association of the luxembourg fund industry

Organisation for Economic Co-operation and Development
For the attn. of
OECD Centre for Tax Policy and Administration
cfa@oecd.org

Luxembourg, 14 December 2020

RE: Response to the OECD Public Consultation Document on the Reports on the Pillar One and Pillar Two Blueprints

Dear Madams,
Dear Sirs,

ALFI is the representative body of the Luxembourg investment fund community which includes investment funds, asset management firms and a large variety of service providers of the financial sector. The Luxembourg fund industry is also the largest fund domicile in Europe and a worldwide leader in cross-border distribution of funds.

ALFI welcomes this further OECD consultation on the Reports on the Pillar One and Pillar Two Blueprints and is pleased to provide here after its responses to the questions raised as well as other related comments on the reports.

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Report on the Pillar One Blueprint

1) Financial services (FS)

Financial services, including the fund industry, have been ring-fenced quite clearly from the application of the new Amount A taxing right.

Para. 123 and 124 address Automated Digital Services (ADS) and Consumer Facing Businesses (CFB) analysis. The rationale for excluding FS from the scope is that for ADS there is a human component involved *("As such, human intervention and judgement is normally a feature of the use of digital functionality in FS"),* and for CFB is that *"very significant parts of FS business are not consumer-facing"*.

In addition, para. 124 of the report indicates financial services are generally excluded from the scope of the Amount A measures *"[…] Though the analysis of CFB raises different issues across the three sectors, the central rationale for the exclusion of FS business from the new taxing right is common to each of the three sectors. That rationale stems from the highly-regulated nature of FS business. However, it should be emphasised that this central rationale is not premised on the mere fact of regulation but rather is based on the effects of that regulation. […]".*

The report on the Pillar One Blueprint covers traditional, regulated financial services entities, specifically banks, insurance companies and generally asset managers. All of which are proposed to be excluded from the Amount A measures (formulary reallocation of residual profits to market jurisdictions). For companies providing products and services related to the financial technology used in the financial services industry, including those operating on a regulated basis within the perimeters of the asset management sector, the position appears less obvious as to whether the OECD Pillar One Blueprint considers that it would be consistent to exclude from the scope of the Amount A measures on the same grounds as for traditional, regulated financial services' entities. This may in particular imply that unregulated activities, such as the provision of technology services that are essential and tailored to the specific needs of the financial and asset management sector, may not be directly excluded from the Amount A measures.

In this respect, in order to provide certainty and achieve a consistent application of the exclusion to asset managers, ALFI believes that it would be important to clearly define the treatment that would apply to unregulated entities and unregulated investment funds.

2) Asset Management Business

Paras. 135 to 140 highlight the various types of participants in the asset management sector.

(i) Funds *per se* are not considered as active businesses, and their tax neutral and passive status is widely recognised. They are thus considered to be outside the scope of the CFB.

(ii) Because financial intermediaries, either those advising investors and offering investment products (indirect model) or investment managers distributing investment products through a broker or a similar regulated entity (direct model), are highly regulated (investor protection, suitability, transparency) and require local presence subject to local country regulations and whose profits would be realised and taxed locally, they are also considered to be outside the scope of CFB.

(iii) The report highlights the reasoning for, and the arguments as to why, investment management is not to be considered as a CFB activity and should thus be out of the scope of the Amount A measures. The carve-out for investment management business is essentially supported by the fact that it is both a highly regulated business, and in large measure not consumer facing.

ALFI strongly supports the above mentioned positions and objects to the statement made that the asset management sector is very lightly regulated.
ALFI thus urges the OECD to conclude more forcefully on the fact the whole EU fund and asset management industry is a highly regulated sector through in particular, but not only, EU Directive 2009/65/EC for UCITS, and Directive 2011/61/EU for AIFMs, that each provide detailed and mandatory EU regulatory frameworks for investment funds and management companies pursuing their activities on a cross-border basis. It is also worth mentioning that Directive 2014/65/EU sets strict investor protection obligations on investment firms or on service providers distributing financial products, including units or shares of UCITS and/or AIFs.

This codified set of rules is reflected in practice in the contractual arrangements entered into between the various entities and intermediaries involved in the asset management and in the cross-border distribution of investment funds. Those entities and intermediaries, such as fund administrators, transfer agents and custodians provide services that are embedded within the asset management value chain and carry out activities that are highly regulated and supervised. They also interact with the investment fund and, as such, are outside the scope of the CFB. For these reasons, these service providers should be considered as an integral part of the asset management business.

In addition, while paras. 138 to 140 do consider “investment management services”, they do not provide a clear definition of this notion.

ALFI encourages the OECD to introduce a definition for “investment management services” by reference to the applicable regulations as provided for by each jurisdiction they may be subject to.

