

## COMMENTS RECEIVED FROM KPMG WORLDWIDE BANKING TAX PRACTICE

### OECD REVISED DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS - PART II (BANKS) AND PART III (ENTERPRISES CARRYING ON GLOBAL TRADING OF FINANCIAL INSTRUMENTS)

#### Introduction

KPMG welcomes revised Part II (Banks) of the OECD's discussion draft on the attribution of profits to permanent establishments ("*Revised banking draft*") as well as Part III on the global trading of financial instruments ("*Global trading draft*"), and is grateful for the opportunity provided to respond to the proposals they contain. In this respect, we are pleased to note that a number of our initial suggestions have been taken up in the revised banking draft, but feel that a number of the revised proposals as well as the proposals on global trading call for additional comment.

This response has been prepared by the KPMG Bank Tax Group and deals separately with parts II and III of the discussion draft. However, as in the case of our response to the initial draft of part II in June 2001, comments made in the specific context of the banking or global trading sectors may be of general application and should be construed accordingly. References in square brackets refer either to part II or part III followed by the applicable paragraph number.

In evaluating the current proposals we have continued to bear in mind what we consider the three key objectives, namely:

- a) minimisation of double (or less than single) taxation;
- b) administrative simplicity;
- c) obtaining broad international acceptance.

While we believe the current proposals go some way towards meeting these objectives, we are not yet fully convinced that a satisfactory balance between them has been achieved. With this in mind we have endeavoured, where possible, to point to practical solutions to the problems we have identified in the current proposals.

By way of preliminary comment we understand that it is proposed to release a final version of this document only when all four parts of the discussion draft are final and ready for release. However, part IV (Insurance) has yet to be released for initial comments and it therefore seems unlikely that the final documents will be released for a further three or four years. Until the revised banking draft is finalised, tax administrations and multinational enterprises are likely to continue working to the OECD's 1984 Report on the taxation of banking enterprises, which does not recognise or deal with current banking practices, as the revised banking draft itself recognises [II:2]. The newly released UK branch legislation is a recent illustration of this. For example, the latter prohibits deduction for payments in respect of intangible assets. However, the revised banking draft [II:15] points out that marketing intangibles are common in the banking area, and gives the use of an intangible asset as an example of "a real and identifiable event" thereby constituting a dealing [II:134].

*Similarly, until the revised banking draft is finalised it seems unlikely that appropriate changes will be made to the Commentary to Article 7 of the OECD Model Convention. Indeed, part I of the discussion draft acknowledges that, in the context of internal services, the Commentary is not even in line with the current OECD transfer pricing guidelines.*

*While we understand the rationale of waiting until all four parts are complete, it seems undesirable that taxpayers should have to operate in such a position of uncertainty as regards the future and that, in the meantime, diverging practices may be introduced or become more entrenched in jurisdictions around the world. This can only lead to an increased administrative burden (taxpayer's will have to apply first one, and then another set of rules) but is also likely to decrease the chances of gaining general international acceptance of the proposals from tax administrations around the world.*

We would accordingly suggest that the revised banking draft should be issued once finalised, and that amendments determined necessary by comments on other parts should be issued as necessary. Such an approach would also seem consistent with the approach taken to the OECD transfer pricing guidelines in general and, specifically, the comments in the revised banking draft regarding the use of safe harbours to deal with thin capitalisation [II:112].

#### **KPMG Detailed Observations on OECD discussion draft revised Part II (Banks)**

KPMG's observations on the revised banking draft are grouped under the following three headings:

1. acknowledgement of positive OECD responses to initial KPMG proposals;
2. previous issues that remain problematic;
3. new issues.

As already indicated, where possible we have endeavoured not only to identify the issues and why they cause concern but also to provide practical solutions to the problems.

##### 2.1 OECD responses to initial KPMG proposals

We note that the general approach in applying the working hypothesis ("WH") has remained largely unchanged. However, the revised banking draft reflects a number of issues raised in our initial response. Of these the following may in particular be noted:

#### ***Recognition of dealings***

Our initial concern was that insufficient guidance was provided on when dealings are recognised. The revised banking draft continues to require the existence of a "real and identifiable event" but now highlights the importance of the risk management function in this context [II:185]. KPMG further welcomes the clarification of the role of the taxpayer's conduct as well as the primary role of the taxpayer's own documentation in the recognition of dealings [II:141-143]. However, we also note with some concern the statement that the onus should be on the taxpayer to demonstrate clearly that any dealing should be recognised as leading to a transfer of assets and risks [II:187]. See further on this point in Section 2.2.1 below.

#### ***Attribution of assets and functional analysis***

In our initial response, we were concerned at the heavy compliance burden involved in the functional analysis approach and urged that branch accounts be taken as the starting point. Moreover, we suggested that the analysis of functions performed in creating a new asset seemed to undervalue the significance of, in particular, the credit committee.

KPMG notes that functional analysis remains central to the WH but sees a positive change in the acknowledgement that the bank's own books and accounts will be a useful starting point [II:56]. This optimism is strengthened by the observations in the revised banking draft that tax administrations are unlikely to initiate a transfer pricing analysis unless profit adjustments are likely to be material and that wide ranges are likely to result [II: Annex 11]. Concerns that remain on this aspect are set out in Section 2.2.1 below.

As regards the functions performed in creating a new asset, we are pleased to note that the new definition of the sales/trading function now appears to take into account the credit committee type function.

