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Insurance Companies and Pillar 2: Understand Your Options

Global Minimum Tax Requires Complex Calculations

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The new Pillar 2 global minimum tax requirements have understandably created consternation among the insurance companies that need to figure out how to comply with them.

These new rules were created by an agreement under the Organisation for Economic Co-operation and Development (OECD) and are being implemented by many countries around the world. And although they haven't been adopted by the United States yet, they will have a substantial effect on global insurance companies, which commonly have subsidiaries in low-tax foreign country jurisdictions.

The requirements create a global minimum effective tax rate of 15% for companies regardless of where they earn their income. The idea behind the requirements is to prevent the race to the bottom where jurisdictions globally were reducing tax rates and taxpayers were taking advantage of cross-border arrangements to achieve low- or no-tax results.

"This global initiative, with over 130 jurisdictions agreeing on a framework to implement a global minimum tax system, was really a novel and monumental idea," said Cory Perry, Grant Thornton Advisors LLC Tax Services Principal. "It's the first time in the tax world where we've had collaboration at this level and agreement that's so broad."

Under the requirements, there are three different ways in which income can be taxed:

- A qualified domestic minimum top-up tax (QDMTT) effectively gives primary taxing rights to the local jurisdiction where the income is earned and the entities are located. For example, if Ireland's effective tax rate under the rules is 12.5%, Ireland gets the first right to collect the extra 2.5% on Irish income of multinationals.
- Through what's known as the Income Inclusion Rule (IIR), if the parent has subsidiaries that are taxed below 15% and a QDMTT does not top them up to 15%, the parent jurisdiction will top up those entities itself up to 15%.
- The undertaxed profit rule (UTPR) enables collection on any profits taxed below the 15% effective rate that weren't captured by either the QDMTT or the IIR. The UTPR operates as a backstop by enabling collection on those undertaxed profits through affiliated brother or sister entities when another mechanism does not impose the tax.

Pillar 2: What's next if you're in scope

The Pillar 2 tax applies to multinationals that operate in more than one jurisdiction and have revenue of 750 million euros or more in two of the previous four years.

"It doesn't just affect the largest companies," Perry said. "It has a broad range, as it also affects the middle market companies that are over the 750 million euros threshold."

The tax took effect in many countries in 2024. Two jurisdictions that are important to the insurance industry have not adopted the rules:

- The United States, which supported the Pillar 2 requirements but has been unable to get them approved from a legislative standpoint. Following the November elections, the status of Pillar 2 in the United States is uncertain.
- The Cayman Islands, a traditional domicile for tax purposes, which came to a different decision on Pillar 2 than Bermuda, which enacted a 15% corporate income tax applicable to Bermuda businesses that are within the scope of Pillar 2.

For insurance companies that fall within the scope of Pillar 2, the question is: what's next?

"That's the biggest hurdle right now for companies," said Grant Thornton Advisors LLC Tax Services Managing Director John Forni. "First, it was figuring out what the tax was going to look like. Now the uncertainty starts with how you arrive at your pre-tax book income for purposes of computing your effective tax rate, which then is the genesis for what's below the 15% required tax."

The income calculation for tax purposes is tremendously complex, but some insurance companies that are subject to Pillar 2 requirements are taking advantage of a transitional safe harbor that can exclude operations in lower-risk countries from a multinational's Pillar 2 calculations for the first three years after the requirements take effect.

The shortcut permits companies to perform three tests on each jurisdiction with income to determine whether it can be excluded from the Pillar 2 calculation. The three tests are:

- **A de minimis test:** If total revenue is less than 10 million euros and profit or loss before income tax is less than 1 million euros for a jurisdiction on its qualified country-by-country (CbC) report, the jurisdiction is not required to be included in the Pillar 2 calculation.
- **An effective tax rate (ETR) test:** A jurisdiction can be omitted from the Pillar 2 calculation if its simplified ETR is equal to or greater than the "transition rate" of 15% for fiscal years beginning in 2023 and 2024, 16% for fiscal years beginning in 2025, and 17% for fiscal years beginning in 2026.
- **A routine profits test:** If a multinational's group profit or loss before income tax in a jurisdiction in the CbC report is less than or equal to its substance-based income exclusion amount (SBIE), the jurisdiction can be excluded from the Pillar 2 calculation.

Perry has seen anecdotally in practice that a vast majority of in-scope jurisdictions, perhaps as many as 95%, are able to be omitted because of one of these three tests. Many countries such as Japan, Mexico, Canada, Germany and France have effective tax rates often much higher than 15%, so the ETR test applies in many major jurisdictions.

Accurate CbC reporting is essential to take advantage of this safe harbor opportunity, which can save insurance companies a significant amount of time.

"If you meet those requirements, you can probably eliminate 90% of your work or more, and then you only need to perform the complicated Pillar 2 calculations on a small subset of your overall population of entities," Perry said. "You have more time to set up your systems and adjust your accounting. It really buys you time because you don't need the scale you would need if you had to comply in hundreds of jurisdictions."

Complex calculation takes center stage

The transitional safe harbor may only be a temporary solution, though, and many insurance companies already are trying to figure out next steps for complying in all jurisdictions once the transition period is over. The Pillar 2 calculation is so complex that some companies are considering implementing new systems to help with the calculation. In general, insurance companies are either outsourcing the calculations to firms that specialize in tax or implementing Pillar 2 software. The software implementation takes a significant amount of work and may also require third-party help. Tax specialist firms are assisting with assessment of insurance companies' needs, selecting the tool that best meets those needs, and implementing the tool that's chosen.

