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South Centre Comments on Regulated Financial Services Exclusion

I. Background

The South Centre is the intergovernmental organization of developing countries that helps developing countries to combine their efforts and expertise to promote their common interests in the international arena. The South Centre has 54 Member States coming from the three developing country regions of Africa, Asia, and Latin America and the Caribbean. It was established by an Intergovernmental Agreement which came into force on 31 July 1995. Its headquarters are in Geneva, Switzerland.

The South Centre in 2016 launched the South Centre Tax Initiative (SCTI). This is the organisation's flagship program for promoting South-South cooperation among developing countries in international tax matters.

The South Centre offers its comments to the OECD Inclusive Framework's Task Force on Digital Economy (TFDE) on the Amount A Regulated Financial Services Exclusion.

II. Overview

As more and more of the draft Model Rules for Pillar One are being released for public consultation, a clear pattern is noticed– that the Rules are being designed to (i) exclude as many companies as possible from the scope of Amount A and (ii) reduce Amount A to the maximum extent.

This can be seen through highly problematic proposals such as making the averaging mechanism a permanent feature, trying to apply averaging to revenues, the introduction of a prior period test, pre-implementation loss carry-forward, the expansion of excluded entities, the multiple reapplications of the scope thresholds for extractives, and so on. In practice, all of these rules will have the effect of reducing the number of companies in-scope and the taxes they must pay to the developing countries, as they will shield mega-rich corporations from paying even a minuscule amount of tax. This attempt is also the primary reason behind the rules' complexity.

The referred to proposals raise questions about how really "inclusive" the OECD Inclusive Framework is? Or will the Organization continue to design rules that will essentially benefit developed countries? Such questions confirm the need for an intergovernmental tax body at the United Nations where all countries can participate in the rule-making process in a genuinely inclusive and democratic manner taking the interest of developing countries into account (through majority voting if necessary).

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The adoption of the UN Tax Committee's alternative solution, Article 12B, was reached after multiple rounds of voting in the UN Tax Committee. It is an example of what can be achieved through a truly inclusive and democratic participation, where the interest of the majority prevails to promote solutions that can benefit the whole world.

It is clear that the more this pattern of unbalanced proposals continues, the less acceptable the Pillar One agreement may become to the developing countries. Their proponents may think they are helping multinational companies (MNEs) to escape from the new tax rules, but in reality they are increasing the possibility of rejection of Pillar One and the continuation of unilateral measures.

The South Centre will release comparative revenue estimates from Amount A and Article 12B for its Member States and those of the African Union, a total of 84 countries, on 1 June 2022.[1]

III. Specific Comments

i. Over-broad, unprincipled exclusion

The rationale behind exclusion of 'regulated' financial services was that the nature of regulation faced by such services such as macro-prudential regulation (capital adequacy norms, etc) would ensure they would be taxable by the market jurisdiction. Hence, the core emphasis was on financial services availing of such regulation to make them eligible for the exclusion.

What has been seen now is an over-broad scope where virtually the entire financial sector is excluded from Amount A. This defeats the policy rationale and undermines the intent of the 8 October political agreement (henceforth 'political agreement'). This is especially concerning as the rise of "fintech" has further blurred the boundaries between the tech and financial sectors. The exclusion of financial services may also end up meaning a *de facto* exclusion of many digital services. For example, an MNE may offer analytics services which predict what a customer is likely to buy based on their past history and financial data. Payment processors and digital wallets similarly blend financial and tech services. There is a risk that such an overbroad exclusion may result in the tech companies escaping taxation, defeating the whole purpose of Pillar One.

