4 April 2022

Submitted via email to PillarTwoConsultation@hmtreasury.gov.uk

HM Treasury
1 Horse Guards Road
London SW1A 2HQ

Re: Investment Management Industry Response on UK Consultation on Implementation of OECD Pillar Two Rules

Joint submission by
The Investment Association (the IA)
and
The Securities Industry and Financial Markets Association Asset Management Group (SIFMA AMG)
In Response to the UK Consultation Document

Thank you for the opportunity to respond to the UK Consultation on Implementation of the OECD Pillar Two rules ('the UK consultation') and for the HMT's continued engagement with the investment fund industry through the past few years in ensuring that the rules protect the tax neutrality of investment funds to the greatest extent possible.

This response has been prepared the **Investment Association** (the IA)[1] and the **Securities Industry and Financial Markets Association Asset Management Group** (SIFMA AMG)[2].

[1] The IA champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 270 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage over £9.4 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 44% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally. For more information, visit https://www.theia.org.

[2] The Securities Industry and Financial Markets Association's Asset Management Group ("SIFMA AMG" or "AMG") brings the asset management community together to provide views on U.S. and global policy and to create industry best practices. SIFMA AMG's members represent U.S. and global asset management firms whose combined assets under management exceed $45 trillion. The clients of SIFMA AMG member firms include, among others, tens of millions of individual investors, registered investment companies, endowments, public and private pension funds, UCITS and private funds such as hedge funds and private equity funds. For more information, visit http://www.sifma.org/amg.

Executive Summary

A. **Implementation date:** For reasons set out below, we are concerned with the rushed and potentially premature implementation of Pillar Two and urge that a common implementation date be established to provide certainty and consistency in the adoption and implementation of these rules. We recommend that:

- In line with the intention to ensure a common approach as outlined in the UK consultation, the UK should look to press the OECD and the Inclusive Framework to agree upon a common date for implementation of the GloBE rules in 2024.
- In the absence of such an agreed upon OECD/ IF Implementation date upon enactment of the UK legislation, the UK's effective date should be no earlier than the implementation / effective adoption dates of other large jurisdictions including the majority of G20 nations (including the EU).
- Additionally, the implementation date should allow for an election to commence at the beginning of the calendar year and apply to accounting periods ending on or after the implementation date, to mitigate split year issues for a significant portion of UK businesses.

- **Impact on UK competitiveness:** With the UK leading the implementation on Pillar Two, it is important that it adopts these rules in a pragmatic and practical manner not only to mitigate uncertainty, disputes, and double taxation, but to also ensure that the UK remains a competitive jurisdiction for investment funds, for investors in these funds and for UK businesses in general. Premature introduction of the GloBE rules before other significant jurisdictions would mean that UK MNEs, including those headquartered in the UK, investment entities or UK investors therein, as well as UK intermediate parent entities of foreign headquartered groups, are subjected to UK tax under these rules before any of the non-UK MNEs, putting UK MNEs at a competitive disadvantage over non-UK headquartered entities. Moving in tandem with other significant jurisdictions will help preserve UK's competitiveness, while not doing so will punish UK businesses, investment entities and investors.

- **Administrative burden on businesses and HMRC:** The complexity of the Pillar Two rules, combined with the late release of the OECD Commentary ('the Commentary') explaining these rules, and the ongoing OECD consultation on important aspects of the implementation framework, necessitates that taxpayers and tax authorities have sufficient time to understand the way the rules are intended to work, while the Inclusive Framework also needs to ensure consistency of adoption across jurisdictions. We are concerned that a rushed implementation, at a UK level or internationally, would result in unnecessary, significant, and disproportionate compliance costs for businesses while causing undue administrative burden on tax authorities. If introduced in 2023, there is a significant risk that there will be material issues with reports and tax payments due to the rushed timetable for implementation.

  More fundamentally, it is critical that there is common implementation and coordination of rules globally, with explicit alignment between the GloBE rules and Qualified Domestic Minimum Top-Up Tax ('QDMTT') regimes to minimise the compliance burden. In addition, from day one of implementation, there must be functioning exchange of information regimes to minimise duplicative reporting, and effective use of safe harbours to eliminate low or zero risk entities/jurisdictions from the regime. This should be coupled with provisions to ensure that the tax administration burden on both taxpayers and governments is minimized, including ceding to the relevant QDMTT or Income Inclusion Rule (IIR) jurisdictions the primary audit rights, so taxpayers do not have to face over a hundred different tax examinations on the same computations.

