

COMMENTS RECEIVED FROM THE EUROPEAN BANKING FEDERATION (FBE)

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 European Banking Federation (FBE)¹ welcomes the opportunity to comment further on revised Part II (banks) and Part III (global trading) of the OECD discussion draft on the Attribution of Profits to Permanent Establishments (PEs), which were issued in March 2003.

PART II (BANKS)

2. The FBE submitted written comments on Part II of the discussion draft issued by the OECD in 2001. We also participated in the discussions held in Paris in April 2002. In addition to these further written comments we look forward to participating in further debate on the important issues raised in the revised Part II before any final decisions are taken.
3. As we commented in our earlier submission, we firmly believe that a further period of study will be required in order to arrive at any acceptable and workable solution. Hence we continue to urge that no immediate action be taken before all aspects have been fully worked out. It is equally necessary for the commencement date to be co-ordinated so that confusion, uncertainty and double taxation are avoided.

Capital allocation

4. A central aspect of the discussion draft is the allocation of 'free capital' to PEs. The most significant change in the revised draft is that it acknowledges that it will not be possible to develop a single internationally accepted approach for attributing equity capital (paragraph 120). However, the draft indicates that the general principles for attributing capital should be applied in a flexible and pragmatic manner, with a range of acceptable results and methods (i.e. Basel based approach, bank's internal risk measurement models, measurements of economic capital, quasi thin capitalization approach; and thin capitalization approach).
5. We are not happy that the tax authorities will be able to choose from various alternatives to allocate the capital. We are extremely concerned that the risk of double taxation being incurred has been increased significantly by the abandonment of any single measure of capital allocation. It appears that the original principle that there should not be double taxation has now been

¹ The FBE represents over 4,000 banks in the 15 EU Members States plus Iceland, Norway and Switzerland.

superseded. It is regrettable that the OECD could not reach agreement on one method, but it is essential that this should not be allowed to result in double taxation. In the absence of a common standard, taxpayers will almost inevitably face the risk of double taxation with only the limited protection offered in practice by option of seeking competent authority relief. Even where available this increases the compliance burden and uncertainty for the taxpayer.

6. If the tax authorities cannot reach agreement the taxpayer should be given the option of choice of 'acceptable method of allocation'. It is unacceptable that a taxpayer with branches in say 30-40 countries should be expected to develop and maintain at least 3 main systems for allocation of capital plus those to cover the inevitable variations introduced by each country. We believe that there must be flexibility of method given to the taxpayer. As long as the taxpayer determines the allocation of capital in accordance with the methods prescribed and that the method is consistently applied then such method should be acceptable to the fiscal authority of the country of the PE. If the OECD cannot agree on a common position it is vital that the country of residence accepts the treatment in the branch country or there will be an element of double taxation.
7. On a related matter the Working Hypothesis proceeds on the basis that there is only one clear set of Basle rules being applied. In practice individual regulators apply some discretion and hence there are variations. We presume that the applicable rules should be as applied by the home country regulator but this also needs to be made clear so as to ensure consistency of treatment globally for the bank and to avoid the potential for double taxation arising.
8. We strongly question whether a "thin capitalization" method of capital attribution, according to which every branch is separately required to have the same amount of capital as an independent carrying on comparable functions under comparable conditions, can be appropriate. Such a method is likely to 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. Moreover this risk of double taxation is specifically recognised at paragraph 111 of the draft. It is therefore questionable why a thin capitalisation method could qualify as an approved method under the Working Hypothesis. We had understood that the reason why the original discussion draft had advocated the "top down approach" to allocate the capital (i.e. the attribution of the bank's regulatory capital to PEs) rather than a thin capitalisation approach was the objective of avoiding double taxation. We therefore urge the OECD to resume its previous position in favour of the top down approach and to exclude the thin capitalisation approach from the set of "approved" capital attribution methods permitted by the Working Hypothesis.

