TAX AND THE CITY REVIEW

It is full steam ahead for implementation of the global minimum tax in the UK and the EU although a number of practical implications and technical details are still being discussed at the OECD/IF level. The Upper Tribunal in *HBOS and Lloyds Banking Group* decides that the taxpayers can claim interest from the date they would have made VAT repayment claims if the UK's bad debt relief legislation had been compliant with its EU obligations. HMRC publishes guidance (written and compiled jointly with the ABI) for insurers seeking approval for a partial exemption special method (PESM).

International tax reform: Pillar Two developments

Continuing the trend of piecemeal consultation and guidance sharing as and when ready, the OECD published a number of documents at the end of 2022 on the two pillars of international tax reform. Of most interest to financial institutions is the progress of Pillar Two (in particular the global minimum tax or 'GloBE' rules).

The GloBE rules provide for a co-ordinated system of taxation for large multinational enterprises (MNEs) that imposes a top-up tax on profits arising in a jurisdiction whenever the effective tax rate (ETR), determined on a jurisdictional basis, is below the minimum rate of 15%. Quite simple as a concept, but incredibly complex when you drill down into the details.

How to achieve tax certainty

It is important to remember that the GloBE rules are being implemented as a common approach – a jurisdiction which signed up to the October 2021 agreement does not have to implement the GloBE rules, but if it chooses to do so, it is committed to following the model rules, model commentary and administrative guidance in order for there to be consistency in the implementation and application of the rules. Even with all that, however, there are still expected to be instances of divergence of interpretation which may lead to double taxation and so the tax certainty piece is crucial.

The consultation 'Pillar Two - Tax Certainty for the GloBE Rules' explores the different options for achieving certainty. One of the options being considered is extending the OECD International Compliance Assurance Programme (ICAP), or developing a similar programme, to cover the tax risks associated with the GloBE rules in order for implementing jurisdictions to give comfort to an MNE in relation to the methodology the MNE used for compiling the information and the accuracy of the computations.

Safe harbours

Safe harbours are an important part of the workability of the GloBE rules. It is inevitable that complying with the GloBE rules will be challenging until everyone knows what the rules are and has processes in place to apply them. Safe Harbours and Penalty Relief: Global Anti-Base Erosion Rules (Pillar Two) explains there will be a transitional country-by-country safe harbour rule that removes the obligation to calculate the GloBE effective tax rate for a MNE's operations in lower-risk jurisdictions in the initial years (which means fiscal years ending on or before 30 June 2028). This removes the disproportionate compliance burden on certain MNEs in respect of their operations in high-tax and other low-risk jurisdictions as MNEs and tax administrations come to terms with their operation.

A permanent safe harbour will be developed which will require simplified income and tax calculations. The Inclusive Framework is also working on a Qualified Domestic Minimum Top-up Tax (QDMTT) safe harbour that would provide compliance simplifications for MNEs operating in jurisdictions that have adopted a QDMTT. A QDMTT safe harbour would eliminate the need for an MNE to perform an additional GloBE calculation in addition to the QDMTT calculation required under local law. This will be considered as part of the Administrative Guidance on the QDMTT. The UK intends to adopt a QDMTT so MNEs operating in the UK will benefit from this safe harbour.

Accounting for Pillar Two

Coming up to the end of 2022 there was concern that the accounting rules might require a deferred tax

provision for Pillar Two top-up taxes even though the rules were not yet sufficiently finalised for the provision to be calculated accurately. In December, the IASB reached agreement that until it makes a firm decision as to whether Pillar Two needs to be reflected in deferred tax provisions, it does not need to be. Instead, new targeted disclosures will be required giving information on the potential exposure to the Pillar Two model rules in annual financial statements for periods beginning after 1 January 2023 in which Pillar Two legislation is enacted or substantively enacted, but not yet in effect.

The IASB is seeking feedback by 10 March on the extent of these disclosures which in the exposure draft include information about such legislation enacted or substantively enacted in jurisdictions in which the entity operates; and jurisdictions in which the entity's average effective tax rate for the period is below 15%. Once top-up tax is effective, the entity would also need to disclose the accounting profit and tax expense (income) for these jurisdictions in aggregate, as well as the resulting weighted average effective tax rate.