B. Qualified Domestic Minimum Top-Up Tax ('QDMTT'): We are concerned that the UK's potential adoption of a QMDTT could result in double taxation particularly for investment managers having their European (and Middle Eastern, in some instances) headquarters in the UK. The recently released Commentary provides very little additional guidance as to the operation of QDMTTs within the GloBE framework, including consistency with GloBE outcomes and, for instance, how CFC Taxes will serve as part of Covered Taxes in the context of a QDMTT regime (recognizing that not all countries will adopt qualifying IIRs and UTPRs). In addition, we are concerned that Excluded Entities and Investment Entities should not be subject to Pillar Two and, likewise, any UK QDMTT regime. Therefore, UK legislation, if a QDMTT is adopted, should expressly provide that such UK QDMTT incorporates, by reference, and is intended to be wholly consistent with all OECD published guidance such as the Model Rules, Commentary, Implementation Framework and other holdings.

Furthermore, if a QDMTT applies in cases where a fund structure inadvertently fails the 95% or 85% ownership tests under the Investment Fund definition, all fund investors will bear Pillar Two consequences. To address this, Investment Entities should be excluded from the application of the UK's QDMTT. At the very least, Investment Entities should be given an opportunity to cure the problem, within a prescribed period or pursuant to a 'good faith' determination, before being subject to the UK's QDMTT.

C. Concerns regarding investment fund entities: Our detailed comments primarily focus on the treatment of investment entities under the GloBE rules and areas where UK rules can address issues and instances of double taxation, in keeping with the objective of Pillar Two. Our response highlights areas where the OECD's Pillar Two Model Rules ('the Model Rules) do not adequately deal with the tax neutrality of fund structures or where double taxation of investments in funds could arise due to the difference between UK domestic rules and the GloBE rules. Where possible, we have offered recommendations on how UK domestic rules could be altered to properly address these issues. As a leading investment management and successful fund location, we urge HMT to give sufficient and careful consideration to potential double taxation issues so as to protect the internationally well understood tax neutrality of investment funds.

D. General administrative issues: Additionally, our detailed comments identify several general implementation and administrative issues applicable to UK based investment management businesses, which require attention and clarification.

We would like to add that in the interest of time and to meet the deadline of responding to the UK consultation, we have focussed on issues identified to date. The IA, SIFMA and our respective members are still working through the recently published Commentary to identify any additional issues or areas where clarification may be required, and we will look to raise these issues with HMT outside of the formal consultation process ahead of the planned issuance of draft legislation in July 2022.

Detailed comments on technical issues

1. Investment Entities

1.1 Tax Transparency Election *(Article 7.5 of the Model Rules)* and UK taxation of funds on realisation basis

Issue: The election can only be made where an entity applies Mark to Market (MTM) accounting for its holding in an Investment Entity. For UK parented groups, this is problematic where interests in funds are required to be taxed on a realisation basis, resulting in double taxation. This is because the Effective Tax Rate (ETR) of the Investment Entity must be calculated separately from the ETR of its parent entity. Covered Taxes arising on any profit arising from the disposal of the Investment Entity are therefore not applied to the ETR of the Investment Entity. As the Investment Entity will benefit from tax exemption on its profits (in line with intended policy in almost all OECD jurisdictions), the proposed mechanic creates an automatic top up tax on the Investment Entity profits. Given there is no credit for Covered Taxes at the parent level, this results in double taxation.

Recommendations:

The double tax that can result from the failure of the Filing Constituent Entity being able to make the Tax Transparency Election (TTE) could be addressed by clarifying that Covered Taxes (both current and deferred) arising at the parent level can be incorporated into the ETR of the Investment Entity, where a TTE/distribution method election is not available. Whilst this scenario is not addressed directly by Article 4.3, it is consistent with the policy intention to align Covered Taxes with the underlying profits that they relate to.

Changes could also be made to UK law to address double taxation, including those described below.

