February 6, 2024

HM Revenue and Customs
100 Parliament Street,
London, SW1A 2BQ

Re: December 2023 Consultation Document on the HMRC Pillar Two Guidance Manual

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association (SIFMA)[1] and SIFMA's Asset Management Group (SIFMA AMG)[2] submit these comments and recommendations in response to the HMRC's public consultation draft released on 21 December 2023 on the Guidance Manual to the Multinational Top-up Tax and Domestic Top-up Tax.

I. Overview and Recommendations

As jurisdictions implement the Pillar Two rules into domestic legislation, consultations are vitally important to ensuring a common understanding of the rules and consistency in application of the rules. The UK draft manual to its Multinational Top-up Tax and Domestic Top-up Tax provides a plain meaning description that aids in understanding the rules and highlights where

[1] SIFMA is the leading trade association for broker-dealers, investment banks and asset managers operating in the U.S. and global capital markets. On behalf of our industry's nearly one million employees, we advocate for legislation, regulation and business policy, affecting retail and institutional investors, equity and fixed income markets and related products and services. We serve as an industry coordinating body to promote fair and orderly markets, informed regulatory compliance, and efficient market operations and resiliency. We also provide a forum for industry policy and professional development. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA).

[2] SIFMA'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.

consistency in the rules is still required.[3] This submission focuses on the following issues of urgent concern to multinational enterprises (MNEs) engaged in the regulated financial services business:

- The treatment of intra-group financing arrangements that are common funding arrangement for foreign branches of global banks.
- Recommendations relating to the allocation of US tax to foreign branches.
- The application of Adjusted Covered Taxes for Loss-Making Parent Entities of PEs.
- Further clarification of the definition of Tax Transparent Entities.
- Simplifying the amounts eligible for the Taxable Distribution Method election.
- Application of QDMTTs to funds.
- The treatment of Umbrella and Sub-funds.

II. Discussion of Issues

A. Intra-group financing arrangements need clarification.

Reference: Model Rule Article 3.2.7 and 3.2.10 / UK Rules 154 and 155 / MTT21240

For real foreign branches of banking MNEs, the anti-hybrid rules aimed at intra-group financing arrangements are far too broad and should be clarified so as not to capture ordinary course transactions where income is already subject to tax (so-called dual inclusion income) as well expense or loss solely with respect to regulatory capital.

By way of background, Article 3.2.7 of the Model Rules excludes any expense attributable to an Intragroup Financing Arrangement that can reasonably be anticipated to increase the expense of a low-tax entity without an increase in taxable income of the counterparty. According to the Commentary, this rule prevents MNE Groups from engaging in transactions that are intended to increase the effective tax rate (ETR) in a jurisdiction that is below the Minimum Rate by reducing the GloBE Income or Loss in such jurisdiction without increasing the taxable income of the counterparty to the arrangement. *See* para 127 of the Commentary at page 67. For Pillar Two purposes, branches are treated as separate constituent entities (CEs) and thus subject to this rule. However, under a worldwide tax system, such as the US tax system, this treatment is not appropriate because branch income is ultimately fully included as taxable income in the United States and should be treated as dual inclusion income.

For many MNE banks, intragroup transactions manifest themselves as loans between the home office and a branch (which are true branches), are ordinary course funding transactions that

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[3] HM Revenue and Customs (2023), Draft guidance on Multinational Top-up Tax and Domestic Top-up Tax [Draft guidance on Multinational Top-up Tax and Domestic Top-up Tax - GOV.UK (www.gov.uk)].

can amount to billions of dollars in a year, and the application of Article 3.2.7 will inappropriately trigger top-up tax and hinder movement of liquidity. Importantly, while many tax systems, like the United States, that fully tax foreign branch income will disregard such transactions, the income ultimately is fully taxed at the full corporate tax rate. In fact, regardless of whether the interbranch loan is recognized or disregarded, the result is the same, with the US including the full amount of the legal entity's income. Therefore, while on a transaction-by-transaction basis, the income received is not regarded for tax purposes. The income is ultimately fully included in the tax base of the CE counterparty, in this case the parent/home office of the branch, resulting in a commensurate increase in its taxable income.

