Memo

To	Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA
From	KPMG International
Date	May 20, 2022
Ref	Comments on the Public Consultation Document for Pillar One – Amount A: Regulated Financial Services Exclusion

Professionals in the member firms of KPMG International[1] ("KPMG") welcome the opportunity to comment on the OECD's public consultation document entitled "Public Consultation Document for Pillar One – Amount A: Regulated Financial Services Exclusion," released on 6 May 2022 (the "Consultation Document").

There are five key issues that we believe warrant specific or further consideration by the Task Force on the Digital Economy (TFDE).

- We support the proposal to exclude a broad range of financial services from the scope of Amount A, and specifically to exclude **banking, insurance (including reinsurance) and asset management**. In addition to the policy rationale outlined in the Consultation Document (with which we also agree), there are a number of practical reasons for excluding the Regulated Financial Services industry from the scope of Amount A. As outlined in *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint*, profit margin (profit divided by revenue) is rarely used to measure profitability in the Regulated Financial Services industry and as a measure of profitability is not comparable to other industries.[2] It is also difficult to define and identify the "market" for financial services. Thus, applying Amount A to the type of financial services businesses described in the Consultation Document could lead to unintended, illogical, and hence unstable outcomes.

[1] KPMG is a global organization of independent professional services firms providing Audit, Tax and Advisory services. KPMG is the brand under which the member firms of KPMG International Limited ("KPMG International") operate and provide professional services. "KPMG" is used to refer to individual member firms within the KPMG organization or to one or more member firms collectively. KPMG firms operate in 145 countries and territories with more than 236,000 partners and employees working in member firms around the world. Each KPMG firm is a legally distinct and separate entity and describes itself as such. Each KPMG member firm is responsible for its own obligations and liabilities. KPMG International Limited is a private English company limited by guarantee. KPMG International Limited and its related entities do not provide services to clients.

[2] OECD (2020), *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS,* paragraph 126.

- There is a risk that **not excluding certain businesses from the scope of Amount A, notably payment service providers, that compete with businesses that are covered by the Regulated Financial Services Exclusion, will create an un-level playing field**, introducing unintended market distortions.

- The **proposed entity-based approach is complex** and will impose significant compliance burdens on taxpayers and tax administrations. Multinational Enterprise (MNE) groups in the Regulated Financial Services sector have hundreds, if not thousands, of legal entities. Though the licencing and regulatory capital requirements of the Exclusion appear to be relatively straightforward to apply (and, if required, to review on an annual basis), the activities requirement is not. The calculations underpinning the activities requirement will need to be updated annually, placing a significant burden on taxpayers and tax administrations. The entity-based approach could be significantly simplified by **removing the activities requirement** without material detriment to the objectives of the Exclusion**.**

- Similarly, the **application of the Amount A rules to MNE groups that are partially in-scope will also be complex**, particularly where bespoke segmentation is required. It is important to ensure that these MNE groups are not disadvantaged, for example, that they are not subject to less generous loss carry-forward rules or a stricter averaging mechanism.

- It is important for the TFDE to consider how to **simplify the administration** of the Regulated Financial Services Exclusion. In this regard, we would recommend that MNE groups that self-assess they are not in-scope of Amount A because of the Exclusion have the **option to file a return** supporting this assessment with relevant tax administrations and / or through the tax certainty process, but that this is **not a requirement**. We also suggest that **consideration be given to a rulings process**, whereby a taxpayer that files a return could receive certainty that they are not in-scope of Amount A for at least 5 years, subject to certain critical assumptions being met.

The remainder of this memo sets out the above issues in more detail, alongside other issues. These issues are grouped into four sections: (1) the scope of the Regulated Financial Services Exclusion; (2) the definition of Regulated Financial Institutions; (3) the application of the Exclusion to partially in-scope MNE groups; and (4) administration.