(a) If it is not possible to modify the Model Rules to accommodate UK law, UK domestic tax rules should be amended to allow interests in these fund entities to be subject to tax on a MTM basis (rather than realisation basis), through election, which would then allow the entity to satisfy the MTM requirement in the TTE. This should not be problematic from a policy perspective as such an election would likely accelerate the tax charge for the investor entity, while also ensuring that there is no double taxation. Such UK election could be at the entity level and could be permanent to avoid abuse.

(b) In addition to election in (a) above, where a TTE under Article 7.5 is not possible, a further election can be provided in UK domestic rules to allow a UK entity to treat its holdings in an Investment Entity as tax transparent for UK tax purposes, which would obviate the need for the GloBE TTE election to the extent that this treatment creates a Tax Transparent Entity within the GloBE rules, and thus ensures there is no double taxation.

(c) To make sure that a UK MNE is not taxed again on disposal of its interest in an Investment Entity, GloBE top up tax paid on the MNE's interest in the Investment Entity should be allowed to be offset against other corporation tax liabilities on its disposal of such interest or other trigger of UK taxation. This solution should not run afoul of a Qualified IIR being prohibited from providing benefits that are related to the IIR or the UTPR as the rule would be applied to solely alleviate double taxation while remaining within the spirit of the GloBE rules.

1.2 TTE and Covered Taxes

Issue: If an MNE makes the TTE under Article 7.5 of the Model Rules, a question arises as to whether it can include the taxes charged on its MTM profit as Covered Taxes. The gain or loss on the Investment Entity (that is not a Short-Term Portfolio Shareholding as defined) is treated as an excluded gain or loss under the Model Rules, which means the tax in respect of that gain or loss is not a Covered Tax. The scheme/purpose of Article 7.5 should mean that this should be the case, but it is not explicit.

Recommendation: UK Pillar Two legislation should explicitly clarify that taxes charged on MTM profits are Covered Taxes where an MNE makes a TTE under Article 7.5 of the Model Rules.

1.3 GloBE income calculations for Investment Entity: Short-term Portfolio Shareholdings

Issue: MNEs may consolidate numerous investment entities which follow a wide range of strategies. Some of these are taxed on a MTM basis in which case, the MNE can elect for transparency under Article 7.5 of the Model Rules, while some are not, which would require calculation of the Investment Entities' ETR separately from the ETR of the MNE in the jurisdiction in which the Investment Entity is located. However, in each case, one would need to calculate the GloBE income for the Investment Entity. Typically, each Investment Entity could hold hundreds of investments, some of which pay dividends between 1 and 4 times a year. The Investment Entity also constantly invests/divests – the number of transactions in a year typically run to the tens of thousands and for some strategies it could be in the millions or indeed higher.

The calculation of GloBE income requires identification of 'Excluded Dividends' as per Article 3.1.2 (b) of the Model Rules. These rules refer to 'Short-term Portfolio Shareholdings', which is explained further by way of examples in Chapter 3 of the Commentary (on page 51) as requiring each holding to be reviewed from each distribution date. For MNEs holding numerous positions in Investment Entities that in turn could hold a large number of investments, the examples in Chapter 3 of the Commentary are unworkable in practice.

Recommendation: The UK guidance should look to provide a pragmatic way of calculating Short-term Portfolio Shareholdings for Investment Entities. One pragmatic solution would be to provide an election to the Investment Entity, or its investors, to MTM for purposes of the Short-Term Portfolio Shareholdings. This would save investment entities and their investors countless hours of unnecessary work and costs for what is, ultimately, expected to be no top-up tax at the Investment Entity level (as any top-up tax would be borne by the MNE).

1.4 Partially Owned Parent Entity (PoPE) rules

Issue: Where an entity does not fall within the Investment Entity/ Excluded Entity definition, the PoPE rules could come into play and effectively taint the whole structure to the detriment of minority investors.

We are concerned that the application of the PoPE rules to commonly used co-investment structures would not only result in an unfair outcome in the form of compliance costs and double taxation for minority investors, but will also cause uncertainty for fund investors. This will detract from the basic purpose of investment funds, notably of pooling monies from varied investors, applying professional management and providing economies-of-scale. In a UK context, investment managers and investors will be faced with undue risks and complexity, resulting in a decline in the UK's attractiveness as an investment management and a fund jurisdiction. In summary, we are concerned that investors may not want to invest in such funds where the PoPE rules could apply, or if they choose to invest, they may demand significant warranties to ensure they will bear no tax cost or filing burden as a consequence therefrom. This would be a very difficult representation for a fund manager to make since many funds provide for periodic redemptions or there could be mergers amongst investors (e.g., insurance companies), both of which could alter the ownership structure. This will likely have the effect of weakening the availability and efficiency of investment for key sectors where co-investment is more common such as Infrastructure.