Credit rating/Guarantee fees

9. The initial version of Part II stated that a failure to achieve neutrality between residents and non-residents would be unacceptable on tax policy grounds as, *inter alia*, it would produce a discrepancy between the tax results of a branch and of a subsidiary carrying on similar operations. However, instead of amending the Working Hypothesis so as to achieve the stated aim, the revised draft has amended the stated aim itself. Under paragraph 5, the aim of the Working Hypothesis is no longer the achievement of equality between branch and subsidiary. We consider that this undermines the integrity of the process and of the Working Hypothesis.
10. Traditionally branches may have only a modest amount of free capital allocated to them, but they benefit from the entity's overall credit rating and hence from its associated funding rate. Subsidiaries require their own free capital, but fund themselves at their own appropriate funding rate or, alternatively, may pay a guarantee fee to the parent to achieve its lower funding rate.

Under the Working Hypothesis proposals, branches would have a capital attribution broadly in line with the capital of a subsidiary. No funding margin on borrowings from the head office or payment of a guarantee fee would be allowed, due to the attribution of the same credit rating. This therefore appears to make it disadvantageous for foreign banks to operate through branches rather than through subsidiaries.

11. We believe that there is double counting when the capital of the entity is allocated to the branch without any adjustment. In capital terms it should be borne in mind that the whole is indeed greater than the sum of its parts. Accordingly, postulating a series of distinct and separate enterprises for an entity's PEs would result in a shortfall of capital. This needs to be recognised by a payment for a guarantee to cover the shortfall, assuming that a PE will be treated as having the same rating as the parent entity. Accordingly we continue to advocate that, once a PE has had its share of the entity's actual capital allocated to it, if this is insufficient to support the assumed credit rating (such credit status being part of the "same or similar conditions" referred to in Article 7 of the model treaty), an appropriate guarantee fee should be deducted from the profits earned by that PE.

PART III (GLOBAL TRADING)

12. The analysis used in the 1998 and current consultations is based on three theoretical models. It then applies a detailed practical analysis of actual activities including more complex business structures. The process stresses the need to examine the actual facts first and then to analyse them and we believe this approach has proved its worth. We hope it continues in any further drafts and in the final version.

The nature of various risks and their treatment

13. We fully agree that the essence of trading in financial instruments (whether globally or not) is the assumption and management of risk. However, we think that it is important to distinguish between various categories of risk, and also to analyze how risk is assumed and managed. We believe that different risks vary not just in degree of importance, but also in kind. We believe that market risk (and its management) is very much of the essence of trading in financial instruments. However, we believe that operational risk is important, but does not create profit. It is more akin to the personnel function or health and safety management in a manufacturing environment, while market risk is more akin to the manufacturing process itself. We believe that operational risk and the other risks should not be analyzed similarly to credit and market risk. It is also important to recognize that different teams will deal with various aspects of market risk.

Models for rewarding the provision of capital and for the allocation of capital

14. We believe that the assumption that the analysis of Part II of the Report applies equally to trading financial instruments is wrong, and that this aspect should be looked at afresh. It seems to us proper in some circumstances for these to be separate activities giving rise to profit which should be judged and allocated separately. We believe a helpful analysis in this is afforded by comparison

with investment in hedge funds, which in certain circumstances could provide an appropriate 'comparable uncontrolled price' (CUP).

Branch recognition and treatment of "dependent agents"

15. We see the treatment of 'dependent agent enterprises', which is addressed in paragraph 256ff, as an important area, where more analysis would be welcome, and where the issues raised go beyond the concerns of financial traders - general trading, and especially e-commerce are also affected. That said, this does give rise to particular problems for financial traders due to the regulatory framework within which they operate. We note that paragraph 256 of the discussion draft excludes from the scope of the report the examination of the issue as to whether a PE exists where a dependent agent concludes contracts in the name of another group company (the "booking enterprise"). We would like to encourage the OECD to reconsider covering this aspect in the current report.