A publication for insurance carriers

Summer 2024

PKF

Insurer **Update**

In this issue

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Insurer Update
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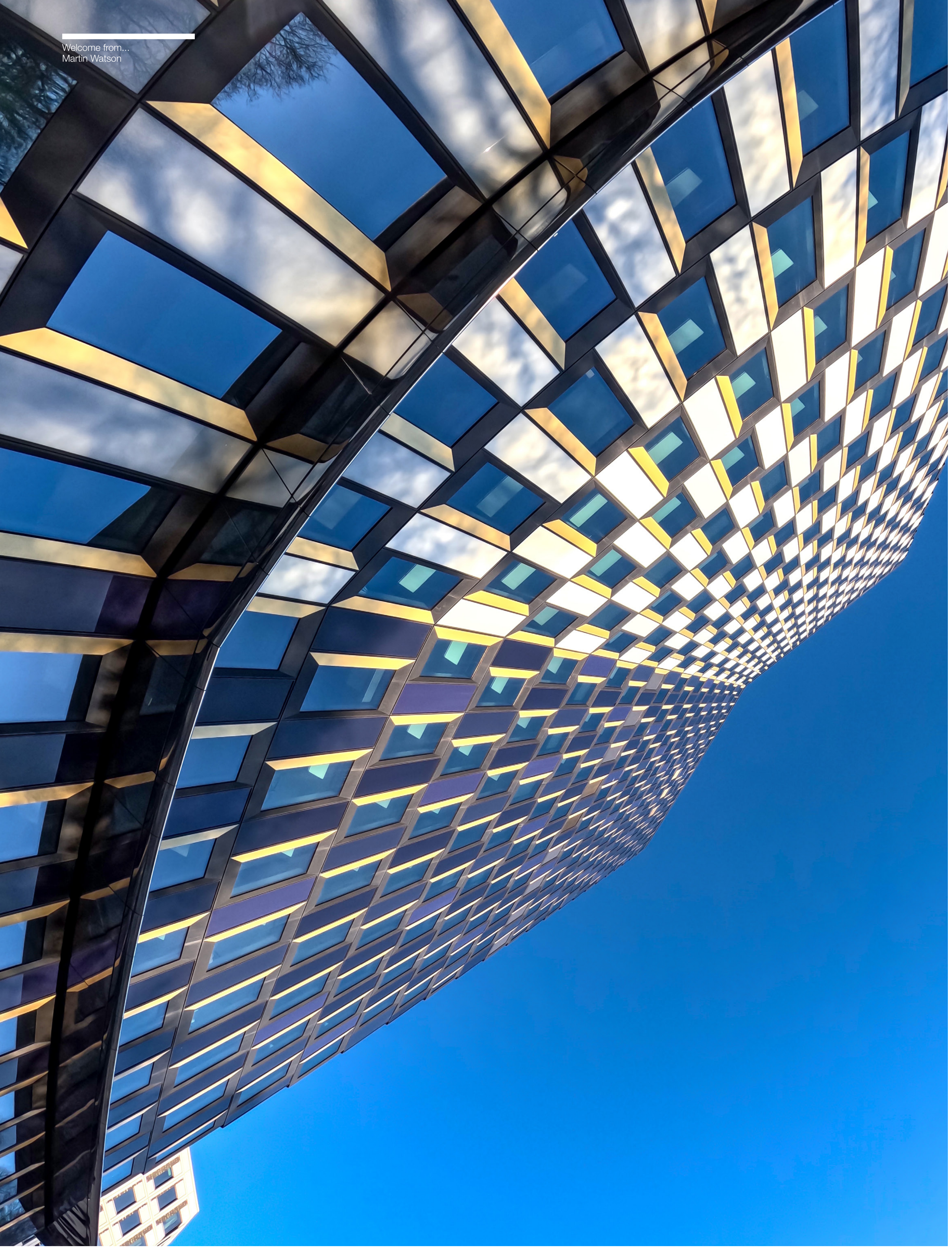

Welcome to our publication for insurance carriers

Welcome to our latest edition of Insurer Update. This publication aims to help carriers across the insurance market understand and digest some of the more pertinent financial reporting and tax developments, and highlight the implications for medium sized and smaller insurers.

Are you ready for the upcoming changes for operational resilience? The growing threats of cyber attacks against a complex geopolitical backdrop, are sharpening the focus of regulators. Jessica Wills explores what firms and boards need to pay close attention to and summarises the changes you need to make by the March IBS deadline.

The FRC have recently published periodic changes to FRS 102. So, what do these changes mean to you and when should you adopt them? Satya Beekarry reviews the changes in detail and shares insights on the key elements, how your revenue streams will be impacted and whether you should consider early adoption.

What do the revised thresholds for Solvency II mean for firms? And what are the benefits of becoming a non-directive firm? James Randall examines the PRA's latest policy statement and summarises the changes coming to small firms under PS2/24 on 31 December 2024.

What does Pillar Two mean for UK intermediate entities of US parented insurance groups? Mimi Chan considers why it is important for multinational entities to understand the interaction of Pillar Two and US tax principles – and how this may affect UK intermediate entities.

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Operational resilience: are you ready?

The growing threats of cyber attacks and operational risks against a complex geopolitical backdrop are sharpening the focus of regulators. We summarise what firms must do by the March IBS deadline.

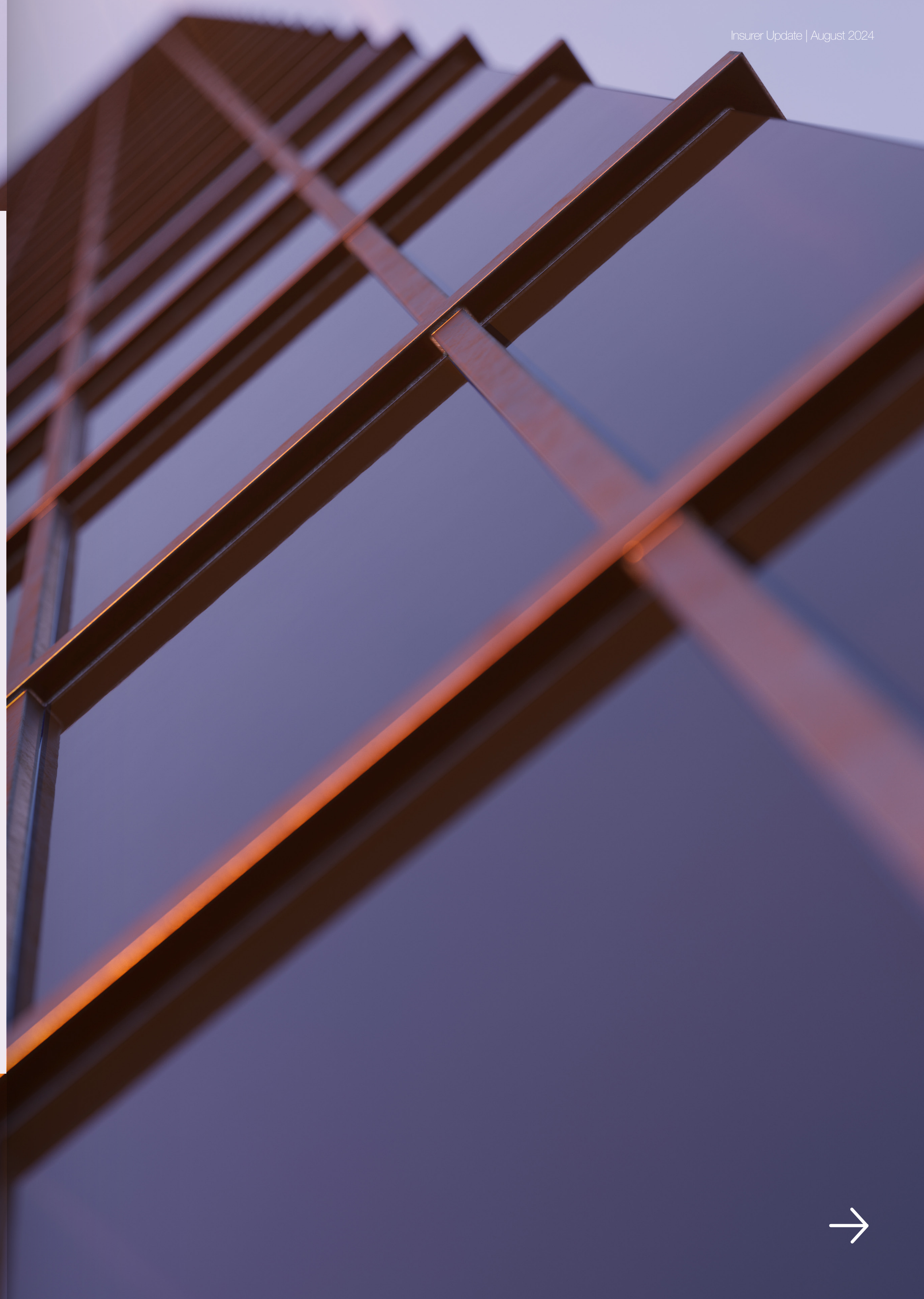
Both the **PRA's Insurance Supervision: 2024 Priorities** and the **FCA's Business Plan 2024/25** highlight the challenging environment and emphasise their ongoing commitment to operational resilience.