### ***Risk measurement***

KPMG is pleased to note the OECD's more flexible approach to risk measurement [II-93]. Acknowledgement of the possibility of using banks' internal models (subject to certain safeguards) as an alternative to the "standardised" approaches should help reduce our previously expressed concerns as to the administrative burden otherwise implied.

### ***Allocation of capital and solo reporting***

KPMG is also pleased to note the OECD's more flexible approach towards the use of alternative capital reporting bases notwithstanding its continued preference for solo reporting [II:100-101]. It is hoped that this more flexible approach will help reduce the potential distortions and additional compliance burdens we noted in our initial response. In this regard we would recommend that the WH take into account international developments such as Basel 2.

### ***Allocation of capital: upwards interest adjustments***

The revised banking draft indicates that a PE should be taxed on the basis that it has no more than an amount of "free" capital within the arm's length range [II:126]. The implication here is that an upwards adjustment of interest expense would be required in the case where the WH results in less capital being allocated than has been allocated in practice. KPMG is pleased that the OECD has dealt with the question raised in our initial response in such a constructive way. In this regard, we would stress the fact that it would be in the interests of both taxpayers and tax administrations that where notional adjustments are made, the administrative procedures for obtaining corresponding relief are both clear and effective. See further 2.3.2.4.

### ***Safe harbours***

The revised banking draft appears to accept in principle KPMG's arguments in favour of a safe harbour (quasi-thin capitalisation) approach based on a fixed percentage of branch assets, albeit with the qualification that this may lead to problems of less than single taxation [II:106-107]. Subject to certain concerns as to the practical impact of the latter qualification, KPMG welcomes the OECD's positive reaction to this suggestion. See further 2.3.2.2.

## **Previous Issues that Remain Problematic**

### ***Allocation of risks and assets***

## People function v risk/booking location

### Issue

In our initial response we noted that the discussion draft, by concentrating on the sales/trading function, appeared to ignore the possibility of attribution on the basis of risk as such. While we sympathise with the OECD's concern that income should not be allocated for tax purposes to a location that has not rendered any commercial services, the focus on "people" should not obscure the fact that, from an economic perspective, the primary reward for risk bearing is justified by the simple fact that the risk is borne. We would submit that attribution of income based solely on the "people functions" distorts this economic reality and is contrary to the arm's length principle. It is not merely these activities, which involve the assumption and management of risk, that gives rise to profits or losses, a general premise which this approach infers.

As acknowledged in the revised banking draft, in the case of separate enterprises, risk can be segregated from capital through contractual arrangements. It is unclear why similar arrangements should not be possible between the hypothesised separate entity and the rest of the banking enterprise under the WH.

In particular, it is not clear why the fact that capital and risks are not segregated from each other in the single legal entity should be regarded as an internal condition of the PE in applying the WH. After all, it is just as much part of the factual situation that capital is not allocated within the single legal entity, but that is not apparently regarded as a problem in attributing capital to PE's under the WH. If the real concern is tax avoidance, we would respectfully suggest that this should be addressed more directly.

### Possible Solution

Once an asset has been created it should be possible, with proper transfer pricing, to make a distinction between the ongoing assumption of risk and its continued management, without this leading to unacceptable avoidance practices.

More generally we would submit that the WH should adopt an approach based on records currently prepared by the bank, namely the assets as shown in the branch accounts. Only if the tax authorities can demonstrate that there has been tax motivated booking of assets to distort the calculation should an alternative approach be permitted. It will then be up to the taxpayer to demonstrate that any relevant dealings have been carried out on arm's length terms in order to rebut such an argument.

In this context we would repeat the observation made in our initial response that the WH should recognise that in general a banking enterprise would book assets in a particular location for regulatory reasons and not for tax avoidance reasons.

A potentially useful tool in this regard could be a bank's internal procedures or policies for the booking of loans. These typically reflect the factors relevant to loan booking, such as performance measurement, incentive schemes, etc., and compliance with these should provide the necessary comfort, particularly if the local tax administration is given the right to review the booking procedures and representations from the bank's management that the procedures have in fact been followed. We would suggest that use of such procedures combined with a functional analysis of any deviations from these procedures should be sufficient to satisfy the taxpayer's burden of proof.

### Anti-avoidance

#### Issue

In this regard, to reject the booking approach on the grounds of problems in defining “abuse” is, to our mind, less than convincing given the numerous instances of this concept in domestic legal systems. If the concept was so difficult to operate, it is difficult to understand the apparent popularity it enjoys in so many countries.

Even if the taxpayer’s books and accounts are taken as the starting point, as is now suggested in the revised banking draft, the risk is that tax administrations will in practice ignore the booking location. The practical and systems issues posed by focusing exclusively on the “people function” should not be underestimated in this respect.

#### Possible Solution

See 2.2.1.1.2 above.

#### Risk management and split ownership

##### Issue

The revised banking draft emphasises the role of the risk management function in allocating capital and assets. In view of the increasing integration of global banking businesses and expansion of banking “products” it may be questioned how easy this test will be to apply in practice. This is particularly so where the integrated business functions lead to multiple joint ownership. The revised draft itself appears to acknowledge the difficulties, in particular in relation to the dividing line between risk management that does or does not lead to a dealing and indicates that in practice this will be determined on a case by case basis following the functional and factual analysis. The level of detail this implies gives a clear indication of the type of compliance burden this is likely to impose.

