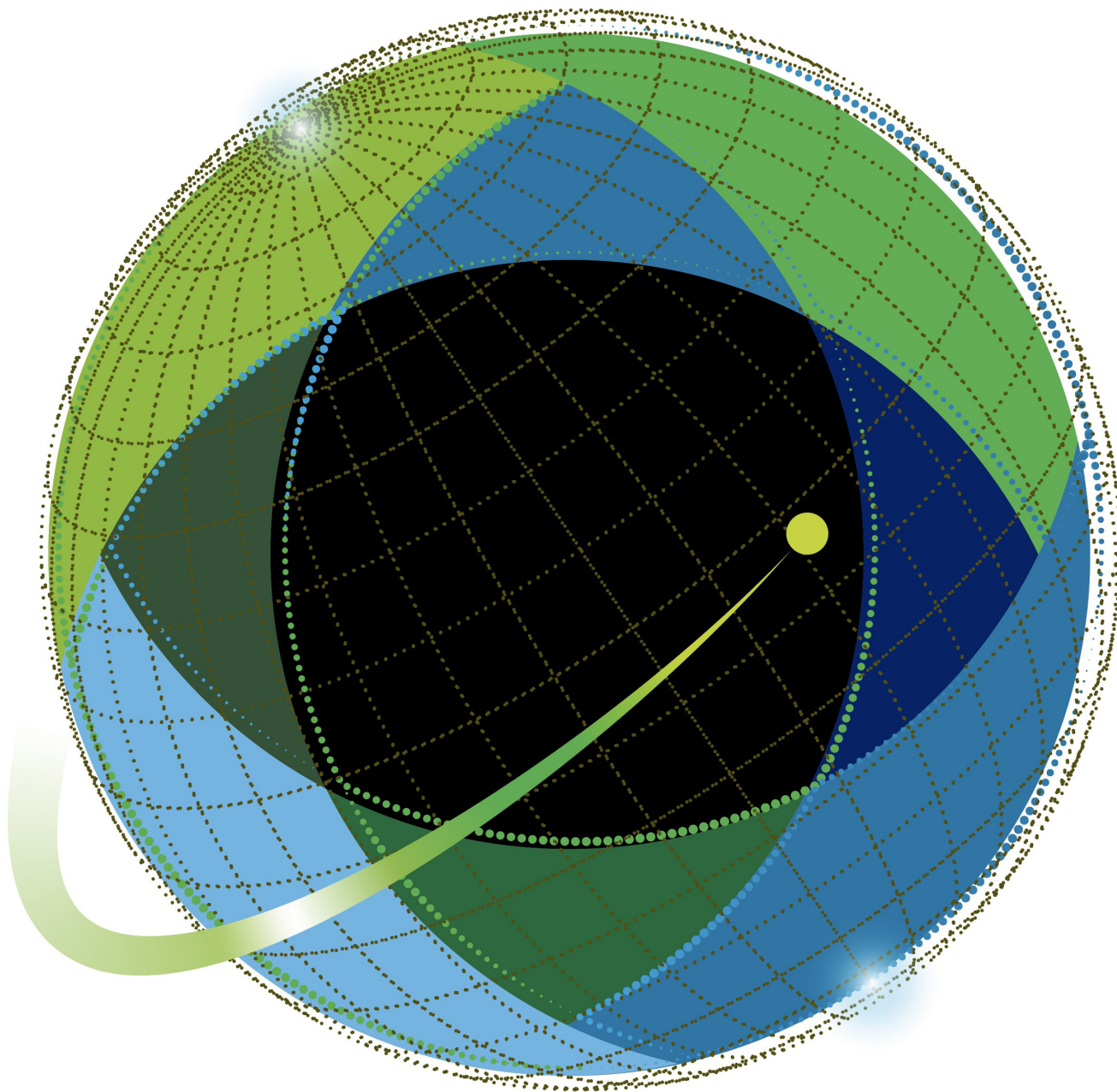




Tax Insights

Pillar Two in Australia: from policy to practice

Key issues for the financial services & insurance sectors

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Whilst we await the outcomes of the OECD's confidential negotiations following the G7 announcement regarding the proposed 'side by side' solution (that may exempt US parented groups from the Income Inclusion Rule and Undertaxed Profits Rule but not Qualified Domestic Minimum Top-up Taxes), the Australian Pillar Two rules remain in force. Therefore, all groups (including US parented groups) continue to be subject to the Australian legislation and associated guidance. In this article we consider the unique impact that Pillar Two has on taxpayers operating in the financial services and insurance sectors.