With regulatory topics like Consumer Duty, multi-occupancy buildings insurance and gap insurance taking the limelight in recent years, the regulators' efforts on resilience are expected to intensify through the rest of 2024 and leading up to the 31 March 2025 deadline.

By March, insurers and other in-scope firms must be able to operate and maintain their important business services (IBS) within their defined impact tolerances. This marks the end of a three-year transition period when firms were expected to refine and test their operational resilience frameworks.

With the clock rapidly ticking, it's important to be prepared. The FCA recently published some helpful insights and firms are encouraged to consider these as they assess their readiness.

We summarise the FCA insights below, along with questions firms may want to ask.

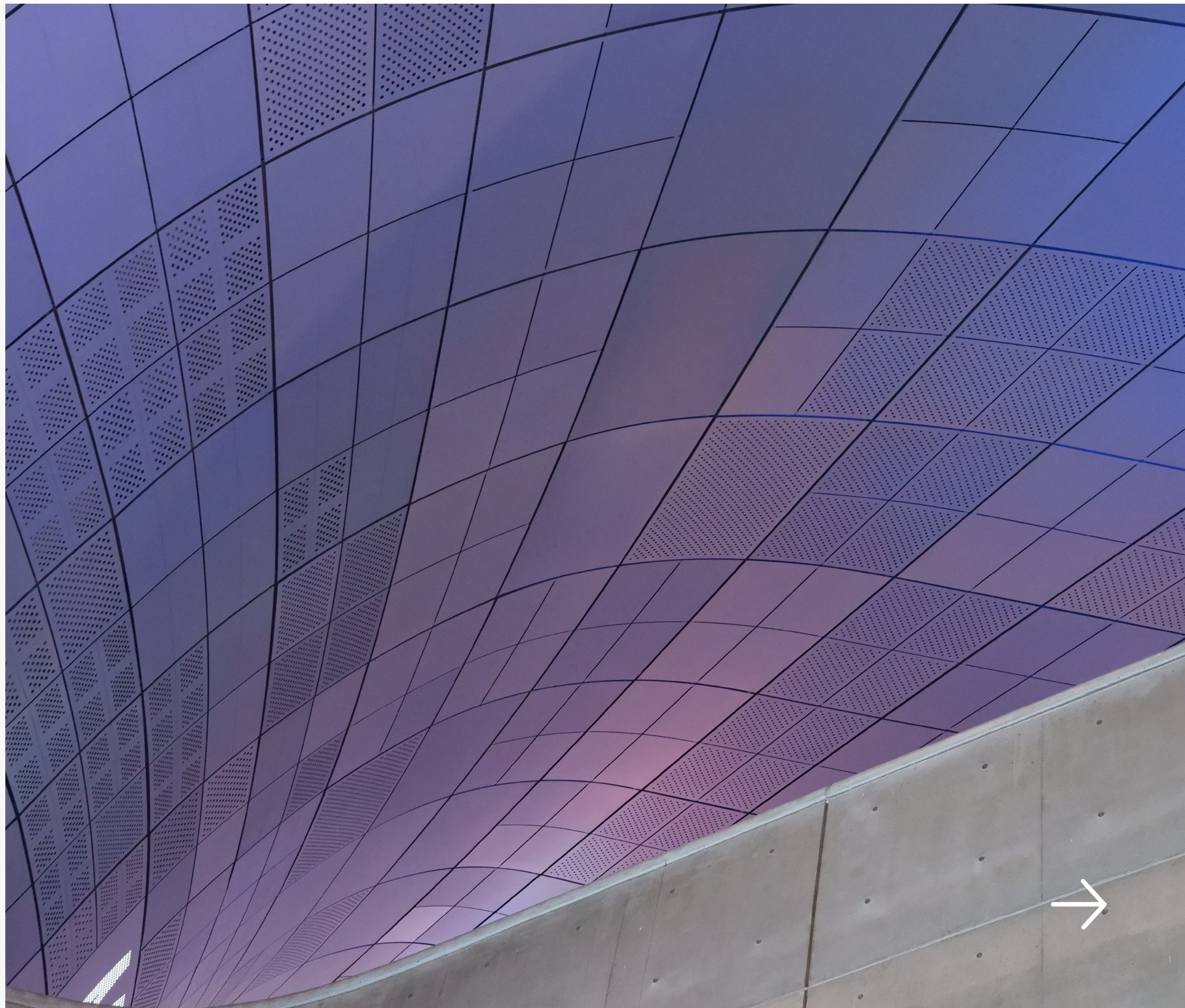


FCA insights	Questions for firms
Important business services (IBS)	
• Inconsistency in firms identifying their IBS appropriately • Need to look at all factors when identifying IBS. SYSC 15A.2.4 lists a minimum 13 different factors to be considered • Rationale and justification for IBS should be documented in firms' self-assessments	• Have there been any changes to your business model or the services you provide? And have these been considered from an operational resilience perspective? • Have any changes impacted the minimum factors that would influence your identification of an IBS? • Is your consideration of, and conclusion on, each of the minimum factors clearly documented? • Does your self-assessment document provide enough information about the IBS you have selected / not selected and your reasons?
Impact tolerances	
• Wide range of impact tolerances identified by firms with limited rationale – this should be documented in firms' self-assessments • Many firms setting time-bound tolerances – firms should consider other measures to complement this • Impact tolerances differ from recovery time objectives (RTOs) which means the maximum time to recover the service. To avoid intolerable harm, processing must take place once the recovery of service is complete	• How well have you explained and justified the impact tolerances you have established? Does the Board understand clearly what has been set and why? • Other than time-bound tolerances, what additional metrics have you considered or established, (eg numbers or types of customers or transactions affected)? • Have you looked at the interaction between impact tolerances and RTOs? RTOs will typically need to be set well within impact tolerances