Some insurance companies also are spending significant time adjusting and enhancing their systems to gather data that has never been needed before. Insurance companies will be required to perform detailed Pillar 2 calculations and extensive reporting on a jurisdiction-by-jurisdiction basis. To achieve this, insurance companies will need to transform aspects of their finance functions. This effort could include:

- Annually gathering, mapping, and analyzing data points that may not be currently readily available or in a usable format
- Presenting consolidated data in a new way, such as consolidation within a jurisdiction
- Rethinking accounting policies such as GAAP and IFRS and how they're applied at the entity, jurisdictional and consolidated levels, including stock-based compensation (SBC) elections
- Making adjustments to data to apply the transitional safe harbor

For large multinationals with revenue from hundreds of countries and thousands of subsidiaries, this effort can be overwhelming.

"That's why this takes center stage right now," Forni said. "Companies are trying to figure out how to do this, and this period where you can reduce the level of effort as you make sure your systems are all sufficient is really important."

Because the fundamentals of the insurance industry are different from other industries, specific rules for insurance are included in the OECD Pillar 2 guidance:

- **Policyholder income can be excluded.** Income that is contractually payable to policyholders is excluded from the Pillar 2 income calculation to avoid inflating the ETR artificially.
- **Policyholder liabilities can be adjusted.** Taxes incurred on returns to policyholders are offset by reductions in policy liabilities, which ensures that these taxes do not affect the ETR.
- **Tier 1 capital gets special treatment.** Distributions related to additional Tier 1 and restricted Tier 1 capital are treated as income or expense in Pillar 2 income or loss calculations.
- **Tax transparency election may apply.** "Insurance investment entities" can elect to be treated as Tax Transparent Entities if certain criteria are met.

Section 953(d) and Pillar 2

A common strategy used by some U.S. multinationals with controlled foreign corporations (CFCs) in the insurance business is to make Section 953(d) elections. A Section 953(d) election allows a U.S. multinational to treat a CFC in the insurance business as a U.S. domestic corporation and potentially avoid the Federal Excise Tax on premiums paid for U.S.-based risks and the complexities of Subpart F income when using an offshore vehicle. This strategy may not only reduce tax liabilities but also simplify compliance, particularly as Pillar 2 requirements come into force.

Section 953(d) allows a CFC engaged in the insurance business to elect to be treated as a U.S. corporation for U.S. tax purposes. Under this election, a CFC will be taxed in the U.S. on its worldwide income and will not be subject to the branch profits tax or the branch-level interest tax imposed by Section 884, and it will remove the uncer-

tainty of creating a permanent establishment (PE) and generating effectively connected income. The excise tax imposed under Section 4371 also will not apply. The election generally will remain effective for subsequent years as long as the Section 953(d) requirements continue to be satisfied (office test/asset test) — unless revoked by the electing insurance company with the approval of the IRS commissioner.

Under Pillar 2, the Section 953(d) election could have a notable impact on a jurisdiction's eligibility for the transitional safe harbor outlined above. The election causes the foreign entity's results to be treated as a "U.S. business entity" under Treas. Reg. Sec. 1-6038-4(b)(4). Thus, the entity is included in the U.S. section of the CbC, meaning these entities would benefit from the same U.S. tax rates that typically protect U.S. entities from top-up taxes under the transitional safe harbor. This could mean that for U.S. multinationals, making a Section 953(d) election might qualify a specific jurisdiction for transitional safe harbor protections where otherwise they wouldn't have, reducing their exposure to Pillar 2 top-up taxes and compliance obligations.

When moving beyond the transitional safe harbor to full Pillar 2 calculations, the situation becomes less clear. Although a Section 953(d) entity is treated as a U.S. corporation for domestic tax purposes (and the CbC), it is likely still considered a foreign entity under the Pillar 2 model rules. There is some ambiguity in how these entities should be treated in full Pillar 2 calculations, but broadly, any U.S. income tax owed would limit the exposure to Pillar 2 taxes.

When navigating the complexities of Section 953(d) elections under the new Pillar 2 regime, it's crucial for multinationals to model the potential outcomes early in the decision-making process. One key aspect to consider is that any federal excise tax is unlikely to meet the definition of a "covered tax" under Pillar 2. This could lead to additional liability if there is insufficient covered tax on the income, particularly when the UTPR becomes effective in many countries from Jan. 1, 2025.

Without adequate planning, companies might find themselves facing unexpected top-up taxes, furthering the benefits of making the Section 953(d) election. However, the Section 953(d) election is not always advantageous and should be carefully modeled, as it may not be suitable for every company. By thoroughly evaluating the pros and cons of the election and understanding its implications within the broader context of Pillar 2, companies can better navigate the potential tax landscape and avoid costly surprises. This is another reason it's critical to integrate Pillar 2 considerations into the overall tax strategy early on.

New requirements, new resources

Insurance companies will likely find that Pillar 2 requirements present substantial compliance challenges, as even assessing potential scenarios can be time-consuming. To navigate these complexities, multinationals should consider bolstering internal tax teams or relying more heavily on third-party tax providers, devoting additional resources to this issue in the coming months. ⊙

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