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**DIRECTORATE FOR FINANCIAL, FISCAL AND ENTERPRISE AFFAIRS  
COMMITTEE ON FISCAL AFFAIRS**

**Working Party No. 6 on the Taxation of Multinational Enterprises**

**CONSULTATION WITH BUSINESS ON THE OECD DISCUSSION DRAFT ON THE ATTRIBUTION  
OF PROFITS TO PERMANENT ESTABLISHMENTS (PARTS I & II)**

**Case Study C: Functional analysis, recognition of dealings, characterisation of dealings, attribution of capital to a Banking Permanent Establishment, split functions.**

*This document is FOR DISCUSSION on Friday 12 April p.m. at the Meeting to be held on 11 and 12 April 2002 at the Headquarters of OECD, 75016, Paris, Room 1, New Building.*

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## **CASE STUDY C: FUNCTIONAL ANALYSIS, RECOGNITION OF DEALINGS, CHARACTERISATION OF DEALINGS, ATTRIBUTION OF CAPITAL TO A BANKING PE, SPLIT FUNCTIONS**

### **A. Issues for Discussion**

1. A number of public comments addressed the issue of the concept of “dealings” and “split functions” developed and used in the Discussion Draft in conjunction with the attribution of capital to a banking permanent establishment:
2. Some comments addressed the issue of ‘recognition of dealings’ and whether and to what extent a functional analysis could be helpful in determining whether a dealing that had taken place should be taken into account for the purposes of attributing profit. This issue is difficult in the PE context because in the relationship between the head-office and the branch (or in inter-branch relationships) this analysis cannot be based on contractual terms, but needs to be derived from facts and circumstances, e.g. the behaviour of the taxpayer.
3. In the discussion draft on attributing profits to a banking permanent establishment it is suggested that where functions with regard to a particular asset are ‘split’ between the head-office and the permanent establishment, this asset might be attributed to both the books of the head-office and the permanent establishment. This could be the case when, for example the risk-management of the loan is performed by the head-office and the performance of the risk management function is rewarded by a profit method. As noted in paragraph 149 of Part II of the Discussion Draft, the risk management location may be treated as the joint owner of the asset it risk manages both for the purposes of sharing the profits and for attributing capital. Doubts were expressed that a functional analysis should lead to this consequence, or that the dealing between the head-office and the permanent establishment with respect to the risk management should rather be characterised and rewarded separately.
4. Related to the concept of dealings is the issue of documentation. It was suggested that further guidance should developed in the Discussion Draft. Some commentators argue that taxpayers should be required to document contemporaneously the intended dealings between a permanent establishment and another part of the enterprise. Others suggested that internal “agreements”, to the extent they have economic substance, are the best evidence supporting dealings within an enterprise and should be respected for tax purposes provided the parties subsequently abide by the terms of the agreements. Other commentators have proposed an additional economic substance test, for example whether in respect of a transfer of risk the part of the enterprise receiving the transferred risk has the capacity to actually manage and bear that risk.
5. The above issues are best illustrated by considering the following case of a banking enterprise operating with branches through the world but where some risk management functions are centralised in the head-office.

## **B. Example – Case C**

For discussion: example on recognition of dealings in respect of transfer of risk and risk management

6. B group is a globally operating banking group headquartered in the Netherlands. B NV, established in the Netherlands, is the main commercial banking entity of the B group. B NV operates in the United States through its New York branch. The New York branch (BNY) is responsible for the banking business of the B group in the United States.

7. BNY draws up its accounts and tax return based on its interpretation of the Working Hypothesis and in the year in question “recognises” the following sets of dealings for the purposes of attributing profits.

**Dealing A** - The “sale” to Head Office of a portfolio of existing loans to US subsidiaries of Dutch multinationals

8. The “sale” is booked at what is stated to be the market value of the loan portfolio. The “sale” follows a change of policy in bank B which is now to concentrate all loans with subsidiaries of Dutch multinationals in the Head Office.

**Dealing B** - A series of “interest rate hedging agreements” between BNY and Head Office

9. These “hedging agreements” effectively transfer market interest rate risk in respect of the loans booked in the branch to the Head Office. The risk transferred is the risk after taking into account any internal hedges within the branch. It is stated that these hedging agreements allow B NV to manage its market interest rate risk globally and to take advantage of internal hedges within the B group. Specialised staff at the Head Office manage the residual risk of the group by using various derivative instruments and by entering into hedging contracts with third parties.

**Dealing C** - A series of “FX agreements” between BNY and the Japanese branch of Bank B

10. Based on a functional analysis, substantial loans in Japanese yen to a few US corporates are attributed to the New York branch. The FX risk with regard to these specific loans is partly ‘hedged’ by entering into “FX agreements” with the Japanese branch and partly hedged by entering into FX contracts with third parties in New York.

**Dealing D** - A “guarantee arrangement” between BNY to Head Office

11. BNY claims a deduction for a dealing described as a guarantee fee charged by Head Office. This fee is stated to be made in return for an agreement whereby the Head Office promises to make good credit losses above a certain amount in respect of an existing portfolio of loans made by BNY to companies with heavy exposure to emerging markets in Latin America.

## **C. Questions**

- a) Which of the above dealings should be recognised for tax purposes and/or under what circumstances ?
- b) In respect of dealing A, does it matter for what purpose the portfolio of loans was transferred to the Netherlands? Would it be necessary for the Head Office to carry out any ongoing functions in respect of the loans for the transfer to be recognised?

- c) In respect of dealing B, would the answer be the same if the actual risk management function was carried out in another part of the bank, say the London branch?
- d) In respect of dealing C, would it be necessary that the Japanese branch hedged the FX risk transferred to it with third parties in the Tokyo market?
- e) In respect of dealing D, does it matter that the Head Office does not carry out any functions in respect of the loans for which it has effectively assumed part of the credit risk? Would the answer be different if Head Office guaranteed all the credit risk of BNY in respect of these loans?
- f) Is it considered that the guidance currently provided in the Discussion Draft is capable or sufficient to assist taxpayers and tax administration to identify and characterise contemporaneously the nature of the arrangement that exist between the head-office and the permanent establishments and between the different branches?
- g) What would be the nature of the documentation that should be required from taxpayers in order to assist tax administrations in properly conducting the factual and functional analysis necessary to apply the WH?
- h) Should the split performance of functions lead to a split attribution of assets to the parts of the enterprise (branches and head office) engaged in the performance of those functions? Would such an approach lead to a different attribution of assets than required by the regulatory authorities?
- i) If the dealings were recognised what would be the consequences for the attribution of free capital to the New York branch?