

## COMMENTS RECEIVED FROM ERNST & YOUNG

### COMMENTS TO THE OECD REGARDING DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS: PART II (BANKS) AND PART III (GLOBAL TRADING OF FINANCIAL INSTRUMENTS)

We submit the following comments regarding the DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS (PES: PART III (ENTERPRISES CARRYING ON GLOBAL TRADING OF FINANCIAL INSTRUMENTS)) (“Part III Discussion Draft“ or “New Draft“). We appreciate the opportunity to provide our perspective on this difficult and evolving issue.

#### Overview

Overall, the New Draft has more rigorously and effectively applied the transfer pricing principles enunciated in the OECD's Transfer Pricing Guidelines<sup>1</sup> to financial services businesses than the 1998 draft document<sup>2</sup>. This is a positive improvement for an industry that heretofore has received little guidance from tax administrations on how to deal with some of the unique value drivers in this industry.<sup>3</sup> Another improvement arises from emphasizing the capital function differences between operating in multiple entity or single entity form.

We commend the OECD for expanding the functional and factual analysis (concentrating on functions, assets and risks) especially the management of credit and market risk. The analysis regarding subsequent functional activity that arises after a financial asset is created is welcomed as recognizing that this phase is an important aspect in value creation in global trading. However, we recommend that further guidance be provided regarding distinguishing between the capital and market risk functions.

We caution the OECD about expanding the definition of permanent establishment, and in particular, the suggestion that among associated enterprises the capital (and/or credit function, to the extent applicable) could be taxable as a dependent agent PE, a position that will certainly result in more controversy and double taxation instead of less.

Our brief comments are organized as follows:

1. OECD highlighted items for resolution;

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<sup>1</sup> Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD, 1995.

<sup>2</sup> The Taxation of Global Trading Financial Instruments, OECD, 1998

<sup>3</sup> One notable exception is the publication of the U.S. Internal Revenue Service's experience regarding global trading in Notice 94-40, Global Trading Advance Pricing Agreements, 1994-1 C.B. 351, April 25, 1994. The IRS limits the applicability of this Notice by stating that “[t]his notice does not provide general guidance regarding the federal taxation of derivative financial products; rather it discusses the Service's experience with issuing these APAs.”

2. Split hedges;
3. Functional analysis of market and credit risks based on facts and circumstances;
4. Capital of a PE relating to global trading; and
5. Dependent agent PE.

## 1. Requested Comments

The OECD has requested input from the financial services industry on the following unresolved items:

- How loss situations should be dealt with in cases where a transactional profit split method is applied;<sup>4</sup> and
- 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.<sup>5</sup>

### a. Loss Situation

Losses should not be stranded in a jurisdiction that is the legal booking entity when in fact there are other jurisdictions that economically bear the risk of profit and loss from activities. Otherwise, the guidance provided by the Part III Discussion Draft would be effectively nullified. As stressed throughout these comments, however, we believe that it is crucial to distinguish between 1) the management and taking of market risk and the management and taking of credit risk and 2) a market risk loss and a credit risk loss. For the market risk taker(s), both profit and loss arising from market risk should be apportioned under the market risk function's transfer pricing method. Also please see the comments in below Section 3 regarding regulatory constraints.

Similarly, for the credit risk taker(s), both the profit and the loss arising from credit risk should be allocated under the credit risk function's transfer pricing method. Also please see the comments in below 1.b regarding internal credit risk transactions.

### b. Internal Credit Derivatives

Transactions that involve the shifting of credit risk within a PE or among associated enterprises before or after the asset is created must be respected. The profit or loss with holding an asset changes over the life of the asset. If the credit risk on an asset is subsequently held by an entity other than the one that created the financial asset, the subsequent entity must receive profit or loss in proportion to the amount of risk it has undertaken.

This view is consistent with the OECD's overall view. The importance of analyzing risk over time is emphasized in paragraph 84 of the Part III Discussion Draft, which states "it will be important to distinguish between the initial assumption of risk and the subsequent bearing of that risk. Further any risk assumed and subsequently borne also has to be managed by personnel undertaking the risk management function." This statement recognizes that a MNE financial services firm may transfer risk bearing

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<sup>4</sup> Par. 178 of Part III PE Draft.

<sup>5</sup> Par. 250 of Part III PE Draft.

responsibility from the entity that initially created the financial asset, of course, as caveated within the New Draft, to the extent that there is business purpose and economic substance to such transfers.

The use of internal credit derivatives to transfer credit risk seems reasonable and would reflect what is already common practice in financial markets for facilitating risk transfers between third parties. However, within PEs or associated enterprises the “risk transfer” might not only be a credit derivative, but also might be an inter-desk or a quasi-inter-desk transaction that places the credit risk in the booking location rather than in the multiple PE locations that are taking the market risk. Separating the credit risk recognizes that such risk is not the function of the traders in multiple locations. In global trading, counterparty derivatives credit exposure is, arguably, always a make-whole/break-even issue objective. With this objective, the MNE financial services firm may want such credit risk in one location so that administratively the risk can be managed centrally, similar to the centralization of operational risk.

