

# INSTITUTE OF INTERNATIONAL BANKERS

299 PARK AVENUE, 17<sup>TH</sup> FLOOR, NEW YORK, N.Y. 10171  
TELEPHONE: (212) 421-1611 FACSIMILE: (212) 421-1119  
HTTP://WWW.IIB.ORG

LAWRENCE R. UHLICK  
EXECUTIVE DIRECTOR AND GENERAL COUNSEL

May 30, 2003

John Neighbour  
Head, Tax Treaty, Transfer Pricing  
and Financial Transactions Division  
Organization of Economic Cooperation and Development  
2, rue André-Pascal  
75775 Paris

Re: Comments on the OECD Discussion Draft on the  
Attribution of Profits to Permanent Establishments,  
Revised Part II (Banks) and Part III (Global Trading)

Dear John:

This letter sets forth the comments of the Institute of International Bankers on the OECD Discussion Draft on the Attribution of Profits to Permanent Establishments, Revised Part II (Banks) and Part III (Global Trading), released March 4, 2003.

Once again, the Institute commends and thanks the OECD for soliciting the input of the business community in the course of developing its position on these complex and important subjects. While we continue to disagree with key aspects of the approach that is reflected in the Discussion Draft, we believe that, as a result of this dialogue with the business community, the report more accurately describes the relevant business activities and responds to various concerns that had been expressed regarding the OECD's prior releases on these subjects.

In the interest of brevity, this letter focuses primarily on new issues raised by this Discussion Draft, rather than repeating the points that were developed in our previous submissions, although reference is made to some of those key points in order to highlight certain critical implications of the approach that is being proposed by the OECD.

As noted in our June 2001 Comment, we believe that the Discussion Draft should be evaluated primarily based on (i) its practicality and administrability, (ii) the extent to which it comports with the arm's length principle, and (iii) the extent to which it fosters uniformity and minimizes the risk of multiple (or less than single) taxation. The revised Discussion Draft generally improves upon the prior releases in respect of these objectives, although for the reasons set forth below and in our previous submissions, we continue to have serious concerns and reservations regarding the revised Discussion Draft.

---

The Institute's mission is to solve the many special legislative, regulatory and tax issues confronting **internationally headquartered** financial institutions that engage in banking, securities and/or insurance activities in the United States.

---

# INSTITUTE OF INTERNATIONAL BANKERS

## **1. The Discussion Draft should more explicitly adopt the Guidelines' approach of requiring taxing jurisdictions to accept results that are within an arm's length range, regardless of the method selected by the taxpayer.**

The revised Discussion Draft emphasizes that its purpose is to provide a framework and guidelines for attributing profits to a permanent establishment ("PE") in accordance with Article 7(2) of the OECD Model Tax Convention, and that these guidelines should be based by analogy on the 1995 OECD Transfer Pricing Guidelines (the "Guidelines"), which provide guidance on the application of the arm's length principle of Article 9.

The touchstone of the Guidelines – reflected as well in the Discussion Draft – is a functional analysis that allows a taxpayer to rely on (one or more of) a number of acceptable methods to arrive at a result that falls within an arm's length range. However, at several critical junctures, including most prominently in connection with the measurement of risks attributable to a PE and the selection of an approach to attribute capital to a PE, the revised Discussion Draft indicates that the taxing jurisdiction may adopt a specific approach and require taxpayers to follow that approach.<sup>1</sup>

We recommend that the Discussion Draft more explicitly provide that any approach that is adopted by a taxing authority is nonetheless subject to the arm's length standard of the Guidelines (as modified by the Discussion Draft), and that a taxpayer's results should be accepted by a taxing authority if they fall within the arm's length range as determined under that standard, regardless of whether the taxpayer applied the specific method prescribed by the taxing authority.

Thus, for example, under an income tax treaty that follows the OECD Model Treaty, a taxpayer should be free to apply any acceptable approach to determine the amount of capital attributable to its various PEs, even where that approach departs from the method prescribed by a country's domestic tax rules. This is particularly fitting in view of the Discussion Draft's recognition that "any of the approaches described in [the Discussion Draft section] are capable of producing an arm's length result in general, although there may be particular situations where the approach does not produce an arm's length result and so flexibility may be required and other approaches used."<sup>2</sup>

By placing all components of the attribution of profits to a PE within the arm's length framework and enabling taxpayers to apply a uniform arm's length method in all jurisdictions, this clarification is likely to reduce the number of (i) controversies between taxpayers and tax authorities, (ii) competent authority proceedings and (iii) situations in which

---

<sup>1</sup> See Discussion Draft, Part II, Paragraphs 93 and 123. Compare Part II, Paragraphs 121 – 122, and Part II, Annex 2, Paragraph 11.