Impact assessment

In January, the OECD presented its findings on the impact of international tax reform in advance of the full report which will follow in the coming months. Pillar Two raises a more significant amount of revenue than pillar one: the estimate is an annual global increase in tax revenue of USD 220 billion (or 9% of global corporate income tax revenues) based on the data from 2018 (the latest year for which data is currently available for the Pillar Two analysis). This is significantly higher than the estimate the OECD produced in 2020 of USD 150 billion. The 2018 data does not take into account, however, the impact of Covid-19, the war in Ukraine, the 2022 global increase in inflation and the ongoing implementation of some aspects of (and behavioural reactions to) BEPS measures and the US Tax Cuts and Jobs Act. So actual Pillar Two annual revenues may be quite a bit lower than this estimate.

Pillar Two modelling is currently only on a global basis with ongoing work on jurisdiction-level estimates. However, as with the OECD's 2020 impact assessment, jurisdictional data will only be shared with the public grouped by low, middle and high income jurisdictions. The individual jurisdictions will, however, receive their assessment directly from the OECD. Modelling work is still ongoing on QDMTTs – this is important for the production of accurate jurisdiction by jurisdiction estimates because a QDMTT will change where top-up taxes are collected. It will shift potential revenue gains from Ultimate Parent Entity jurisdictions to affiliate jurisdictions where low-tax profits are currently located.

There is evidence of a high share of low-tax profit located in high tax jurisdictions (tax incentives are a key factor). This will make a QDMTT more attractive for such high tax jurisdictions.

Implementation in the UK

We await the Spring Finance Bill for the latest draft legislation which, according to the announcement at the Autumn Statement, will include a QDMTT. Originally, the UK intended to bring in the multinational top-up tax first and a QDMTT would follow later but it makes sense to have the QDMTT in place from the start to protect UK tax revenues and to allow MNEs with UK operations to benefit from the QDMTT safe harbour.

Administrative guidance is expected to be issued on a rolling basis with the first tranche having been published on 2 February. The administrative guidance is intended to ensure the GloBE rules are implemented and applied in a co-ordinated manner. The UK has been hoping to use the guidance as a way of resolving some of the discrepancies between the domestic tax base and the tax base for the GloBE which could otherwise result in a lower effective tax rate and it looks like it has succeeded in some areas such as corporate rescue debt releases and net investment hedges. The legislation for the multinational top-up tax and the QDMTT to be included in the Spring Finance Bill is expected to reflect the administrative guidance to the extent it is significant to the UK or to the overall functioning of the rules save where further clarification and decision making is required at international level.

The timing of the UK's implementation is aligned with the OECD's timeline and the EU Directive and is expected to apply to accounting periods beginning on or after 31 December 2023.

HBOS and Lloyds: VAT overpayment interest

The Upper Tribunal in HBOS PLC and Lloyds Banking Group v HMRC [2023] UKUT 13 had to consider the question of timing of interest on VAT repayment claims pursuant to VATA 1994's 78 in relation to bad debt relief legislation that had previously been held to be incompatible with EU law. The Upper Tribunal held that interest can be claimed from the date the taxpayer would have made repayment claims if the UK legislation had been compliant with EU obligations, rather than from the date the claims were actually made. This meant the taxpayers were entitled to interest of around £10m starting from when the valid bad debt conditions were met rather than £872,000 from date of the claims as HMRC had argued.

This case is good news for any other taxpayers with repayment claims based on UK legislation which has shown to be incompatible with EU law. The amount of interest at stake may be significant.

New guidance on partial exemption special methods for insurers

HMRC has published guidance (written jointly with the ABI) to help insurers gain approval for a fair and reasonable partial exemption special method (PESM) with the minimum of cost and delay. The guidance is neither mandatory nor binding and HMRC will consider whether to approve any PESM that an insurer declares fair and reasonable.

The guidance recognises that many insurance businesses are complex organisations providing different services in different countries using costs from around the world in different proportions. For such a business a 'one pot' method is too simplistic and so rather than use the standard method most insurance businesses will need to apply to HMRC for approval to use a PESM. HMRC encourages the use of sectorised methods because they are more likely to be fair and reasonable than a simple method.

The guidance will be updated regularly by the ABI and HMRC to reflect new issues arising and to help ensure consistency of treatment across the insurance industry.

What to look out for:

- The Upper Tribunal is scheduled to begin to hear the appeal in *GE Financial Investments v HMRC,* on the application of the UK/US double tax treaty, between 27 February and 1 March.
- 28 February is the closing date for the consultation on draft guidance on the Finance Act 2023 reforms of the R&D rules due to be implemented on 1 April 2023.
- On 6 March, the Upper Tribunal is scheduled to begin to hear the appeal in *Hargreaves Property Holdings Ltd v HMRC* on withholding tax on interest payments.

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