For the attn. of:
Tax Policy and Statistics Division
OECD / Centre for Tax Policy and Administration

TFDE@oecd.org

Luxembourg, 12 November 2019

RE: Response to OECD Public Consultation Document – Secretariat Proposal for a "Unified Approach under Pillar One" – 12 November 2019

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 consultation on the OECD Secretariat Proposal for a Unified Approach on Pillar One. As previously mentioned, our industry is a high-value and only partially digitalised business industry. Our industry is quickly increasing its reliance on digital means, through blockchain technology for example, and we are very much interested in this topic.

As also already mentioned in our response to the OECD consultation dated March 2019, past experiences have shown that, although the investment fund and asset management industry is not always the intended recipient of certain tax measures, they may have unintended consequences for our industry.

Preliminary comments

At the risk of repetition, we would like to stress again some specific essential features of the investment fund and asset management industry.

An access to professional portfolio management for retail investors: Our industry plays a key role in particular by allowing small investors to invest in highly liquid products that grant the investors access to a number of markets that might be otherwise closed and gain the benefits of economies of scale of mutualized investment even if they have relatively little to invest.

association of the
luxembourg fund industry

A wide and diversified market: The market of investment funds is wide and diversified and includes, among others, investment funds open to retail investors in a context of low interest rates on more traditional savings products/accounts, as well as vehicles serving pension funds providing retirement or similar benefits but also investment funds distributed to professional and institutional investors that may (or may not) pursue more alternative investment policies such as funds invested in listed transferable securities, but also real estate funds, private equity funds, etc.

A highly regulated industry: The investment fund industry is a highly regulated industry for which, in particular, Directive 2009/65/EC for UCITS [1] and Directive 2011/61/EU for AIFMs[2] 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 Directive 2014/65/EU[3] that set strict investors' protective 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 cross-border distribution of units/shares of investment funds.

Tax neutrality is an essential feature of investment funds: From a tax perspective, the tax treatment of investment funds is designed to preserve the tax neutrality of investments made through investment funds compared to a direct investment. This principle has been recognized by the OECD in the 2010 Report[4]in relation to treaty access for investment funds and by the European Commission in its notice dated 19 July 2016 related to State aid[5]. Most countries thus have a tax system that provides for their neutrality, either by treating them as fiscally transparent in which case taxation applies at its holders' level on income received or as opaque (to a greater or lesser degree) and, in such a case their investment funds are in principle subject to tax but are either exempt or subject to tax on a reduced tax base or at a low or zero tax rate. In Luxembourg for example, collective investment funds are exempt from income tax but subject to a specific annual subscription tax computed quarterly on their net asset value at the end of each quarter.

It is however important to bear in mind that taxation arises at all (other) levels in an investment fund structure i.e.

- through withholding taxes applied at source on certain type of income received by the fund;
- in the hands of investors in the fund on income received or gain realized in accordance with the tax rules applicable in their country of residence. Exchange of information mechanisms put in place, such as the Common Reporting Standard, have ensured that income and capital gains are effectively taxed in the hands of investors by the relevant States.

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[1] Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)

[2] Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011 on Alternative Investment Fund Managers and amending Directives 2003/41/EC and 2009/65/EC and Regulations (EC) No 1060/2009 and (EU) No 1095/2010

[3] Directive 2014/65/EU of the European Parliament and of the Council of 15 May 2014 on markets in financial instruments and amending Directive 2002/92/EC and Directive 2011/61/EU

[4] The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles (adopted by the OECD Committee on Fiscal Affairs on 23 April 2010)

[5] Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union - 19 July 2016 - Para. 161: "*It is generally accepted that investment vehicles, such as undertakings for collective investment, should be subject to an appropriate level of taxation since they basically operate as intermediary bodies between (third party) investors and the target companies that are the subject of investment. The absence of special tax rules governing investment funds or companies could result in an investment fund being treated as a separate taxpayer — with an additional layer of tax being imposed on any income or gains by the intermediary vehicle. In this context, Member States generally seek to reduce adverse taxation effects on investments through investment funds or companies compared to direct investments by individual investors and, as far as possible, to ensure that the overall final tax burden on the basket of various types of investments is about the same, irrespective of the vehicle used for the investment.*"

- on the net profit realized by distributors on the marketing of funds' units/shares locally in accordance with the applicable tax rules in their country of residence; and
- on management companies pursuing activities of collective portfolio management on a cross-border basis by establishing subsidiaries, branches or in accordance with the freedom to provide services in line with national tax laws and provisions of applicable double tax treaties.

