

COMMENTS RECEIVED FROM SWISS BANKERS ASSOCIATION

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)

1. The Swiss Bankers Association is pleased to have the opportunity to comment on the revised draft Part II, and the draft Part III, of the above report published on 4 March 2003. The SBA is the leading professional organisation of the Swiss financial centre, having a membership of some 400 banks and approximately 8,300 individual members.

2. On an overall level, we would like to commend the OECD on the general high quality of the latest draft. We believe that, subject to our comments below, they will represent a step forward in achieving consistency of treatment between OECD Member countries on PE taxation. However, we consider the points raised below to be of significant importance, and ones which must be addressed before the report and the WH are finalised.

Revised Draft Part II of the Report

Free Capital Attribution

a) Single v. Choice of Approach

3. We are disappointed that the OECD member countries have been unable to agree on a single method for allocating free capital to PEs. It seems to us that this significantly detracts from the potential benefits of the report and of the WH, and we would urge the OECD to make further efforts to reach such an international consensus.

4. If such a consensus is not possible, then we consider it vital (particularly in a treaty context) that taxpayers should be entitled to apply any one of the approved attribution methods described in the report, provided that a single method is used consistently. We regard it as unacceptable for taxpayers to be required to apply different capital attribution methods in different countries according to the particular choice of individual tax authorities. Otherwise there will be undue compliance burdens, lack of certainty and, most importantly, an increased risk of double taxation (all of which would be inconsistent with the OECD's objective of promoting global trading and inward investment). The potential for double taxation if such a taxpayer choice is not allowed is recognised at para.123 of the draft, but we cannot agree that relying on mutual agreement procedures is an acceptable backstop to reduce this risk. Rather, the WH must allow scope for a (consistently applied) taxpayer's choice of method as outlined above.

b) Thin Capitalisation Method

5. We strongly question whether the use of a “thin capitalisation” method of capital attribution can be appropriate in the context of multinational banks operating in many countries worldwide. It seems to us that it will lead to an unacceptable risk of double taxation due to the total amount of (actual) capital being less than the sum of the (notional) parts. Indeed this risk is specifically recognised at para.111 of the draft, where it is stated that “under a thin capitalisation approach, it is perfectly possible for either more or less capital than the enterprise as a whole possesses to be attributed amongst its various parts...Double, rather than less than single, taxation is more likely to occur under a thin capitalisation approach...”. We agree with this statement, and are therefore unsure why a thin capitalisation method can qualify as an approved method under the WH. In fact, the risk of double taxation under the thin capitalisation method would seem to exist not only in those cases of risk intensive PEs referred to in the draft, but in all cases, due to the “whole being less than the sum of the (notional) parts”. In particular, we cannot help asking what a home jurisdiction tax authority will do when it finds that all (or almost all) of the entity’s capital has been attributed to various overseas PEs under a thin capitalisation approach, such that there is little (or no) capital left to tax in the head office location (despite a large degree of activity and capital usage in that location). In fact, we had understood that the reason why the original discussion draft had advocated the “capital allocation” approach (rather than, say, a thin capitalisation approach) was for the very objective of avoiding double taxation. We therefore urge to OECD return to the previous position and exclude the thin capitalisation approach from the menu of “approved” capital attribution methods permitted by the WH.

c) Preferred Capital Attribution Approach

6. It seems to us that the most appropriate method of capital attribution would, in fact, be to follow a “capital allocation” approach (by reference to the relative RWAs of, or possibly book values of assets attributable to, the various PEs), but as amended to exclude at the outset the effect of any surplus capital which is, as a matter of fact, held to support the business of the head office (or another PE). So, for example, in the case of Swiss domiciled banks, they are typically highly capitalised in order to sustain the private banking business undertaken from Switzerland (customers are attracted by such a degree of capitalisation when placing their funds with an overseas financial institution). It is therefore necessary to “haircut” the capital to be allocated between the various PEs to take account of this specific head office factor. However, once this has been done, it seems to us there can be no better method, consistent with the provisions of Article 7 of the model treaty and the principle of avoiding double taxation, than to allocate the entity’s actual capital (after the haircut) to the various PEs based on their relative RWAs. We would suggest that this “modified capital allocation” approach is possibly the only method capable of achieving, on a consistent basis, the goal of the arm’s length standard whilst having regard to the principle of avoiding double taxation. We would therefore urge the OECD to consider it as a possible basis for a single agreed approach to capital attribution.

