

COMMENTS RECEIVED BY FEDERATION BANCAIRE FRANCAISE

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)

I should like once again to express the gratitude of the French Banking Federation for the opportunity of expressing its views at the public meeting held by the OECD on 11 and 12 April 2002.

Well aware of the subject's importance, it was with all due diligence that our members examined the new version of Part II and Part III of the reference report on the attribution of profits to permanent establishments.

Attached please find the comments of our Federation, and I thank you in advance for giving them your full attention.

The revised version of Part II of the draft Report is a follow-up to the meeting held in Paris on 11 and 12 April 2002, during which a large number of industry organisations were able to express their views on the topics under consideration. Part III, which for the first time is being submitted to interested parties for their comments, takes up most of the subjects raised and the principles and hypotheses described in Part II.

The FBF has reviewed these revised versions very closely and would like to formulate the following comments.

I. General comments

In respect of Part II, a number of adjustments advocated by industry organisations at the April 2002 public meeting have been incorporated into the revised version, but we deem them too minor for the meeting to have proven as constructive as it was expected to be.

We regret that the new version of this part of the Report takes only partial account of the comments made by numerous industry organisations regarding use of the Basel ratio.

The new version of Part II considers that it is no longer possible to recommend a single, simple method for attributing capital to a permanent establishment. The limited scheme of the first version has been replaced by a presentation of new models for incorporating capital and risks. As a result, the Report does not provide taxpayers with guarantees of legal security, and it introduces the potential for double taxation. The same may be said regarding the attribution of assets, especially insofar as the host country establishes its tax base on the basis of non-consolidated financial statements.

More so than in the past, banks are going to be thrust into uncertainty as regards taxation, which is detrimental to the development of their international activities.

Because of this lack of guidance, it is possible that different methods may be applied from one establishment to another, and within one and the same establishment from one tax audit to another.

The proof of this is the fact that an establishment may elect to use internal criteria rather than the Basel ratio, provided that the criteria are relevant and have been accepted by the appropriate regulatory and tax authorities, with no indication of which authority takes precedence over the other in choosing the applicable method.

In view of this proliferation of methods, it is paradoxical that no concrete proposal has been made to afford rapid relief for all of the consequences of any double taxation.

The emphasis should therefore be put on eliminating double taxation. In this regard, given the large number of different methods it is necessary to provide for corresponding methods of adjustment. To enhance efficiency, the tax authorities of the State in which a bank is headquartered should be invited to recognise the methods used by their counterparts in the jurisdictions in which the bank's branches are located, as long as those methods comply with the OECD principles. This is made especially necessary by the fact that mutual agreement procedures are lengthy and do not necessarily yield results.

Regarding Part III of the Report, we note that it is built upon a rejection of risk transfers and internal guarantees not justified by functional analysis. Nevertheless, such analysis, as presented by the Report, does not adequately take account of the fact that the day-to-day risk-taking function can be shared between an operator and the team that oversees and manages the risks. This reflects a deficient vision of financial organisations. The recognition of such transfers is crucial to a fair allocation of the profits of different financial institutions for tax purposes in the various jurisdictions. Such transfers ought to be recognised as soon as they meet the conditions set forth in the Report and, for that reason, reflect an economic reality.

Moreover, with regard to independent agents, it seems essential to stipulate the common conditions, as determined by the OECD, under which the global trading interventions of such agents can be construed as constituting a permanent establishment. The criteria adopted for this purpose should not impose constraints on a bank's choice of agents (branch versus subsidiary), which in most cases is dictated by legal or regulatory obligations, lest this thwart the development of global trading activities. Furthermore, assuming that a subsidiary is considered a permanent establishment of its parent company in respect of certain activities, it would seem vital that the subsidiary alone should be taxed on the overall result of its activities, i.e. with reward for profits.

Lastly, on a general level, given the technical nature of the themes discussed, the clarity of the Report would be enhanced by a glossary defining the main notions used.

II. Specific comments

Part III, Section B defines global trading and contains a functional analysis of such transactions.

To this end, it presents a discussion of business strategy in a Sub-Section B-2 entitled "Factual situation", and "Functional analysis" in a Sub-Section B-3.

We deem it necessary for the authors of the Report to provide certain additional information in these two Sub-Sections.

Sub-Section B-2

It is our view that the strategies presented in §§21 and 22, while different, are not mutually exclusive. It would be quite possible for an establishment to have a dual strategy, engaging in both a high value-added activity and more conventional lines of business.

In this regard, the draft Report's analysis of the factual situation looks at the human function without making any distinction between qualitative and quantitative aspects, thus generating some confusion as to the nature of the labour required (see §21: "This strategy...followed by some...derivative houses, is very labour-intensive").