Recommendation: We question why minority investors are not hurt where an Intermediate Parent Entity is in an IIR jurisdiction, but minority investors are tainted in a PoPE setting. In order to be consistent with the expressed tax policy objective of tax neutrality for funds, we recommend that Investment Entities with minority investors are not subjected to these rules.

1.5 QDMTT and Treatment of Top-up Tax

Issue: The categorisation of top up tax will have an impact on its creditability for tax purposes. Given that many countries are likely to introduce a QDMTT (like the UK), it is important to ensure that any top up tax paid in that jurisdiction is treated as creditable.

Recommendation: The UK's QDMTT rules should allow credit for taxes paid on foreign operations in non-IIR jurisdictions when calculating the ETR. This is consistent with the treatment of CFC Taxes, as Covered Taxes, and their allocation provided in Pillar Two. The same is true of Covered Taxes paid by a Main Entity that are allocated to a PE under Article 4.3.2(a). Such credit should be applied on a jurisdictional basis on a just and reasonable basis.

1.6 Domestic life companies holding funds

Investment funds are used by individual consumers to provide pension savings. In the life insurance industry, policyholders pay premiums to the insurer that are invested to generate a return sufficient for the insurer to meet the long-term commitments to policyholder. This means that the vast majority of the invested assets and investment returns are for the benefit of the policyholders. The insurance company is taxed on the profits attributable to shareholders after taking into account premiums received, movements in insurance reserves, payments to policyholders, investment returns and other operating expenses.

Typically, investment funds are structured to be tax neutral so that the return can be passed gross to the underlying saver who will be taxed on that return in accordance with the tax provisions of the jurisdiction where the individual lives. Worldwide insurance companies and fund managers hold trillions of dollars through investment funds which underpin the pension savings of millions of individual consumers. It is therefore fundamentally important that the Pillar Two rules do not impose additional tax charges on investment funds that will damage individual consumers, which would be outside of the policy rationale for Pillar Two.

The interaction of the interpretation of the definition of Investment Entities and Insurance Investment Entities and the taxation regime criteria required in order that a TTE can be made is critical for the smooth operation of the regime. The Commentary has to some extent softened the impact of the definition of an Insurance Investment Entity outlined in the Model Rules being narrower than the definition of an Investment Entity. However, this is still an area where further work is required. Also, an election under Article 7.6 does not seem to be available to an Insurance Investment Entity and, a result that may cause double taxation, including for policyholders, where an election under Article 7.5 or 7.6 may not be available.

Recommendation: We understand that some of these issues may be resolved through clarifications and further work undertaken in respect of the development of the Implementation Framework, but this work appears somewhat narrow in scope. In light of the policy intent expressed in the Model Rules around protection of policyholder returns, and the clear intention that tax neutral investment entities should not suffer additional tax charges as a result of the implementation of the Model Rules, we would urge HMT to undertake further discussions with the broader industry, including investment funds and the insurance sector, around a broad basis in the OECD regime of facilitation of life company access to the TTE. We expect that the requirements for the TTE should be met in these circumstances, but it would be helpful to get clarity in this regard to ensure that the provisions are interpreted consistently with the wider policy intents.

2. Other calculation and administrative issues

2.1 GloBE income calculation – financial statements

Issue: The information included in consolidated financial statements are almost invariably different from the year-end local financial statements, due to year-end adjustments and materiality etc. Typically, consolidated financial statements are prepared in a compressed timetable post the financial year-end. Whilst these figures are subject to audit, group level materiality typically runs at around 5% of profit. As a result, there are likely to be significant discrepancies between entity figures used for consolidated accounts purposes and entity numbers used for the statutory accounts process that takes place later in the year (and for any local corporate tax filings). In effect, the GloBE rules as drafted are requiring MNEs to accurately compute covered taxes for all of their jurisdictions within that very truncated year-end period (typically only a couple of weeks). The resultant inaccuracies will cause significant problems. To the extent that tax is incorrectly calculated as too low, the result may be a top-up tax that is unfairly and inaccurately charged. To the extent that tax is incorrectly calculated as too high, the GloBE calculations may need to be resubmitted. A GloBE reporting deadline of 15-18 months after year end does not address the time constraints associated with the preparation of consolidated financial statements.