Moreover, these ordinary course lending arrangements are subject to regulatory constraints that relate to the adequate funding of the entities that are party to the arrangements, and they cannot be created for artificial purposes. Applying the rule to such transactions is far beyond the intent of Article 3.2.7 of the Model Rules. Therefore, Article 3.2.7 as well as the UK guidance should be clarified to ensure such payments between branch and home office that are fully taxable in the home office jurisdiction are not captured by the anti-hybrid rule.

Most recently, the OECD on December 18, 2023, issued administrative guidance (December AG) on the transitional CbCR Safe Harbor that sought to address "avoidance transactions" that exploit differences between tax and accounting treatment of certain transactions in order to allow a CE to qualify for the Safe Harbor, noting that Article 3.2.7 was not originally included in the Safe Harbor rules.[4] The December AG thus addressed in the context of the Safe Harbor so-called deduction/non-inclusion arrangements in a manner similar to Article 3.2.7 and noted that further guidance will be provided to address hybrid arbitrage arrangements in the context of the GloBE rules. The Safe Harbor rule applies when one CE directly or indirectly provides credit or otherwise makes an investment in another CE that results in an expense or loss in the financial statements of the CE to the extent that "there is no commensurate increase in the revenue or gain in the financial statements of the CE counterparty; or the CE counterparty is not reasonably expected over the life of the arrangement to have commensurate increase in its taxable income." *See* para 74.27 of the December AG (defining a deduction / non-inclusion arrangement). The December AG adds that an arrangement will not meet the definition of a deduction / non-inclusion arrangement to the extent the relevant expense or loss is solely with respect to Additional Tier One (AT1) Capital.

Additional guidance is required to properly incorporate the December AG's exclusion of AT1 Capital as a deduction / non-inclusion (DNI) arrangement into the GlobE Rules as well as clarify that the December AG's paragraph 74.27 (defining a DNI arrangement) and Model Rule's Article 3.27 do not apply to the extent the relevant payment is reduced by dual inclusion income. The UK's own dual inclusion income can provide a basis for this guidance but should be imported into Article 3.2.7 in a way that is broad enough to apply to income that is taxed under various types of CFC tax regimes. Moreover, the Dec AG applies the dual inclusion income rule to duplicate loss

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4 OECD (2023), Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), December 2023, OECD/G20 Inclusive Framework on BEPS, OECD, Paris, http://www.oecd.org/tax/beps/administrative-guidance-global-antibase-erosion-rules-pillar-two-december-2023.pdf.

arrangements (DLA, defined in the Dec AG's paragraph 74.28) but is too limited. The exclusion applies only to the extent the particular CE (with the relevant expense or loss that might create a DLA) also reports income. *See* paragraph 74.30(f) of the Dec AG. Requiring income to be matched to the CE with the expense or loss does not properly monitor whether there is DLA. We think dual inclusion income should also include revenue of other CEs located in the same jurisdiction as the loss CE if that income is subject to tax in the jurisdiction of the CE owner. For example, if a branch CE has a 100x loss and a hybrid CE in the same jurisdiction has income, both flow to the CE-owner and the loss of the branch should not be a DLA to the extent the Hybrid CE reports income. Applying the dual inclusion income rule on a jurisdictional basis is a better measure of whether a DLA exists.