[1] https://taxinitiative.southcentre.int/event/coalition-for-dialogue-on-africa-south-centre-dialogue-series-on-iffs/

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Further, the financial sector has been arguably as responsible if not more than the tech sector for tax avoidance and evasion. The mismanagement, greed and corruption of financial institutions in the developed countries in 2008 harmed the entire global economy, punishing developing countries for no fault of theirs and caused the initiation of the BEPS project. The financial sector has increasingly become detached from the real economy, with the Over the Counter (OTC) derivatives market alone in 2020 valued at close to USD 600 trillion, almost seven times global nominal GDP.[2] It is imperative that this wealthy sector pay their fair share of taxes to the developing countries.

Recommendation: The entire set of Regulated Financial Institutions must be reviewed to ensure a minimal scope where only those facing macro-prudential regulation are excluded.

ii. Wholesale exclusion of Regulated Financial Institutions

It has been proposed to 'wholly' exclude entities from Amount A, if they meet the definition of a Regulated Financial Institution (RFI). This is problematic. There is no rationale why the residual revenues, which are in-scope, should be excluded from Amount A.

The draft prescribes that the entity must derive at least 75% revenues from financial services to qualify for the exclusion.

Given the large amounts of revenue involved in the financial sector, removing the entities and reapplying the threshold tests may greatly reduce the number of companies in the scope of Amount A.

Conversely, including the residual, in-scope revenues into the scope of Amount A would increase the taxes to be paid to the developing countries. It appears the most damaging approach to the developing countries was chosen.

Recommendation: If an entity qualifies as an RFI, it must nevertheless remain in scope. This will be consistent with the principle of excluding only *revenues* from regulated financial services. All in-scope revenues must be included in the Amount A calculation.

[2] https://stats.bis.org/statx/srs/table/d5.1

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iii. Deletion of Steps 2 and 3

Building on the principle of exclusion only of *revenues* from Amount A, and as stated in the prior South Centre comments on the Extractives Exclusion, it is completely misleading to interpret the political agreement to re-apply the scope thresholds multiple times. Once an MNE is in-scope, it must remain in scope. Steps 4-7 already provide the details of how excluded revenues will be removed from Amount A.

Recommendation: Steps 2 and 3 must be removed from the exclusion rules.

iv. Lower predominance test for financial sector vs extractives

The text states that an entity must derive at least 75% revenues from financial services to qualify for the exclusion (barring depository institutions). However, for the extractives industries a higher threshold of 75 – 85% is mentioned. This indicates a bias towards the financial sector which must be corrected.

Recommendation: A consistent range of 75% - 85% must be used for the RFIs as well.

v. Depository Institutions

The definition for these is a Group Entity "For which at least [20] percent of the liabilities of the Entity consist of Deposits, as at the balance sheet date for the Period."

Such an institution would be a depository institution (or bank) only in name. This is borne out by data. Data on 22 major economies reported by the Bank of International Settlements shows their average loans and deposits: liabilities ratio is 78% as of December 2021.