Recommendations: Where entity accounts are prepared using the same acceptable GAAP as the consolidated accounts, these accounts should be treated as an acceptable starting position, for GloBE purposes, as long as the approach is applied consistently. This approach would align the GloBE tax basis with the starting point for most tax returns.

Clarification would also be welcome on the use of financial statements of the local entity when the local entity has a different year end than that of the UPE. The country-by-country reporting (CbCR) guidance does comment on this and allows businesses to use different year ends. A similar approach should be adopted for GloBE purposes in the UK legislation.

2.2 Scoping threshold and deemed consolidation rules

Issue: Definition of Consolidated Financial Statements in the Pillar Two Model Rules includes the following deeming provisions:

"Where the Ultimate Parent Entity does not prepare financial statements described in the paragraphs above, the Consolidated Financial Statements of the Ultimate Parent Entity are those that would have been prepared if such Entity were required to prepare such statements in accordance with an Authorised Financial Accounting Standard ..."

The above seems to hypothesise that consolidated financial statements are required even though the relevant GAAP does not provide for it and doing so is inconsistent with the CbCR rules. The CbCR rules only require the reporting of consolidated group numbers if the group actually is required to prepare them under the relevant GAAP, or would be so required if equity interests of any group member or members were publicly traded on a securities exchange. Typically, under relevant GAAP, an entity which is an Investment Company is not permitted to consolidate subsidiaries. This is, in part, because the Investment Company is not considered to be engaged in a trade or business and therefore, recognising that consolidation with an operating business would not be appropriate or fair to users of the Investment Company's financial statements. Accounting rule-makers, thus, prohibit such consolidation. Given the underlying policy of Pillar Two, the deference accorded to the relevant GAAP rules in the Pillar Two Model Rules and the OECD's long-standing express tax neutrality principle intended to apply to funds, we see no reason to require 'deemed consolidation' in a fund context.

This inconsistency between the CbCR rules and Pillar Two rules, in absence of further clarity, would result in requiring businesses to perform separate threshold calculations for CbCR and Pillar Two purposes. Given that the threshold for Pillar Two has been aligned with the CbCR threshold, the consolidation and deemed consolidation rules should also work in the same way, ensuring that businesses can use their CbCR assessments for determining their Pillar Two scoping threshold.

From a fund perspective, the deemed consolidation rules in the Model Rules could *prima facie* inadvertently sweep up portfolio entities in a fund structure within the scope of Pillar Two, despite these entities not actually being a part of an MNE's group.

Recommendation: Apply the CbCR deemed consolidation rules to ensure wider consistency, as also referred to in paragraphs 4.5 and 4.6 of the UK Consultation.

Conclusion

The IA and the SIFMA AMG appreciate the opportunity to submit these comments on the UK Pillar Two Consultation. We recognize and appreciate the considerable time and energy that HMT and HMRC have devoted to understanding the unique and sometimes complex operations of investment funds. Your focus on these issues over the last two years has been incredibly important in ensuring that the Pillar Two rules recognize the importance of maintaining the tax neutrality of investment funds, and the risks of not protecting such tax neutrality.

It is critical that investment funds are not inadvertently subjected to Pillar Two, including any QDMTT, in order to maintain and respect the basic principles of tax neutrality for such structures. At the same time, implementation of the complex Pillar Two rules must not be rushed and must be thought through carefully, bearing in mind that important work continues on much needed additional guidance at the OECD level as part of the so-called the Implementation Framework. In short, the IA and SIFMA AMG stand ready to continue to work with the HMT and HMRC as the UK transposes the Model Rules, the Commentary, and additional guidance as part of the Implementation Framework into legislation this summer.

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We thank you for your consideration of these comments. Please contact Anshita Joshi at the IA anshita.joshi@theia.org), Justin Sok at SIFMA (jsok@SIFMA.org), (Jeff Levey (Jeff.Levey@ey.com) or Rebecca Burch (Rebecca.burch@ey.com) via email if you have any questions regarding this submission.

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