Mapping and third parties	
• Mapping expected to have matured over time • Where third parties support or deliver IBS and fail to remain within impact tolerance, this is still the responsibility of firms • Relationships with third parties should be actively managed • Detailed mapping should help firms to identify vulnerabilities	• Have there been any changes to people, processes, technology, facilities and information that need to be reflected in your mapping? • Have all relevant third parties been captured in your mapping? • Where you rely on third parties to provide an IBS, how well do you understand their people, processes, technology, facilities and information? • Have you established appropriate governance and controls around critical third-party relationships to manage these on an ongoing basis? • Have you revisited your mapping to see if any new dependencies or vulnerabilities have emerged?
Scenario testing	
• Firms should consider the five minimum scenarios in SYSC 15A.5.6 • Testing expected to have matured and become more sophisticated over time. Includes increasing the severity of disruption to fully understand the effectiveness of response and recovery plans and the severity at which the firm can no longer remain within impact tolerance • Firms should mature the format and type of testing – evolve from judgement, desk-based scenario tests to a wider range of tests (eg penetration tests, disaster recovery / failover tests, simulations, lessons learned from real scenarios • Testing should include third parties • Should perform horizon scanning to develop understanding of new and emerging risks – this will inform testing	• Has the testing so far considered the minimum scenarios? • Have you completed the testing plan originally established? And has this evolved and matured over time, including testing against greater levels of severity? • Have you performed different types of tests, including live simulations? • To what extent has your testing involved third parties?

Vulnerabilities and remediation	
• Vulnerabilities identified early in transition period should have been remediated (or significantly progressed) and re-tested to verify that vulnerabilities have been resolved • Remediation plans should be approved, fully-funded and governed • As mapping and scenario testing matures, vulnerabilities should be reviewed regularly. Any new vulnerabilities should be remediated	• Have you addressed any vulnerabilities identified from the testing to date? • Have you re-tested these vulnerabilities and used different scenarios or severities to prove the vulnerability has been remediated? • Are there any remaining vulnerabilities? And do you have an approved and fully-funded remediation plan? What is the governance that ensures completion by March 2025?
Response and recovery plans	
• Response plans are important as they can buy time for recovery plans to complete and may help to avoid breaching impact tolerance • There is limited testing of response plans	• Do you have response plans setting out your initial reaction to an operational incident? • Does your response plan consider management actions / decision-making and the necessary communications? • Have you tested your response plan?
Governance and self-assessment	
• Self-assessment must include minimum requirements in SYSC 15A.6.1 and detail firms' journeys to operational resilience • Expected to mature and develop over time • From a governance perspective, firms must provide sufficient information and justifications on the determinations, decisions and plans to ensure continued resilience. This allows governing body members to understand firms' positions and roadmaps to resilience • Should highlight any concerns and document the remediation work needed	• Is your self-assessment up to date and does it contain the minimum requirements? • Does the self-assessment reflect the journey (eg from March 2021 to date), and the actions the firm has taken to improve its operational resilience? • Is the self-assessment clear and does it provide sufficient information to inform your Board? • Has your self-assessment been subject to any assurance (eg from internal audit or external parties)? • Does your self-assessment provide a realistic view of any remaining vulnerabilities and the actions you need to take?

Embedding operational resilience	
• Requirement to be operationally resilient is not a 'one and done' activity or seen as a tick-box regulatory compliance – it should be embedded into overall firm culture • Should be embedded into firms' ERM frameworks, including change management and strategic planning • As part of BAU, firms should be reviewing IBS, impact tolerances and mapping regularly (at least annually or if there is a material change to business or market) – as well as regular testing	• Is consideration of operational resilience sufficiently prominent, eg part of Board and management discussions and decision-making? Is it front of mind? • How have operational resilience risks been incorporated into your ERM framework, risk registers, etc? • Is operational resilience given sufficient consideration in strategic planning and change activities? • Have you implemented a regular cycle of reviewing and testing your operational resilience?



What's the impact in Gibraltar?

Operational resilience requirements are well established in the UK, but now we're starting to see them replicated in other jurisdictions, like Gibraltar, where the Financial Services (Operational Resilience) Regulations 2023 were introduced. Under these, firms had until 13 July this year to identify IBS and set impact tolerances. They now have a two-year transition period to July 2026. By then they should have sound, effective and comprehensive strategies, processes, and systems that mean they can address risks to their ability to remain within their impact tolerance for each IBS, in the event of a severe but plausible disruption.

Operational resilience and the plan for the forthcoming thematic review were discussed at the GFSC Insurance Industry Event earlier this year. The key messages were that firms should have:

- Identified their IBS and set impact tolerances for each
- Mapping and scenarios testing programmes should have started
- Mapping should include all critical resources, internal and external dependences for people, processes, technology, data and facilities
- Mapping and scenario testing should evolve with senior management and Board-level involvement
- Scenario testing must assume disruption has occurred. The higher the impact of the disruption, the less likely desktop testing will be sufficient
- Firms should allow sufficient time to identify and address vulnerabilities and build resilience by completing the testing earlier
- Firms must demonstrate the lessons learned and acknowledge any failures in their approach.

In conclusion, it is clear that, in both UK and Gibraltar, there is a lot of work that firms still need to do to reach regulatory requirements and expectations in this area. Combined with the growing threats of cyber risk and operational risks, it is important that firms and their boards pay close attention to make sure they are operationally resilient.

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Solvency UK: changes for small firms

What do the revised thresholds for Solvency II mean for firms? And what are the benefits of becoming a non-directive firm (NDF)?

In November last year, we looked at the potential impact on Solvency UK of the PRA's consultation paper 12/23. This was most likely to affect smaller insurers, as the PRA continues its drive to have a more proportionate approach to the regulation of small firms.

Across the industry, there were 36 responses to CP 12/23. Having considered these, the PRA released a policy statement in February (PS2/24 – Review of Solvency II: Adapting to the UK insurance market | Bank of England). There were a number of changes to the original consultation paper, most notably:

- Capital add-ons (CAOs) – firms won't have to disclose residual model limitation (RML) CAOs in their solvency and financial condition report (SFCR), and safeguards (including RML CAOs) have been removed from the PRA's regular aggregate report on CAOs.
- CAO flexibility – allows for the possibility of setting a CAO which moves dynamically in line with certain outputs calculated by a firm, to show how the underlying risk deviation varies over time.
- Calculating the group SCR – allows an insurance group up to six months after an acquisition to create a clear and realistic plan to integrate any internal models (rather than requiring this immediately on acquisition), and a two-year period thereafter to implement the plan.
- TMTP financial resource requirement (FRR) test – the PRA no longer expects firms to carry out the FRR test when recalculating the TMTP. This is subject to case-by-case assessments for some firms. The change has been made a year earlier than proposed in the consultation paper.
- Solvency II thresholds – increases the threshold for gross written premiums, above which a firm enters Solvency II, to £25m. This is an increase of £10m compared with the original proposals.