As a final introductory comment, we note that the Consultation Document is primarily presented in narrative form, and only provides specific legal definitions for Regulated Financial Institutions. In light of the two-week turnaround, given the issues outlined above and below, and that it is envisaged that the Model Rules will serve as the basis for a Multilateral Convention (MLC) that will determine how Amount A is applied, we strongly encourage the TFDE to undertake a **second round of public consultation on the Regulated Financial Services Exclusion,** preferably as part of a broader consultation on a comprehensive set of Model Rules. Once further details on the Model Rules and MLC emerge, we may have additional comments.

1 Scope of the Regulated Financial Services Exclusion

The scope of the Regulated Financial Services Exclusion is ultimately a policy decision that must be made by the Inclusive Framework. That said, we agree that the industry "is subject to a unique form of regulation … that generally helps to align the location of profits with the market".[3] In addition, there are a number of other practical reasons why applying Amount A (in its current form) to groups in the Regulated Financial Services industry may lead to unintended, illogical, and hence unstable outcomes. It is important to acknowledge these practical reasons for the Regulated Financial Services Exclusion.

Key considerations for banking, insurance (including reinsurance) and asset management

Under Amount A, in-scope groups will be required to allocate 25% of their profits in excess of a profit margin of 10% to market jurisdictions using a revenue-based allocation key.

In the financial services industry, profitability is typically not measured as a return on sales, with return on assets a more commonly used way to assess financial performance. Moreover, as outlined in *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint*, a group's profit margin (profit divided by revenues) is not an appropriate way to compare the profitability of the financial services industry with other industries.[4] There are a number of reasons for this. For example, banks typically report trading revenue net of trading costs, and interest revenue net of interest expense, which means that their profit margin (calculated on these revenues) is in effect artificially inflated when compared to other industries.

In addition, and separate from the above, it would be helpful to clarify when determining whether a group meets the revenue threshold and calculating its profit margin for the purpose of Amount A whether gross or net revenue should be used. In this regard, we note that Paragraph 22(c) refers to "gross income" and that footnote 13 states that this is the defined term "Revenue".

For many of the products and services provided by banks, insurers (including reinsurers) and asset managers it is difficult to identify the "market jurisdiction". For example, where a reinsurer provides reinsurance to an insurer for catastrophe risk, there is a question whether the "market jurisdiction" is the jurisdiction where the insurer is located or where the insurer's customer is located. A similar question arises where an asset manager provides asset management services to an investment fund formed in one jurisdiction where customers from many different jurisdictions invest, either directly or indirectly through other funds (for example, five pension funds located in five jurisdictions each with participants located in different jurisdictions, could be the direct investor of the investment fund), or where an investment bank advises a large multinational client headquartered in one jurisdiction on the acquisition of another large multinational client headquartered in a different jurisdiction.

The difficulty of identifying the "market" for some Regulated Financial Services products and services means that if Regulated Financial Services were included in-scope of Amount A it would be necessary to rely on an allocation key to allocate the relevant portion of a group's residual profits. However, given the concentrated

[3] OECD (2022), *Public Consultation Document for Pillar One – Amount A: Regulated Financial Services Exclusion*, p. 3.
[4] OECD (2020), *Tax Challenges Arising from Digitalisation – Report on Pillar One Blueprint: Inclusive Framework on BEPS,* paragraph 126.

nature of the Regulated Financial Services industry, using an allocation key such as gross domestic product (GDP) or final consumption expenditure would likely be an inaccurate approximation of where revenues from the industry are generated.

In combination, the fact that profit margin is a poor measure of "residual profit" and the challenges of allocating residual profits, mean that if Amount A were applied to banks, insurance (including reinsurance) or asset management it would lead to outcomes that are difficult to rationalize. This would make Amount A inherently more unstable, reducing the likelihood that it successfully achieves Pillar One's objectives. Consequently, we welcome the Exclusion for Regulated Financial Services.