The centralised management model presented in §28 of the Report no longer corresponds to reality, the general trend being the elimination of back-to-back transactions following a centralisation of back offices to reduce operating costs.

Analysis of transactions also entails a summary study of the schemes under which transactions are effected, which spotlights the dynamic and flexible nature of the operations carried out. In this regard, the Report stipulates in §37, "In particular, any transfer pricing analysis should proceed as always from the facts and circumstances of the individual taxpayer and should consider the exact functions being performed, assets used and risks assumed, rather than attempt to determine which model the organisation of the trading/risk management functions most closely resembles." But the corollary of this case-by-case approach is legal insecurity for the taxpayer.

In addition, the Report does not state, in respect of transfer pricing, the implicit consequences of a situation in which the central function in charge of assessing, authorising and monitoring risk-taking would be disconnected from the centre of operations (selling or trading) that generated the risks in question. In this case, the principle of remunerating this central function overseeing risks must be recognised, in the form of a guarantee commission or an allocation of profits.

Sub-Section B-3

This part describes the main functions performed by firms engaging in global trading.

With regard to the role of sellers, §44 stipulates that "a key difference is that in global trading businesses it is the traders, rather than the marketers, that normally undertake functions leading to the assumption of market risk, even though the marketers may assist the traders to do this in some situations." We feel that this affirmation ought to be qualified, especially in the case of structured products, insofar as sales functions may be very closely integrated with trading functions. Here, sales personnel represent far greater value added than a mere assistant's role.

While the descriptions of treasury and support functions prompt no comments, the descriptions of dealing and day-to-day risk management functions warrant a number of clarifications:

- The term "dealing" is *inappropriate* because it is associated with the intervention of a market-maker. To avoid any confusion, we feel this should be replaced by the term "transactions on behalf of clients" as opposed to "proprietary transactions".
- We feel that the term "market making", in respect of which the French text uses the expression *teneur de marché*, ought to be translated as *intervention de cotation de prix*, insofar as the former, in our view, conveys a more specific meaning.

It is stated in §66 that computer systems are “critical to the proper functioning of a global trading operation”. In many cases, their role is not limited to carrying out transactions but also contributes to the strategic development of the business, providing in fact high value added.

Moreover, analysis of the strategic risk management function cannot be limited to the function as described in §72. In some cases, it does not correspond to organisational reality if risk-taking decisions are validated, supervised and managed by a useful, high value-added function, which cannot be considered a support function.

With regard to review of risks assumed, and more particularly risks classified in category c—operational risk and other risks—we think it would be useful to spell out more clearly or to define what the OECD refers to in §94 as “Herstatt risk”.

Part III, Section C examines the application of the arm’s length principle to global trading conducted between associated enterprises.

To this end, Sub-Section C-1 deals with transfer pricing methods, and Sub-Section C-2 identifies the main globalised transactions linked to each of the functions analysed above. Sub-Section C-3 deals with application of profit-based methods in a more detailed manner.

In our view, the authors of the Report ought to clarify a number of points in these three Sub-Sections.

Sub-Section C-1

With respect to transfer pricing methods (§§104ff), the Report indicates that “there may be little difficulty in using traditional transaction methods and in finding comparable transactions so that an arm’s length price or gross margin can be determined”. In most cases, it is impossible for firms to find such comparables if the figures in question result from the business policies of competitors with which no communication exists. As a result, the difficulties in finding comparable data cited in §107 are going to be the rule.

Sub-Section C-2

Regarding Item (i) “Sales and Marketing”, it should be noted that sales personnel may perform operations that generate credit risks that are authorised and supervised at another location. In such a case, it may be necessary to acknowledge the transfer of credit risk, depending on the level of intervention of that location.

Under Item (ii), the statement that the “monitoring and strategic risk management functions ... generally do not give rise to the assumption of market risk” strikes us as narrowing the scope of the functional analysis and for this reason closes the door on economic models that are nonetheless in use.

In particular, this would seem to preclude using a hedge fund method, whereas §§145ff would appear, on the contrary, to validate the method.

Here, we feel a distinction is needed, depending on whether we are in the presence of two separate legal entities or not, insofar as this paragraph strikes us as difficult to apply in respect of a sole legal entity.

Lastly, we feel that the example cited in §127 about internal hedging transactions seems to introduce a presumption of abuse which strikes us as dangerous and unfounded. An internal transaction should not be eliminated if it serves an economic purpose for the head office which may be independent from the establishment’s trading function.

As stated earlier, the function presented in §134 as “support ... in systems and intangible development” is in fact, in respect of structured products, a highly integrated function and thus one with substantial value added; in some cases, we feel that the profit-splitting method is more appropriate than cost-plus.