The Pillar Two rules contain few provisions that are specific to the financial service or insurance industries. Nonetheless, groups in these industries face unique Pillar Two issues given the way that the groups are typically structured, including the use of fund and joint venture structures and branches.

In this second article in our series (see our first article - [Accessing the transitional safe harbour](#)), we consider the key challenges facing groups operating in this industry as they work towards compliance with the Pillar Two rules.



MNE groups in scope of Pillar Two

When the OECD Secretariat released its Blueprints for the Pillar One and Pillar Two rules to the G20 in 2020 it was after many years of concentrated effort on the original BEPS Action 1 Report and against a background policy debate about the weaknesses of traditional tax rules and the base erosion and profit shifting behaviours that were opportunistically adopted by some of the largest, fastest growing and well financed multinational groups in the technology sector. However, as the rules evolved around Pillar Two it was quickly apparent that addressing BEPS risks in a principled manner could not be limited to the digital sector, and therefore the scope of the rules settled on all MNE groups, irrespective of industry, provided the group had a global footprint and met the 750m+ Euro global turnover (within 2 of previous 4 years). Hence, there are no industry-based exemptions from the rules (albeit a limited exclusion for 'shipping income' is afforded the shipping industry).

The fundamental basis for the scope of the Pillar Two rules is consolidated financial reporting. A 'Group' is broadly defined in the OECD Model Rules as a collection of entities related through ownership or control such that the assets, liabilities, expenses and cashflows are either included in the Consolidated Financial Statements of the parent or excluded solely on the grounds of materiality or being held for sale. A Group also includes a parent and its permanent establishment, which is also regarded as an entity for Pillar Two purposes.

The rules further define Consolidated Financial Statements as those that are prepared in accordance with an acceptable accounting standard or those that would have been so prepared if none exist. The latter part of this test, referred to as the 'deemed consolidation' brings into scope potential groups of entities that would not ordinarily be accustomed to preparing consolidated financials, and may, in some cases not practically consider themselves to be part of a 'Group'. However, the deemed consolidation test must be interpreted within the context of the Accounting Standards themselves and, where the IFRS 10 Investment Entity exception from financial reporting is in play, the OECD guidance has clarified that the deemed consolidation test does not override this. That is, if an entity applies the IFRS Investment Entity exception and is not required to consolidate on a line-by-line basis, it would not, all things being equal, qualify as a MNE Group for the purposes of Pillar Two.

If an entity does produce Consolidated Financial Statements or is otherwise in scope, the Pillar Two rules also contain a separate (but aligned with IFRS 10) definition of Investment Funds and Investment Entities. Such entities are excluded from the rules if they are the Ultimate Parent Entity of the group, but this does not necessarily exclude their controlled investments, which can result in umbrella funds quickly reaching the 750m+ Euro threshold. Furthermore, Investment Entities are subject to special rules within Pillar Two which generally means there is no blending of income with non-investment entities. Moreover, special elections are available to ensure the policy behind tax neutral investment vehicles is not adversely impacted.

The OECD guidance provides some leeway for jurisdictions' policy choices when it comes to investment entities. For example, certain common funds jurisdictions such as Ireland and Hong Kong have legislated a 'switch off' rule to exclude Investment Entities from their local domestic minimum tax rules. Australia did not implement this exception, although Securitisation Vehicles are expressly excluded from the Australian DMT, which was the result of swift advocacy by the Australian Securitisation Forum in the lead up to the implementation of the Australian DMT legislation.



Entity classification

The starting point for determining the impact of Pillar Two for all groups (not just those in the financial services and insurance sectors) is to determine the group 'perimeter' and to then characterise each entity within the group according to the Pillar Two classification rules. This characterisation is critically important as it can determine an entity's location, whether income or taxes are allocated to or from the entity, as well as whether the entity can benefit from the Transitional Safe Harbour ("**TSH**") provisions.