<sup>2</sup> Discussion Draft, Part II, Paragraph 121.

# INSTITUTE OF INTERNATIONAL BANKERS

there is a risk of multiple (or less than single) taxation, and will also likely reduce administrative burdens on both taxpayers and tax authorities.

## **2. The Discussion Draft should permit taxpayers greater flexibility in applying the functional analysis in a manner that (i) is consistent with the Guidelines and the arm’s length principle and (ii) reduces compliance costs and burdens.**

The revised Discussion Draft more accurately and realistically depicts the various functions and factors that are involved in creating and managing financial assets. For example, the revised Discussion Draft more clearly acknowledges the importance of appropriately remunerating the contributions of various categories of “people functions” other than marketers, traders and market risk managers (including for example, those responsible for evaluating, assuming and managing credit risk). The revised Discussion Draft also sensibly recognizes the problems and limitations in mandating the use of the BIS ratio approach for allocating capital.<sup>3</sup>

Nonetheless, the Discussion Draft continues to be overly prescriptive, and thereby appears to depart from the arm’s length principle, as articulated in the Guidelines, in several significant respects, including the following:

*a. The exaltation of “people functions.”* As previously noted, the Working Hypothesis (“WH”) articulated by the Discussion Draft is unduly anthropocentric, in that it does not adequately acknowledge the independence of various factors from “people functions.” Our prior submissions focused on the treatment of capital (including internal guarantees) under the Discussion Draft, where this phenomenon is most obvious, and the treatment of capital continues to concern us for the reasons previously discussed.

Another, analogous, area that is not properly and adequately addressed is the attribution – and remuneration of the contributions – of intangibles, including technology and other systems; reputation; relationships with customers, investors and the capital markets; management and operating efficiencies; size, etc. As with capital, it does not appear to be satisfactory to maintain that these intangibles should be attributed entirely to where they are “used” (*i.e.*, where the “people functions” leading to the creation and risk management of financial assets takes place).<sup>4</sup>

---

<sup>3</sup> In this regard, we welcome the acknowledgement that accommodations may be appropriate in the application of a BIS ratio approach to take account of differences in conditions, temporary surpluses, solo-consolidated regulatory rules and other factors, as well as the recognition that other alternative approaches (including relying on a bank’s own risk management models for allocating regulatory or economic capital, quasi-thin capitalization and thin capitalization approaches) may be adopted (*see* Discussion Draft, Part II, paragraphs 85 – 123).

<sup>4</sup> We understand that certain aspects of the treatment of intangibles may be addressed in the revision of Part I, and we look forward to reviewing that document.

## INSTITUTE OF INTERNATIONAL BANKERS

*b. The adoption of an “ownership” model.* The revised Discussion Draft explicitly adopts an “ownership” model, whereby assets are fragmented and allocated to different locations based on where the “people functions” relating to the creation and management of those assets takes place. In so doing, the Discussion Draft consciously rejects other business models that are commonly found, both in dealings between unrelated parties and between associated enterprises (“AEs”). In particular, it is unfortunate that the Discussion Draft is unwilling to entertain a joint venture/service provider model, where one participant is respected as the owner of the asset and remunerates one or more service providers (including, where appropriate, through an allocation of virtually all of the residual profit and loss).<sup>5</sup>

In many circumstances, a joint venture/service provider model more accurately reflects the economic and legal arrangements between PEs, and it is likely to be considerably easier to administer. Given that unrelated parties, as well as AEs, can and do enter into such arrangements, is the intention of the Discussion Draft to override such arrangements between PEs even if they are explicitly documented and, if so, how is that position to be reconciled with the arm’s length principle?

