Inclusive Framework BEPS Agreement

Public Consultation on Pillar One Amount A – May 2022

Policy Perspectives Update – the Hong Kong SAR

Public consultation on regulated financial services exclusion under Amount A of Pillar One

On 6 May 2022, the OECD published another public consultation document on Pillar One Amount A. The schedule contained in the consultation document provides a description and explanation of the envisaged draft rules for the **Regulated Financial Services Exclusion under Amount A**. Similar to the consultation document on extractives exclusion under Amount A issued in April, this document (except for the definitions for the scope of the exclusion) is in a narrative format rather than in the form of draft model rules.

Summary of the rules

The consultation document sets out the definitions of "Regulated Financial Services" (RFS) and the seven types of "Regulated Financial Institution" (RFI), and the steps taken to exclude the revenue and profits generated from RFS from the scope of Amount A.

Scope of the regulated financial services exclusion

- "**Regulated Financial Services**" is defined as services carried out by an RFI as defined.
- A "**Regulated Financial Institution**" means:
  1. a Depositary Institution;
  2. a Mortgage Institution;
  3. an Investment Institution;
  4. an Insurance Institution;
  5. an Asset Manager;
  6. a Mixed Financial Institution; and
  7. an RFI Service Entity.
- The consultation document indicates that the above list of RFIs does not reflect the final or consensus views of the Inclusive Framework on BEPS and that some members hold the view that **reinsurance** and **asset management** ought not to be excluded from the scope of Amount A.
- The definition for each type of RFI generally contains three elements: (1) a licensing requirement, (2) a regulatory capital requirement and (3) an activities requirement. The revenue and profit of an entity are wholly excluded from Amount A if **all** of the three requirements are met.
- In essence, the defining character of the RFS 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 borne by a financial entity.
- The test for regulation on capital adequacy applies at an entity level - which means the regulation should require either (1) a separate, appropriately capitalised entity to be established for operating within a market or (2) a local branch of a foreign entity to be able to call on sufficient capital of the entity or capital held in the local branch. The rules do not require the entity to be subject to capital adequacy requirements in each branch location but instead require the entity (as a whole) to be subject to the regulations at the home jurisdiction.

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- There is a safe harbour for the activities requirement in the definitions of the RFIs (except for RFI Service Entity which needs to perform administrative services exclusively for the benefit of one or more other RFIs in the same group). As such, a financial entity does not need to wholly and exclusively carry out the defined RFS activities to qualify as an RFI.

  For example, for Depositary Institution (e.g. a licensed bank), the activities requirement is met if at least [20]% of the bank's liabilities consist of deposits at the balance sheet date of an accounting period. For Investment Institution (e.g. an investment bank or a broker/dealer) and Asset Manager, the activities requirement is met if the total gross income attributable to the specified activities is not less than [75]% of the entity's total gross income. For Insurance Institution, the gross income threshold is set at exceeding [75]% and the activities requirement can also be met if the aggregate value of the assets held to manage risk associated with insurance and annuity contracts exceeds [75]% of the value of the total assets at the balance sheet date of an accounting period.

- An entity of which a "substantial portion" of its business is conducted with the other group entities that not RFIs would not qualify as an RFI. Examples are group treasury centres and captive insurers. In this regard, a "substantial portion" means that the total gross income attributable to such intra-group business is not less than [50]% of the entity's total gross income during an accounting period.

- The definition of Excluded Entity (e.g. an investment fund or a real estate investment vehicle as defined under Pillar One) is applied in priority to the exclusion for RFS. As such, an Excluded Entity is excluded from Amount A regardless of whether it meets the definition of an RFI.