Significance of new thresholds

It is the last change, a further increase in the Solvency II thresholds, which is the most interesting for insurers at the smaller end of the industry. The original proposal to increase the thresholds to £15m for gross written premiums and to £50m for technical provisions was expected to affect nine firms currently required to comply with Solvency II.

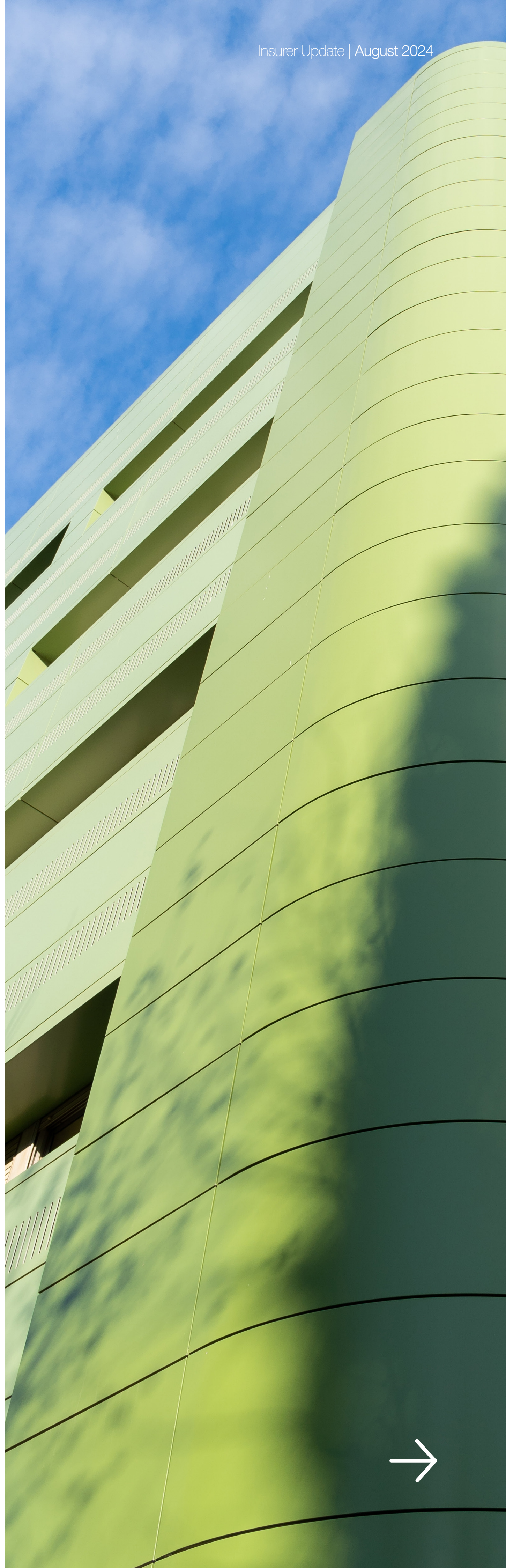
Combined with the confirmed switch in currency to pounds sterling from euros, the PRA estimates the GWP threshold extension to £25m will now give roughly 15 firms an option to move out of Solvency UK. This would account for around £187m in annual gross written premiums for life and non-life business at year end 2021 and £86m in technical provisions across the UK market.

These firms would be excluded from the Solvency UK regime based on their premium income and technical provisions, and have the option to become a non-directive firm (NDF). So let's take a closer look at the potential choices and several of the implications for those considering becoming an NDF.

Initial application

A firm that falls under the new Solvency UK thresholds will not automatically be subject to the prudential regime for NDFs. It must assess whether the threshold increases and currency change will impact its status as a UK Solvency II firm at 31 December 2024.

If a firm concludes it will no longer meet the Solvency UK thresholds and doesn't want to voluntarily become a Solvency UK firm, it should tell the PRA the date on which it will become subject to the NDF section of the PRA Rulebook. Firms can still volunteer to operate under the UK Solvency II regime by applying for a Voluntary Requirement (VREQ) with the PRA.



It's important to consider your organisation's future business plans and projections before taking this decision. The PRA has made clear that firms will only be exempted from Solvency UK at the point of implementation if they have not exceeded any of the revised thresholds for three consecutive years and don't expect to exceed any in the following five years. So forward planning is key to avoiding the risk of constant process changes if your business were to 'bounce' between regulatory regimes.

Reporting requirements

Becoming an NDF is likely to mean less regulatory reporting.

Whilst the requirement for Solvency UK firms to submit a regular supervisory report (RSR) has already been removed with effect from 31 December 2023, the Solvency & Financial Condition Report (SFCR) is still compulsory.

There is no equivalent narrative report necessary for NDF firms. But several quantitative templates are still required, which can be viewed on the PRA website.

Regulatory oversight and audit requirements

It's worth noting that even if a firm falls under the new thresholds and chooses not to comply with the Solvency UK regime, the PRA has said it would still be considered a public interest entity (PIE). This is because PIE is defined under the Companies Act 2006 and cannot be amended by the PRA.

But the FRC's definition of a PIE only includes insurers which are subject to Solvency UK. Some industry participants are therefore seeking to clarify this matter with the PRA. It is the FRC's definition which drives additional regulations for audit firms. Our view is that NDF firms should have a greater choice of external auditor, as they'll no longer be restricted to those on the PIE auditor register.

This has potential benefits for firms. However, most firms that qualify for NDF status will already be exempt from the regulatory audit of their SFCR. In contrast, all NDF firms' regulatory reporting must still be subject to external audit in accordance with the PRA Rulebook. Many in the industry are questioning whether this is proportionate.

Other considerations

As you would expect, NDF firms benefit from a simpler, more proportionate prudential regulatory framework, with generally lower capital standards than are applicable under Solvency UK.

Additional benefits include the freeing up of smaller firms from the qualitative requirements of Pillar 2. For example, they would no longer have to produce an ORSA, and risk and governance requirements would become less onerous.

Some other factors for NDFs to consider include the requirements for senior management functions (which are, again, simpler than those for Solvency UK reporters), the actuarial requirements and other rules relating to conduct and fitness and propriety. We've included some links below for further information.

Whilst it is unlikely that any smaller insurance groups will be writing business outside of the UK, any requirements of overseas regulators should also be considered before changing your regulatory regime.

The implementation date of PS2/24 is 31 December 2024, so firms that fall under these revised thresholds should consider the points in this article, and decide the best option to suit their needs.