ALFI is finally of the opinion that, although so-called “tracker” funds are to a larger extent both brand-driven and digital in both their contact with retail investors and their management of fund assets, they should nevertheless be considered as falling outside the scope of CFB. This is because their business model and manner of functioning are aligned with the rest of the sector and so should, for the same reasons mentioned above, be fully out of the scope of Amount A. ALFI would welcome and encourage explicit confirmation of this position in the final OECD Pillar One report.

3) Amount B - Marketing and distribution profits safe harbour

“Amount B” proposals (which would apply universally, not just to groups that are over the EUR 750 million global revenue threshold) result in potential safe harbours, and reduction in transfer pricing compliance burdens, and are arguably thus a “good thing”. But the proposals only apply to group business units that are related party distributors that perform “baseline marketing and distribution activities”, with this being defined fairly sharply and only in the context of the distribution of physical goods.

Financial services entities are not explicitly excluded from the Amount B proposals. However, in practice, financial service entities should not be affected by Amount B, since financial service entities, including asset managers, are not typically engaged in traditional “buy / sell” activities.

That said, the Report on the Pillar One Blueprint notes that the Inclusive Framework members wish to have a broader scope, e.g. one that provides for standardised remuneration also for commissionaires or sales agents, or for distribution entities whose profile differs from baseline marketing and distribution activities. Given the specificities of the asset management industry, a broader scope approach, whereby commissionaires or sales agents would be included, may potentially capture distribution activities within the asset management industry.

Hence, ALFI believes this should be further clarified to ensure that unnecessary complications affecting the asset management industry are not created. Indeed, as acknowledged by the OECD, a broader scope would raise issues that would require further work, including how to reconcile the fixed return profile for these activities with the arm's length principle.

4) Alternative investment fund structures

On the basis that there is intended to be consistency between the scope of the CbCR regime (i.e. EUR 750 mi global revenue threshold) and the Pillar One proposals, alternative investment fund structures would almost always fall outside the scope of the measures, because that they are generally not required to prepare accounts that consolidate underlying target investments.

ALFI would welcome the introduction of additional comfort and clarifications, mirroring the contents of the Report on the Pillar Two Blueprint as regards the definition of "investment fund" in Section 2.2. and para. 82 of the Pillar Two report, that investment fund structures which "may use special purpose vehicles to hold assets or to make certain investments" and which "essentially function as part of the infrastructure of the fund itself" fall outside the scope of the measures.

In this respect, please also see immediately below the comments in relation to the notion of "wholly-owned or almost exclusively owned" entities or arrangements under Pillar Two: these would also be relevant here.

Report on the Pillar Two Blueprint

1. Definition of "investment fund"

Para. 75 indicates *"The definition also includes any entity or arrangement that is* ***wholly-owned or almost exclusively owned****, directly or indirectly, by one or more Investment Funds or other Excluded Entity and that does not carry on a trade or business but is established and operated exclusively or almost exclusively to hold assets or invest funds for the benefit of such Investment Funds or other Excluded Entity.*"

ALFI supports the introduction of clarifications as to how the expression *"wholly-owned or almost exclusively owned"* entity or arrangement should be understood; and to ensure that if an entity or arrangement is exclusively or almost exclusively owned by such funds it may also benefit from the exclusion. The introduction of a minimum threshold of e.g. 75% is suggested. This would help remove uncertainties with regard to its interpretation, in particular in the context of alternative fund structures.

One of the cumulative conditions as set under point f. of the investment fund definition for an investment fund to be considered as an Excluded Entity is that *"it is managed by fund management professionals on behalf of the investors"*. ALFI would support a clarification with regard to this definition to ensure that "self-managed" funds (implying there are no external professional managers) could also be considered as an excluded entity should they meet all the other relevant conditions.

The definitions of "Excluded Entities" (other than non-profit organizations) include wholly owned entities, but the criteria for wholly owned entities slightly vary depending on the category (e.g., in some cases they may be owned by more than one Excluded Entity, in some cases they must be established *"almost exclusively"* to invest funds for the Excluded Entity or Entities). These entities may be owned by several Excluded Entities according to the definition of excluded investment funds, but for pension funds those entities may only be held by pension funds or by a government.

ALFI suggests to clarify that "exclusively owned entities or almost exclusively owned entities" may be owned by any combination of Excluded Entities.

2. The anti-fragmentation rule

Para. 126 states that *"Further work could be undertaken to* ***consider whether the consolidation threshold should be supplemented with a targeted anti-avoidance rule to avoid the fragmentation of a single MNE Group into different subgroups in order to avoid the EUR 750 M threshold.*** *This work would need to take into account the on-going work on the 2020 Country-by-Country (BEPS Action 13 Minimum Standard) review process and the outcomes from this work would be incorporated into the development of model rules (see Section 10.5.1 below)."*

ALFI understand that this rule would only come into play if no exclusion applies and would thus apply to entities in scope only. ALFI asks for a clarification of this anti-fragmentation rule.

