MEMO# 34163

May 27, 2022

ICI Comments to OECD on Pillar One Exclusion for Regulated Financial Services

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TO: ICI Members
ICI Global Members
Global Tax Committee
Management Company Tax Subcommittee
Tax Committee SUBJECTS: Tax RE: ICI Comments to OECD on Pillar One Exclusion for Regulated Financial Services

The ICI has submitted the attached comments to the OECD[1] regarding a financial services exclusion from the proposed "Pillar One" regime for allocating profits to market jurisdictions. Our submission urges that the financial services exclusion proposed on May 6, 2022 be modified to cover all asset managers—rather than only those subject to capital adequacy requirements.

Background

The OECD/G20 Inclusive Framework on BEPS,[2] as mandated by the G20 in 2017, has been developing a consensus approach for addressing the tax challenges of the "digitalizing economy."[3] The approach includes two Pillars (the second of which involves crafting a global minimum tax).[4] A political agreement amongst 137 jurisdictions on these two Pillars was announced in July 2021 and expounded upon in October. Work on the technical aspects of the Pillars continues.

Pillar One, among other things, would provide market jurisdictions with a new right to tax a portion of allocable "residual profits" (Amount A) regardless of whether the taxpayer is physically present in that jurisdiction. Although "digital" companies[5] were the original focus of Action 1 of the OECD's BEPS project,[6] the 2015 Action 1 Report concluded that it was not possible to "ring-fence" the digital economy.

The OECD's proposed approach for addressing the digitalizing economy has evolved. In a February 2019 Public Consultation Document, the OECD considered three alternative criteria—user participation, marketing intangibles, and significant economic presence—for determining those businesses subject to the new taxing rights. In the October 2019 Public

Consultation Document,[7] the focus turned to automated digital services and consumer facing businesses. These two business types remained the scope criteria in the 2020 Public Consultation "Blueprint" Document.[8]

The 2020 Blueprint discussed funds and asset managers in some detail. Importantly, the Blueprint stated that funds are out of scope because they are "not active businesses." Asset managers, the Blueprint noted, "raise more complex questions." While the Blueprint noted that, "on balance," asset management is properly seen as a component of the service the financial intermediary offers its clients, some jurisdictions opposed an asset management exclusion. These jurisdictions, the Blueprint stated, "believe that the asset management sector is very lightly regulated, which (unlike retail banking) may not ensure that the major part of residual profit is captured in market jurisdictions."

The ICI provided detailed comments on the 2019 and 2020 public consultation documents.[9] The October 2019 comments[10] urged a Pillar One exclusion for both funds and asset managers. The November 2020 comments[11] supported strongly the Blueprint's conclusion that funds and asset managers, like banking and insurance, should be excluded from Amount A. The ICI's 2020 comments also discussed at length the complexities that large financial service firms would confront if asset management were "in scope" while banking and insurance were excluded.

The New Quantitative Approach for Allocating Profits Under Amount A

In July 2021, the OECD proposed a new quantitative approach for allocating to market jurisdictions some portion of the profits from (approximately) the 100 largest multinational enterprises (MNEs). As proposed, only MNEs with global turnover above 20 billion euros (10 billion euros after seven years) and profitability above 10 percent would be subject to Amount A. The allocation of "residual profit" to market jurisdictions would be limited to 25 percent of the amount above the 10 percent ("routine profit") threshold; only those jurisdictions in which an MNE had revenues above the nexus threshold of 1 million Euros (250,000 Euros for developing countries)[12] would receive Amount A revenues. The proposal would exclude from Amount A "Extractives" and "Regulated Financial Services (RFS)"—although no details were provided regarding the scope of the RFS exclusion.

On May 6, 2022, the OECD released a Public Consultation Document entitled "Pillar One Amount A - Exclusion for Regulated Financial Services." The seven types of Regulated Financial Institutions (RFIs) covered by the RFS exclusion are: Depositary Institutions; Mortgage Institutions; Investment Institutions; Insurance Institutions; Asset Managers; Mixed Financial Institutions; and RFI Service Entities. The public consultation document states that the "defining character" of an RFI is "a unique form of regulation, in the form of capital adequacy requirements, that reflect the risks taken on and borne by the firm."

An "Asset Manager" eligible for RFS exclusion, as proposed, must meet these three requirements: (1) be licensed to carry on enumerated activities (listed in the third part of the test); (2) be subject to capital adequacy requirements incorporating a risk-based measure; and (3) have total gross income attributable to one or more of the following activities equaling or exceeding [75] per cent of the Group Entity's total gross income during the Period: investing in, administering, managing or distributing interests in, an Investment Fund or Real Estate Investment Vehicle, Financial Assets, or money for or on behalf of other persons.

ICI Comments on 2022 Public Consultation Document

The ICI's submission supported strongly the Pillar One Amount A exclusion for RFIs that are asset managers—but noted that the proposed definition of "Asset Manager" is too narrow. Specifically, the capital adequacy requirement would not be met by asset managers with respect to their US business operations.

To address this inequity, the ICI urged that this test be modified to ensure that all revenues that arise in the manager's residence jurisdiction are excluded from Amount A under a domestic business exclusion. Alternatively, the revenue sourcing rules should be modified to allocate all revenues from asset management businesses focused on one local market to that market under a domestic sourcing rule. Additional, more technical, clarifications also were requested.

The revenues generated by US asset managers attributable to their US regulated investment companies (RICs), the ICI stated, should be excluded from Amount A. No policy rationale supports allocating any portion of these revenues and profits—arising from transactions with US residents—to other jurisdictions.

The modifications that we proposed would address several significant concerns. First, they would level the playing field for US asset managers that are objectively comparable to other asset managers (such as those in the European Union) that meet the proposed test for RFI status. Second, they would prevent a financial institution with highly interconnected business units, not all of which qualify as RFIs, from incurring substantial compliance costs; these costs can be recouped only by increasing fees on the institution's customers who are saving for long-term needs and financial security. Third, they would prevent asset managers from potentially avoiding smaller markets out of concern that outsize profits would be allocated to those markets pursuant to Amount A based upon relatively insignificant market contacts.

The OECD will release a revised Pillar One proposal after all elements of the package have been released for public comment and due consideration has been given to the comments received.

Keith Lawson
Deputy General Counsel - Tax Law

endnotes

[1] OECD is the acronym for the Organisation for Economic Co-operation and Development. The OECD consists of 37 member jurisdictions.

[2] The Inclusive Framework involves 137 members, including the OECD members, participating on an equal footing.

[3] See, e.g., 2018 Interim Report on Tax Challenges Arising from Digitalisation, 2019 Policy Note, 2020 Statement.

[4] See, e.g., Institute Memorandum No. 32072, dated December 2, 2019.

[5] "GAFA" (Google, Amazon, Facebook, and Apple) was the short-hand reference for prominent digital companies.

[6] BEPS is the acronym for the OECD's Base Erosion and Profit Shifting initiative.

[7] See, Institute Memorandum No. 32004, dated October 10, 2019.

[8] See, Institute Memorandum No. 32827, dated October 13, 2020.

[9] See, Institute Memorandum No. 31808, dated June 14, 2019.

[10] See, Institute Memorandum No. 32049, dated November 12, 2019.

[11] See, Institute Memorandum No. 32981, dated December 14, 2020.

[12] The lower threshold would apply only in jurisdictions with gross domestic product below 40 billion Euros.