#### Possible Solution

See 2.2.1.1.2 above.

#### Internal Guarantees

##### Issue

The revised banking draft explicitly states that dealings similar to guarantee fees will not be imputed under the WH [II:170]. However, we would suggest that that this goes too far and that a complete ban on internal guarantees would, moreover, be at odds with the Global trading draft, which recognises the possibility of internal indemnifications, albeit subject to the requirement of continuing credit risk functions [III:250]. On the latter aspect see 2.2.1.1.1.

#### Possible Solution

A distinction should be made between “blanket” guarantees under which a bank guarantees the PE’s creditworthiness, and transaction based guarantees under which credit risk is transferred. With proper transfer pricing there seems no reason why the latter type of dealing should not be recognised under the WH.

#### ***Interaction with Second Banking Directive***

##### Issue

KPMG wishes to underscore the remarks in its initial response as regards the potential conflict between the WH and the Second EC banking directive (98/646/EEC). This concern has not been addressed in the revised draft and, if left open, will lead at best to continued uncertainty as regards the application of the

WH within the European Union and in a worst case to inconsistent application of the WH between EU member states and other OECD member states.

#### Possible Solution

A more detailed review of the interaction with the Second EC banking directive and, where necessary adjustment of the WH in the light of EU law.

### *Allocation of entire capital*

#### Issue

The revised banking draft specifically addresses objections to the allocation of the bank's entire capital. However, it maintains its position that this is the correct approach under the arm's length principle. This is primarily on the basis that the assets and risks have been attributed to the various parts of the bank under a functional analysis and there is no reason to allocate capital to the head office on the basis that it would be expected to absorb any extraordinary and unforeseeable losses [II:97-99]. Specific, practical arguments are raised with regard to temporary surpluses or "war chests", for example, whether it would be necessary to demonstrate that the funds are segregated.

#### Possible Solutions

As regards the practical objections raised in the revised banking draft, we question whether workable solutions cannot be drawn up. One approach may be to rely on banks' own internal allocation systems to allocate surplus capital to specific locations (that may be other than the head office). Alternatively, or in addition, we would endorse the use of the quasi-thin capitalisation method specifically in order to quantify the "surplus" capital attributable to the head office.

Where no specific location can be identified, the question remains whether allocation to the head office can be justified. In our view there is every reason to allocate such surpluses to the head office on the basis that it bears the ultimate risk just as the parent company of a multinational group ultimately bears the risks directly borne by its subsidiaries (or perhaps more so). The well-publicised financial services debacles in recent years would seem to more than bear this out.

### **New Issues**

#### *Conflict with domestic legislation*

#### Issue

One of the three key objectives in our review of the revised banking draft is the need to ensure a broad acceptance of the proposals by tax administrations around the world. The need to take into account domestic divergences can be illustrated by existing conflicts. The revised banking draft states that a head office cannot guarantee a branch and vice versa [II:51, 75-76, 170]. This is at odds with the UK legislation that offers scope for deductions where transactions are in the ordinary course of business.

It is clear that without a broad international consensus, including as regards the detailed aspects of the WH, the scope for disputes and double taxation will increase.

#### Possible Solution

The suggestions made in Section 2.3.2.4 below, regarding improved dispute resolution procedures are equally applicable to this issue.

### *Choice of capital allocation methods*

#### Issue - No single method

The revised banking draft details a number of options for attributing capital. However, while strengths and weaknesses are addressed there is no clear consensus on the correct method to use and, accordingly, “it will not be possible to develop a single internationally accepted approach” for attributing capital, including “free” capital, to the PE. It further notes that a review of OECD Member countries’ respective domestic laws reveals that there are different views on the preferred approach to capital attribution so that it will not be possible to develop an internationally accepted hierarchy of approaches to capital attribution [II:120].

KPMG is concerned that this lack of consensus will lead to a mixed and uneven approach between OECD Member countries. This is likely to lead to double taxation. Although the revised banking draft concedes that this is an issue that may be resolved by referring to the mutual agreement procedure of Article 25 of the OECD Model Convention, it may be questioned whether this mechanism is an adequate or appropriate solution in terms of cost and time.

Further, as the revised banking draft acknowledges, the application of the arm’s length principle to attribute capital is likely to result in “a range of results rather than a single number” and it goes on to suggest the use of more than one capital attribution approach as a “sanity check”. This seems to lead to an unrealistic level of administrative compliance as well as continued uncertainty as regards the choice of a particular method.

If it is not possible to reach consensus on this point we recommend a fast track dispute resolution and APA procedure be set up. See 2.3.2.4 below.

#### Possible Solution - Safe harbour

In the absence of such consensus, it may be that the safe harbour principle could provide a practical solution.

In this respect, while KPMG welcomes the OECD’s positive reaction to the safe harbour principle, it is feared that the qualification regarding less than single taxation may be used in practice to prevent reliance on a safe-harbour approach. Furthermore, the qualification may arguably be considered unwarranted given that acceptance of the WH by OECD Member States implies to a greater or lesser extent a general adaptation of PE state taxing legislation and should therefore equally imply an adaptation, where necessary, of the corresponding rules relating to double taxation relief in the home state.