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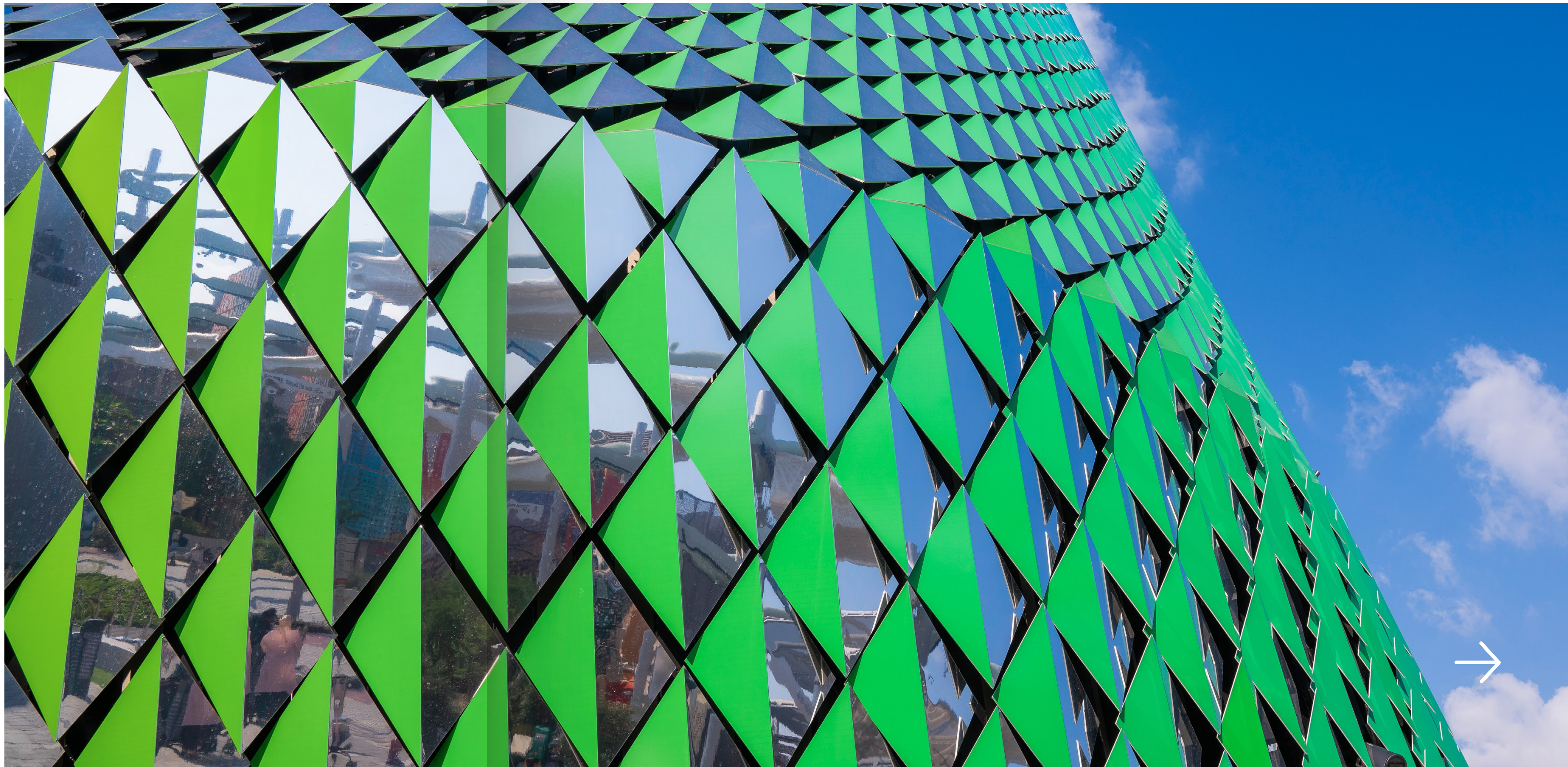


UK GAAP: the latest

We take a look back and forward at this year's consultation papers and recent legislative changes.

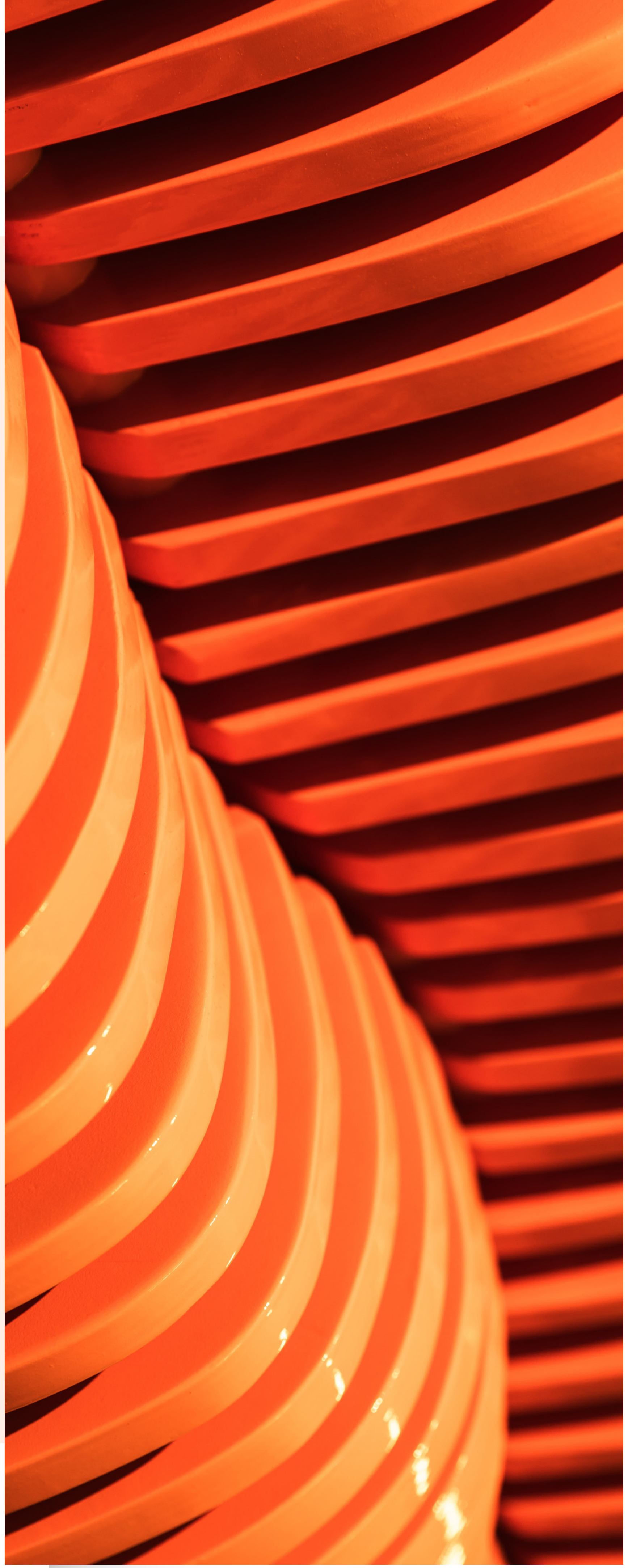
In a previous edition, we provided an overview of the proposals in FRED 82, which were issued at the end of 2022. In March this year the FRC made amendments to FRS 102. These include a new model of revenue recognition based on IFRS 15, a new model of lease accounting based on IFRS 16, new transition requirements for insurance contracts, and various other incremental improvements and clarifications. The revised standard is applicable from 1 January 2026.

Periodic amendments happen at least every five years, but these latest changes are significant for most UK GAAP reporters, including insurers. The FRC has considered proportionality in making them and allows for more flexibility and practical expedients compared to the equivalent IFRS 15 and IFRS 16 standards.

A key benefit of alignment with IFRS principles is that high quality financial information supports a range of broader effects, including improved access to capital. There is consistency with international accounting principles in key areas, which improves comparability and reduces 'GAAP differences'. This means the consolidation process requires fewer topside adjustments for IFRS groups with subsidiaries reporting under UK GAAP. On the other hand, with further alignment while providing reduced disclosure frameworks, UK GAAP is a more attractive option for IFRS group subsidiaries.