d) Other Aspects of Free Capital Attribution

7. Para.129 of the draft suggests that applying the WH to attribute free capital may, if there is no (or presumably an insufficiency of) intra-entity interest expense available for disallowance, result in interest paid by the PE to third parties being disallowed. We cannot agree that such a disallowance is compatible with Article 7(3) of the model treaty (which specifically provides for expenses incurred for the purposes of the PE to be allowed in computing its taxable profits). Para.130 of the draft suggests that the method of making such an adjustment might be to impute a “loan” from the PE to the enterprise’s treasury location (e.g. the Head Office). However, we cannot agree that Article 7 of the model treaty allows the imputation of such notional transactions when, in fact, no such dealings have occurred. To do so also seems contrary to the principle put forward at para.144 of the draft, namely that tax administrations “should not disregard the actual dealings [of the PE] or substitute other dealings for them”.

8. Para.128 of the draft goes a step further in suggesting that where there is no (or presumably an insufficiency of) intra-entity or third party interest expense available for disallowance, the PE may be attributed with income on an imputed “loan” from the PE to the enterprise’s treasury location. Again, we cannot agree that such an approach is compatible with Article 7 of the model treaty, as it requires the postulation of transactions by the PE which have not in fact taken place.

9. Para.127 of the draft suggests that the scenario referred to at para.128 (i.e. where there is a lack of borrowings to be disallowed) is unlikely to arise in practice. However, we believe this may be an oversimplification, as it ignores the question of the currency of the PE’s borrowings. Take, for example, a United Kingdom PE of a Swiss resident bank whose actual share capital and reserves (i.e. tier 1 capital) is denominated in Swiss francs (CHF). It can be assumed that the Swiss bank will have invested its (actual) capital in CHF denominated assets, given that it is seeking to maximise its profits in CHF. It is therefore CHF interest income which will be earned on that capital. It therefore follows that it is the United Kingdom PE’s CHF intra-entity interest expense which should be disallowed (not interest on other currency borrowings which may carry a lower or higher interest rate)¹; indeed any other approach would result in a significant likelihood of double taxation (and not be compatible with treaties). But it may well be the case that the PE has a relatively low level of CHF borrowings if its business is conducted principally in (say) US dollars and Euros. In such a case, it will presumably be necessary to reflect the free capital attribution adjustment by imputing CHF interest income to the UK PE, rather than disallowing such interest expense. We therefore believe that the assumption in para.127 that the question of imputing notional income (as opposed to disallowing interest expense) will only arise in exceptional cases may, in fact, be misfounded.

Allocation of Other (Tier 2) Capital

10. We agree that tier 2 capital should be taken into account in attributing capital to PEs. We strongly favour the “pure” approach described at para.114. It has the benefits of consistency with the approach used for attributing free capital and of transparency. In contrast, we would question whether the “cleansed” approach described at para.115 is used by many multinational banks in practice and it would seem to be much more difficult for local tax authorities to audit the amount of the interest deduction. We would also question why such an approach should be allowed for attributing tier 2 capital but not free capital itself. We would therefore suggest that only the “pure” approach should be permitted by the WH.

Credit Rating/Guarantee Fees

11. We agree that a PE should be deemed to have the same credit rating as the overall entity of which it forms part (such credit status being part of the “same or similar conditions” referred to in Article 7 of the model treaty). However, we continue to take issue with the failure of the WH to allow the imputation of a guarantee fee. We will not repeat all of the arguments made in our previous submission. We would, however, refer back to the example given in the presentation by the Japanese Bankers Association at the OECD consultation meeting in April 2002. This clearly illustrated that the imputation of free capital to a branch without the allowance of a deemed guarantee fee would result in a branch being taxed more harshly than a subsidiary. We note that the response to this in the revised draft Part II has, in fact, simply been to change the stated aims of the WH. In the original draft Part II, it was stated that a failure to achieve