3. Definition of Constituent Entity – "the deemed consolidation test"

The "deemed consolidation test" in para. 58: does not take into account any materiality threshold. Compared to current applicable consolidation rules which consider materiality thresholds, this non-exclusion rule (no exclusion based on size or materiality threshold) would create additional accounting work for consolidation purposes for Constituent Entities that seems disproportionate compared to the objectives pursued under Pillar Two.

ALFI is of the opinion that a simplification rule, whereby entities representing less than 2.5% of the consolidated turnover are excluded, would be a fair measure compared to the risk that is meant to be covered (para. 395).

4. Other generally accepted financial accounting standards

Para. 173 indicates that *"[…] It is not proportionate or reasonable to require such MNE Groups to prepare financial accounts under a different accounting standard solely for purposes of complying with the GloBE rules if their existing accounting standard is recognised by an appropriate authority and it does not result in material competitive distortions under the GloBE rules.* Para. 174 further indicates that "*[…] In an accounting context, a material competitive distortion is an outcome that departs significantly from the result that would be realised under IFRS in a way that materially affects the ETR under the GloBE."*

ALFI understands consolidated accounts prepared under national recognised GAAP, such as Luxembourg GAAP, would be an acceptable standard in Luxembourg, provided no material competitive distortion arises.

ALFI is of the opinion that it would be important to provide additional guidance as to what a "material distortion" may be in practical terms and who should be responsible to confirm that an actual material competitive distortion is to be recognised ("appropriate authorities"). In the absence of such guidance, and similarly to our comments on para. 58, additional accounting work that seems disproportionate compared to the objectives pursued under Pillar Two may be required to ensure compliance with IFRS.

5. Portfolio dividends

ALFI welcomes the recommendation of para. 181 *et seq.* for the recognition of dividend exemptions, exclusions or credits and the exclusion of related taxes from the GloBE tax base. ALFI is also supportive of excluding gains on portfolio from the GloBE tax base under the same rationale.

ALFI further supports the general dividend and capital gains exclusion based on the holder's percentage ownership of e.g. 10%. ALFI further recommends that this minimum percentage of portfolio ownership should be complemented with the introduction of an alternative minimum threshold participation amount of e.g. EUR 1.2 million, as included in the participation exemption regime for both dividends and capital gains in the Luxembourg tax law. This could have a direct and significant impact on the ETR of a Constituent Entity that might for this reason ultimately fall foul of the minimum standard taxation.

6. Emergency government assistance

Para. 247 indicates that *"The provision of emergency government assistance (e.g. government grants and tax credits designed to mitigate the impact of Covid19) may lead to a lower GloBE ETR calculation that could trigger a top-up tax under the GloBE rules. Further consideration will be given to whether there should be a special exemption (…)".*

ALFI hereby stresses the need for such a special exemption to ensure that the GloBE ETR calculation is consistently applied over time.

7. Post-filing adjustments to tax liability and the GloBE tax base

Para. 328 notes that a post-filing tax increase could result in Income Inclusion Rule (IIR) tax credits to the extent IIR tax paid during the look-back period has not already given rise to an IIR tax credit. Any excess is treated as a local tax carry-forward related to the year to which the tax increase relates or the last year in which IIR tax was paid, with the carry-forward period based on such year. Although Pillar Two Blueprint does not specify it, presumably a local tax carry-forward resulting from a post-filing increase in tax should be treated as related to the later of the year to which the tax increase relates or the last year in which IIR tax was paid in order to minimize the possibility of expiration of the carry-forward without use.

ALFI recommends introducing clarifications and confirmation in this regard.

8. Tax administrative guidance

Para. 404 *et seq.* recommend tax administrative guidance. More specifically, a simplification measure would establish a process for tax administrations to work, together with stakeholders, to identify jurisdictions where the tax base is sufficiently similar to the GloBE Tax Base and the rate is sufficiently high. MNE Groups would benefit from a presumption that an ETR calculation would not be required for identified low-risk jurisdictions unless requested specifically by a tax authority within a specified period of time. The "low-risk" determination could (in particular) be granted to MNE Groups operating within certain sectors as a result of peer reviews that are conducted by the Global Forum.

ALFI would support such a measure, as it appears to present by far the greatest potential to simplify compliance and improve certainty for taxpayers. As noted in the Report on the Pillar Two Blueprint, such an approach would be most effective if it took place before the GloBE rules become effective.

9. Other covered payments - Nominal test applied on a payments basis

Para. 591 reads as follows *"In addition to payments of interest and royalties, the STTR would therefore apply to the following categories of payments primarily based on these mobile features:*
[…]
e. An amount paid to or retained by the payee that is consideration for the supply of marketing, procurement, agency or other intermediary services."