*c. Application of the “hypothesized functionally separate enterprise” concept without sufficient regard for the realities of an integrated single enterprise operating through PEs.* The revised Discussion Draft notes that “the aim of the WH is not to achieve equality of outcome between branch and subsidiary,”<sup>6</sup> which generally seems reasonable. However, in the course of providing guidance for applying the hypothesized functionally separate enterprise concept to PEs, the Discussion Draft seeks to treat a PE as if it were a completely separate company, without adequately taking account of its being part of an integrated single enterprise. As discussed in point 3, below, as well as in our previous submissions, this has negative and distortive implications for the treatment of off-balance sheet items, capital and other items.

We recommend that the OECD remove these artificial constraints on the application of the arm’s length principle that are contained in the Discussion Draft.

We also recommend that the Discussion Draft specifically permit taxpayers to utilize simplified methodologies and assumptions on a consistent, objective basis, in order to minimize the administrative burdens and costs of complying with the WH. Such a clear statement would provide greater assurance to taxpayers than the revised Discussion Draft’s response to taxpayers’ concerns regarding the perceived compliance burden, that “it is worth noting that like transfer pricing generally, tax administrations are unlikely to incur the

---

<sup>5</sup> The revised Discussion Draft also does not address many obvious issues relating to the application of an ownership model, including the tax consequences, if any, of any implicit shifts in debt and equity capital arising from the original acquisition of an asset and its subsequent transfer to another part of the entity.

<sup>6</sup> Discussion Draft, Part II, Paragraph 5.

# INSTITUTE OF INTERNATIONAL BANKERS

administrative cost of initiating a transfer pricing analysis unless the adjustments to the attribution of profits are likely to be material.”<sup>7</sup>

### **3. Because the distortions created by off-balance sheet items are not limited to “extreme” situations, the Discussion Draft should permit appropriate adjustments to address such distortions in all relevant cases.**

We appreciate the Discussion Draft’s recognition that while an enterprise requires capital in order to assume risks arising from off-balance sheet items, these items do not require debt or equity funding, and therefore an independent enterprise would probably invest that capital in income-producing assets which, in the “extreme situation” of a PE that has no on-balance sheet assets, might be deemed “loan” to the treasury location within the enterprise.<sup>8</sup>

We have previously demonstrated at length that off-balance sheet items have the potential to create significant distortions not only in that “extreme situation,” but whenever a PE conducts a business with significant off-balance sheet exposures that is functionally distinct from its other business operations. Our June 2001 Comments used as an example a PE with a commercial loan business and a separate currency swaps business.<sup>9</sup>

In our April 18, 2002 letter, we stated that,

“the off-balance sheet positions of international banks can be enormous and can fluctuate dramatically in amount and geographical location. We respectfully submit that it is inconsistent with the arm’s length principle (and with commercial reality and common sense) for the WH to prescribe that the capital that supports the off-balance sheet exposures of a PE is always deemed to be invested in the on-balance sheet assets of that branch, other than government securities. In practical terms, this means that bank branches will often be faced with disallowances of interest expense on their deposit and other liabilities that will represent an exceptionally large percentage of their funding, and that will vary in often haphazard and uncontrollable respects. *The WH will place branches at a competitive disadvantage with domestic banks operating in the same market to a degree that cannot possibly be justified under the arm’s length principle, even accepting that the taxation of branches and subsidiaries cannot be identical.*”

Therefore, we recommend that the Discussion Draft be revised to permit appropriate adjustments (including deemed “loans”) to reflect the investment of the capital attributable to off-balance sheet items in assets other than those of the PE’s unrelated business. While we favor addressing the problems presented by off-balance sheet items through a simpler,

---

<sup>7</sup> Discussion Draft, Part II, Annex 2, Paragraph 11.

<sup>8</sup> Discussion Draft, Part II, Paragraphs 127 – 128.

<sup>9</sup> See paragraphs 45 – 57 of the OECD’s reprint of our June 2001 Comments.

# INSTITUTE OF INTERNATIONAL BANKERS

alternative approach to capital attribution, this minimum recommendation would mitigate the problems under the WH.

