

COMMENTS RECEIVED FROM LONDON TAX DEPARTMENT

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

Background

Goldman Sachs is writing to you in response to the invitation extended in the OECD Press Release which accompanied the above document . We welcome the opportunity to comment on Part III and we have restricted our comments to the issues we consider to be of particular importance and relevance, the most important of these being the analysis set out in Section D-3 (paragraphs 256-261) of Part III.

Goldman Sachs is a leading global investment banking and securities firm that provides a wide range of services globally to a diversified client base including corporates, governments and individuals. Goldman Sachs is a member of the New York Stock Exchange and all other leading Exchanges around the world.

A separate PE tax return?

Paragraph 261 states that the danger of overlooking the assets used and risks assumed in the performance of the functions in the PE jurisdiction is minimised if the existence of the dependent agent PE is formally recognised so that it is clear that the host country has taxing rights over two different legal entities - the dependent agent PE and the dependent agent enterprise.

We note that paragraph 261 is widely perceived as suggesting that two tax returns need to be submitted to the relevant tax authorities and this inference has been confirmed in public presentations associated with Part III.

To the extent that this interpretation of paragraph 261 is correct (i.e. Part III does indeed suggest the submission of two tax returns), we would formally request that the OECD re-consider its position on this point.

We believe there are a number of compelling reasons for this.

First, paragraph 261 is drafted on the basis that "formal recognition" is required in *all* circumstances where global trading business is undertaken by dependent agent PEs. This appears to be on the basis that, when attributing profits to the dependent agent PE, there are likely to be profits (or losses) over and above any arm's length fee paid to the dependent agent enterprise (paragraph 260).

However, consistent with the specific facts and circumstances, where in practice the method of attributing profits to the dependent agent enterprise precisely follows the manner set out in Section C of Part III; i.e. by reference to a full factual and functional analysis of the risks under the arrangements and the functions performed by the dependent agent enterprise, there are unlikely to be profits (or losses) over and above any arm's length fee paid to the dependent agent enterprise, and this should render formal recognition unnecessary.

Additionally the general thrust of Section C of Part III is to stress the importance of the particular facts and circumstances in determining the appropriate profit split rather than promoting the adoption of a generalised approach.

It would therefore seem appropriate for national tax authorities *first* to examine, on a case-by-case basis, the precise methodology utilised by a financial institution in attributing profit to a dependent agent enterprise *before* reaching the conclusion that the remuneration received by the dependent agent PE does not fully reflect the assets used or risks assumed by the PE.

By way of illustration, where a dependent agent PE acts as an *intermediary or agent*, executing transactions on the principal's instructions in consideration of a commission, one would not expect any profits to be properly attributable to the PE over and above such commission. Conversely, in circumstances where a dependent agent PE acts in effect as a *principal*, undertaking significant activity and accepting significant risk by virtue of the dependent agent enterprise acting on a discretionary basis, and in return taking a significant entitlement to profits calculated in the manner set out in Section C of Part III, such profits would *already* be taken into account in the dependent agent enterprise's own tax computations. We would therefore suggest (by reference to the illustrations) that the methodology utilised by a financial institution in attributing profit to a dependent agent enterprise, could, and perhaps should, (if it does not do so) fully capture the appropriate profit level without any need for the dependent agent PE to submit a separate tax return.

Recommendation

We would therefore suggest that Part III is revised to clarify that, in circumstances where a financial institution has adopted a methodology for attributing profit to a dependent agent enterprise which complies with the economic substance required by Section C and satisfies the relevant national tax authority, that tax authority is *not* obliged to formally recognise the existence of the dependent agent PE.

In other words, Part III should make it clear that such national tax authority will, in such circumstances, retain discretion to waive any requirement that a separate tax return must be submitted in respect of the activities carried out by the dependent agent PE.

We believe that such clarification would be consistent with the overall emphasis in Part III on flexibility, pragmatism and consideration of profit attribution issues on a case-by-case basis.

Trading and Risk Management

Second, we are concerned that the assumptions made in Part III and in particular paragraph 123, provide an unsound basis for the calculation of profits attributable to the dependent agent PE. Paragraph 123 states that "the key function here is the day to day decision making that directly gives rise to the assumption of market risk."