Moreover, adopting a narrower Exclusion, for example, not excluding reinsurance and asset management from the scope of Amount A, would increase the number of MNE groups that are partially covered by the Regulated Financial Services Exclusion. For example, it is common that insurers also provide reinsurance and that banks perform asset management. As acknowledged in the Consultation Document and discussed further below, applying Amount A to partially in-scope groups will be complex and impose significant compliance costs on taxpayers and tax administrations. Narrowing the Exclusion would also increase the risk that businesses providing comparable products and services are treated differently, creating an un-level playing field. Both these issues support the argument for a broader Regulated Financial Services Exclusion and would not undermine the broader policy objectives of Amount A.

Risk of an un-level playing field

There is a risk that even the Exclusion currently proposed creates an un-level playing field between businesses that provide comparable products and services, introducing unintended market distortions. For example, the current Exclusion will likely result in payment service providers that provide services to third party financial institutions falling outside the scope of the Regulated Financial Services Exclusion. In contrast, the profits a Regulated Financial Institution generates from payments services that support its own operations are likely to be covered.

2 Definition of Regulated Financial Institutions

General comments

The entity-based approach adopted for the Regulated Financial Services Exclusion has the potential to impose significant compliance costs on taxpayers and tax administrations, given that large MNE groups in the Regulated Financial Services industry can have hundreds, if not thousands, of legal entities. Therefore, it is critical that, as outlined in the Consultation Document, the definition of Regulated Financial Institutions can be applied as "a filtering function" and "is relatively easy to apply and document".[5] In this regard, we welcome the suggestion (in paragraph 14) that groups could apply the Exclusion to their largest entities in order to demonstrate they fall below the EUR 20bn revenue threshold.

[5] OECD (2022), *Public Consultation Document for Pillar One – Amount A: Regulated Financial Services Exclusion*, paragraph 15.

The activities requirement has the potential to add significant complexity to the definition of Regulated Financial Institution, as it means that each year a taxpayer would be required to compute whether each entity meets a specific quantitative threshold. This will have knock-on implications for the administrative burden tax administrations will face when they review the application of the Exclusion.

We understand that the activities requirement has been included due to concerns that entities may meet the relevant licensing and regulatory capital requirements, but then primarily perform other types of activities. As a general matter, we think that this concern is overstated, as regulators will typically place strict limits on the non-regulated activities that regulated entities are permitted to perform. Additionally, we note that the activities requirement creates a significant cliff-edge effect where, for example, an entity that meets the conditions set out in 20(a) and 20(b), but with 19% of its liabilities in the form of Deposits would not be defined as a Depositary Institution and hence ineligible for the Exclusion, in contrast to an entity which has 21% of its liabilities in the form of Deposits. Again, this would be likely to generate an unintended market distortion. The entity-based approach could be simplified, and this cliff-edge effect addressed by removing the activities requirement.

Depositary Institution

The proposed licencing and regulatory capital requirements are a good way to define depositary institutions, though as outlined above we have concerns about the activities' requirement.[6] In the commentary to the Model Rules, it would be helpful for the TFDE to specify how a taxpayer would demonstrate that the licencing and regulatory capital requirements had been met, in a way that minimises compliance costs for taxpayers and tax administrations.

Paragraph 12 states that "An Entity, for the purposes of Amount A, includes any branches, whether or not there is a permanent establishment under domestic law and the applicable tax treaty, and the Entity is tested as a whole". Whilst footnote 8 states "The Commentary would explain that this licensing requirement is tested looking at the operations in the local jurisdiction, and may need to be tested at branch rather than Entity level." We would like to confirm that where an entity or a branch of an entity meets the licensing requirement, the entity as a whole will be eligible for the Exclusion; and that the regulatory capital requirement and activities test are only applied at an entity level.

The regulatory capital requirement requires that a Depositary Institution is subject to "capital adequacy requirements that reflect the Core Principles for Effective Banking Supervision as provided by the Basel Committee on Banking Supervision." We would like to confirm that the commentary to the Model Rules will provide further guidance on which jurisdictions have capital adequacy requirements that meet the Core Principles for Effective Banking Supervision.