The good news on IFRS 17 first

Let's get the elephant in the room out of the way. The FRC is not bringing IFRS 17 (Insurance Contracts) into UK GAAP. At least not yet. This is a welcome relief for insurance carriers that report under FRS 102/103 or have transitioned from IFRS. In fact, the FRC has gone further. It's made an amendment to FRS 103 that would allow current IFRS reporters to transition in future to UK GAAP and unwind their IFRS 17 accounting policies. This is effective for periods beginning on or after 1 January 2024.

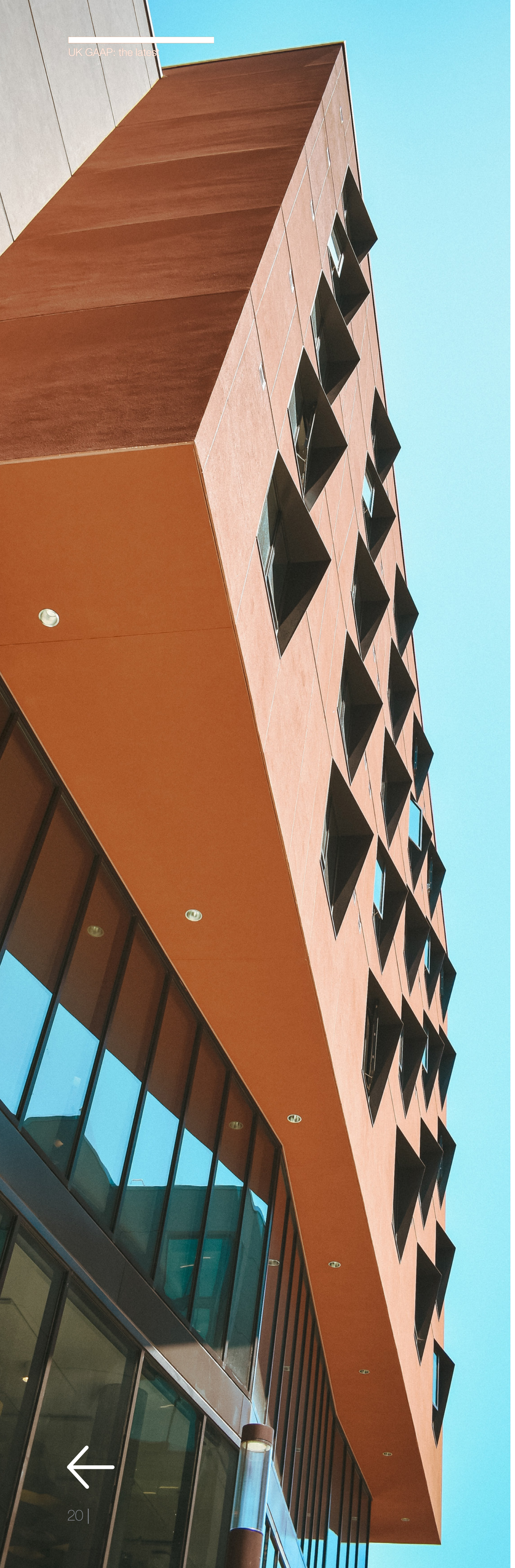


It's an attractive option, especially where there are alterations to ownership structure that might trigger a change in reporting framework or new circumstances that might merit a change to UK GAAP for certain group entities.

This amendment follows feedback expressing concerns that once an entity applied IFRS 17, there would be 'no way back' as FRS 103 would 'grandfather in' existing accounting policies. The FRS 103 amendment requires an insurer that applies adopted IFRS (or an equivalent financial reporting framework), and transitions to FRS 103 for the first time, to disregard its existing accounting policies for insurance contracts.

This is because the provisions in FRS 103 for an insurer to continue with its existing accounting policies for insurance contracts on transition were not intended to provide a mechanism for importing accounting principles from IFRS 17 through the back door. In this scenario, an insurer should apply FRS 103 as if it were setting accounting policies for insurance contracts for the first time.

But bear in mind that FRS 101 (ie IFRS with reduced disclosure framework) is no longer an option for Schedule 3 insurers, because of the conflicts between IFRS 17 and company law. The FRC has concluded that insurers applying IFRS 17 in Companies Act accounts (ie those prepared in accordance with FRS 101 or FRS 102/103) would not be complying with company law.



Given the complexity of IFRS 17, the IASB is unlikely to complete its post-implementation review of the standard by 2026. What's more, the FRC's periodic consultation timetable means IFRS 17 is unlikely to be incorporated, if at all, any earlier than 2030. But at least the current amendments to FRS 103 provide certainty in the medium term for the insurance industry, and this is good news.

What are the other key changes?

Leases

In short, if you have material operating leases you will be impacted.

The key changes to leases are:

- No longer a distinction between operating and finance leases
- More leases now recognised with an asset and liability on-balance sheet (similar to the now extant finance lease accounting)
- Recognition exemptions allow short-term leases and leases of low-value assets to remain off balance sheet
- Compared with IFRS 16 leases, a higher threshold for low-value assets means FRS 102/103 does not require recognition of as many leases on balance sheet.

The FRC claims the changes provide several benefits. Financial information is improved through greater transparency over the indebtedness of the business. Information about assets and liabilities is more relevant, with a clearer picture of the economics of significant lease arrangements.

Non-insurance related revenue recognition

In short, if you have revenue streams (other than under FRS 103), you will be impacted.

The key change is the introduction of a single, comprehensive five-step model for revenue recognition. This will apply to all contracts with customers broadly aligned with IFRS 15, but with some simplifications. The five steps are:

1. Identify the contracts with a customer
2. Identify the performance obligations in the contract
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognise revenue when each performance obligation is satisfied.

The FRC believes these changes will make it easier for entities to account for revenue transactions correctly and consistently, across all sizes of entity and all contract types. This means more reliable and useful information about the nature, amount and timing of revenue and cash flows arising from contracts with customers.

Other changes

Other amendments include:

- Section 2A Fair Value Measurement – updated to align definitions with latest international standards, and provide additional guidance
- Section 7 Statement of Cash Flows – new disclosure requirements for supplier finance arrangements (effective 1 January 2025)
- Section 26 Share-based Payment – additional guidance, making application of the principles easier in certain situations
- Section 29 Income Tax – introduction of guidance on accounting for uncertain tax positions
- Section 34 Specialised Activities – improvements and clarifications on existing requirements and how to make consequential changes to reflect other amendments.

How might you be impacted?

The commercial impact of these changes could be wide reaching for the insurance industry. For the non-carriers in your group (eg intermediaries, service and treasury entities) the new model for revenue recognition could have a significant impact on the timing of revenue recognition. For example, revenue contracts with multiple performance obligations (such as brokerage, claims management, and policy administration) will be affected. So it's important to review all major customer contracts in detail to understand the potential impact.

The new lease accounting model will see most material leases brought onto the balance sheet. This will affect your financial statements and key ratios, as your lease liabilities and right of use assets are reflected. It will also increase finance expenses and depreciation of the right of use assets and decrease the operating lease rentals in the income statement.

The IFRS 16 definition of what constitutes a lease might also mean that new contracts are identified as leases that were not previously accounted for under that heading. For example, in group scenarios, a decision on which entity has the right of use of an asset could mean new leases and sub-leases, in turn resulting in more complexity.

All these changes could affect your profit margins, reward schemes, and ability to meet financial obligations or pay dividends. So it's important to start planning for a successful transition now. Insurers should also consider any potential impact on their Solvency UK balance sheet, although this is unlikely to be significant for most.

