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CLIENT ALERT

Pillar One: Asset Management Industry Responds to OECD Consultation

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Introduction

The OECD's consultation on the "regulated financial services exclusion" to Pillar One, which ran from 6 May to 20 May, elicited a number of responses from the asset management industry in relation to the potential removal of asset management activities from the scope of the exclusion. This note provides background to Pillar One and summarizes the asset management industry's responses to the consultation.

Background

The consultation highlighted the work undertaken to date by the OECD/G20 Inclusive Framework towards developing a multilateral convention and supplementary model rules through which "Amount A" of Pillar One will be implemented.

In short, Pillar One reallocates taxing rights to the jurisdictions where large multinationals have customers, regardless of whether they have an office or any physical presence there. It is currently proposed to apply to groups with revenue of at least EUR 20 billion and relative profitability as measured against revenue in excess of 10%, although in time the threshold is expected to be reduced to revenue of at least EUR 10 billion. Whilst Pillar One was originally conceived to target the profits of global digital enterprises to reallocate them to "user" jurisdictions because traditional allocations based on physical presence were considered out-of-date for the digital economy, the proposals may impact multinational enterprises in any sector.

The "regulated financial services exclusion" introduces an exclusion for revenues and profits from certain regulated financial institutions from the scope of the new taxing rights under Pillar One. The OECD's policy basis for the exclusion is that the "defining character" of the sector is that it is "subject to a unique form of regulation, in the form of capital adequacy requirements, that reflect the risks taken on and … this regulatory driver … helps to align the location of profits with the market". However, in the consultation document, the OECD was keen to stress that this does not reflect the final or consensus view on the "regulated financial services exclusion" and certain members of the OECD/G20 Inclusive Framework hold the view that reinsurance and asset management should not be excluded from the new taxing rights under Pillar One. The opposition to an exclusion for reinsurance and asset management appears to be formed on the grounds that there is an increasing interconnection between the technology and financial sectors.

Consultation

On 6 May 2022, the OECD invited public input on the regulated financial services exclusion under "Amount A" of Pillar One. Whilst the initial proposals include asset management within the scope of regulated financial services for the purposes of the exclusion, the consultation focused on certain design aspects relevant to the asset management industry. A number of industry bodies responded to the consultation, including AIMA, ALFI, Business at OECD, BVCA, CMTC, EFAMA, FSC and ICI. The main responses are summarized below.

Responses to consultation

Should asset management be included within the financial services exclusion?

In light of the commentary that certain members of the OECD/G20 Inclusive Framework consider that reinsurance and asset management should not be within the scope of the exclusion for regulated financial services, the responses place emphasis on asset management generally satisfying the three elements which the OECD/G20 Inclusive Framework has stated each type of "regulated financial institution" should satisfy, being:

- a licensing requirement;

- a capital adequacy requirement incorporating a risk-based measure; and

- an activities requirement.

All responses emphasized that asset management should generally meet these requirements. Ultimately, the capital adequacy requirements applicable to the asset management industry are a principal factor aligning the location of profits with market and the highly regulated nature of the fund industry further ensures that profits are located in line with the recipient of asset management services.

Whilst there was general consensus for the three elements required for a "regulated financial service" to be excluded from "Amount A", a number of respondents expressed concern that the capital adequacy requirements incorporating a risk-based measure excluded asset management in certain jurisdictions. The BVCA emphasized that there are many different investment management and advisory structures and arrangements that are commonly seen in the market, so the final form of the exclusion and associated guidance should appropriately cover all common arrangements.

Integration between asset managers and other financial service providers

Respondents placed particular emphasis on the level of integration between the asset management industry and other regulated financial services. For example, the EFAMA noted that a wide range of investment products similar to investment funds are offered to customers by insurers and banks (often including management by asset managers), therefore any exclusion for regulated financial services that does not incorporate asset management businesses is likely to distort the financial services market.

It was widely considered that a broad exclusion was less likely to generate competitive distortions and would avoid excessive compliance costs associated with extracting the asset management element of an integrated financial services business in order to apply "Amount A" for limited profit reallocations. Such extractions could prove especially difficult and cumbersome for an industry where it is common practice for a client to pay a single fee for an integrated service and the separation of such services does not reflect the economic reality of how the client receives the services.

Lack of interaction with end-consumers

Generally, the asset management industry provides services to investment funds rather than directly to end consumers and, therefore, should not fall within the definition of consumer facing business. On that basis, removing asset management from the regulated financial services exclusion appears to run contrary to the intended scope of Pillar One (as discussed above).

The German Insurance Association also raised the important consideration that financial intermediaries typically sit between the consumers and asset manager. In such cases, the asset manager is unlikely to have sufficient access to end-user data to make a proper allocation of revenues without significant challenges. Compliance would therefore be costly and burdensome for asset managers.

Unintended consequences

The most significant concern to several stakeholders in the asset management industry is the unintended consequences that may arise from requiring asset managers to undertake a significant tax compliance exercise and incurring additional tax costs not levied on other financial services groups providing similar services. The ICI noted that, if subject to the "Amount A" rules, asset managers may need to consider which jurisdictions to enter and distribute their investment funds in and could result in it not being economically viable to market funds in new markets. The ICI also noted that asset managers could potentially withdraw from smaller markets due to the increased costs associated with complying with the "Amount A" rules.

Conclusion

It appears from the proposed drafting that the majority of OECD/G20 Inclusive Framework members consider that asset management should be within the financial services exemption and the anticipated delays in implementing Pillar One (with the rules now anticipated to have effect from 2024 rather than 2023) may allow OECD/G20 Inclusive Framework members to consider the consultation responses and reach a consensus in the coming months. Further support for the inclusion of reinsurance and asset management in the exclusion from Pillar One was provided by the U.S. Treasury in a statement released by Michael Plowgian of the Treasury Office of Tax Policy on 3 June 2022.

However, if a consensus view on the exclusion is not possible and Pillar One is to apply to the asset management industry in some form, the model rules would need to be drafted with great care to apply appropriately to asset managers operating in each participating jurisdiction and avoid possible market distortions from distinctions between profits from standalone asset management and integrated asset management services. Following careful implementation of legislation, a long lead time would be necessary to allow financial services groups to identify the profits that should be reallocated.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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