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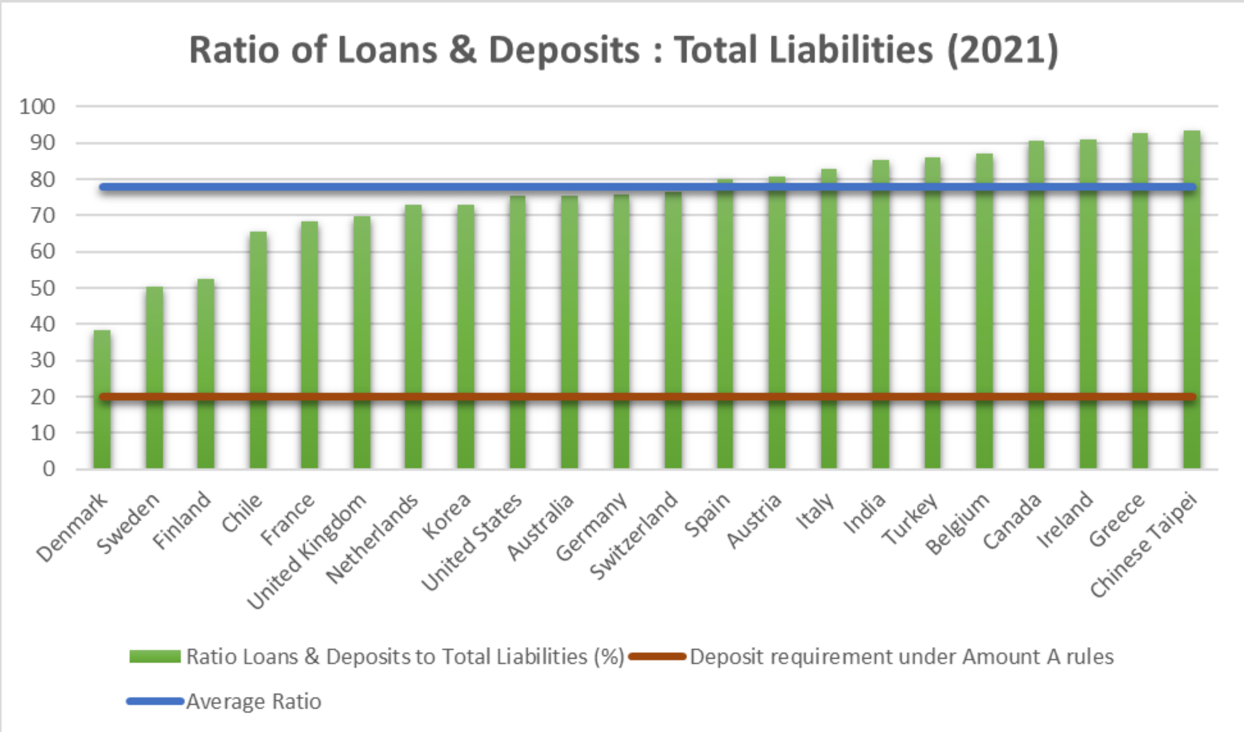

Source: Bank of International Settlements
https://stats.bis.org/statx/srs/table/b1?m=S

Excluding loans from the equation and taking only a deposits : liabilities ratio will reduce the average somewhat, but it is certain to be far higher than the minuscule 20% figure mentioned in the document. This will open the possibility of companies creating entities which are banks only in name, load them with in-scope functions, and use the exclusion rules to escape Amount A.

Recommendation: Deposits must be at least 60% of total liabilities, consistent with the data on how actual banks operate.

vi. Depository Institutions in Jurisdictions without central banks

Some jurisdictions known as tax havens like Jersey[3] do not even have a central bank. It is unclear who is responsible for enforcing the regulations essential to determine whether the financial institution is out of scope.

Such jurisdictions, already expert in damaging developing countries through facilitating tax avoidance and evasion, may further add to the problem by becoming

[3] Ranked 19 on the Financial Secrecy Index 2022
https://fsi.taxjustice.net/

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preferred locations for abusing the exclusion rules. MNEs can create fake banks taking advantage of the regulatory gaps and escape Amount A.

Recommendation: The rules must specify how jurisdictions without central banks will enforce the exclusion rules.

vii. Reinsurance

Reinsurance, being an essentially cross-border activity, must be in the scope of Amount A. The revenue must be sourced to the jurisdiction where the underlying assets which are being insured are located, and from where the payment arises.

The argument is made that such an approach would create compliance burdens as it would need modified tax base determination rules to account for income from dividends. However, complexity has never been and should not be a factor in determining exclusion. If this standard is applied, the entire Two Pillar solution will collapse.

Recommendation: Reinsurance must be in-scope, and if modified tax base rules are necessary, it would be a small price to ensure that reinsurance companies pay their fair share of taxes to the developing countries.

viii. Asset Management

The same rationale applies to asset management. Some companies manage assets in the tens of trillions of dollars from all over the world. Consistent with the Amount A logic of aligning markets and profits, the revenue must be sourced to where the investor is, because they are the source of the asset managers' revenues.

Recommendation: Asset management must be in-scope.

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