For AT1 Capital or qualifying tier one capital, the Commentary to Article 3.2.10 of the Model Rules and the UK rules under Section 155, expressly excludes certain intragroup transfers from the anti-hybrid rules when related to regulatory capital. It is important that the definition of bank regulatory capital be as expansive as possible, and that regulatory capital be defined properly. For AT1 that is accounted for under IFRS as equity, paragraph 144 of the Commentary (at page 70) expressly excludes the application of the anti-hybrid rule: "Article 3.2.7 does not apply to deny a deduction for distributions treated as an expense pursuant to Article 3.2.10." This exclusion will not apply when AT1 is accounted for under US GAAP. US GAAP treats AT1 as debt and the adjustment to GloBE Income provided by Article 3.2.10 is unnecessary for US GAAP. However, AT1 accounted for under US GAAP is equally in need of the exclusion from Article 3.2.7 that para 144 provides. This idea was acknowledged in the CBCR guidance that expressly excludes an expense or loss with respect to AT1 from being a deduction / non-inclusion arrangement. Moreover, the EU Commission released an FAQ that clarifies that a broader range of regulatory capital instruments that can have loss absorbing/bail-in effects in times of financial stress should be excluded from 3.2.7 treatment. These are instruments that are categorized as AT1 under the Basel III regulatory framework and encompasses Tier 2 and other subordinated instruments classified as Mandatory Requirement of Eligible Liabilities, or MREL, a well as Total Loss Absorbing Capital, or TLAC. This more expansive range of regulatory capital instruments should be incorporated. Therefore, it is appropriate to exclude from 3.2.7 such regulatory capital in as broad a manner as possible.

Guidance is also required for determining the scope of the rules. It is notable that while Article 3.2.7 only applies to low-tax borrowers, the December AG applies to all jurisdictions. This further complicates the ability of banks located in high-tax jurisdictions to utilize the CbCR Safe Harbor and could prevent these banks from availing themselves of the Safe Harbor due to the magnitude of these ordinary course banking transactions. We urge the UK to consider this prospect when implementing the guidance. Importantly, the guidance should not be applied retroactively.

Moreover, the UK's version of Article 3.2.7 states: "a member of a multinational group is a 'low tax member' in an accounting period if the effective tax rate for the standard members of the group located in the member's territory for that period would, ignoring intra-group financing arrangements, be less than 15%." *See* section 154 of the UK Rules. This suggests a hypothetical ETR calculation is required because the language demands that the taxpayer ignore the arrangement when making "the low tax member" determination. Guidance on how this hypothetical ETR calculation should be made would be helpful and should be interpreted to ensure

the rule does not capture payments from a jurisdiction like the UK that, from a GloBE perspective, would generally be a high tax jurisdiction with or without the arrangement.

B. A methodology is needed for the allocation of US tax to foreign branches.

Reference: Model Rule 4.3 / UK Rule 177 / MTT4xxxx

For tax systems that fully include the income and taxes of branches, a methodology is necessary to both determine the income of the branches and the amount of home office tax that results in the amount of tax to be pushed down to the branches (Step 1), and then a methodology is necessary for allocating the home office taxes to each branch (Step 2). The UK rules, like the Model Rule, recognize the current tax expense assessed on the income of PEs is to be allocated. The method of determining the amount to be allocated and how to allocate the tax in various PEs has not yet been determined.

Regarding Step 1: Determination of income and tax of branches -- In the case of branches of US MNEs, the branch income is reported on a US Tax form (Form 8858), which effectively captures the books and records of each branch. The Step 1 amount would derive from this form and be multiplied by the US corporate tax rate of 21%, reduced by the US foreign tax credits (FTCs) used (which are also reported on a US Tax form (Form 1118).

Regarding Step 2: Allocation of US tax for branches -- The temporary CFC push down rule that applies to GILTI should apply for allocating US tax to PEs as well with the applicable rate for the PE allocation being increased to the 21% US corporate income tax rate instead of the 13.125% US tax rate on GILTI.

C. Application of adjusted covered taxes for loss-making parent entities of PEs should be applied equally.

Reference: Model Rule 4.4.1(e) as updated by the Feb 2023 AG

We do not observe in the UK Rules the clarification from the February 2023 Administrative Guidance (Feb AG) to Model Rule Article 4.4.1(e) but further clarification is needed for the application of this rule to permanent establishment (PEs) located in the UK.[5]

Article 4.1 of the Model Rules defines Adjusted Covered Taxes of a CE, in relevant part, as the current tax expense accrued in its Financial Accounting Net Income or Loss (FANIL) with respect to Covered Taxes, adjusted for the Total Deferred Tax Adjustment Amount (determined under Article 4.4 of the Model Rules), and increased by "any amount of Covered Tax accrued as an expense in the profit before taxation in the financial accounts" *See* Article 4.1.2 (a) of the Model Rules. Covered Taxes include taxes imposed in lieu of a generally applicable corporate income tax pursuant to Article 4.2.1(c) of the Model Rules. The Total Deferred Tax Adjustment Amount for

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[5] OECD (2023), Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), OECD/G20 Inclusive Framework on BEPS, OECD, Paris. www.oecd.org/tax/beps/administrative-guidance-global-anti-base-erosion-rules-pillartwo.pdf.

a CE equals the deferred tax expense accrued in its financial accounts but excludes the amount of deferred tax expense with respect to the generation and use of tax credits according to Article 4.4.1(e) of the Model Rules.