¹ This comment applies equally in a thin capitalisation or quasi-thin capitalisation context as well as under a capital allocation approach, as one of the “same or similar conditions” is that the notional separate entity would, similarly to the entity of which it forms part, seek to maximise its profits in the head office currency (in the above example CHF) and hence denominate its capital (and draw up its accounts) in that currency.

neutrality between branches and subsidiaries “would be unacceptable on tax policy grounds...[as it would produce]...a discrepancy between the tax results of a branch and of a subsidiary carrying on similar operations”. However, it is now stated (at para.5 of the revised draft Part II) that “the aim of the WH is not to achieve equality of outcome between branch and subsidiary in terms of profits”. It therefore seems to us that, regrettably, the response to the previous submissions has simply been to change the stated aims of the WH, rather than amending the WH to fit the original objectives. Moreover, even if such equality is not an end of the WH in itself, it should surely be an objective to achieve a broadly equivalent outcome in circumstances where the branch and a subsidiary are, in essence, in the same economic (albeit not legal) position.

12. We should note that if an internal condition of an enterprise, e.g. its credit rating, is the true result of synergies and internal set-offs within the overall entity, then we do not quarrel with the proposition that such benefits should be shared out between the various PEs for tax purposes. However, it seems to us that the WH, as currently drafted, goes much further than that, in that it does not seek to differentiate between those PEs which make such synergistic contributions and those which do not. Let us examine, for example, the situation where a thin capitalisation approach is adopted for free capital attribution purposes. The justification for such an approach is said to be that it places the PE in the same position as if it were a distinct and separate enterprise dealing wholly independently with the rest of the entity. How can it then be justifiable not to apply the same principle to the closely connected issue of funding? If the same test is applied, i.e. if the PE was a separate enterprise dealing on wholly independent terms, it would unquestionably have to pay a guarantee fee in order to benefit from the stronger credit status of the other separate entity. In our view, it is illogical (and inequitable) to combine the non-imputation of a guarantee fee with a thin capitalisation method for attributing free capital, and we also doubt whether it is compatible with the non-discrimination article of the OECD model treaty. As noted at paragraph 5 above, we would suggest that a thin capitalisation method should be regarded as inappropriate for the purposes of attributing free capital. However, if such a method is to be permitted by the WH, then at least a guarantee fee must be allowed in the context of that particular method.

13. Turning to the detailed points made in the draft report, we believe that the example at para.73 only addresses half of the issue. Whilst it must be correct that a wholly independent AA rated bank would not borrow at 5.1% in order to on-lend at 5.05%, the question arises whether a banking subsidiary would ever borrow from the market at 4.95% on the basis of a parent company guarantee, on-lend to the customer at 5.05% and then pay a guarantee fee to the parent entity? The answer must be yes (on the basis that a subsidiary may well decide its terms of business on the basis of the benefit to the group as a whole). So the question then arises what the tax position should be in these circumstances. The answer is to be found at para.127 of draft Part III of the report, namely that where a subsidiary enters into a transaction for a wider group benefit, then it should be regarded as performing a service for which it should be rewarded by the other group company(ies). This is the type of analysis which we suggested (at paragraph 13 of our previous response) should be applied in the branch context such as that referred to at para.73 of the revised draft Part II. Moreover the point becomes all the more relevant if a thin capitalisation is used for free capital purposes. We would submit that it is not right to short-cut this type of conceptual approach and simply ignore both the guarantee fee and the reward for the group service function, as this gives the wrong answer for those transactions (the majority) which are profitable on their own even with the guarantee fee (i.e. in the example above, those which would have been entered into by an independent AA bank). Nor can we agree with the justification at para.76 of the draft which relies on the same credit rating being an “observable condition” of the PE, as it could equally be said that it is an “observable condition” of many PEs that they do not have any capital of their own. Finally, we are surprised by the justification made at para.82 of the draft that “if the tax authorities followed the regulatory approach, which is indifferent as to whether any capital is attributed to PEs, the PE would be much more lightly taxed than the subsidiary because of the absence of ‘free’ capital”. Not only do we consider this to be incorrect (as it does not take into account the credit rating/guarantee aspects), but it also seems difficult to reconcile with the statement

at para.5 that it is apparently not an objective of the WH to achieve equality of outcome between branches and subsidiaries.