The reference to the OECD guidelines’ position on safe harbours is also unclear in this context. Insofar as the OECD guidelines’ position is considered relevant (the revised draft suggests that the WH should be governed by the same principles – that are currently under review - as for thin capitalisation), this does not seem significantly to weaken the arguments in favour of safe harbours. The OECD guidelines’ main objections appear to be: double taxation, less than single taxation, and equity/uniformity.

The revised draft itself points out that the safe harbour approach can actually reduce double taxation concerns. The risk of less than single taxation has already been addressed above. As regards the question of equity/uniformity, in view of the fact that banking enterprises are already acknowledged as a separate category of taxpayers in applying the WH generally, it seems inappropriate to raise this as an objection to application of the safe harbour approach in the context of part II of the discussion draft.

There seems no reason why taxation in the PE state on the basis of the safe harbour principle should not be accompanied by application of double taxation relief rules based on the same principle. Less than single taxation should not therefore result.

#### Possible Solution - Hierarchy of methods

In the event that such a consensus proves impossible on this issue, an alternative solution would appear to be to agree on a hierarchy of methods (in a similar way to the OECD transfer pricing guidelines), outlining the circumstances under which each method should be used. A taxpayer should have the right to determine the most appropriate method. This choice should, in principle, then be binding on all tax administrations concerned.

In this regard we find the statement that because of divergent domestic approaches an internationally accepted hierarchy would not be possible somewhat surprising (see above). The existence of diverging domestic practices would not seem a valid argument for rejecting the possibility of reaching a consensus, certainly not in the context of a compromise approach implied by a hierarchy of methods.

At the very least, in order to provide certainty, part II should limit taxpayers and tax administrations to the three preferred methods contained in the discussion draft and it should not be possible to use hybrid methods or other unspecified methods.

#### Possible Solution - Fast-track Dispute Resolution and APA procedures

If a solution based on a hierarchy of methods approach did prove impossible - or perhaps by way of additional support for the “hierarchy” approach - attention should be focussed on developing a “fast track” dispute resolution and APA procedures that are specifically tailored to the issue of capital allocation.

#### Improved dispute resolution procedure

While we consider an improved APA procedure of value, it would seem inappropriate for the WH to in effect force taxpayers into APA procedures. In the absence of clear guidelines under which taxpayers could choose the most appropriate method it will be important to ensure that the competent authority machinery is adequate to resolve the inevitable disputes that arise in a timely and cost-effective manner. We would therefore also advocate developing a fast-track dispute resolution procedure specifically for resolving problems arising in this area. For these purposes, it would seem appropriate to take note of ongoing developments on dispute resolution procedures within the EU’s Joint Transfer Pricing Forum (including those relating to the EU Arbitration Convention) and to address this issue specifically in the context of the OECD’s own recently launched initiative on the resolution of cross-border tax disputes.

#### APA

A fast track APA procedure would help provide taxpayers with upfront certainty while avoiding the practical drawbacks of competent authority procedures.

### ***Expansion of Part II with Part III section on risk***

#### Issue

As indicated in the introduction, there are various concerns regarding the timing of publication of the various parts of the discussion draft. An aspect of this is that to the extent that parts II and III are mutually dependent it makes it more difficult to release the parts separately.

However, insofar as there are common aspects that can usefully be dealt with together, some degree of cross-referencing may be inevitable. This also appears to be recognised in paragraph 177 of the revised banking draft.

Although Part II and Part III are closely related in terms of the issues discussed, Part III discusses in more detail the difference between the initial acceptance of risks and the ongoing management of such risks. Although Part III pertains to global trading activities that, at a minimum, involve market making on a global or 24-hour basis [III:8], certain types of financial services have characteristics akin to global trading especially when considering credit risk management. For example, a financial services entity may write loans in one location, but the initial assessment of the credit risk in addition to the ongoing management of such credit risk may very well be performed in another tax jurisdiction or jurisdictions.

#### Possible Solution

KPMG suggests that Part II should include specific comments on the internal transfer of risks similar to those included in Part III. Useful paragraphs contained in Part III and potentially transferable to Part II (given minor amendments) are paragraphs 85 to 88 and paragraphs 245 to 250.

#### 2.3.4 Capital allocation in excess of actual funding

##### 2.3.4.1 Issue

The revised banking draft addresses the issue of capital allocation in excess of actual funding requirements, in particular where this arises because of taking into account off-balance sheet items. The solution proposed is to treat the excess capital as a loan from the PE to the treasury location. This is justified on the basis it is the “likely investment” an independent enterprise would make. Not only does such hypothesizing seem to be stretching the arm’s length principle beyond reasonable proportions, but, as indicated in our initial response, is an unwelcome addition to the administrative burden.

Moreover, depending on the circumstances and, in particular, the method chosen to allocate capital, this approach raises the question of whether the interest rate charged should reflect the costs of the actual funding mix of the bank of which the PE is a part (see II:116-117 and the discussion on agency or conduit functions at II:193-203).

##### 2.3.4.2 Possible Solution

If it proves unacceptable to ignore off-balance sheet items in allocating capital to banking PE’s, a solution that involved minimal administrative burden would seem appropriate in this context. We would therefore advocate fixing the interest rate on such dealings by reference to normal inter-bank standards.

#### **2.3.5 Profit computation**

##### 2.3.5.1 Issue

The draft does not address the general issue of potential mismatches in profit allocation arising from the application in different jurisdictions of different generally accepted accounting principles for computing profits.