## 2. Split Hedges

For the OECD's future work on split hedges, we provide some additional observations. The OECD correctly recognizes that there are instances where a capital providing entity should not return a full trading book loss to the regulated, primary risk management entity that a priori compensated the trading location for loss protection. This full trading book profit and loss position (“P/L”) is expected over time to be profitable, with the capital provider expecting over time to have an appropriate return for providing this function. In a split hedge, the entity booking the hedge has no expectation that over time its P/L will be positive. Therefore, such entity is not a capital provider, but a mere booking location for the location with the primary underlying. Thus a split hedge profit/loss result (less an administrative fee) should be allocated from the booking location to the entity holding the primary underlying of the hedge.

The treatment of split hedges needs to be uniformly adopted by the member countries. Currently, many tax administrations are not respecting taxpayers' legitimate risk shifting arrangements and this will result in unneeded tax controversy and potential double taxation.<sup>6</sup>

## 3. Functional Analysis of the Credit and Market Risk Functions Based on Facts and Circumstances

The Part III Discussion Draft has made significant improvements in its analysis by concentrating on fact-finding regarding the market risk and credit risk functions. We suggest, however, that the OECD further emphasize that the allocation of profit from a global trading operation will be highly dependent on the facts and circumstances of a taxpayer's particular operations. We further suggest that tax administrations be advised to accept a taxpayer's description of such operations so long as there is economic substance underlying the description and that the taxpayer consistently applies such description, excepting circumstances where business change results in a modification of these operations.

### a. Credit Risk Function

As discussed in above 1.b, in global trading, credit risk is not a profit driver, and, if supported by the facts, can be centralized in one location that will earn a routine functional return. This is consistent with a position taken by the United States in its proposed global dealing regulations.<sup>7</sup> The OECD supports treating capital relating to this function as a “routine” function. By this the OECD means that there should be benchmark data available to determine how much remuneration capital should receive for the level of

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<sup>6</sup> See, e.g., Interview of CCRA Economist Simkover, Transfer Pricing Report, Vol. 12, No. 7, August 6, 2003, pages 266-270.

<sup>7</sup> REG-208299-90, 1998-16 IRB 26, proposing Prop. Reg. Section 1.482-8.

risk it has borne.<sup>8</sup> Such a return may be substantial, but it should not be considered to be a residual profit factor where remaining system profit is allocated to it on some relative contribution basis.

#### b. Market Risk Function

In general circumstances, the market risk function will be shared by the respective trading locations, and a residual profit (loss) method is most likely the appropriate transfer pricing method. Arguably, this residual profit split is a short-cut that combines the return attributable to the market risk manager services and the return attributable to the locations bearing the market risk into one calculation because all locations provide such services and bear such risks.

If a regulatory restriction prevents a regulated entity with a market risk manager from suffering a loss that is booked in another entity, market risk can not be borne by the trading entity in its financial accounts or in its tax accounts.<sup>9</sup> In this case, we note what we consider an important deletion of paragraph 137 from the OECD's 1998 Global Trading Draft regarding the role of a booking entity, which provided:

[T]he profit split method may be applied at, or after, the year end and will result in an allocation of profits or losses away from the booking jurisdiction. This potentially raises a number of regulatory issues where application of the profit split methodology leads to movements of funds or capital. If losses are allocated to another location will the regulators in that location also insist on the provision of regulatory capital? Would this have to be additional capital or would the regulatory authorities of the booking jurisdiction agree to the transfer of an appropriate amount of capital to the other location or agree that less capital be provided in the booking location to reflect the allocation of losses.

In our opinion, this deletion signifies that the OECD has concluded that assets and capital cannot be allocated among associated enterprises in contravention of the actual bookings. Recognizing that protection from loss in regulated entities is extremely important in financial services, then the booking location should be compensated for bearing the market risk and supplying such loss protection. Of course, the amount of total compensation awarded to the booking location will depend on what other functions and risks it has undertaken.

It can be argued that the proper functional analysis in this case is to decompose the profit split method discussed above into its two components – the market risk management services return and the entity market risk return, with the latter being the final calculation (or plug) of the transfer pricing method.

#### **4. Attribution of Assets and Capital of PEs relating to Global Trading**

We believe that the Part III Discussion Draft generally concludes that the income of PEs in a global trading operation should be determined under the same principles as those of associated enterprises, except for additional accounting for asset and capital attribution arising from operating as a single legal entity. We

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<sup>8</sup> Par. 155 of Part III PE Draft.