The Feb AG modifies the exclusion of the amount of deferred tax expense with respect to the generation and use of tax credits from Total Deferred Tax Adjustment Amount. As explained, the modification is necessary to produce functionally equivalent outcomes for tax attributes that are provided for in lieu of a loss carry-forward when there is a domestic source loss and foreign source income in the same year. The Feb AG allows for a Substitute Loss Carry-forward DTA. The definition of a Substitute Loss Carry-forward DTA would not limit its application to income arising through a PE. In fact, the Feb AG acknowledges some jurisdictions have rules that operate in the same manner with respect to income arising through PE but defers on whether a Substitute Loss Carry-forward DTA can be extended to PEs, indicating that some differences in mechanisms may be necessary given certain differences between the two contexts. We believe similar consideration should be given to expanding this rule in appropriate circumstances to hybrid entities and tax transparent entities.

Until the additional mechanisms that may be necessary for PEs are identified, the rule should apply equally to PEs. We appreciate unique issues with respect to PEs might be considered within the GloBE rules but for this rule, until the nuances of PEs can be discussed, the Substitute Loss Carry-forward DTA should be applied equally to CFCs and PEs.

D. Definition of tax transparent entities needs refinement.

Reference: Model Rule 10.2.4 / UK Rule 168 / MTT17020

The Model Rules try to align income and tax in the same jurisdiction by allocating either income to where tax is assessed (e.g., a Flow-through Entity that is a Tax Transparent Entity (an FTE-TTE)) or tax to where income is reported (e.g., a Hybrid Entity). *See* Model Rule Article 4.3. How tax and income are aligned depend on these definitions, which in turn depend, in part, on whether reference to ownership must be direct or can include indirect ownership.

The UK accurately interprets ownership as both direct and indirect. This is the correct interpretation to ensure FANIL and Covered Tax are aligned. An Entity that is an FTE-TTE (but not the Ultimate Parent Entity), allocates its FANIL to its Constituent Entity-owners in accordance with their Ownership Interests. *See* Article 3.5.1(b). If the Constituent Entity-owners are also FTE-TTEs, FANIL continues to move up the chain until it reaches the UPE (provided the UPE is not an FTE, in which case Article 7.1 applies). *See* Commentary at paragraph 214 (page 81).

An entity located in a jurisdiction without a corporate tax system will not satisfy the fiscally transparent requirement. If the owner of the entity is in the same jurisdiction, the failure of that requirement keeps income from being allocated to the jurisdiction where tax has been assessed.

We appreciate that enacted UK legislation (Section 168) seeks to address and take into account chains of indirect ownership. This is the correct interpretation of the rule, although further refinements to this language would be helpful to ensure that income and tax are always aligned.

E. Amounts eligible for the Taxable Distribution Method election need simplification.

Reference: Model Rule 7.6 / UK Rule 214 / MTTxxxxx

There is a need to simplify the measurement of distributions under the election. Recent guidance achieves some simplification. However, the current design still appears to require calculating 100% of the investment entity's (IE's) undistributed net GloBE income in the tested year and then determining the CE-owner's proportionate share. Undistributed net income is total income of the IE less covered taxes, distributions and deemed distributions to shareholders (other than CEs that are IEs), GloBE Losses in the testing period and investment loss carry-forwards. The real challenge comes with identifying these items at the IE level to arrive at the net income of the IE from which the CE-owner takes its share. This seems to create an impossible task.

We understand there are proposals to simplify applying the TDM election and recommend those simplifications to be incorporated into the UK guidance.