##### 2.3.5.2 Possible Solution

In line with the principle behind the second EU banking directive one possibility could be to use the principle of home country rule.

## **KPMG Detailed observations on OECD discussion draft Part III (Global Trading)**

KPMG's observations on the Global trading draft are grouped under the following two headings:

- (1) OECD acknowledgement of issues previously raised by KPMG;
- (2) new issues

As with KPMG's comments on the revised banking draft, we have endeavoured to provide a number of practical solutions to the issues identified.

### **OECD acknowledgement of issues raised by KPMG - Loss instead of profit split**

During the first consultative round, KPMG noted in its response dated 2 April 2002, that the use of compensation plus bonus may lead to non-arm's length results when faced with overall losses incurred from trading a global book. As the largest part of the bonus pool is likely to be paid to individuals that are perceived to create the most value, a typical profit split model would allocate the largest part of the loss to the location with individuals that created the most value.

We are pleased that the Global trading draft explicitly invites comments from the business community on how loss situations should be dealt with in cases where a transactional profit split method is applied [III: 178]. In this regard, we have set out below five potential alternatives to split losses as opposed to profits using a transactional profit split method.

### ***Inverse of compensation factor***

Where compensation, base salary including bonuses and incentive payments, is a good indication of value creation in global dealing surroundings, the inverse may be applied when the global book incurs an overall, global loss. Assuming a multifactor model with two locations, A and B, the following example illustrates the application of inverting this factor.

- **Profitable operations**
  - Assume following inputs:
    - Overall (residual) profit= USD 1 million
    - Factor 1= Compensation (including bonuses)
    - Factor 2= Volume of trades, i.e. number of transactions
    - Compensation location A= USD 5 million
    - Compensation location B= USD 3 million
    - Number of trades entered into by traders in location A= 3,500
    - Number of trades entered into by traders in location B= 1,500
    - Weight factor 1= 70%
    - Weight factor 2= 30%

The formulae below illustrate how profits would be split between location A and location B respectively.

$$\left[ \frac{5}{(5 + 3)} \times \text{USD}1,000,000 \times 70\% \right] + \left[ \frac{3,500}{(3,500 + 1,500)} \times \text{USD}1,000,000 \times 30\% \right] = 647,500$$

$$\left[ \frac{3}{(5 + 3)} \times \text{USD}1,000,000 \times 70\% \right] + \left[ \frac{1,500}{(3,500 + 1,500)} \times \text{USD}1,000,000 \times 30\% \right] = 352,500$$

In this case, location A would receive USD 647,500, with location B receiving the remaining profit of USD 352,500.

- **Loss making operations**

Assuming the same inputs as the above example, except that the overall profit of USD 1 million is now a loss of USD 1 million. Applying the above formula would attribute the largest loss to the location with the highest compensation and the highest number of trades. However, since compensation includes bonuses, it may very well have been that location A was rewarded by the global organisation for its performance in a bear market environment. As such, allocating a larger part of the incurred loss to location A appears to contradict the arm's length principle.

However, the above issue may be resolved by computing the loss split using the inverse of the compensation factor. By taking the inverse, location A would be allocated USD 472,295 of the overall loss with location B being allocated USD 527,705 of the overall loss.

The above result was arrived at as follows:

The inverse of 5/8 is 8/5 or 1.6 (location A). The inverse of 3/8 is 8/3 or 2.67 (location B). The proportion of the loss allocable to location A when looking at the compensation factor only would therefore be

$$\frac{1.6}{1.6 + 2.67} \times \text{USD}1,000,000 \times 70\% = \text{USD}262,295$$

Adding USD210,000<sup>1</sup> to the above figure would result in a total loss allocable to location A of USD472,295, with a loss of USD527,705 being attributed to location B.

In addition to the above, it may be appropriate to consider whether the apportionment should be calculated by reference to the entire compensation, i.e. base salary and bonuses, or whether excluding base salary and looking at bonuses only is a more appropriate course of action.

KPMG is of the opinion that total compensation is a good indicator for the value created by the trader(s). In our experience, this appears to correspond with the view of most tax authorities. In practice, greater base salaries may be accompanied by smaller bonuses. In addition, differences in base salaries across jurisdictions may arise in part by virtue of external factors such as government regulations and their effect on job security (e.g. a trader in NYC may face termination at short notice, whereas a trader in Brussels has a certain job protection through federal legislation). As such, traders with apparent differences in base salaries may have similar discounted prospective income flows when analysing base salaries on a net present value basis.

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<sup>1</sup> Added to take into account the number of trades factor and calculated previously, as follows:  $\{[(3,500/5,000) \times 1 \text{ million}] \times 30\% \} = 210,000$ .

### **Relative changes in bonus payments**

As bonus schemes operative in global trading environments are a good indicator of value creation, an alternative may be to analyse changes in bonus payments in the different locations. By reference to the above example, location A may have incurred a decrease in overall bonus payments of 10% due to the global decline in profitability. Compared to the profitable year, location B may have incurred a decrease in overall bonus payments of 20%. This bonus policy would appear to “punish” location B more severely for the overall bad performance of the global book, indicating a bigger role attributed to location B in incurring the overall loss.