ALFI's views

ALFI's key conclusions on the Secretariat Proposal may be summarised as follows:

- A clear distinction should be made between the investment funds as investment vehicles, and fund management activities. Investment funds, both CIVs and non-CIVs, hold assets for the benefit of their investors and are not businesses in the traditional sense. Fund management as a business is generally carried out by fund managers or investment advisers separate from the funds.

- The asset management industry involves a complex web of B2B and B2C interactions and fund managers create value from offering fund products to retail investors (i.e. consumer-facing) and to institutional investors (i.e. business-facing), and in many cases to both, in a heavily synergistic way.

- For the reasons listed under the question related to "carve outs that might be formulated" (point 1. e. below) and also as foreseen by the Secretariat Proposal, ALFI is supportive of a carve-out of the investment fund activities *per se* in consideration of their specific features.
  ALFI is also supportive of a carve out of the asset management industry in consideration of the practical difficulties raised in relation to disentangling the value created from working with institutional investors from the value created by activities with consumer-facing activities. ALFI considers that achieving a workable result in the context of the Secretariat Proposal in terms of both the scope and the recognition of a new nexus, would put an undue burden of efforts and costs on the asset management activity as a whole.

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

Appendix 1: ALFI responses to the questions raised in the OECD Public Consultation Document – Secretariat Proposal for a "Unified Approach under Pillar One" – 12 November 2019

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1. **Scope**

Under the proposed "Unified Approach", Amount A would focus on, broadly, large consumer (including user) facing businesses. What challenges and opportunities do you see in defining and identifying the businesses in scope, in particular with respect to:

a. their interaction with consumers/users;

The Secretariat Proposal primarily concerns itself with businesses that, through interaction with a consumer base, create value without a traditional physical presence. However other businesses that market their products to consumers, and that may use digital technology to develop a consumer base, are also seen as being in scope.

The fund management industry involves a complex web of B2B and B2C interactions and fund managers create value from offering fund products to retail investors (i.e. consumer-facing) and to institutional investors (i.e. business-facing), and in many cases to both, in a heavily synergistic way.
For retail products, there is significant business-to-business activity in the value chain, often at multiple levels, arising from the complex web of intermediaries and distribution channels. A retail investor may often in practice have little input into the choice of the fund that his capital ultimately flows to: heavy reliance is placed on investment advisers, insurers, and fund-of-fund managers. Consequently, interaction between a fund manager and a retail consumer base is generally not the key value driver.

It is also important to bear in mind that the investment fund and asset management industry as a whole is heavily regulated in almost all its aspects and when it comes to marketing towards retail investors, the applicable investors' protection rules in most cases trigger the involvement of an intermediary that has a geographical proximity or another kind of relationship proximity to the investor.

With regards to investors, investment funds and management companies mostly deal with institutional investors, professional intermediaries in charge of marketing and other financial intermediaries that are not in charge of marketing but merely place orders they receive from their clients but also with other service providers assisting them with investors' related questions.

Finally, although some activities, including marketing activities, are already being performed through digital platforms, for the time being, these still represent a limited part of the activity. Such platforms are mainly designed for processes streamlining/efficiency and are more dedicated to and used by institutional and knowledgeable investors rather than the public consumer base as targeted in the Secretariat Proposal.

b. defining the MNE group;

When defining an MNE group, existing definitions, as for example in the context of Country-by-Country reporting or for accounting consolidation purposes, are probably appropriate.

With regards to asset management activities, management companies in charge of managing investment funds together with other service providers to which they delegate functions (marketing of units, investment management of the funds' assets, central administration) may often (but not always) belong to the same group of entities that would qualify as an MNE group. However, for investment funds *per se* and investment funds' structures, we would like to stress the fact that consolidation requirements are very different from those of a typical MNE group. Certainly a fund and a fund manager should not be regarded as comprising parts of the same MNE group for the purposes of the Secretariat Proposal.

c. covering different business models (including multi-sided business models) and sales to intermediaries;

