusion which would apply to highly regulated industries including insurance businesses. Groups falling within the exclusion would not be required to reapportion their profits to market jurisdictions and would continue to be taxed in the jurisdictions in which they operate and have a physical presence. The OECD's policy basis for the exclusion is that the "defining character" of the sector is that it is "subject to a unique form of regulation, in the form of capital adequacy requirements, that reflect the risks taken on and … this regulatory driver … helps to align the location of profits with the market".

Consultation

On 6 May 2022, the OECD invited public input on the regulated financial services exclusion from Pillar One. There were a number of aspects relevant to the insurance industry, including certain defined terms and whether reinsurance should be included within the financial services exclusion.

On 26 May 2022, the OECD published the consultation responses. A number of insurance industry bodies responded, including Lloyd's, the ABI, Insurance Europe and the German Insurance Association. The main responses are summarized below.

Responses to consultation

Should reinsurance be included within the financial services exclusion?: The consultation paper stated that a number of OECD members do not agree with the proposed definition of "Insurance Institution" and consider reinsurance activities should be excluded from the financial services exclusion. We understand this is likely because reinsurers do not always have a physical presence in the jurisdiction of the insurer and are not always subject to capital requirements in that jurisdiction. This potentially allows for the profits of the underlying insurance contract to be moved (admittedly alongside the associated risk) to a different (and potentially lower tax) jurisdiction. Some members take the view that this differentiates reinsurance from insurance as it is unusual for an insurer to be able to sell insurance to a policyholder without a local physical presence.

The industry was unanimous in responding that reinsurance should be included within the financial services exclusion, stating that reinsurance is an integral component of insurance and it would be costly and artificial to divide the two. Some responses noted the additional regulatory requirements some jurisdictions have put in place where insurers transfer risk to foreign reinsurers. These were noted to include the pledging of local assets, withholding taxes, or a requirement for a local presence or registration.

Implementation timeline: The ABI noted that the proposed implementation timeline for Pillar One was "incredibly challenging" and noted that unless the "full range of insurance and reinsurance activities" are excluded from Pillar One, they would need "significant time" to implement systems to decouple profits within scope of Pillar One.

When the consultation was launched, the OECD was targeting implementation from the beginning of 2023. However, OECD Secretary-General Mathias Cormann has since told the World Economic Forum in Davos that the agreement needed to finalize Pillar One is likely to be delayed, resulting in practical implementation from 2024.

This remains a challenging timeframe as the ABI indicated it would take 18–36 months for proper IT systems to be developed following finalization of the proposed rules.

Definition of "Insurance Contract": Several responses noted that the proposed definition of "Insurance Contract" was too narrow. The definition is a component of the "Insurance Institution" definition and it is therefore essential that it captures all types of insurance. As currently drafted, it could be interpreted as excluding only certain types of insurance from Pillar One and this could potentially cause an unintended divergence of applications across different jurisdictions. Several responses noted that cyber and longevity insurance were not within the proposed definition's scope. This could easily be addressed by amending the definition to make clear that the examples of insured risks are non-exhaustive. Alternatively, the definition could be aligned with an established regulatory or accounting definition.

Definition of "Insurance Institution": One component of the "Insurance Institution" definition is the proportion of income deriving from "Insurance Contracts" and "Annuity Contracts" and the proportion of assets held to manage risk associated with those contracts. The proportion was proposed to be 75%. If an institution was below that threshold it would not be within the exclusion. A number of responses noted that 75% was an appropriate proportion and that the figure should not be set any higher.

Management of investments: Some responses noted that more detail should be provided on how the investment income of insurance groups should be excluded from Pillar One. In particular, the ABI noted that the exclusion should apply to investment subsidiaries that are majority-owned by "Insurance Institutions". In particular, they advised that the exclusion should not be limited to only wholly-owned subsidiaries as it is not uncommon for insurers to invest alongside third parties, and a distinction in treatment could create a distortion in the tax treatment of otherwise similar groups.

Conclusion

The timeline to implementation of Pillar One is currently unclear because of the difficulty in reaching a global consensus on a number of key issues. It is not yet known whether it will be possible to pass enacting legislation in the U.S. with Republicans staunchly opposed to the proposals. Without the participation of the U.S., it is unclear whether the project will proceed.

It appears from the proposed drafting that the majority of OECD members consider that reinsurance should be within the financial services exemption and the delays may allow OECD members to consider the consultation responses and reach a consensus in the coming months. If that is not possible and Pillar One is to apply to some insurance or reinsurance profits, the Model Rules would need to be drafted with great care to apply appropriately to insurance groups operating in each participating jurisdiction and covering every type of insured risk. Following careful implementation of legislation, a long lead time would be necessary to allow insurance groups to identify the profits that should be reallocated.

It appears to us that the effort in implementing such rules could be disproportionate to the benefit they afford in terms of reallocating taxing rights. Pillar Two is further developed and is likely to result in higher effective tax rates for some global insurance groups. Reinsurers may respond to that project by establishing physical presences in more market jurisdictions and governments could (if they wish to do so) encourage this by imposing measures such as withholding taxes on reinsurance premiums and local capital requirements. While reinsurers are unlikely to welcome such changes, they would be considerably more straightforward than establishing new systems to address the requirements of Pillar One.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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