For example, entities that are 'fiscally transparent' with respect to their income, expenditure, profit or loss in the jurisdiction they were created in, are termed a 'Flow-Through Entity' (unless the entity is tax resident and subject to Covered Taxes on its income or profit in another jurisdiction). Flow-Through Entities are generally treated as 'stateless' entities and are therefore excluded from applying the TSH. However, Flow-Through Entities that are also the Ultimate Parent Entity or '**UPE**' of the group are treated as located in the jurisdiction in which they were created and can therefore in principle benefit from the TSH.

Flow-Through Entities are then further classified into either Tax Transparent Entities or Reverse Hybrid Entities. The relevance of this sub-classification is in relation to the allocation of the entity's income or taxes when performing the ETR calculations for Pillar Two. Specifically, the Financial Accounting Net Income or Loss' or 'FANIL' and Covered Taxes of Tax Transparent Entities (being entities that are also fiscally transparent in the jurisdiction in which their owner is located such as a US LLC that is owned by a US incorporated (regarded) company) are allocated to the Transparent Entities' Constituent Entity-owners. As a result, whilst a Tax Transparent Entity is excluded from applying the TSH, in practice this may have less relevance because the entity should not have any GloBE Income.

On the other hand, the FANIL and Covered Taxes of a Reverse Hybrid entity (being a Flow-Through Entity whose owner treats it as a fiscally opaque entity) remains allocated to the entity. In that case, the inability of the entity to access the TSH does have a practical impact because the entity will have FANIL and, as it is fiscally transparent in the jurisdiction of creation, will typically not have any Covered Taxes.

But even in this 'simple' set of rules there are a number of complex questions that arise when applying them to real-life examples, many of which are the subject of pages of OECD Commentary. For example:

- When classifying a Flow-Through Entity as a Tax Transparent or Reverse Hybrid Entity, which owner should be the 'reference entity to determine this sub-classification'?
- The consequences of an entity being partly Tax Transparent and partly Reverse Hybrid depending on each owners' treatment of the entity?
- How should you treat FANIL and Covered Taxes of a Tax Transparent Entity that is also the UPE of a group, on the basis that there is no 'Constituent Entity-owner' to which you can allocate the FANIL and Covered Taxes?
- When testing if a jurisdiction treats an entity as fiscally transparent, how does this apply to jurisdictions with no tax regime (e.g. Cayman Islands)?

The above matters are complicated for most financial services and insurance groups and grows more complex where fund structures are equity accounted, as discussed below.



Fund structures

Funds are typically structured as trusts or partnerships and may be established under Australian or (more often) foreign law. Accordingly, classifying funds will generally require a detailed understanding of the treatment of the fund in multiple jurisdictions (particularly if the fund has more than one owner).

Furthermore, where a fund is established in a jurisdiction where there is no corporate tax regime (such as the Cayman Islands or the British Virgin Islands), the OECD Commentary states that these entities cannot be fiscally transparent in their jurisdiction of establishment and, therefore, cannot be Flow-Through entities. The surprising consequence of this is that such entities are therefore in principle eligible to apply the TSH because they are 'located' in a jurisdiction rather than being stateless.

Applying the TSH to such entities is further complicated by OECD Action 13 Country-by-country ("**CbC**") guidance which provides specific rules for how to report the income of tax transparent stateless entities.



Joint Ventures

The treatment of JVs depends on whether the JV is consolidated on a line-by-line basis or whether it is subject to equity accounting or recorded at cost. In the former case, these entities are not strictly subject to the specific Pillar Two rules for “JVs”; instead, their treatment depends primarily on the level of the UPE’s ownership.

In the case of equity accounted funds, if the UPE owns at least 50% of the entity, then it will be subject to specific JV provisions in the Pillar Two rules. Those provisions effectively treat the JV (and its subsidiaries) as a separate ‘group’ for Pillar Two purposes and it will calculate its ETR without blending FANIL or Covered Taxes with other members of the UPE group.

Again, this rule is in principle relatively straightforward. However, significant complexities arise when, for example, the JV is itself a Flow-Through Entity on account of a deeming rule that treats the JV to be a UPE and its subsidiaries as Constituent Entities of a separate (deemed) Group.