The proposed definition of "Deposit" is broadly drawn and principles-based. This is important, given that the definition will be applied across a broad range of jurisdictions and businesses, which may define deposits in

[6] We read the licensing requirement paragraph 20(a) as requiring a Depositary Institution to perform some, but not all, of the activities listed in paragraph 20(c) and footnote 9. We recommend clarifying this in paragraph 20(a).

different ways. We note that if the activities requirement is retained, we consider that setting the percentage of an entity's liabilities that must consist of Deposits at 20% is a reasonable threshold.

Mortgage Institution

The proposed licencing and regulatory capital requirements are a good way to define mortgage institutions, though as outlined above we have concerns about the activities requirement. Again, it would be helpful for the Commentary to clarify how compliance with the licencing and regulatory capital requirements could be demonstrated.

Again, we would like to confirm that the commentary to the Model Rules will provide further guidance on which jurisdictions have capital adequacy requirements that meet the Core Principles for Effective Banking Supervision.

The activities requirement requires that "the total gross income attributable to the granting of such credits equals or exceeds [75] per cent of the Group Entity's total gross income during the Period".[7] This high threshold could result in entities that generate the majority of their income from granting mortgages not being covered by the Exclusion. If the activities requirement is retained, we suggest lowering this threshold to 50 per cent. Additionally, it should be made clear that income from the sales of mortgages, income from servicing mortgages, and hedging mortgage servicing rights should be "good income" for purposes of the threshold test.

Investment Institution

The proposed licencing and regulatory capital requirements are a good way to define investment institutions, though as outlined above we have concerns about the activities requirement. Again, it would be helpful for the Commentary to clarify how compliance with the licencing and regulatory capital requirements could be demonstrated.

Again, we would like to confirm that the commentary to the Model Rules will provide further guidance on which jurisdictions have capital adequacy requirements that meet the Core Principles for Effective Banking Supervision and the Objectives and Principles of Securities Regulation as adopted by the International Organisation of Securities Commissions (IOSCO); and if the activities requirement is retained suggested lowering the threshold to 50 per cent.

Insurance Institution

The proposed licencing and regulatory capital requirements are a good way to define insurance institutions, though as outlined above we have concerns about the activities requirement. Again, it would be helpful for the Commentary to clarify how compliance with the licencing and regulatory capital requirements could be demonstrated.

[7] OECD (2022), *Public Consultation Document for Pillar One – Amount A: Regulated Financial Services Exclusion*, paragraph 21(d).

Again, we would like to confirm that the commentary to the Model Rules will provide further guidance on which jurisdictions have solvency standards incorporating a risk-based capital measure; and if the activities requirement is retained suggested lowering the threshold to 50 per cent.

As currently drafted, we are concerned that the definition of “Insurance Contract” and “Annuity Contract” may not cover all life insurance policies. The definition of a “life insurance contract” or “life policy” can vary by jurisdiction, and it is important that the definitions of “Insurance Contract” and “Annuity Contract” do not inadvertently exclude life insurers in some jurisdictions from the Regulated Financial Services Exclusion. For example, in Australia regulated life insurance companies issue life policies that are purely investment (i.e. no risk component).[8] These are policies that can only be issued by regulated life insurance companies, and which may include a guaranteed return. If the activities test is retained and the income from these policies is not taken into account, there is a risk that regulated life insurance companies that issue these policies do not meet the Insurance Institution definition as currently drafted. To address this, we suggested adding a specific reference to these types of contract to the definition of “Insurance Contract” or “Annuity Contract”.

If the activities test is retained, we consider that paragraph 23(c) should be clarified to make clear that “gross income” is determined based on gross written premiums, not net written premiums.

Asset Manager

We are concerned that as currently drafted the definition of “Asset Manager” will not apply as intended. The type and purpose of regulation that applies to asset management is different from that which applies to banks and insurers; and in particular, “capital adequacy requirements” are significantly less relevant. Though in some jurisdictions entities that perform asset management may be subject to “capital adequacy requirements incorporating a risk-based measure”, in other jurisdictions they are not. For this reason, we suggest focusing the definition of “Asset Manager” on the licensing requirement only. If the "capital adequacy requirement" is retained we think that the definition currently proposed in footnote 19 requires further work and would welcome the opportunity to discuss this further.

