

COMMENTS RECEIVED FROM KOREAN FEDERATION OF BANKS

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)

Part II (Banks)

(1) Transitional Measure: We propose a transitional measure for at least three years before applying the terms of this particular part of the transfer pricing guideline to banks. Each member country may have different domestic laws and regulation, and legislative process also differs each other. Most of member countries would have to revise the present banking, foreign exchange, supervisory, tax, and accounting rules to reflect the concept of arm's length principles, and if so, each country should decide how the administration and legislative body should perform the task. We think it unacceptable to rely on the future judicial process and/or the mutual agreement procedure with no revision to domestic laws in advance, rendering the principle in this guideline untested under domestic law.

(2) Para 2: There are a few unusual characteristics of banks, such as quasi central banks, and banks in corporate reorganization. Their objective for banking is on national interest or major creditors (usually government) interest, rather than maximizing shareholder wealth. It should be useful to include a remark on whether the transfer pricing regime would apply to a limited extent in such unusual, or temporary circumstances.

(3) Para 29: It is true that any evaluation of creditworthiness is usually undertaken by reference to the bank as a whole or to specific financial instruments and not to individual branches. This statement appears to support the use of an apportionment formula on the basis of overall capital or assets employed, and therefore proper reference should be made to the application of an arm's length principle. It may be useful to have such reference in addition to the present exceptional situation.

(4) Para 38: This paragraph requires banks to book its assets in the country in which most of the profits related to those assets are in fact earned. When foreign exchange restrictions are regulated by a central bank to a limited extent, we think that it is not entirely the bank's decision where to book. Banks in such situation would need a transitional measure when regulatory restrictions are imposed. Also, similar rules should apply to a booking location for funding or financing (treasury functions), as well as loan assets (sales and trading). In general, the guideline is based on an assumption that treasury function supports sales and trading, and we think it possible to have a permanent establishment whose main function is treasury.

(5) Para 52: The draft duly pointed out that "dealings between a PE and the rest of the enterprise of which it is a part normally have no legal consequences for the enterprise as a whole." Due to such a reason, domestic laws tend to ignore or reject the dealing recognized for the purpose of transfer pricing. Absent

regulatory revisions, transfer pricing rules hardly take effect in a host country. International consensus will be required to give rise to necessary revision to domestic laws and regulation.

(6) Para. 56: We particularly noted the sentence: “For example, while taxpayers may book assets in a particular jurisdiction, the results of such booking practices should not be respected where they are inconsistent with the functional and factual activities.” This remark might give rise to great tax risk and exposure when no consideration is given to regulations and other elements that drove the bank to choose a booking location. In other words, location value from the perspective of a host country would have to be considered.

(7) Para. 58: In addition to “people functions,” we suggest that you include “degree of importance and value of knowledge collected and used in the dealings in light of ultimate profits earned.” Value of knowledge and information should also be taken into consideration.

(8) Para. 61: The term “economic owner” invites concern over a wide variety of approaches in determining an economic owner. Further explanation should be warranted after the term is used, for example, by referring to previous work products of OECD concerning the substance over form principle. The term has been used throughout this draft, *e.g.*, in Paragraph 171. Each country would have a variety of cases in determining this important terms which may vary. In the future, efforts may be exerted at an international level to develop workable solutions on the subject.

(9) Para. 63: Again, the paragraph includes a strongly expressed view in regard to a booking location. There will be different views in determining whether a location in question is “where none, or very few, of the functions related to their creation or subsequent management were performed.” Different views will result in a bank’s bearing the burden of double taxation. At least in the interim period, a mechanism may be necessary to resolve conflicted views among countries concerned.

(10) Para. 68: We suggest that several examples be provided to help understand why and how such key entrepreneurial risk-taking functions are evaluated. Further, to understand how much would be regarded as significant relative value, *e.g.*, 10% or 20%.

(11) Para. 83: The conclusion means that banks should apply an arm’s length principle separate from existing regulatory requirements. Such application is not desirable, among other reasons, because it incurs additional compliance costs to banks.