F. Application of QDMTT to investment entities needs to be clarified.

Reference: Model Rule 7.4 as updated by July Guidance / UK Rule 267 / MTTxxxxx

The general GloBE rules appropriately preserve neutrality of funds by collecting the tax from a parent entity under an IIR. The QDMTT rules, as issued in the July Administrative Guidance (July AG), potentially violate neutrality by allowing jurisdictions to collect the tax from the fund as the default rule. *See* para 118.40.5 of the July AG. The UK legislation, however, correctly protects the neutrality principle by excluding IEs from being chargeable. Specifically, the legislation provides that, for multinational groups, an investment entity is not a qualifying entity, but is still treated as member of the group under the DTT for the purposes of:

- Determining its top-up amount (and whether that amount is to be attributed to another member of the group), and
- Assessing whether the group meets the revenue threshold for DTT purposes (see MTT11020).

For any other purpose, an investment entity is treated under the DTT as not being a member of a group. *See* 10020 Scope Domestic Top-up Tax – Excluded entities.

We appreciate that enacted UK legislation preserves the neutrality principle by excluding IEs from assessment under its DTT.

G. Treatment of umbrella and sub funds should be the same.

Reference: UK Rule 233 and 155 / MTT10130

The UK legislation expressly determines that protected cell corporations will not be treated as entities for purposes of the GloBE rules. An umbrella fund should receive the same treatment and we recommend for the sake of clarity and certainty they be addressed as part of the UK Rules.

An umbrella fund is a collective investment scheme that exists as a single legal entity but has one or more distinct sub-funds which operate as separate investment funds. This type of arrangement originated in the European investment management industry, most notably with the SICAV (an open-ended collective investment). The SICAV model was copied for the UK Open-ended investment company (OEIC) rules and the Irish VCIC. Umbrella funds can also take the form of trusts.

The umbrella fund structure makes it less expensive for investors to move from one sub-fund to another and saves the investment manager costs relating to regulatory duplication. Assets are legally ringfenced at the sub-fund level such that each investor in a sub-fund is insulated from the risks/rewards arising in other sub-funds. Such funds typically produce a set of consolidated accounts and also accounts at the sub-fund level.

> As explained in the UK Manual A protected cell company is a type of insurance transformer vehicle that is, legally, a single entity. It is composed of a number of cells, each of which is economically independent and bankruptcy-remote from the others. In addition to the cells, the protected cell company will include a "core" component which effectively acts as an administrator of the protected cell company.
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> A protected cell company, for MTT purposes, is a protected cell company that is incorporated under Part 4 of the Risk Transformation Regulations 2017. [Cross-reference to different manual providing guidance on PCCs].
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> Absent this special provision, the protected cell company as a whole and each of its cells and core would be entities for the purposes of MTT. The provision effectively disregards the company as a whole, and provides that each of its constituent parts is to be regarded as an entity in its own right (supporting the definition of entity, which each constituent part would likely satisfy on the basis it is an arrangement that results in the preparation of separate financial accounts).
>
> When determining whether a component of a protected cell company is a member of a consolidated group, it is of no relevance that it is a part of a protected cell company.

The issues for umbrella / sub funds are similar to those arising for protected cell companies. To ensure certainty, we recommend the UK guidance clarify that where umbrella funds produce accounts corresponding to the individual sub-funds then it is the sub-fund that will be regarded as the entity for MTT purposes. In line with the definition in 10.1, calculations within the MTT should then follow this principle for example 3.2.1 (B)and (C), (7.4-7.6).

III. Conclusion

SIFMA and SIFMA AMG appreciate the opportunity to make this submission on key Pillar Two implementation issues of interest to our members in response to the public consultation on the Guidance Manual to the Multinational Top-up Tax and Domestic Top-up Tax. We look forward to continued discussions with the UK government on these and other issues relating to the

implementation of the GloBE rules. Please feel free to contact PJ Austin (paustin@sifma.org) at SIFMA or Jeff Levey (jeff.levey@ey.com) or Rebecca Burch (Rebecca.burch@ey.com) if you have any questions regarding this submission.

Respectfully submitted,

P.J. Austin
Vice President, Tax
SIFMA