Mixed Financial Institution

As currently drafted, paragraph 25(c) does not take into account the gross income an entity derives from the performance of “banking or similar business” as defined in footnote 9. We are concerned that this could lead to scenarios where entities that should meet the definition of a Mixed Financial Institution are not covered. Therefore, we would suggest extending the gross income taken into account in paragraph 25(c) to include income from “banking or similar business”.

The rationale for excluding “Mortgage Institution” from paragraph 25(a) is unclear and we do not believe there is any compelling reason to do so. We recommend including “Mortgage Institution” in paragraph 25(a).

[8] See the definition of life policy in section 9 of the Life Insurance Act 1995 (Cth) which includes “investment account contract” and “investment-linked contract”.

Consistent with our comment above about eliminating capital adequacy requirements for Asset Managers we do not believe that an entity should need to satisfy a capital adequacy requirement to meet to the Mixed Financial Institution definition.

RFI Service Entity

Given the objective of the Regulated Financial Services Exclusion is to exclude profits from Regulated Financial Services, there is a strong rationale for excluding entities that meet the definition of a “RFI Service Entity”. However, it is unclear to us why paragraphs 26(a) and 26(b) are not sufficient for an entity to meet the “RFI Service Entity” definition, given that 26(b) requires that such entities perform services exclusively for a Regulated Financial Institution.

We are particularly concerned by the suggestion in footnote 23 that entities that provide “fintech” would not meet the “RFI Service Entity” definition. For example, this could mean that an entity that develops and owns the technology underpinning an app used solely by a group to support the provision of its own consumer banking services is not covered by the Regulated Financial Services Exclusion. It is difficult to rationalise, in this example, why these profits should not be covered by the Exclusion, given they arise from the group’s banking activities and would be covered if performed by an entity that met the other definitions of a Regulated Financial Institution.

We also note that requiring that a RFI Service Entity exclusively provides services for Regulated Financial Institutions (other than a RFI Service Entity) may be overly restrictive. In many groups it is likely that these types of entities provide services to entities (such as holding companies) that do not meet the Regulated Financial Institutions definition. There may also be limited circumstances where these entities may provide services to third parties, for example, as part of a transitional service arrangement following the sale of part of the group. For these reasons, we would suggest that “RFI Service Entity” be required to perform services “primarily” or “principally” for the benefit of other Regulated Financial Institutions, rather than “exclusively”.

3 Partially in-scope MNE groups

It is important to acknowledge and seek to minimise to the greatest extent possible the complexity of applying the Amount A rules to partially in-scope MNE groups.

Bespoke segmentation

First, we agree that these groups should only be in-scope of Amount A if their third-party revenues from non-Regulated Financial Services activities exceed EUR 20bn. We also agree that a partially in-scope MNE group’s non-Regulated Financial Services activities should be treated as a standalone group, and hence should only be in-scope if the profit margin from their total revenues (third party revenues plus revenues from sales to group entities that meet the Regulated Financial Institution definition) exceeds 10%. Without taking into account both third party revenues and revenues from sales to group entities that meet the Regulated Financial Institution definition, the profitability of a MNE group’s non-Regulated Financial Services activities could be materially overstated.

We are concerned about the complexity of requiring all partially in-scope MNE groups to prepare bespoke accounts for their in-scope activities and think that taxpayers should be given some flexibility to select an appropriate method for determining their in-scope profits, relying on existing financial information where possible. We recognise that where a group is in-scope of Amount A it is difficult to envisage how its in-scope profits could be calculated other than using the top-down or bottom-up approaches suggested. However, we wonder if as a simplification groups could be given the option to demonstrate that they do not meet the 10% profitability threshold using information that they already disclose for financial reporting purposes or that they prepare for management reporting purposes, as part of an early or advanced tax certainty process.