This results in seemingly contradictory provisions in the Australian rules - does the deeming of the JV as a UPE mean it must strictly apply all of the look-through allocation provisions applicable to UPEs (essentially allowing the JV to reduce its GloBE Income if its direct owners are subject to tax on the JV’s income to at least 15%), or can a group that is applying an IIR or QDMTT to a flow-through JV avail itself of provisions that would respect a consistent outcome with a Constituent Entity (allowing the JV to trace through to indirect owners to determine whether this subject to tax requirement is met)?

There is minimal guidance on the treatment of flow-through JVs and taxpayers with these fact patterns are therefore left with a difficult analysis on their hands.

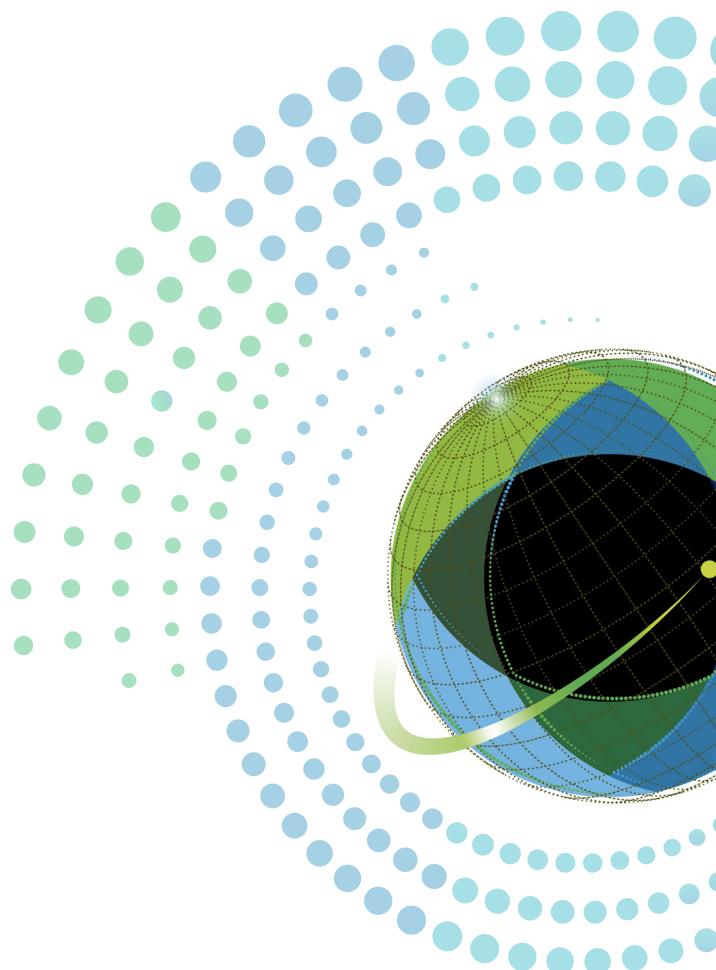
One alternative that groups with these structures might consider is for the JV to apply the TSH instead, thereby avoiding this uncertainty under the full GloBE rules. But this brings an entirely new set of uncertainties:

- Section 8-80 provides a special rule for JVs applying the TSH to address the problem that, typically, unconsolidated JVs will not be included in the MNE Group’s CbC report. As a concession, therefore, the rules allow JVs to access the TSH but, instead of relying on CbC data to calculate their profits, they instead take this information from Qualified Financial Statements (“QFS”) of the JV. In principle this is a helpful concession for JVs. But a benefit of relying on CbC data is that, per the OECD Action 13 guidance, dividends from other Constituent Entities are excluded from revenue and profits (and therefore excluded from the TSH calculation). Taking data from Qualified Financial Statements may not allow adjustment for intra-JV group dividends if not prepared on a consolidated basis;

- Section 8-85 contains an additional TSH rule for UPEs that are Flow-Through Entities which effectively imports the ‘full’ GloBE rule restriction in s 7-5(2) discussed above. However, the TSH version of the rule is even stricter – if there is even a *single* direct owner of the JV that doesn’t meet the subsection (e.g. one direct owner does not subject the income of the JV to at least 15% taxation), then the jurisdiction in which the UPE (i.e. the JV) is located cannot rely on the TSH.