Distribution networks models used in the asset management industry are largely diverse: some mainly rely on in-house intermediary networks while others are entirely or partially externalised and deal with third party financial intermediaries that operate independently in or more jurisdictions at their own risks.
In the latter case, such an intermediary may to some extent be considered as a customer-facing business and may, on the face of it, be considered as falling in the scope of the proposed unified approach. However it may prove extremely difficult for an intermediary engaged, as it is often the case, in the marketing of investment funds pertaining to several asset management houses, to identify whether and which part of its taxable profit realised locally should be allocated to its own performance and track record rather than to other factors such as trade intangibles.

d. the size of the MNE group, taking account of fairness, administration and compliance cost; and

Considering the work already done in the context of Country by Country Reporting, total consolidated revenue equal or higher than € 750.000.000 threshold determined therein may be a starting point for the discussion.
However, and as mentioned above, a clear distinction should be made between the investment activities of a fund, and asset management activities. As mentioned for the definition of an MNE group, most investment fund structures would not fit into the definition. Widely distributed investment funds, but also non-CIVs, very often hold EUR billions of assets under management that are ultimately owned by their investors and not by any group the investment fund would be managed by or be linked by name to.
Additional granularity from both regional and business activities perspectives would need to be considered as a revenue only threshold consideration might lead to unintended outcomes.

e. carve outs that might be formulated (e.g., for commodities)?

Paragraph 20 of the Secretariat Proposal indicates that *"[…] Further discussion should also take place to consider whether other sectors (e.g. financial services) should also be carved out, taking into account the tax policy rationale as well as other practicalities. Such discussion should also include consideration of size limitations, such as, for example, the €750 million revenue threshold used for country-by-country reporting requirements."*

A carve out of the financial sector in general and of the investment fund and asset management industry in particular as foreseen by the Proposal would be justified under several circumstances. Considering the tax policy rationale of the Proposal which is the focus on consumer participation as a value driver for the creation of a new taxable nexus, the financial services sector should be carved out as this rationale does not apply. Moreover, the application of the Proposal to the fund industry (including the asset management industry) would be not practical and inappropriate. In particular:

- As mentioned above, the fund management industry involves a complex web of B2B and B2C interactions and fund managers create value from offering fund products to retail investors (i.e. consumer-facing) and to institutional investors (i.e. business-facing), and in many cases to both, in a heavily synergistic way. For retail products, there is significant business-to-business activity in the value chain, often at multiple levels, arising from the complex web of intermediaries and distribution channels. It would be extremely difficult to disentangle the value created from working with institutional investors from the value created by activities with consumer-facing activities.

- Also, an important element to be considered is that an adequate allocation of revenues to consumer jurisdictions would be a challenging exercise. The allocation key in such a case would likely be the amounts of assets under management owned by investors geographically based in a specific country rather than the "sales" as such. In a multi-tier intermediaries' context where confidentiality rules apply, identifying the residency of the ultimate investor would in practice be extremely difficult as well as a time consuming and costly.

- For the time being the activities are only partially digitalised and mostly for process streamlining/efficiency and do not aim at reaching out to new or larger markets or as means for realising profits from third parties. Also, the financial services sector does not tend to rely on user/consumer participation as a value driver and operators in the financial sector are generally not able to "monetise" their customer lists or data, due to the applicable confidentiality rules and regulatory constraints. Moreover, the financial services sector tends not to rely on user/consumer participation as a value driver.

- These activities are heavily regulated in almost all their aspects and in particular, marketing towards retail investors in the EU but also outside the EU is subject to stringent regulatory authorisation processes and supervision requirements. Such regulations essentially require financial institutions to have a regulated entity in local jurisdictions that the respective financial regulators and supervisors have direct access and control. The situation is slightly different for financial intermediaries operating in Europe under the freedom of establishment and passporting rules. In such a case one regulated entity in one EU jurisdiction engages across borders with customers in other EU jurisdictions. Considering that financial intermediaries are generally subject to the regulatory requirements applicable in local jurisdictions, the regulatory requirement creates the need for a physical presence, and therefore also a taxable nexus. In other words, most financial institutions are generally already present in their customers' jurisdictions where profits are consequently attributed according to existing transfer pricing rules and regulations. As an example, for this very reason, regulated financial services were excluded, to some extent, from the scope of the UK digital service tax.