In this situation, the original compensation factor of 5/8 for location A and 3/8 for location B may be replaced by the respective decline in bonus payments. Location A could be attributed USD443,333 of the losses, calculated as follows (assuming same volumes traded as in original example):

$$\left[ \frac{0.1}{(0.1 + 0.2)} \times USD1,000,000 \times 70\% \right] + \left[ \frac{3,500}{(3,500 + 1,500)} \times USD1,000,000 \times 30\% \right]$$

Since the decrease in bonus payments was less pronounced in location A than in location B, location A should be allocated less losses than location B. As shown above, this is indeed achieved by analysing the relative changes in bonus payments rather than compensation itself.

However, the above calculation may require adjustments for certain eventualities, including:

Bonus payments may represent a distorted picture if a head trader is replaced during a financial year. Attracting a new head trader from outside the company, or even internally, may cause the location hiring the new head trader to incur above normal bonus payments due to a potential large sign-on bonus paid out to the new head trader.

While one location may experience a general decrease in bonus payments, another location may experience an increase in bonus payments, notwithstanding the overall loss incurred with respect to the global trading operation. Using relative changes in bonus payments, disregarding whether a change is positive or negative, may attribute an inappropriate amount of the losses to a location; in this case, the location which experienced a general increase in bonus payments. This would again appear to violate the arm’s length principle in that an independent party would probably not have agreed to such an arrangement.

Although analysing average bonus increases/decreases per location, i.e. total change in bonus payments divided by number of employees eligible for bonus payments, may go some way to mitigating the abovementioned issues, further work would be needed to account for situations where both bonus increases and decreases have occurred.

### **Base compensation only**

Although ignoring bonuses and other incentive payments and taking base salaries only into account may yield an imperfect result, it would likely improve results when faced with splitting a loss compared to using the standard overall compensation computation. Furthermore, considering base salaries only when allocating an overall loss benefits from a certain simplicity and ease of administration.

### **Headcount**

Alternatively, the impact of compensation could be ignored completely and instead be replaced by a headcount number. As with the option of base compensation only (Section 0 above), this method may be imperfect, but will likely yield more reliable results than maintaining standard compensation formulas

during non-profitable years in a global trading operation. Using headcount as a factor is making the implicit assumption that all traders are equally productive, and that differences in salary and bonuses reflect locational differences and not productivity differences.

In order to take into account that certain locations may have a greater overall responsibility and/or compensation burden, the headcount figure may be weighted. For example, senior management headcount could be multiplied by 1.5 or 2 to reflect its overall responsibility in a company's financial result.

### ***Identification of specific factors contributing to a loss***

Finally, it may be possible in certain cases to identify the main contributors to an overall loss. Losses result in a broad sense from market risk, credit risk, operational risk, or a combination of the above.

Market risk is generally managed on a global level and it may therefore be extremely difficult if not impossible to identify the geographic location(s) where the market risk resulted in a global loss.

If a loss would be incurred due to bad counterparty risk management, it may be argued that the location responsible for acceptance and ongoing management of the credit risk should bear the loss. Where the loss results from a breakdown in operational controls, the location responsible for the operational failure may be 'held responsible' for the loss. A preferred approach, however, would be to explicitly reward bearing credit risk, if it is separable, and take the losses associated with credit risk where the reward has been earned.

### **Newly identified issues**

#### ***Credit risk***

The OECD has invited comments from the business community on the issues related to the shifting of risk from one part of an entity to another, particularly transfers of credit risk and whether the use of internal credit derivatives would be acceptable.

Where suitable benchmarking information is available, credit derivatives can indeed provide a good approximation of the arm's length price for shifting credit risk from location to another. However, this method may prove overly complex to implement, not in the least as it could only be implemented if the counterparty has publicly traded equity. In addition, a credit derivative is for a fixed term and in these operations it may be difficult to determine the exact term of the credit risk. Finally, there is also the issue that the default event is not independent of the parties to the transaction, thus there is the possibility of one party forestalling the default of a weak credit in order to avoid triggering the payout of the credit derivative.

In cases where no information is publicly available to benchmark the price of the credit derivative, alternatives would need to be explored in order to price the intra-group shifting of credit risk. We have outlined three such alternative approaches below.

- Certain bank customers are allowed a credit line with the bank. Interest rates charged on such credit lines are generally reflective of the credit risk perceived by the bank in relation to such customers. It may therefore be appropriate to analyse the spread between an appropriate risk free rate and the applicable interest rate on the amount of the credit line used to approximate the profit from bearing credit risk regarding a particular client of the bank.
- Certain banks charge their clients specifically to cover credit risk. In such cases, these incremental charges may represent a reliable approximation of the profit from bearing credit risk.

- The new Basel Capital Accord (“Basel 2”) may provide the basis for an alternative credit risk calculation in that Basel 2 currently suggests a more detailed asset categorisation in order to accurately risk weight those assets. The baskets proposed by Basel 2 may provide a helpful starting point in calculating the credit associated with a certain type of asset.

At present, it is unclear from the discussion draft where profits will be taxed, or conversely where losses will be recognised, if credit risk has been shifted at arm’s length to another jurisdiction than where the transaction was entered into originally. In KPMG’s experience, there is a substantial risk that the recognition of profits (e.g. recognised in the jurisdiction that originated/booked the transaction) may not be aligned with the deductibility of a potential loss (e.g. as the same tax authority may argue that credit risk is not assumed by the location that originally entered into the transaction).