Whilst the decision making is a component, and not an insignificant one, of the global process in generating profits or losses for an overseas enterprise, it is not of itself sufficient to ensure the expected or anticipated result for the overseas enterprise. Other key components are, ensuring that the enterprise has sufficient capital to meet its obligations under the contract entered into by its agent and co-ordinating the individual book contributions to ensure that the directional philosophy is being adhered to and that the global efforts do not neutralise each other at the enterprise level. These are generally not functions that the agent has any involvement in, and yet it appears that the authors of this paper do not take account of these (and other) functions when they argue that the whole profit on a transaction should be attributed to the jurisdiction of the "day to day decision making". The authors of this Paper appear therefore to be adopting a "force of attraction" concept that has historically been rejected by the OECD. Additionally if the correct

remuneration has been allocated to the dependent agent enterprise for its involvement there should, as mentioned above in paragraph seven, be no surplus profit or loss over and above the arm's length fee paid to the dependent agent enterprise.

In summary we do not accept the philosophy that the correct profit and therefore remuneration paid to the dependent agent enterprise must in every case be the whole (rather than merely an appropriate part) of the profits attributable to the decision taken by the dependent agent enterprise with a deemed capital structure.

Turning now to the tax position of the dependent agent enterprise, paragraph 260 states "the service fee should provide the appropriate remuneration for the functions performed (taking into account assets used and risks assumed) by the dependent agent enterprise in its own right". It is accepted that some dependent agent enterprises undertake a more sophisticated level of activity than other dependent agent enterprises and that where this occurs the agent should be remunerated to reflect that increased level of sophistication.

We assume that the distinction here seeks to differentiate between a dependent agent enterprise that conducts transactions on instructions from the overseas principal and a dependent agent enterprise that is empowered to exercise a greater degree of discretion in terms of the decisions which it may make on behalf of the overseas principal.

Where we differ substantially from the authors of this Paper is that there is an implicit assumption that in taking decisions the dependent agent enterprise acquires or assumes the risks associated with those decisions. This is not the case, the factual situation is that the risk is located in the books of the overseas principal. It is for this reason that the regulators do not require the agent to provide regulatory capital associated with his discretionary actions on behalf of the overseas principal. The only risk assumed by the dependent agent enterprise is the risk of reduced remuneration for poor performance or the elimination of the services of the dependent agent enterprise.

The reason the dependent agent enterprise has historically and generally been paid more when operating in the discretionary mode is to incorporate the profit of the dependent agent PE (which, as indicated above, should be part but not the whole of the profit of the overseas enterprise) resulting from his efforts.

We understand that the authors feel strongly in respect of this matter and the capital attribution concept discussed below, however, we do not believe that this view equates to the reality of the contractual arrangements or the legal relationship between the principal and the dependent agent enterprise.

In summary we believe that these assumptions are fundamentally misguided.

Capital attribution to dependent agent PE

Third, we respectfully dissent from the proposition that capital must be deemed to be attributed to the dependent agent PE in order to cover risks assumed by the PE. We consider that the OECD Commentary on article 17 paragraph 25 referred to at the end of this section supports this view.

As noted in paragraph 13 of Part III, global trading firms require capital to give clients and counterparties confidence that they are able to assume and manage risks arising from global trading. However, viewed from the perspective of a third party client or counterparty, it is difficult to see why the *PE* should have risk (and therefore capital) attributed to it, even though the entity for which the PE acts has risk when such third party is contracting with, and looking to the credit of, the *principal* and not the deemed PE of the principal.

We also respectfully query the attempt in Part III to apply the same principles to the PEs of non-bank financial institutions (paragraphs 214-215), particularly in circumstances where such financial institutions

are not required to allocate, and have not in fact allocated, any capital to the PE for regulatory or other purposes.

In any event, we submit that the effect of attributing capital to a global trading PE for tax purposes (particularly in circumstances where no capital has been allocated to the PE for regulatory or other purposes) should not have the effect of imposing a higher tax burden on the PE than would otherwise be the case in the absence of such capital attribution. Additionally to do so is to implement the force of attraction concept for a PE with major negative consequences that can result from this approach.

Any other result would give rise to the risk of double taxation to the extent that the "home" country did not fully recognise the effect of such capital attribution by the "host" country of the dependent agent PE.

Furthermore, any such result would be contrary to the thrust of the Commentary on Article 7 to the Model Convention which emphasises that profits to be attributed to a PE should be determined by reference to criteria which reflect the *real facts* (paragraph 25 of Commentary). To the extent that such capital attribution does *not* reflect the real facts, insofar as it would attribute a level of profits to the PE that would be in excess of the PE's real contribution to the overall profits, we would respectfully submit that the OECD re-consider its position on this issue.