Other Issues

14. There are certain other minor aspects of the revised Part II on which we have set out comments in the Appendix to this letter.

Draft Part III of the Report

Capital, Credit Rating and Guarantee Fees

15. The comments made above in respect of capital, credit rating and guarantee fees in relation to Part II apply equally to Part III of the discussion draft. Therefore, rather than repeating those comments, we would simply refer you to the text above.

Dependent Agent PE Issue

a) General

16. We note that para.256 of the draft excludes from the scope of the report examination of the issue of whether a PE exists where one entity (the “dependent agent enterprise”) concludes contracts in the name of another group company (the “booking enterprise”). We would encourage the OECD to reconsider covering this aspect in the current report, given that the report goes on to consider what the tax consequences are where such a PE does exist. Having said this, we commend the analysis contained at paras.257ff of the discussion draft. We believe there is sometimes a risk of mistakenly ignoring the technical issues associated with dependent agent situations in the interests of pragmatism. For example, it is sometimes attempted to characterise activities as being within the independent agent exemption (for example by stretching the principles of a hedge fund type analysis) when, in truth, they fall into the dependent agent category. Additionally, we believe that the tax technical position is sometimes ignored by concentrating simply on a jurisdictional, rather than entity by entity, allocation of profit. We believe that such an approach is misguided and that it is necessary to separate the technical from the practical considerations, as considered further below.

b) Technical Position

17. From a technical perspective, we agree with the implication at para.256 that a dependent agent PE can be expected to exist where one group company (or its employees) concludes contracts in the name of another (unless that function can be said to be within the “ordinary course” of the former’s business, such that the independent agent exemption applies). We also agree with the conclusion at para.257 that in such circumstances the host jurisdiction will have taxing rights over two different enterprises, namely the dependent agent enterprise (as principal) and a PE of the contracting entity (i.e. the dependent agent (as agent)). This point sometimes seems to be ignored, either due to questionable technical reasoning or for reasons of practical convenience. However, we believe that it is in fact important to observe the correct technical principles in order to arrive at the appropriate tax result. We therefore commend the OECD for the clear technical analysis set out in the discussion draft. We believe that the issue can be illustrated as follows.

18. Take the position of a UK parent bank with a US broker dealer subsidiary. For a combination of regulatory, credit and/or capital reasons, the group's US equity derivatives business is booked not in the US broker dealer subsidiary, nor in a US branch of the UK parent, but rather in the UK head office of the parent. Assume, for ease of illustration, that all front office trading activity is conducted out of the US (by the US broker dealer subsidiary and its employees, who are authorised to conclude contracts in the name of the parent's UK head office). There are two steps to the analysis:-

- (i) Firstly, it is necessary to allocate profit between the US broker dealer (for the functions which it undertakes) and the UK parent (for putting its capital at risk). Depending on the circumstances, a hedge fund type model might be applied. We suggest that the discussion draft should make reference to the possibility of adopting a hedge fund type approach for these purposes (e.g. at paras.148, 164, 179 and 235, and also at para.141 where we agree with the reference made to situations where "it is necessary to separately evaluate the role of capital, i.e. where arrangements exist between the associated enterprises whereby the capital necessary to support the risks resides in a different legal enterprise from the enterprise which performs the functions giving rise to the risks actually assumed as a result of the global trading activity").
- (ii) Having addressed this first aspect, it is then necessary to consider in which jurisdiction(s) the UK parent's profit should be taxed. The correct answer must be firstly the US (via a PE of the UK parent, i.e. the US broker dealer as the UK parent's dependent agent). Then, if the parent's country of residence (e.g. the UK) operates a DTR credit system, the profit in question will be taxed in that country as well, subject to DTR.