(12) Paras. 103 and 108: The economic capital allocation approach seems to require a bank to allocate a substantial sum of its resource to properly apply relying on economic analyses of banks. However, there is no specific guideline. As to Para 108, when a thin capitalization rule is applied on an arm’s length principle, and a same or similar circumstance may be found and may apply to support a taxpayer’s debt situation, albeit its strong logical background, we experienced difficulty or found it almost impossible to locate such same or similar circumstances. Likewise, we expect that the economic capital allocation approach may be good in theory, but practicality is minimal.

(13) Para. 120: We particularly support the view that “it will not be possible to develop a single internationally accepted approach for making that attribution of capital, including ‘free’ capital.” We also

support the view that “it will not be possible to develop an internationally accepted hierarchy of approaches [to capital attribution].”

(14) Para. 123: We noted that there is significant likelihood that each jurisdiction may not adopt the same approach to attributing capital, which will result in double taxation. Accordingly, there will be more cases that have to put through the Mutual Agreement Procedures under the relevant tax treaty. In this regard, it will be absolutely necessary to improve the present Mutual Agreement Procedures, such as taking into account an arbitration approach as accepted by respective domestic law of the relevant jurisdiction.

(15) Para 129: The second and third sentences seem to need further explanation, and a more straightforward expression should be used. We think that an arm’s length principle should apply in the case where all the operations of PE are funded by borrowings from third parties, and in most cases, still “free” capital would arise due to the fungibility of funds. In fact, paragraph 130 needs to include a few cases for illustration purposes, in a separate note or annex. In the latter paragraph, it becomes clearer that free capital nevertheless should apply under normal circumstances, *e.g.*, Para. 169. See our comment in (18) below.

(16) Para 132: It is not currently supported by banking regulation that any economic relationships (dealings) exist between the hypothesized distinct and separate enterprise and the rest of the bank. Banks will need domestic law and regulations to support such economic relationships, and to create and maintain contemporaneous documentation as indicated in Paragraph 141. With no such law and regulations, banks will not have the justifications to their respective supervisory organizations.

(17) Para. 152: We think that the degree of sophistication of regulators should also be taken into consideration in a less or more regulated market in regard to the fourth comparability factor (economic circumstances).

(18) Para. 169: Internal interest that compensates treasury functions clearly should be determined by taking into consideration “free capital.” Even in cases of fully debt-funded basis, in most circumstances, “free” capital should be taken into consideration. We think it worthwhile to mention the exceptional circumstance where no “free” capital can be attributed.

(19) Para. 173: We noted and agree with the view that the sales/trading function is generally the key entrepreneurial risk-taking function that leads to the initial assumption of all the risks related to the newly-created financial assets. Therefore, the booking location may be the place where such function is performed. But, the paragraph also mentions that dealings could lead to another location assuming and bearing those risks. It would be useful if you present at least one simple example.

(20) Para 187: In regard to transfers of existing financial assets, we need clarification as to the situation where some country’s domestic law does not recognize loss transaction between related parties. Perhaps, you should again refer to the arm’s length principle, and such non-recognition of loss transaction should be justified by an arm’s length principle.

Part III (Enterprises Carrying on Global Trading of Financial Instruments)

We formulated comments as to those areas that OECD had particularly invited public comments:

(1) Page 38: How loss situations would be dealt with in cases where a transactional profit split method is applied.

We think that loss situations must have arisen due to a variety of reasons. Common reasons are market penetration motive, bank's function in relation with national interest due to the fact that its major shareholder is the government, and banks under corporate reorganization or one of the merger and acquisition schemes. The comparable situation used in profit split method should take into account such motives as well as location benefits where global trading takes place through a particular PE.

(2) Page 53: Issues related to the risk shifting from one part of an entity to another, particularly transfers of credit risk and whether the use of internal credit derivatives would be acceptable.

We think that the transfer should be accompanied by real transfer of functions and risk, rather than simply through documentation. We concur with the analysis in Para. 173 of Part II, in that any transfer of risk would have to be accompanied by a transfer of risk management functions. The use of internal credit derivatives appears to be on-paper transfer. Although such transfers may be useful for regulatory purposes, it is not sufficient for transfer pricing purposes.

We trust that the foregoing comments will be useful in your efforts of finalizing the guidelines.