Application of the regulated financial services exclusion

The RFS exclusion is operated on an entity-by-entity basis. That is, an entity that meets the RFI definition is wholly excluded from Amount A whereas an entity that does not meet that definition is wholly included in Amount A. The consultation document sets out the following steps (with simplification measures) to exclude the revenue and profits derived from RFS from the scope of Amount A:

- **Applying the revenue threshold to in-scope revenue** - A group that meets the EUR20 billion revenue threshold and 10% profitability threshold before the exclusion will re-determine whether the revenue threshold is met by (1) subtracting the total third party revenue of the largest RFIs within the group to the extent that the remaining revenue is below EUR 20 billion (i.e. the group does not need to identify and remove all RFIs) or (2) adding the total revenue of all in-scope entities (i.e. non-RFIs) and testing whether such revenue exceeds EUR 20 billion (without subtracting the intra-group revenue). If such revenue from in-scope entities is not above EUR20 billion, the group is not in scope of Amount A.

- **Applying the profitability threshold to in-scope profits** - A group with revenue from in-scope entities above EUR20 billion will re-determine whether the 10% profitability threshold is met by excluding the profits from RFS. This can be done by (1) first excluding the third-party revenue and costs of RFIs from the consolidated group and then adding back the related-party revenue and costs arising from transactions between in-scope entities and the RFIs (i.e. top-down approach) or (2) recombing the in-scope entities into a consolidated segment to include the revenue and costs arising from third-party transactions of these in-scope entities and intra-group transactions with the RFIs (i.e. bottom-up approach). If the profit margin of the group after these adjustments is not above 10%, the group is out of scope of Amount A.

What's next

The consultation document was released for seeking public comments and does not reflect the final views or consensus of the Inclusive Framework members. Further changes to the conceptual framework may be required before it is translated into model rules format.

Interest parties are invited to submit their comments no later than **20 May 2022**, in particular on the reasonableness of the proposed thresholds, the practical challenges in applying the rules for identifying excluded and in-scope revenues and profits and the additional compliance simplifications needed.

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Hong Kong business considerations

The proposed definitions of the seven types of RFI should have already covered the typical financial service activities performed by business groups in the financial services sector. But it has yet to see whether reinsurance and asset management will be included in the final scope of excluded financial services. Also, the inclusion of the risk-based capital adequacy requirements in the definition of Asset Manager may result in some of the entities engaging in asset management not being able to qualify for the exclusion. On the other hand, large financial services groups in Hong Kong may benefit from the inclusion of “Mixed Financial Institution” as one type of RFIs, which allow them to house more than one types of RFS in one group entity (i.e. depositary, investment, insurance and asset management).

Large business groups in Hong Kong that conduct both financial services and non-financial services business activities should examine the various business lines currently housed in different entities within the groups. As the exclusion applies on an entity basis and there is a minimum threshold for the activities requirement (except RFI Service Entity) that needs to be met, these groups should consider whether any business restructuring to consolidate the financial services business within the groups into one or a few group entities is desirable for the purposes of the exclusion.

Large financial services business groups in Hong Kong should also assess whether their current accounting and reporting systems are able to generate the detailed information and data required for applying the exclusion and whether any system upgrade is required.

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Contacts

Global Tax Policy Leadership Group

David Linke
Global Head of Tax & Legal Services
E: David.Linke@kpmg.co.uk

Grant Wardell-Johnson
Global Tax Policy Leader and Chair
E: Grant.WardellJohnson@kpmg.co.uk

Manal Corwin
Americas Regional Tax Policy Leader
E: mcorwin@kpmg.com

Vinod Kalloe
EMA Regional Tax Policy Leader
E: kalloe.vinod@kpmg.com

Conrad Turley
Asia Pacific Regional Tax Policy Leader
E: conrad.turley@kpmg.com

Chris Morgan
Responsible Tax Project Leader
E: christopher.morgan@kpmg.co.uk

Regional contacts

John Timpany
Head of Tax, Hong Kong SAR
E: john.timpany@kpmg.com

Ivor Morris
Hong Kong SAR BEPS 2.0 Project Leader
E: ivor.morris@kpmg.com

Anita Tsang
Director, Tax Policy and Knowledge Management
E: anita.tsang@kpmg.com

kpmg.com/cn/socialmedia

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