19. In our view, this type of analysis gives the correct technical, as well as a common sense, result. If all of the front office trading functions are undertaken from the US, then the whole of the group's profits from that activity (excluding the required compensation for the sales and back office functions) should be taxable in the US. Furthermore, this also gives a sensible result from a policy perspective, in that it is the same result as if the relevant functions had been carried out by a US PE of the UK parent entity itself. In this latter case, under the WH, the capital would be attributed to the US (being the location in which the people functions are performed), and hence that would be where the entire profit would fall to be taxed.²

20. We are aware that a "hedge fund model" analysis is sometimes cited as a justification for a different result from that described above. We agree with the potential application of such a model in determining the split of profit between the agent and the capital provider (see paragraph 18(i) above. We also accept that in circumstances where the independent agent exemption applies, the proper application of that model may be the end of the matter. However, as noted at paragraph 17 above, that will only be the case where the agent is acting in the ordinary course of its business, (i.e. where it undertakes the same type of activity for third party customers). In those many cases where this test is not satisfied, the application of the hedge fund model cannot be the end of the matter, as it fails properly to address the question of *where*

² In this respect, we agree with the statement at para.235 that "under the WH, where one enterprise both possesses the capital and performs the global trading functions, the total capital of the enterprise that supports the risks would be attributed to the parts of the enterprise performing the global trading functions that created and subsequently managed those risks". We would suggest that it should be made clear in the report that the application of the WH will not be affected by regulatory rules, e.g. that the fact that the activity in question is not permitted to be carried on by an "actual" US branch of the parent entity should not prevent the attribution of profit to a US dependent agent PE of that entity.

the capital provider's profit should be taxed. We therefore agree with the comments made at para.188 of the discussion draft, in particular that "accordingly, it is not possible for one part of the enterprise to be treated as possessing the capital needed to support a certain amount of risks assumed where those risks have been properly attributed to another part of the enterprise following the functional and factual analysis." In other words, consistent with the rest of the WH, the attribution of capital between jurisdictions within the capital provider must follow the functional analysis, not vice versa (i.e. a "provision of capital" function should not be deemed to have been carried out in a jurisdiction where, in fact, no "people functions" have been performed).

21. Obviously the example at paragraph 18 above is somewhat over-simplistic, and there may well be some front office activity carried out in other countries (including the booking location, e.g. the UK in the above example). In such circumstances, we would expect the overall profit to be split between (i) the capital provider (i.e. the UK parent) and (ii) the entities undertaking the "people functions" (e.g. the US broker dealer and the UK parent), the split being calculated on the basis of (say) a hedge fund model. The profit in item (ii) would then be apportioned between the US broker dealer and the UK parent's head office according to (say) the relative compensation of the traders in each location. The capital provision profit in item (i) would also be apportioned, in the same ratio, between a US dependent agent PE of the UK parent and the latter's UK head office, reflecting the fact that the commitment of the entity's capital is committed by traders based in both locations.

c) Practical Position

22. Having considered the technical position, we then turn to the question of how these principles should be applied in practice. It is sometimes said that the type of approach described above is impracticable. However, we believe that the practical difficulties can be overstated and that in reality they are no different from those encountered in other transfer pricing areas. Moreover, if the correct technical approach is ignored, it seems to us that there is a real risk of tax being levied in the wrong jurisdiction. For example, in the rather simplistic example at paragraph 18 above, we believe that it would clearly be wrong to look simply at the jurisdictional situs of the performance of the people functions, ignoring the separate entities involved. For example, a simple transfer of 100% of the profit to the US broker dealer (with taxation being applied in that entity) would give an inappropriate result as far as the UK is concerned, as the UK parent entity needs to be rewarded for its provision of capital and the consequent risks borne (albeit via a deemed PE in the US, and notwithstanding that in practice no incremental UK tax may be levied due to availability of a DTR credit). Likewise, to ascribe the "provision of capital" function to the parent's UK head office would also give the wrong result, as it would lead to taxation being levied in the UK when all of the relevant "people functions" had been performed in the US.

23. Having said this, we would recommend that the discussion draft should allow for the possibility of adopting a pragmatic approach (rather than having to follow the strict technical position) where this has no effect on the overall tax position. Suppose for example, in the context of the illustration at paragraph 18 above, that the UK entity was replaced with a Swiss entity. Given that Switzerland uses an exemption method for allowing DTR, there would be no practical reason why the group should not be allowed to transfer the full amount of profit to the dependent agent enterprise (i.e. the US broker dealer), as this has no impact on the amount of tax chargeable in the country of residence (i.e. Switzerland). It can then be left up to the host jurisdiction tax authorities (in this example the US) to decide whether they are content for the whole profit to be taxed in the dependent agent enterprise as principal, or whether they wish to insist on the taxable profit being apportioned into two parts (i.e. one part being taxed on the dependent agent as principal and the other part being taxed on the dependent agent as agent for the non-resident capital provider).