The way this paragraph is drafted seems to suggest that point e. may apply to services, such as marketing or distribution services provided to investment funds or investment fund structures. ALFI recommends introducing a specific carve out of such payments made by or in favour of regulated investment funds and assimilated entities. Such an approach would be in line with the Excluded Entity status granted to investment funds under the GloBE rules. Moreover, as the STTR rule only applies to connected entities, the rule would create a market distortion between independent distributors and dependent distributors (i.e. distributors being part of the same group as the asset manager).

In addition, para. 641 indicates that *"An adjusted nominal rate determined along these lines would, for example, apply to low or zero rate jurisdictions; payments to a territorial regime where such payments are not brought into account as income in the residence state; payments eligible for a preferential tax regime and regimes that provided for a full or partial exclusion from income."*

ALFI understands that, in the investment fund context, this rule could apply to a payment of distribution fees made by a management company to an entity located in a low or no tax jurisdiction that would thus be subjected to a withholding tax. ALFI is concerned that those payments would suffer an "over taxation" as the withholding tax would be levied on the gross amount, and so would create a distortion between internal vs. external distribution models and jeopardise the model whereby fund distributor are connected. This "overkill", which is suggested by the text of para. 649 (see below) itself, is detrimental. Ways should be found to make sure that it does not lead to taxation over and above the minimum standard.

ALFI is of the opinion that this rule should be reviewed to consider primarily the operational nature of the activities the payments are related to, rather than solely considering that the payment is made to a low or zero rate jurisdictions.

10. Setting nominal tax rate

Para. 649 states that "*Given that the nominal tax rate trigger applies to the gross amount of the payment, on a transaction by transaction basis and does not allow for blending, the STTR might, in certain cases, give rise to the risk of over-taxation. This over-taxation could arise, for example, where a covered payment is made to an entity that is subject to tax at a nil rate but which has incurred expenses in deriving that income. In this case, applying the minimum ETR determined under the income inclusion and undertaxed payments rules to the gross amount of the payment when computing the top-up rate to be applied to that payment under the STTR would give rise to an effective tax rate above that minimum rate and could even give rise to taxation in excess of economic profit. In order to limit this risk of over-taxation,* ***Inclusive Framework members could decide to limit both the trigger rate and the amount of top-up tax under the STTR to a rate that is lower than the minimum ETR under the income inclusion and undertaxed payments rules." (Emphasis added).***

The fact that the nominal tax rate trigger (withholding tax) applies to the gross amount of payments rather than on a net amount (which the payer disposes of) could lead to taxation that may be well above the minimum standard as suggested by the GloBE rule.

ALFI is of the opinion that limiting the trigger rate and the amount of top-up tax under the STTR to a rate that is lower than the minimum ETR under the income inclusion and undertaxed payments rules should not be an option left to Inclusive Framework members, but should instead be set as a mandatory rate in the final OECD Pillar Two Report, to ensure that fair taxation is ultimately levied.

11. The treatment of investment funds (as defined in Section 2.3.) under the GloBE rules. Para. 75 to 82 of the Blueprint

Generally, in Luxembourg fund structures, investment funds would not be considered as UPE under GloBE rules. They would meet the condition set in the definition and qualify as Excluded Entities. In order to ensure that all investment funds would more clearly meet the requirements in this respect, the definition of Investment Fund might be amended as emphasised below:

Investment Fund means an entity or arrangement that meets all of the following criteria set out in paragraphs (a) to (f) below:

- *(a) it is designed to pool assets (which may be financial and non-financial) from an Excluded Entity* ***or an investor*** *or a number of investors (at least some of which are not connected);*
- *(b) it invests in accordance with a defined investment policy and/or to reduce transaction costs and research and analytical costs and/or to spread risk collectively;*
- *(c) it is primarily designed to generate investment income and/or gains or protection against a particular or general event or outcome;*
- *(d)* ***the investor or*** *investors have a right to return from the assets of the fund, or income earned on those assets, based on the contributions made by those investors;*
- *(e) the fund, or the management of the fund, is subject to the regulatory regime for investment funds in the jurisdiction in which it is established or managed (including appropriate anti-money laundering and investor protection regulation); and*
- *(f) it is managed by fund management professionals on behalf of the investors.*

Indeed, dedicated investment funds with few investors are still as regulated and supervised as entities, and in the same way, as other comparable regulated and supervised investment funds. In addition, investment funds are fully in the scope of mandatory automatic exchange of information rules as defined under the OECD Common Reporting Standard and the Foreign Account Tax Compliance Act under which information on financial accounts are exchanged as the case may be and taxation applies at investors' level as defined in their country of residence.

We are grateful in advance for your attention to our response to this consultation and we welcome the opportunity to discuss ALFI's views with you.

Should you need any additional information, ALFI would be pleased to assist you. Please do not hesitate to contact us.

Kind regards,

ALFI