<sup>9</sup> In many tax jurisdictions, because of “book/tax conformity,” if the financial accounts cannot bear the loss, the tax accounts cannot bear the loss. Even if a tax jurisdiction allows for book/tax differences, because the tax adjustment cannot be financially transferred because of a regulatory restriction, the book/tax adjustment mechanism cannot be utilized.

believe that such a position is a workable position for financial services institutions, to the extent reasonably ascertainable rules can be devised for asset and capital attribution.

Unfortunately, we do not believe such rules have been articulated sufficiently to achieve consistent application among the various tax administrations. We suggest that for determining attributable assets the credit risk and market risk analysis discussed above should be used. See 4.a and b, below.

For capital purposes, applying capital analysis analogous to that of the Bank of International Settlements (“BIS”)<sup>10</sup> to such allocated assets could be done. If so, it is highly questionable whether it is necessary to attribute capital under the OECD’s Transfer Pricing Guidelines, which stress functions, risks and assets. The important point is that once the designated PEs have taken the credit or market risk, it is assumed that each has enough capital to withstand all the risks it has undertaken.

#### a. Credit Risk

As discussed in 1.b above, we believe that the PEs conducting a global trading business can in an arm’s length manner arrange that all credit risk is in one location. In this case, all credit assets (the amounts owed by the counterparties)<sup>11</sup> should be allocated to such location. When credit risk is shared by the trading locations, the assets and capital required for the credit risk per the transfer pricing method should be appropriately adjusted.

#### b. Market Risk

When a global trading business is conducted solely among PEs, regulatory restriction preventing a profit or loss transfer to a trading location, the trading assets less the credit assets of above 4.a can be allocated among the trading locations in the same percentages as computed under the profit split method for the combined market risk management and market risk functions.

### **5. Dependent Agent Permanent Establishment**

We believe that the OECD needs to further clarify when activities of a PE results in the taxation of a quantum of income beyond that related to the activities of the PE and the capital attributed to financial assets created from such activities. Currently, Paragraph 256 states that: “[i]t is quite common for functions associated with a global trading business to be undertaken by dependent agents.” Then, Paragraph 256 states: “[t]his Report does not examine the issue of whether a PE exists under Article 5.” These two statements make it unclear as to how dependent agent PE should be treated for global trading purposes.

Clarification is required in part because Paragraph 260 discusses what amount of profit (loss) might be subject to tax of the deemed agent PE by stating: “[i]n short, when attributing profits to the dependent agent PE, there are likely to be profits (or losses) over and above the arm's length service fee paid to the dependent agent enterprise.” It is not clear from this statement whether the additional profit (loss) relates only to the capital attributed to the underlying activities of the dependent agent PE or to more.

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<sup>10</sup> See [www.bis.org](http://www.bis.org) for the current Basel Accord that sets out guidance for calculating capital based on credit and market risk.

<sup>11</sup> We believe this amount should reflect all cross-business netting, which would minimize the asset and capital, because, as stated within the text, credit risk is not a profit driver of global trading.

It is disappointing to have both the text of paragraphs 256-262, and Working Party No. 6 stating that they will not examine the issue of whether in the financial services industry a dependent agent need not give rise to a PE. There are excellent reasons for distinguishing global trading from other industries. As implied in the OECD's analysis in paragraph 260, unlike most other dependent agent PE analyses, the entire contractual profit is not taxable to the deemed agent PE because the global trading transfer pricing functional analysis attributes marketing and trading and risk management service profit allocations to such activities. Only the profit/loss related to the capital provider will be taxed as earned by the PE.

For purposes of determining whether a dependent agent PE exists, it seems the OECD has ignored considering what happens when the dealing functions of marketing and trading risk management have been rewarded through global trading transfer pricing analysis. What remains is a return to the deemed capital investor, which has been determined to be initially attributed to the entity creating the financial asset. Usually, a capital investor is only taxed in its home location, not the host location as is the proposal under this Discussion Draft. If so, the creation of a dependent PE should be an unnecessary analysis.

Furthermore, pragmatism should apply to prevent excessively burdensome calculations. For example, regulatory and financial accounting records would require adjustment to reflect the correct tax liabilities and correct location of risks. Regulatory issues could arise regarding whether home or PE regulators would need to be informed. Even without a formal notification, the adjustments to the regulatory accounting records will eventually yield questions and create additional costs for financial services institutions to comply with tax and regulatory provisions.

## **Conclusion**

We believe the Part III Discussion Draft has generally improved the guidance regarding the taxation of global trading operations. We believe certain issues described above require further clarification and modification. We suggest that the OECD undertake further discussions with the financial services institutions to ensure that its final guidance satisfies the needs of the tax administrations and the affected taxpayers.