In addition, we note that the Consultation Document does not clearly explain how the Regulated Financial Exclusion will apply to groups that are only in-scope of Amount A due to the exceptional segmentation rule. This will be particularly complex, as it could require a group to test whether an entity earns profits from a disclosed operating segment in-scope of Amount A, and then test whether the Regulated Financial Services Exclusion applies to that entity. Given the potential complexity, we think that this issue should be covered as part of a future public consultation.

Averaging mechanism and loss carry-forward rules

We agree that for groups that are partially covered by the Regulated Financial Services Exclusion applying the averaging mechanism and carry forward loss rules will be particularly complex. The application of both mechanisms would require that an MNE group has (or prepares retrospectively) bespoke accounts identifying its in-scope profits, which are then used to determine whether the profitability threshold has been met for the relevant prior periods and / or whether there are any historic losses to offset against its current Amount A tax base.

To ensure that groups that are partially covered by the Regulated Financial Services Exclusion are not disadvantaged, we consider it important that these groups have the option to apply the same averaging mechanism and loss-carry forward rules that apply to other groups. However, we also consider that groups should have the option not to apply the averaging mechanism or loss carry-forward rules, where this would require them to calculate their in-scope profits retrospectively for prior periods.

Marketing and Distribution Profits Safe Harbour and Elimination of Double Taxation

We agree that for coherence with the policy objectives of the Regulated Financial Services Exclusion, where an MNE group is only partially in-scope of Amount A the profits covered by the Regulated Financial Services Exclusion should not be taken into account when applying the Marketing and Distribution Profits Safe Harbour or eliminating double taxation. We strongly encourage the TFDE to cover both these issues in the public consultation on the Marketing and Distribution Profits Safe Harbour and Elimination of Double Taxation.

4 Administration

For groups that are covered by the Regulated Financial Services Exclusion it is critical that the approach to administration minimises their compliance burden. Most importantly, there should be no requirement for

groups to file annual returns to show that they are not within scope of Amount A. This would place a significant additional annual compliance burden on groups that ultimately fall outside the scope of Amount A.

The best approach would simply be to allow taxpayers to self-assess that they fall outside the scope of Amount A, with the documentation underpinning this assessment provided to tax administrations on request. An alternative would be for taxpayers that have more than EUR 20bn in revenue to notify relevant tax administrations that they are not eligible for Amount A through a single standardized return, again with the documentation underpinning this assessment then available on request.[9]

That said, there should be an option for taxpayers to file an Amount A return, or other relevant documentation, with relevant tax administrations and / or through the early or advanced tax certainty process to request certainty that they fall outside the scope of Amount A. This would be consistent with the commitment of the October Statement to provide tax certainty on “all issues related to Amount A”.[10]

In addition, consideration should be given to a rulings process, whereby, a taxpayer that files a return, or other relevant documentation, could receive certainty that they are not in-scope of Amount A for an agreed future period of at least 5 years. The rulings process could be subject to certain critical assumptions, reflecting the approach that is already used for Advanced Pricing Agreements (APAs). A rulings process would be of benefit to both taxpayers and tax administrations, as it would reduce the burden placed on the annual Amount A tax certainty process.

Finally, we note that the Regulated Financial Services industries will change over time, leading to the emergence of new products and services and new regulations. We suggested that the MLC includes a provision to allow for the review of the Regulated Financial Services Exclusion, at least every 5 years.

KPMG Contacts	Firm	E-mail
Manal Corwin	KPMG in the US	mcorwin@kpmg.com
Marcus Heyland	KPMG in the US	mheyland@kpmg.com
Quyen Huynh	KPMG in the US	qhuynh1@kpmg.com
Alistair Pepper	KPMG in the US	alistairpepper@kpmg.com
Grant Wardell-Johnson	KPMG in the UK	Grant.WardellJohnson@kpmg.co.uk

[9] Though the Administration building block has not yet been subject to public consultation, it is assumed that MNE groups that fall below the revenue threshold will not be required to file any type of Amount A return.
[10] OECD (2021), *Statement on a Two-Pillar Solution to Address the Tax Challenges Arising from the Digitalisation of the Economy*.