Regarding Item (iv) on the role of capital, §148 seems to be aimed at management companies. If this is the case, it would probably be useful to say so explicitly.

Sub-Section C-3

In our view it is important, in the principles applicable to the transactional methods examined in §150, to establish the principle that the reference situation is always the mark-to-market rule.

Presented in §156, the contribution profit split method poses the problem of ascertaining the relative contributions of each party. This is a difficult process to implement if the functions performed are not equivalent.

As stated under (ii) (a), the application of profit-sharing methods to global trading entails beginning by identifying the functions to be rewarded by a share of the profit.

In doing so, while we share the analysis in §163, it is nonetheless a fact that certain *support* functions, even if they “play significant roles in determining the profitability of the whole operation”, still involve support. Consequently, we do not think it necessary to put the back office director and traders on the same level (*conversely, see our comments on §134*).

Moreover, the scope of §164 in respect of “the risks assumed from the performance of ‘people’ functions” ought to be clarified.

Next, as indicated under (ii) (b), application of profit-splitting methods to global trading entails measuring the relative contribution of functions - weighting of the factors.

It is stated in §169 that “where compensation is used to measure both the trading and marketing functions, the compensation of the traders could be multiplied by 1.5 where it could be demonstrated that trader compensation results in the earning of 1.5 times the profit earned from marketers’ compensation”. Beyond this example, we would like to see some clarification as regards the determination of such a multiplier. Furthermore, because these methods are subjective (choice of weightings), they are tricky to implement and open to challenge. Their use may be exceptional.

Lastly, as indicated under (ii) (c), application of profit-splitting methods to global trading entails determining the relative contribution of each location – measurement of factors.

If, as stated in §170, there is a correlation between the earning of profit for the firm and the earning of compensation for individuals, it is nonetheless important not to misunderstand the limitations on the use of this factor, stemming *inter alia* from the existence of corporate incentive policies. In addition, in certain locations bonuses may in some cases be guaranteed or pooled. In any event, information about bonuses is extremely sensitive, is obtained with difficulty and after a considerable lag, and needs to be handled with care.

In addition, we gather from §177 that no adjustment ought to be made, in respect of the cost of living, for example. In point of fact, if we assume that the higher the cost of living, the higher the salaries, it would mean that persons paid higher salaries generate a relatively greater profit, which does not seem

economically sound. For this reason, we believe that the use of relevant corrective indices would be justified in certain cases.

Lastly, the transactional profit-splitting method based on an allocation and incorporating compensation and bonuses shows its limitations when the business in question generates a loss. If that is the case, as an exceptional hypothesis, we nonetheless believe that the overriding consideration ought to be the permanence of the method, the coherence of which needs to be assessed over time, recommending that allocation methods be maintained. In the event of a loss, any bonuses paid would no longer be considered variable performance-linked pay but would be incorporated into base compensation. If this were not the case, another allocation key could be considered.

Section D examines special issues involving the application of the arm's length principle to global trading enterprises operating through a PE.

Sub-Section D-1

The attribution of “free” capital evoked under (iii) (a) prompts the following remarks:

1. The lack of guarantee surrounding the determination of the capital endowment

In respect of attribution of “free” capital, the draft Report recognises the use of internal corporate models, and necessarily those of banks. This entails communication of such internal models so the tax authorities concerned can check that arm's length conditions have been met. The Report does not, however, address the crucial issue of the consequences in terms of double taxation if the tax authorities of one of the jurisdictions have not validated the internal model.

It is explained in §219 that the use of particular models could be approved as long as the models were consistent with the arm's length principle “and sufficient details, for example the assumptions underlying the bank's internal model, are made available to all the relevant tax authorities”. However, communication of such internal models poses not only the problem of confidentiality but also, in some cases, that of document intelligibility. For example, the fact that in France there is no obligation to comply with regulatory ratios at the level of non-consolidated financial statements often leads to inadequacy of internal models and incomprehension on the part of the tax authorities.

2. Reversing the burden of proof

In order to protect States against transfers of assets and risks for tax reasons, the Report provides that it is the taxpayer's responsibility to show clearly that a transaction ought to be considered as resulting in such a transfer.

As it is written, §252 puts the burden of proof on businesses to demonstrate that a transfer is in no way tax-motivated. The notion of exclusivity is not taken up here, placing firms in a delicate legal position.

Sub-Section D-2

Regarding the determination of the profits of a theoretically distinct enterprise on the basis of a comparability analysis—a theme developed in this Sub-Section—the principles set forth in §§245ff would seem to work only in the case of centralised management. It would be useful for the final version of the Report to express an opinion on this subject.