#### **4. It is critical that internal transfers of risk that are effected on an arm's length basis be respected.**

The Discussion Draft invites comments “on the issues relating 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>10</sup> The Discussion Draft also notes that some countries consider that the position of the WH regarding risk transfers does not provide sufficient protection against tax-motivated transfers of assets and risks.<sup>11</sup>

The request for comment is curious, in view of the Discussion Draft's acknowledgement that credit risk may be evaluated, managed and borne in different locations (and apart from market risk),<sup>12</sup> and that similarly other forms of risk may be evaluated, managed and borne in different locations.<sup>13</sup> The recognition of such transfers is essential to the proper allocation of profits of financial institutions among different taxing jurisdictions. Obviously, such transfers should be acceptable, at least where the transfers meet the condition imposed by the Discussion Draft that the transfers reflect “a real and identifiable event, i.e., a genuine change in the part of the enterprise that is managing” the risks.<sup>14</sup> In our view, this condition – which we do not favor because it does not conform to market practice, whereby risks may be borne by entities that do not necessarily manage them to the extent that the Discussion Draft evidently requires – should provide sufficient protection against tax-motivated transfers.

#### **5. The Discussion Draft should be revised to permit all of the profit or loss attributable to an agency PE to be allocated to, and reported by, the dependent agent AE.**

The Discussion Draft provides that in cases where a PE arises from the activities of a dependent agent, “the host jurisdiction will have taxing rights over two different legal entities – the dependent agent enterprise (which is a resident of the PE jurisdiction) and the dependent agent PE (which is a PE of a non-resident enterprise).”<sup>15</sup>

This result may be the theoretically correct result under the OECD Model Treaty, but it is completely impractical in the context of global trading, and produces unacceptably large

---

<sup>10</sup> Discussion Draft, Part III, Paragraph 250.

<sup>11</sup> Discussion Draft, Part III, Paragraph 252.

<sup>12</sup> See Discussion Draft, Part II, Paragraphs 173 – 183; Part III, Paragraphs 245 – 250.

<sup>13</sup> See Discussion Draft, Part III, Paragraphs 48 – 57.

<sup>14</sup> See Discussion Draft, Part III, Paragraph 247.

<sup>15</sup> Part III, Paragraph 257.

## INSTITUTE OF INTERNATIONAL BANKERS

tax exposures and compliance and administrative burdens. The issue of when and under what circumstances a PE arises in the global trading context is one of the most difficult issues presented by global trading,<sup>16</sup> and for a typical multinational banking and securities group, can result in scores of potential agency PE risks, involving many companies, within the group.

We recommend that the OECD adopt a practical approach to the problems presented by agency PEs in the global trading context, by permitting all of the profit or loss attributable to an agency PE to be allocated to, and reported, by, the dependent agent AE. We believe that such an approach is amply supportable under the arm's length principle.

Specifically, if an agency PE is deemed to exist in a given situation, the principal AE and the dependent agent AE can reasonably be regarded as having agreed to enter into a joint venture partnership, in which the agent acts as a service provider and the principal provides capital and other functions. Independent parties acting at arm's length in such a situation may very well agree between them that income of the principal AE that is attributable to activities of the dependent agent AE (which would ordinarily be allocated to the agency PE) should instead be allocated and paid to the dependent agent AE. Such an arrangement, we assume, would generally be respected under the partnership taxation rules of most countries.

In the context of global trading operations, one could reasonably envision AEs, acting on an arm's length basis, entering into such an arrangement. One common situation in which the risk of an agency PE may arise is where each AE conducts substantial operations for its own account in its home country, but as an ancillary matter also exercises discretionary authority with respect to financial instruments maintained by its foreign affiliates (for example, to fill its own customers' orders from time to time or to protect its affiliates' trading books from adverse market changes during off-business hours). It would seem perfectly rational and arm's length for each AE to cede to its affiliates on a reciprocal basis the income and losses (as well as the taxation thereof) attributable to the ancillary exercise of discretionary authority by the other AEs.

Another common situation in which the agency PE issue arises involves an AE that is a broker-dealer located in a particular country and that, for regulatory or legal reasons, must execute and book its transactions for the account of an affiliate located in another country. In that case, subject only to any regulatory or legal constraints, parties acting at arm's length can reasonably allocate all the income or losses attributable to the activity (net of funding costs) to the broker-dealer that is in the first country, with the exception of a ministerial/service fee for the limited contribution of the foreign affiliate.<sup>17</sup>

---

<sup>16</sup> See OECD, *The Taxation of Global Trading of Financial Instruments*, paragraph 230 (1998).