What makes this strict position even more confusing in the JV context is that the OECD Commentary on the corresponding Model rule was intended to address a very specific mischief; namely, a mismatch between a Flow-Through UPE’s GloBE Income and its income reported for CbC purposes for the TSH. However, as explained in the bullet point above, JVs do not use CbC data for the purposes of their TSH calculations and, arguably therefore, the mischief does not arise in the context of JVs.

As can be seen from the above, funds and JV structures that are commonly used in the financial services and insurance industries present enormous difficulties for multinationals in understanding, interpreting and applying a myriad of complex and often contradictory rules.





Financing arrangements

Certain arrangements involving the provision of credit or the making of an investment are the subject of the only targeted anti-avoidance provisions in the OECD Model Rules - specifically, Article 3.2.7 in the full GloBE rules and the Hybrid Arbitrage Arrangement ("**HAA**") rules in the TSH. Whilst the two rules are similar, surprisingly the HAA in the TSH is the more complex and comprehensive rule.

Where Article 3.2.7 or HAA applies, typically the expense arising from the provision of credit or investment is removed from the GloBE or TSH calculation, thereby increasing the ETR.

Whilst all groups will need to contend with the broad application of Article 3.2.7 and HAA, financial services and insurance groups are again more likely to be impacted, particularly where they have branches in their group structure.

Article 3.2.7 – Branch financing

Article 3.2.7 applies to Intragroup Financing Arrangements where it can reasonably be anticipated over the life of the arrangement to increase the amount of expenses taken into account in calculating the GloBE Income of a Low-Tax Entity without a commensurate increase in the taxable income of the High-Tax Counterparty. For these purposes an Intragroup Financing Arrangement means an arrangement entered into between two or more members of the MNE Group whereby a High Tax Counterparty directly or indirectly provides credit or otherwise makes an investment in a Low-Tax Entity.

In the context of banks, it is not uncommon for an Australian bank to provide a loan to its foreign branches that may be located in a low-tax jurisdiction. To the extent that the branch is exempt from Australian income tax, interest income arising to the Australian head office on such a loan would not be subject to income tax.

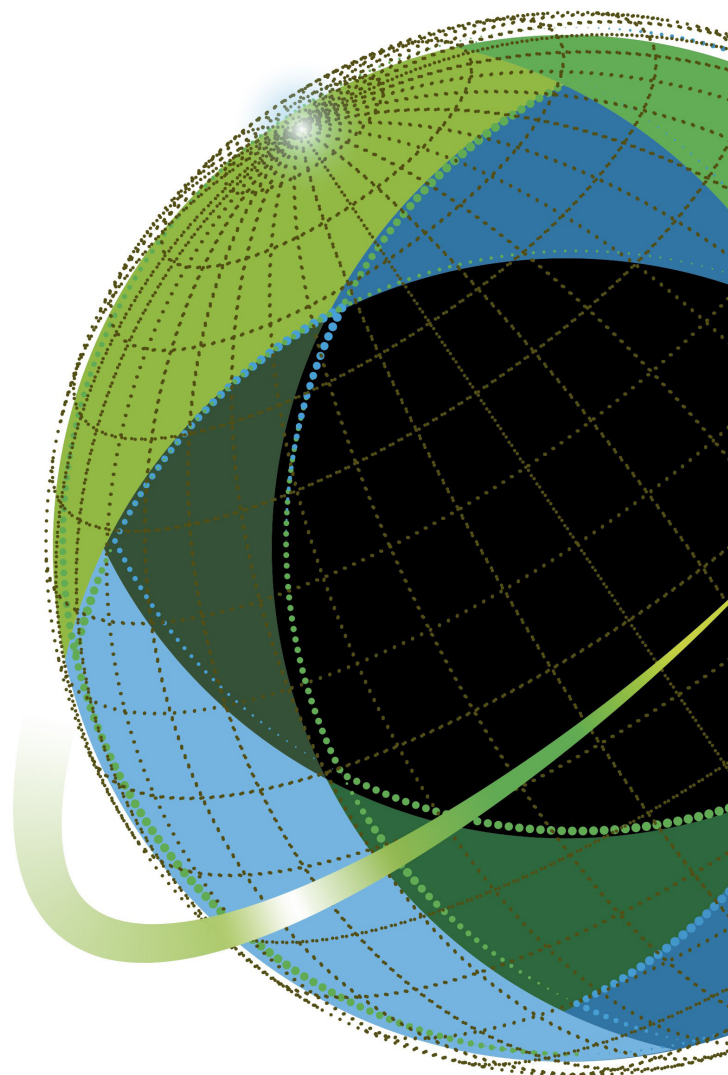
In that case, the expense may be excluded under Article 3.2.7 for the purposes of the branch jurisdiction's ETR. This is despite the fact that the loan may be entirely tax neutral, i.e. non-deductible in the branch jurisdiction and non-taxable in Australia.