Other Issues

24. We have set out in the Appendix to this letter comments on certain other minor issues relating to Part III of the Discussion Draft.

Conclusion

25. As noted above, we are grateful to have had the opportunity of commenting on these issues. We trust that consideration will be given the comments made above, particularly on the question of the thin capitalisation method of free capital attribution and deemed guarantee fees, and we look forward to inputting into any further OECD consultations on these issues.

APPENDIX

Part II

Para.12: The draft states that “an area of particular significance to a bank is the function relating to the supervision of the management of the bank’s overall capital and risk exposure”. However, the draft appears to contain little guidance on how this function should be compensated in practice. We would suggest that the report should contain more specific guidance on this point, and in particular the fact that a profit share should not, as a general rule be attributed to such functions carried out by risk committees or officers (e.g. credit risk officers).

Part III

Para.13 In the 1st bullet point, conceptually we can see no reason why the credit risk (as well as the market risk) may not be transferred, via a mirror transaction, to another entity in either the same jurisdiction or another jurisdiction in which the credit risk exposure is managed.

Para.88: We suggest that further guidance should be given on when (if at all) credit risk should be attributed to the separate “middle office” credit risk management/ monitoring function. In our view, the answer should be only rarely. In addition, we suggest that the final three sentences of this paragraph should be amplified, so as not only to note the existence of such risk centralisation models, but also to confirm that they should be respected for tax purposes provided that the pricing is at arm’s length.

Para.126: Whilst the issue of split hedges between associated enterprises may be difficult, we would urge the OECD to address the issue as part of the current exercise, rather than leaving it to be the subject of future work. Either way, the document should make it clear that split hedges within a single legal entity will not be respected for tax purposes, but rather that the overall net result should be apportioned to, or between, the relevant PE(s) according to the functions which they have respectively undertaken.

Para.142: See the comment below in connection with para.187.

Para.155: We would suggest that clarification should be included as to what is meant by “routine”. The draft appears to use the term in the sense of being capable of transaction on a standalone basis, whereas we would normally interpret the term as conveying a sense of normality (and usually being of low value).

Paras.174/178: In response to the question at the end of para.178, we agree that the issue raised at para.174 is conceptually a difficult one (i.e. the compensation ratio for that year could quite possibly become artificially skewed, such that the location which had previously been entitled to a large share of profit would subsequently be required to bear a much lower share of the loss). We would suggest that at arm’s length, independent parties might agree that in such circumstances the losses should be apportioned in the same ratio as that in which profits had been apportioned in previous years (or, if there is a lack of relevant profit history, should initially be apportioned according to the current year’s compensation ratio but then subject to a “true up” once the ratios for subsequent profitable years are known).

Paras.175-177: We agree that, in theory, adjustments should be made where relative compensation levels do not reflect the value of the function’s contribution but merely unrelated geographic differences. However, it is necessary to take a practical approach in this area. We would therefore suggest that it should be agreed that the need for such adjustments should be disregarded. However, if that is unacceptable to OECD member countries, then a sensible compromise would be for the OECD to publish a list of compensation ratio weightings by country, so that taxpayers can apply a straightforward and objective adjustment.

Para.179: We would suggest that reference be made to the possibility of using a hedge fund type model to attribute profit to the capital provider in appropriate circumstances.

Para.187: This paragraph suggests that if entity A provides a guarantee to entity B in respect of the latter’s risks, then entity B will be relieved from the requirement to support those risks with capital of its own. We do not believe that this will necessarily be the case (at least not in all countries) if entity B is a regulated entity. This is because entity B will still have a residual exposure, namely the risk of entity A failing in its performance under the guarantee, which may itself need to be underpinned with capital in entity B (in addition to the requirement for entity A to underpin with capital its exposure under the guarantee).

Para.235: The comment above in respect of para.179 applies here also.

Paras.246-250: The comment above in respect of para.13 applies here also.