- In the financial sector, profits are more likely driven by the “track record” and performance. As mentioned above, considering the variety of the distribution models, it seems rather difficult to define one solution that would fit the all financial sector in general and all types of investment funds and all asset management business models in particular. The same difficulties arise in agreeing on a formula that would allow, in a relatively straightforward manner, to determine which part of the profit derives from a marketing intangible (such as a brand). We therefore consider that any solution for the industry sector would probably be a complex one that would require specific additional transfer pricing analysis and which would trigger additional significant tax compliance costs. From a cost-benefit analysis standpoint, we would question the benefit resulting from additional tax revenues allocated to any jurisdiction compared to the implementation costs its complexity would entail.

- The profitability of the entities acting in the financial sector can vary substantially across business lines, regions or markets. Taking into consideration that investment funds in particular, are not profitable entities as they do not make money raises the difficult question of the profit’s determination, segmentation and allocation. Similarly, the allocation of the investment manager profits would not be practical and would be inappropriate as it would indirectly target the investment funds.

- Financial services, and in particular the fund and asset management industry is a complex industry that works from a long-term perspective. The industry is currently organised around a conjunction of a large number of legal, regulatory, transfer pricing and tax rules. The application of a new nexus and new profit allocation rules would be a further burden and disruption for our industry.

- Finally, revenues from sales are not always reflecting the “value” created by the users/customers. As an example, in some jurisdictions/markets, there may be significant sales on distribution activities without correlated profitability because profitable margins are not subject to the same constraints in all jurisdictions or in all markets.

2. New nexus

Under the proposed “Unified Approach”, a new nexus would be developed not dependent on physical presence but largely based on sales. What challenges and opportunities do you see in defining and applying a new nexus, in particular with respect to:

- ***a. defining and applying country specific sales thresholds; and***
- ***b. calibration to ensure that jurisdictions with smaller economies can also benefit?***

In general, the identification of “revenues” as the factor to create a nexus could create certain difficulties for fund managers, in particular when they are part of a group also operating in other industry sectors such as banking, insurance etc.).
However, and as mentioned above, assuming revenues could be identified, another difficulty to be overcome would be the adequate allocation of these revenues to consumer jurisdictions. In this instance, the allocation key which is the best proxy is then likely to be not “sales” *per se*, but amounts of assets under management for investors geographically based in a specific country. Considering the intermediaries’ multi-tier context (involving funds of funds, nominee arrangements and other types of intermediaries), identifying the residency of the ultimate investor would be a challenging exercise.

We would like to draw your attention to the specific situation of investment funds *per se*. Income and gains received from or realised on investments made by the fund qualify as financial income and should in our view be excluded from these sales thresholds considerations. Subscription fees received from investors entering in a fund should also not be considered as the result of sales unless the fund has a direct B2C relationship with the investor, which happens only in a very marginal number of situations. Investment funds as such should therefore not be caught by this sales threshold approach.

In addition, using revenues from sales as the "nexus" element requires there to be a clear definition of revenues as this creates uncertainty and potentially trigger divergent treatments were the definition to be left to domestic rules.

Having stated the above, the identification of a high enough threshold of revenues to trigger the nexus with a jurisdiction would avoid administrative burden and costs in respect to jurisdictions in which funds do not have a significant activity. Care should be taken to ensure when defining the threshold that it would not have the effect of incentivizing funds to exit certain markets/locations.

Calibration of the "revenue" threshold based on the size of the jurisdiction could potentially allow small economies, such as Luxembourg, to be treated fairly under the Proposal. On the other hand, it would be important to understand how such calibration would be determined. For example, if done using social security or payroll data, revenues generated in Luxembourg might be overestimated considering the significant number of commuters, conversely, if their residences are used, it could be underestimated.

3. Calculation of group profits for Amount A.

The starting point for the determination of Amount A would be the identification of the MNE group's profits. The relevant measure could be derived from the consolidated financial statements. In your view, what challenges and opportunities arise from this approach? Please consider in particular:

- ***a. what would be an appropriate metric for group profit;***
- ***b. what, if any, standardised adjustments would need to be made to adjust for different accounting standards; and***
- ***c. how can an approach to calculating group profits on the basis of operating segments based on business line best be designed? Should regional profitability also be considered?***

The consolidated financial statement approach may be considered as a pragmatic approach to identify a MNE group profit. However, additional elaboration would be needed for groups operating in more than one business activity.