<sup>17</sup> Indeed, the broker-dealer in the first country might reasonably be viewed as the principal, acting for its own account, and as having borrowed the balance sheet of its affiliate for a fee.

Where regulatory or legal constraints preclude all of the profits and losses from being paid to/borne by the

## INSTITUTE OF INTERNATIONAL BANKERS

Based on the foregoing joint venture model, AEs that are faced with the potential risks and adverse consequences of agency PEs should be permitted to elect to specially allocate all of the profits and losses of the agency PE to the dependent agent AE under specified conditions, such as those outlined below. While taxpayers would still be responsible for all tax liabilities owed in respect of the agency PE to the country in which it is deemed to exist, the administrative burdens of multiple tax return filings as well as potentially significant ancillary adverse substantive tax consequences would be avoided.

To implement this suggested approach, we recommend that the Discussion Draft confirm that, consistent with the arm's length principle and the deference accorded under the 1995 Guidelines to the manner in which taxpayers structure and characterize transactions between AEs, taxpayers may choose to adopt a joint venture model under the following conditions, and member states should be encouraged by the OECD to implement this approach through appropriate regulations and procedures:<sup>18</sup>

- a. The amount of profit or loss of each agency PE, determined in accordance with applicable rules (including Article 7 of the Model Treaty and the arm's length principle), if and to the extent not otherwise reported on an income tax return that is filed by the principal AE, may be allocated to and reported on the tax return of the dependent agent AE, provided that the conditions set forth in paragraph b, below, are satisfied.
- b. The dependent agent AE must include with its tax return an information statement identifying each participant in the business activity whose income or loss from such activity that is attributable to the country in which the dependent agent AE is filing the tax return is included in the dependent agent AE's tax return and stating that such participant is not an actual (formal) branch of the principal AE in that country. The information statement may list participants on a protective basis without conceding that they have an agency PE in the taxing jurisdiction.
- c. The dependent agent AE would be treated for all substantive tax purposes as earning the income (or incurring the losses) of all participants in the business activity that are properly identified in the statement referred to in paragraph b, above. Adjustments to the aggregate amount of income or loss of such

---

broker-dealer in the first country, the proposed approach (as discussed below) would treat the full amount as having been received (or paid) by the broker-dealer and then re-transferred as a contribution or distribution, as appropriate, with the pertinent ancillary tax consequences applying.

<sup>18</sup> Obviously, however, consistent with the arm's length principle, taxpayers should not be required to make a special allocation of profits and losses of an agency PE to the dependent agent AE under a joint venture model. Independent parties acting at arm's length can reasonably conclude that the dependent agent AE should be compensated only for the services of its traders, marketers and other personnel, and that the principal AE should bear the risk (and earn the return) attributable to the use of its capital, in which case the principal AE would be subject to tax on the profits attributable to the agency PE.

## INSTITUTE OF INTERNATIONAL BANKERS

participants would be made in the first instance with respect to the tax return of the dependent agent AE. The dependent agent AE would be responsible for any understatement of tax (as well as for interest and penalties) in respect of the income of such participants from the business activity.

- d. Notwithstanding paragraph c, each participant will also have joint and several liability with the dependent agent AE in respect of any understatements of tax, as well as interest and penalties, in respect of such participant's allocable share of income from the business activity. However, so long as the statement referred to in paragraph b, above, was properly filed, the participant will not be subject to the disallowance of deductions or other penalties for failure to file a tax return (or to pay any amount of tax that is included in the return of the dependent agent AE) in respect of an agency PE.
- e. If and to the extent that the dependent agent AE that reports income (or losses) of other participants does not receive (or pay) amounts corresponding to such income (or losses), or have a receivable (or payable) in respect of such amounts bearing interest in accordance with the arm's length principle, it would be deemed to have received (or paid) such amounts and such amounts would then be deemed to have been transferred to (or from) the respective participants as distributions or contributions, as appropriate.

\* \* \*

Please feel free to contact, in New York, the undersigned (212-421-1611; [luhlick@iib.org](mailto:luhlick@iib.org)) or the Institute's tax counsel, Yaron Z. Reich at Cleary, Gottlieb, Steen & Hamilton (212-225-2540; [yreich@cgs.com](mailto:yreich@cgs.com)), if we can be of further assistance in this matter.

Very truly yours,



Lawrence R. Uhlick  
Executive Director and  
General Counsel