### *Split hedges*

The discussion draft appears to recommend that split hedge transactions should be analysed on a transaction-by-transaction basis, especially where losses are recognised in one jurisdiction but a gain corresponding with an offsetting position is recognised in another jurisdiction [III: 126 and 127]. KPMG strongly recommends that such potential transaction-by-transaction approach be abandoned by the OECD as it would require financial services enterprises to install additional control systems to be able to track and document the profitability of each transaction throughout the year. This would, in effect, impose an inequitable administrative and compliance burden on such companies, in particular where dealings are conducted along the ‘integrated trading model’.

Furthermore, analysing split hedges on a transaction-by-transaction basis instead of looking at the hedge as an integrated dealing is contradictory to the economic substance of this dealing. As a result, the financial institution could be taxed on profits it did not actually earn. KPMG therefore submits that the net effect of split hedges should be analysed to determine taxable profits and the allocation thereof.

### *Compensation of capital*

The Global trading draft identifies the need to establish a return to capital. (See, e.g., III:148.) There are a number of potential approaches one could take, and it would be useful if the OECD would provide some guidance on acceptable methods. For the OECD’s consideration, we set out three potential and not mutually exclusive methods, and some of the difficulties in implementing them in a separate entity trading framework, in a separate entity situation.

#### Hedge Fund Model

Hedge funds have certain similarities to globally traded books, in that the owners of capital are generally separate from the traders who trade the capital. Under the hedge fund model, an arm’s-length return to capital for a global book is evaluated with respect to the return to capital typically observed in a hedge fund.

To illustrate briefly, the profit from a hedge fund (after an administrative fee is paid to the traders to cover the overhead of running the hedge fund, though not trader bonuses) is typically split between the traders and the investors. Many hedge funds compensate traders with 20 to 25 percent of the profit, with the remaining 80 or 75 percent going to the investors.

In considering whether the hedge fund approach is appropriate, one should bear in mind that there are examples of traders who either left investment bank employers to establish hedge funds or were compensated by their investment bank employers much like hedge funds compensate their traders. One example is the team headed by John Meriwether who left its investment bank employer, Solomon Brothers,

to form Long Term Capital Management, a hedge fund company.<sup>2</sup> The team raised capital, traded it and split profit with the investors much like the hedge funds described above.

Another example is the arrangement between American International Group (“AIG”) and the traders of its subsidiary AIG Financial Products Corporation (“AIGFP”).<sup>3</sup> AIG recruited Howard Sosin, a Drexel Bernham Lambert trader, to form AIGFP. Under the 1987 arrangement, Sosin received 20 percent of the equity in the company, granting him the right to 20 percent of the AIGFP profit. Later, when Sosin left AIGFP, AIG negotiated a similar deal with AIGFP traders, who together received a 20 percent stake in the company.

These two examples suggest that global books and hedge funds may be sufficiently similar to find the hedge fund model a reliable working hypothesis. There are differences between hedge funds and global books that would likely necessitate adjustments to achieve an arm’s-length result. For instance, hedge funds take a different legal form from globally traded books. The traders in a hedge fund also raise their own capital, unlike traders of a global book. Further, hedge funds take proprietary positions while some global books are in the business of market making for customers and taking only small proprietary positions.

One key empirical issue is whether the 20 to 25 percent of the profit is sufficient to cover trader compensation and bonus.

It would be useful if the OECD would opine on whether it is feasible to make reliable adjustments for those differences.

#### Sequential Approach

An alternative approach is to determine which functions have priority of claim on earnings. Under the sequential approach, residual profit is paid to trading locations and capital in sequence, to mirror the relative risk each bears.

If, for example, the issue is separating the return between labour (trading function) and capital, then the entity employing the labour may have first claim on earnings until it has recovered its costs or possibly cost with a base level of profit. The entity or branch providing the capital may then have the next claim on earnings until it has recovered a hurdle rate of return. At this point there are several options with the residual profit. One would be to attribute all to the labour function or to suggest a split between labour and capital.

The appropriate split is established by the facts and circumstances. One of the critical issues within the facts and circumstances is likely to be the reconciliation of the tax position with the regulatory position. Often multinational trading organisations have obtained charters/licenses from regulatory bodies representing that an operation in their jurisdiction will not bear significant capital risk. In these cases, the risk has been represented to the regulators as limited to the operating expenses. In these cases, it is important to identify a transfer pricing method that does not contradict this representation. A sequential approach allows for the labour function to bear very limited risk and earn a share of the upside profit potential.

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<sup>2</sup> “Archimedes on Wall Street.” *Forbes*. October 19, 1998.

<sup>3</sup> We note information relating to traders’ compensation packages are rarely made available to the public. In this instance, a dispute between AIGFP trader Howard Sosin and AIGFP’s parent company led to the release of this information to the public. See, for example, “The Shadow War at AIG,” *Investment Dealers’ Digest*. September 6, 1993.

For instance, the facts and circumstances may suggest that the most reliable results are achieved when capital—up to some hurdle rate—is compensated first and the balance is paid to the trading locations. This order of compensation places the greatest risk on the trading locations. The provision of capital bears only the risk that the total amount profit is not great enough to cover its hurdle rate of return.

Alternatively, the facts and circumstances may suggest that trading locations should not bear the risk that the residual profit is not great enough to cover both the hurdle rate of return to capital and its trading costs, inclusive of trader compensation. Instead, the most reliable results may be achieved when trader costs are paid out first, then capital—up to a hurdle rate, and the balance is paid to the trading locations.