In respect to the specific questions:

- An appropriate metric would be the one representing the "operating profit" of the group, given the business sector in which the group operates. For the fund industry this maybe the "net income profit".
- Given the above, certain adjustments would need to be performed to ensure that groups operating in the same segment of activity use the same metric to identify their profits. The use of "standardised" adjustments would eliminate uncertainties, but – on the other hand – may not perfectly capture specific facts and circumstances for each segment of activity. The typical accounting translation issues and their subsequent tax implications (timing differences of recognition of profits) are to be expected.

- Similar to the threshold argument for size, regional profitability should be taken into account. Each region or market differs from the other with respect to their economic profitability.

4. **Determination of Amount A.**

In determining Amount A, the second step would exclude deemed routine profits to identify deemed residual profits. The final step would allocate a portion of the deemed residual profits (Amount A) to market jurisdictions based on an agreed allocation key (such as sales). In your view, what challenges and opportunities arise from this approach?

A formulaic approach would certainly simplify the computation of Amount A albeit at a potential "accuracy" cost. Accuracy may be increased by diversifying the percentage of the deemed routine profits per industry and business line.

The allocation of the residual profit based on a "key" is of course a highly simplistic approach and the Proposal suggests "sales" as an allocation key. It would then be important, as mentioned above for the thresholds, both to exclude investment funds *per se* and to clarify the meaning of "sales" for the asset management industry.

5. **Elimination of double taxation in relation to Amount A.**

What possible approaches do you see for eliminating double taxation in relation to Amount A, considering that the existing domestic and treaty provisions relieving double taxation apply to multinational enterprises on an individual-entity and individual-country basis? In particular, which challenges and opportunities do you see in:

a. ***identifying relevant taxpayer(s) entitled to relief;***
b. ***building on existing mechanisms of double tax relief, such as tax base corrections, tax exemptions or tax credits; and***
c. ***ensuring that existing mechanisms for eliminating double taxation continue to operate effectively and as intended.***

As mentioned above, for the asset management industry it would be essential to be able to identify the entity/ies in the business that may be caught by these new rules, with a view to averting any double counting and consequently any double taxation in asset management structures.

For Amount A, it is also important to ensure that the overall amount of deemed residual profit, and no more than this, is taken in consideration and that any double inclusion of all or part of this amount is strictly avoided and that this amount is taxed only once across the jurisdictions involved.
Also, tax credits may not be a sufficient mechanism to eliminate double taxation in respect to Amount A. The Proposal should consider the disparity between tax systems in terms of the determination of the taxable basis and the level of applicable tax rates between jurisdictions.

6. **Amount B.**

Given the large number of tax disputes related to distribution functions, Amount B of the "Unified Approach" seeks to explore the possibility of using fixed remunerations, reflecting an assumed baseline activity. What challenges and opportunities does this approach offer in terms of simplification and prevention of dispute resolution? In particular, please consider any design aspects and existing country practices that could inform the design of Amount B, including:

- ***a. the need for a clear definition of the activities that qualify for the fixed return; and***
- ***b. a determination of the quantum of the return (e.g., single fixed percentage; a fixed percentage that varied by industry and/or region; or some other agreed method).***

For the same reasons as mentioned above investment funds should be excluded from this approach on sales and distributions and therefore from the activities that qualify for the fixed return of Amount B.

A consensus on what distribution activities cover would be required, and assuming a definition has been agreed upon, determining a fair return would need to account for regional characteristics, the nature of the underlying investments as well as the track record of the fund (i.e. a good track record normally would require less involvement of distribution functions).

7. **Amount C/dispute prevention and resolution.**

In the context of Amount C of the "Unified Approach", what opportunities do existing and possible new approaches to dispute prevention offer to reduce disputes and resolve double taxation? In particular, what are your experiences with existing prevention and resolution mechanisms such as:

- ***a. (unilateral or multilateral) APAs;***
- ***b. ICAP; and***
- ***c. mandatory binding MAP arbitration?***

On the basis of our experience, APAs are costly and time consuming, and require the disclosure of a significant amount of information to the tax authorities.

As to the mandatory binding MAP arbitration, for the time being not all countries, such as China or India, have adhered or are party to this type of mechanism. Considering the importance of these countries, this may limit its usefulness.

In our views, Pillar 1 measures should not be implemented unless and until much more robust, effective and short time-limited dispute resolution mechanisms are put in place.