While 2026 might seem a long way off, it's still wise to put these amendments onto your finance team's agenda, given the implementation costs and challenges brought by IFRS 15 and IFRS 16.

Why not start by drawing up an inventory of all revenue and lease contracts, including any side agreements and implied contracts? Consider setting up an implementation team that includes not just those in finance but also contract managers, legal, brokers and IT.

Start engaging with your contract counterparties to clarify any contract terms that are subject to interpretation, and formalise any intercompany arrangements that could be impacted. Depending on the complexity of your contracts, consider seeking professional advice.

UK GAAP reporters can benefit from the lessons learned from IFRS 15 and IFRS 16 implementation. We highly recommend getting your finance team to look at some of the findings from the FRC's thematic reviews of disclosures on the first year of application of IFRS 15 and IFRS 16.

Should you early adopt?

It depends on your circumstances. Early adoption might make sense for some.

The main effective date for the amendments is accounting periods beginning on or after 1 January 2026. Early application is allowed, so long as all amendments are applied at the same time. A different effective date applies to amendments made to FRS 103 (see above).

This is a great opportunity for reporters to align UK GAAP accounting policies with IFRS groups, if applicable. Even if you're not part of an IFRS group, doing so early has the benefit of adding credibility and comparability to your business as you become more aligned with IFRS reporters.

It could also make your business more valuable to a potential acquirer and/or lender and improve access to capital.

In general, these amendments make transition more attractive for entities reporting under full IFRS or FRS 101 within a group to FRS 102. That's because there might be minimal changes to accounting policies, while significantly reducing disclosure requirements for eligible entities. But for insurance groups reporting under IFRS, this transition might not be as practical for the carriers in the group, which will still need to prepare IFRS 17 financial information.

Whether or not early adoption is the best approach for you, our experience of helping others through the IFRS 15 and IFRS 16 transitions tells us you should tackle the potential transition issues early. This means they can be factored into your financial project plans and budgets, securing resources in advance and avoiding other potential future conflicts in your teams.

How can we help?

Our accounting advisory team can help you with impact assessment, implementation and transition to the amended FRS 102 standards. We have a team of experienced accounting specialists who have previously worked on IFRS 15 and IFRS 16 transition and understand the challenges these changes pose.

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Pillar Two: what it means for UK intermediate entities of US parented insurance groups

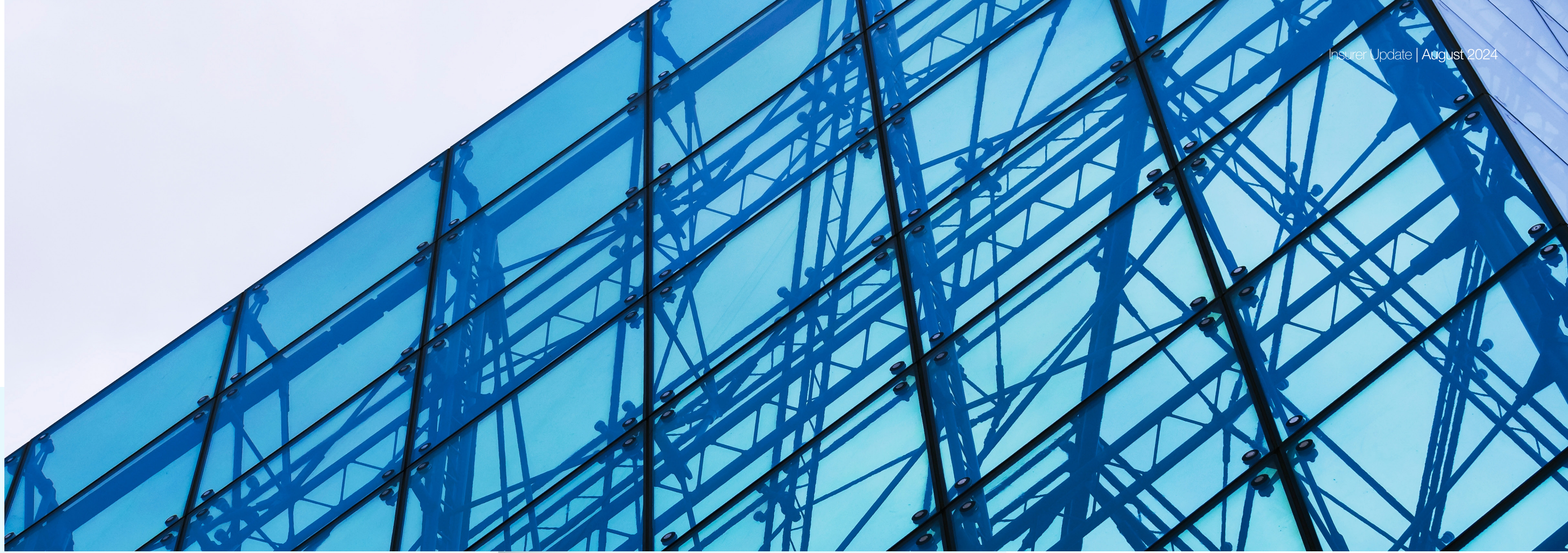
We explain why it is important for multinational entities (MNEs) to understand the interaction of Pillar Two and US tax principles – and how that affects UK intermediate entities.

Some of the largest property and casualty insurers are headquartered in the US and the EU. Last December, the EU Minimum Tax Directive was transposed into the respective jurisdiction tax codes and hence Pillar Two group considerations are expected to be led by the EU parent entity.

Within the last decade, the US have introduced minimum tax like measures but have yet to adopt Pillar Two. Under the Trump administration, the 2017 Tax Cuts and Jobs Acts brought in:

- Base erosion and anti-abuse tax (BEAT) which imposes a minimum tax of 10% rising to 12.5% in 2026 on certain deductible payments made to related non-US corporations.
- Global intangible low-taxed income (GILTI) – taxation on shareholders of controlled foreign companies at a rate of between 10.5% and 13.125% to discourage the movement of intangible assets and its related profits to jurisdictions with tax rates lower than the 21% US corporation tax rate.

Under the Biden administration, the latest measure is the Inflation Reduction Act which includes a new corporate alternative minimum tax (CAMT). This imposes a minimum tax equal to the excess of 15% of an applicable corporation's adjusted financial statement income (AFSI) over its regular tax liability, plus any BEAT for the taxable year.



The CAMT applies to US-parented groups whose average AFSI for the last three years exceeds US$1bn. However, this tax only applies to US operations and is based on net income rather than turnover and hence is not compliant with Pillar Two.

GILTI and BEAT also fall short of the Pillar Two requirements. GILTI is not aligned with Pillar Two on account of this being calculated using a global average rather than a jurisdiction by jurisdiction minimum tax. BEAT tax does not allow for foreign credits – this leads to double taxation and is therefore inconsistent with the Pillar Two single tax principle.

Until US legislation implements Pillar Two, the administrative burden of performing Pillar Two calculations and meeting its compliance obligations may fall to UK subsidiaries of US-headed MNEs if such subsidiaries are considered the intermediate parent entity.

Pillar Two recap

MNEs within the scope of Pillar Two rules must calculate their effective tax rate (ETR) for each jurisdiction in which they operate. They are liable to pay a top-up tax for the difference between their ETR for each jurisdiction and the 15% minimum rate of tax.