This approach has the benefit of correlating compensation with the level of risk borne by trading locations and capital. The difficulties in applying this method are many and relate to both establishing the appropriate facts and circumstances under which this method is appropriate and to the difficulty of establishing an arm's-length return to capital.

It would be helpful if the OECD would comment on the viability of this approach and the facts and circumstances under which it would be most appropriate. With regard to the appropriate hurdle rate, the difficulty in establishing the arm's-length rate arises because of the sheer number of possibilities, which include, using the capital provider's weighted-average cost of capital, its return on equity, its hurdle rate for other investments, or, as we set out in the next section, the use of a Monte Carlo analysis. It would be useful if the OECD would opine the appropriate measure of the arm's-length return.

#### Monte Carlo Approach

The Monte Carlo approach provides a framework for developing an appropriate return to capital is not a method per se but a technique for evaluating the arm's-length nature of the abovementioned methods. Thus, this approach may be used in conjunction with the sequential approach or it may be used to validate the return to capital established by some other approach, such as the hedge fund approach.

Under the Monte Carlo approach, the transfer pricing method/model is constructed. The results of this model are then simulated over the range of reasonable future scenarios taking into account the probability or likelihood of specific scenarios. As such, it permits a review of the arm's-length nature of the results of a method based on a forecast of its likely results. The main benefit of this approach is that it arrives at a return to capital based on economic theory and empirical analysis. Its main drawback is that it requires a substantial amount of data, which some global dealing operations may not retain.

#### **Research**

Although briefly mentioned in III:64, we would recommend that the OECD explicitly recognise the valuable function of research. The functional analysis section is fairly comprehensive, but appears to be focused primarily on the functions that pertain to instruments such as foreign exchange and interest rate derivatives. The overview of the entire paper includes the global trading of equity securities, and, in regard to equities, the function of research can be very important and quite different, depending upon the facts and circumstances.

The generation of commission revenue from equity sales is often intimately linked to the research function. The functions involved in equity trading are as follows:

- The research function of the investment bank identifies attractive equities to purchase (or, in some case, to sell short).

- The sales function transfers these recommendations to potential buyers, such as portfolio managers at institutional investors.
- If the sales effort is successful, the portfolio manager that makes a decision to buy sends that information to a trader within the institutional investor with the direction to acquire a specific equity.
- The institutional investor's trader is charged with acquiring the equity at the best execution costs, meaning lowest transaction cost and with price improvement if possible.
- The trader at the institutional investor contacts the sales trader of the investment bank. The sales trader provides information on the day-to-day, hour-to-hour price movements in the market for the equity to help design an acquisition strategy that minimizes the acquisition costs. It is sometimes necessary to spread the acquisition of the position over hours or days if the order is large and this might have the impact of moving the market price.
- Finally the orders are sent to the trader to execute. Fulfilling the orders generates the commission income.

Institutional investors realize that to obtain research from the best research teams, they must execute trades with the investment banks employing those teams. Institutional investors typically review the quality of each investment bank annually and create a ranking of all investment banks taking into account the quality of the research function. The institutional investor's trading business is then directed to various investment banks in proportion to this ranking. This method of selecting investment banks for trading demonstrates the importance of the research function, even though it is rarely ever compensated with a direct fee from investors.

Furthermore, the salaries paid to top equity analysts (researchers) could suggest that they create significant value.

Research most commonly occurs in the same location as the trading, but not necessarily in the same location as the marketing function. There are occasions when research is a cross border function. It may be that research is concentrated in a region in a single location. For example, all European equity research is performed in one location, possibly London or the head office of a European bank, but the traders may be located in a different jurisdiction.

In addition, there is often an issue of cross border research with regard to securities traded in the form of depository receipts. For example, the stocks of major European companies are often traded as American Depository Receipts (ADRs), which is a dollar denominated equivalent to the common equity of the company. In these cases, the sales and trading functions are likely to occur in the US, home of ADR trading, and the research function is often performed in the home country of the company or another European location.

Introducing the research function into the analysis does add some technical complications. The research function supports more than just the equity division of an investment bank. It also supports the investment banking division (also known as corporate finance division in some cases, the business area that address such customer issues as advising on mergers and acquisitions) and it supports the equity capital markets division (the business focused on the primary issuance of stock such as IPO or secondary offerings). It may also support the fixed income division (secondary trading of debt instruments) and the debt capital markets division (underwriting and issuance of new debt instruments).

Appropriate allocation of research division costs to these various areas raises additional complexities. For management accounting purposes, it is common for the business heads of the separate divisions to negotiate a split of the costs of the research function. Given the incentives to maximize the profitability of their respective divisions, this may be close to an arm's length result. It is difficult to establish that it is an accurate allocation of costs to which unrelated parties might have agreed. Normal cost allocation keys, as gross revenues or gross costs, have the fundamental problem that they imply that research contributes to the creation of revenue in identical proportions in two or more radically different businesses.

***Arm's Length Range***

The Global trading draft cites the arm's-length range as the arm's-length standard, with no specific definition. The OECD Guidelines define the arm's-length range in Chapter 1, Section C-iv. It would be helpful if the OECD would cite the standard from the OECD Guidelines as the arm's-length standard for global dealing operations, to ensure there is no lack of clarity.