Article 3.2.7 – Tracing methodology

Article 3.2.7 contemplates a tracing of funds between High-Tax and Low-Tax counterparties. However, it is not clear whether the "directly or indirectly" language is intended to apply to the provision of credit as well as the making of an investment.

For example, consider a scenario where High-Tax A Co (located in jurisdiction A) subscribes for ordinary shares in High-Tax B Co (located in jurisdiction B). High-Tax B Co on-lends the funds to Low-Tax C Co (located in jurisdiction C). Ordinarily, C Co could claim a deduction for the interest expense and the corresponding income is fully taxed in B Co. However, A Co may not be subject to tax on dividends it receives from B Co due to a dividend participation exemption.

In this scenario, High-Tax A Co may be considered to have made an "indirect" investment in Low-Tax Co, however, has not provided 'indirect provision of credit'. Article 3.2.7 should therefore not apply, but this simple example highlights how the lack of clarity regarding the scope of Article 3.2.7 can give rise to material uncertainty in respect of scenarios that are relatively common, such as intragroup loan tracing.





Industry-specific

Insurance

Insurance groups face a number of unique challenges in the context of Pillar Two. For example, due to regulations in certain jurisdictions, insurance groups will often hold a substantial amount of government-issued bonds which can subject to preferential tax treatment (including outright exemptions in respect of interest arising under the bond). This can result in insurance groups having a 'structural' ETR deficiency in certain jurisdictions, with any Pillar Two top-up tax liability eroding the benefit of these preferential regimes.

Applying the undefined 'annual revenue' definition to assess the 750m Euro threshold in the context of net revenue activities as commonly reported by those in the insurance (and banking) sectors also adds a complexity.

Insurance groups also have a number of specific adjustments and elections within the rules, including:

- Income that is contractually payable to policyholders is excluded from GloBE income;
- Taxes incurred on returns to policyholders are offset against reductions in policy liabilities (i.e. these taxes are effectively removed from the ETR calculation); and
- Allowing so-called Insurance Investment Entities (being entities that would otherwise meet the definition of an Investment Fund or Real Estate Investment Vehicle except that they are established in relation to liabilities under an insurance or annuity contract and are wholly-owned by an insurance entity) to elect to be treated as a Tax Transparent Entity in certain cases.

Banking

Banks will typically face all the issues set out in this article (other than the insurance-specific topics immediately above). Beyond this, there is only one Pillar Two provision that is specific to the banking industry in relation to Additional Tier One capital (albeit this may also be relevant for insurance groups too).

Additional Tier One Capital is defined to be an instrument that is:

- Issued pursuant to prudential regulatory requirements applicable to the banking sector;¹
- Convertible to equity or written down if a trigger event occurs; and
- Has other features which are "designed to aid loss absorbency in the event of a financial crisis."

Typically, Additional Tier One capital is treated as equity for accounting purposes such that distributions made or received under the instrument do not impact the P&L (and therefore are not considered when calculating GloBE Income). However, the capital can also be treated as debt for tax purposes in a number of jurisdictions resulting in a permanent difference between accounting and taxable income.

In order to address this issue, the rules allow for increases or decreases in equity attributable to Additional Tier One capital to be included as income or expense in the GloBE Income calculation. Moreover, the OECD Commentary states that the intra-group financing rule in Article 3.2.7 (discussed above) does not apply to distributions that are treated as an expense under this rule.



¹ For completeness, the OECD guidance recognises that similar instruments are issued by insurance groups (often called Restricted Tier One Capital). The guidance notes that the special rules for Additional Tier One Capital should equally apply to these instruments.