The OECD introduced this requirement in December 2021 as part of its Pillar Two global minimum tax model rules.

A qualifying MNE is broadly one with annual revenues above €750m in at least two of the previous four accounting periods, as per the consolidated financial statements of the ultimate parent entity.

If the ETR domestically is 15% or more, no top-up tax is payable. Pillar Two rules have the following components:

- An income inclusion rule (IIR), which imposes a top-up tax on the ultimate parent company in respect of the low-taxed income of a constituent entity. Where an entity's ETR in jurisdiction is below the minimum 15% rate, the ultimate parent is primarily liable for a top-up tax to bring it up to 15%. If the ultimate parent's jurisdiction has not implemented the Pillar Two rules, an intermediate parent entity is liable instead.

- A jurisdiction may also choose to implement a qualified domestic minimum top-up tax (QDMTT) alongside the IIR. A QDMTT ensures any top-up tax which would otherwise flow overseas is collected in the jurisdiction in which the profits are generated. In the UK, UK activities of in scope companies or groups that have an ETR under 15% are taxed under the QDMTT.

In the UK, Pillar Two is now included in the Finance (No.2) Act 2023 and comes into effect for accounting periods beginning on or after 31 December 2023. For most insurance groups, the first applicable period will be year end 31 December 2024. The enacted legislation includes the IIR and the QDMTT.

- An undertaxed profits rule (UTPR), which will require subsidiaries to collect top-up taxes if a parent entity is in a jurisdiction that has not implemented the IIR.

Last September the UK Government published draft legislation that would prevent the UTPR from being implemented before 31 December 2024. So, for insurance groups with a 31 December year end, it would be applicable for year ends 31 December 2025.

To reduce the compliance burden on companies in their early years, UK legislation includes various transitional safe harbour provisions and groups should consider the availability of these. Most are calculated using country-by-country report (CbCR) data and are explained in our separate article on transitional safe harbour tests.

Pillar Two tax breakdown

The order of precedence of Pillar Two taxes in the UK is as follows:

- UK activities of in-scope companies or groups with an ETR under 15% will be taxed under the QDMTT

- Foreign activities of in-scope UK group companies with an ETR under 15% will generally be collected under the IIR

- Foreign profits taxed at an ETR under 15% which are outside the scope of the IIR can be taxed in the UK under the UTPR.

Whilst BEAT, GILTI and CAMT are not fully aligned with Pillar Two, they reduce but do not eliminate the risk of non US jurisdictions like the UK from applying UTPR to say, US group entities. However, because of a transitional safe harbour and the US having a corporate tax rate of 21%, the UTPR may not apply to companies that are headquartered in countries such as the US with a statutory corporation tax rate above 20% until 2026.

Next steps

Although the US has not yet implemented an IIR under Pillar Two rules, the Biden administration's Green Book includes proposals to:

- align the US global intangible low-taxed income (GILTI) rules with Pillar Two
- bring in measures to qualify the CAMT as an IIR under Pillar Two by increasing the ETR and switching to calculations on a jurisdiction-by-jurisdiction basis
- replace BEAT tax with the UTPR.

No changes are expected until after the November US presidential election. Therefore, until the US implements Pillar Two / aligns the US tax code with Pillar Two, there may be instances where UK subsidiaries of US-headed MNEs will be the group's responsible member for Pillar Two. For a 31 December year end, the UK responsible member will therefore need to make the first registration which will be due by 30 June 2025, with the first return filing and payment of top-up tax due by 30 June 2026. This will include calculating IIR and accounting for it to HMRC.

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Get in touch today to see how we can help...

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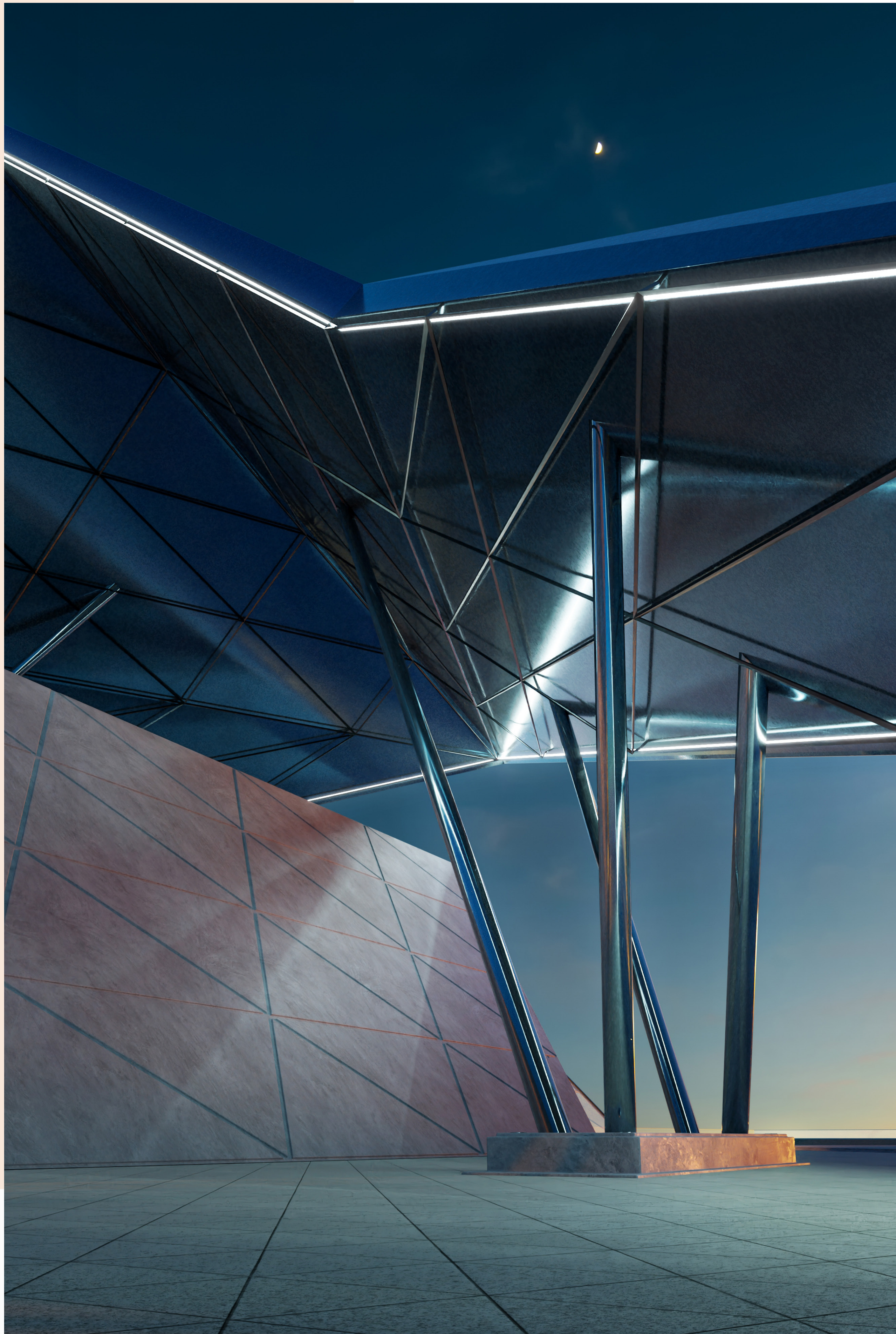

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