Concluding remarks

Groups should be mindful of the breadth of the Pillar Two rules so that they can anticipate and plan for unexpected outcomes that can arise. The rules are complex and unfortunately given there is no blanket exemption for the sector, a 'one-size fits all' approach could lead to unwelcome surprises, particularly for groups in the financial services and insurance sectors.



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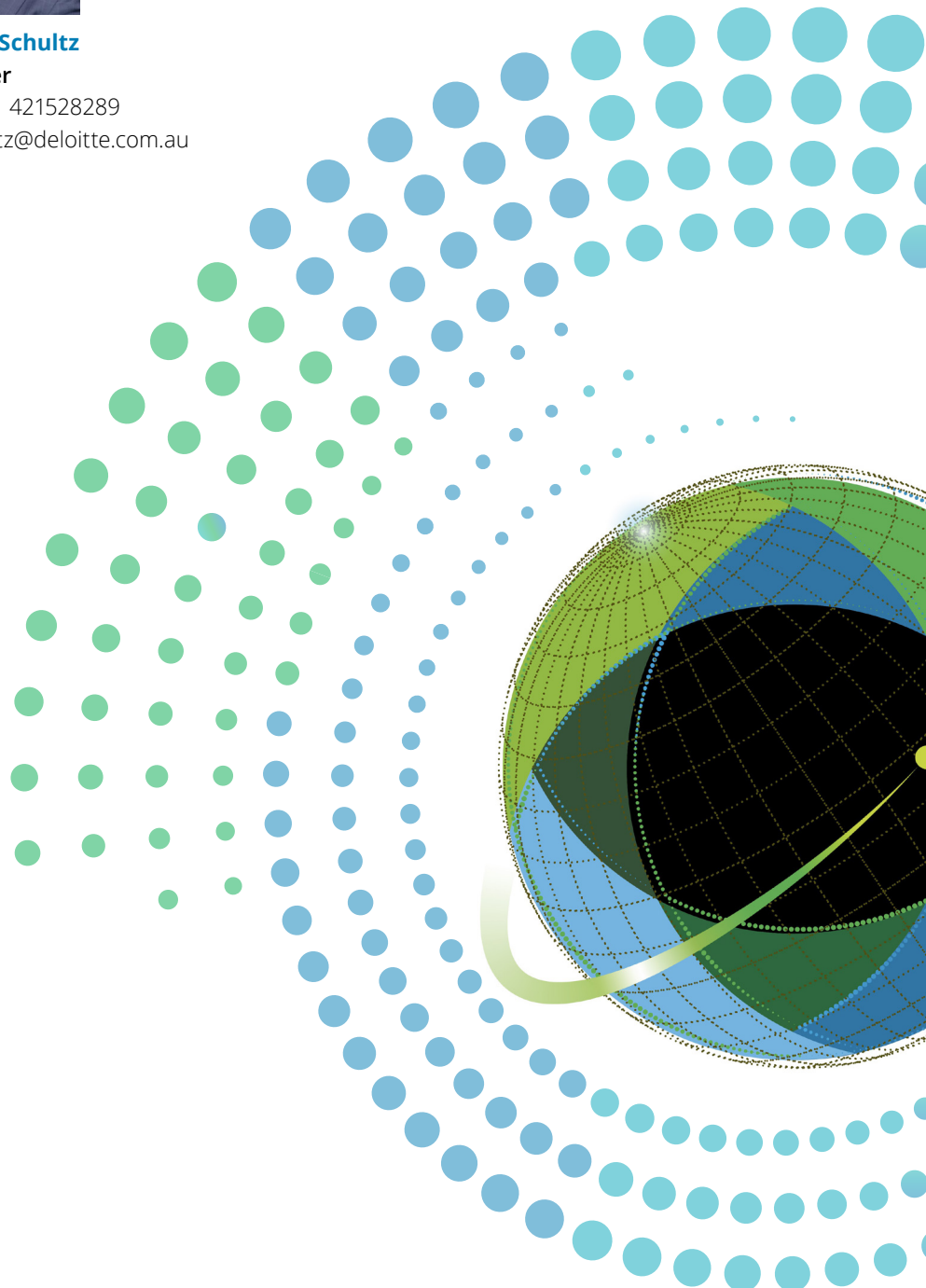
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