

**PUBLIC COMMENTS RECEIVED ON THE DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS –
PART II (SPECIAL CONSIDERATIONS FOR APPLYING THE WORKING HYPOTHESIS TO PERMANENT ESTABLISHMENTS OF BANKS)**

Institute of International Bankers

Introduction and Executive Summary

1. This paper sets forth the comments of the Institute of International Bankers on the Discussion Draft on the Attribution of Profits to Permanent Establishments, issued by the Organisation for Economic Co-operation and Development (the “OECD”). The Institute represents the interests of internationally headquartered financial institutions that conduct banking, securities and insurance operations in the United States. The Institute has been considering many of the issues raised by the Discussion Draft for several years, in the context of its ongoing discussions with the US Treasury Department and Internal Revenue Service regarding the existing US tax regime applicable to US branches of international banks and their securities and derivatives affiliates, and possible changes thereto.

2. The Institute commends the OECD for its willingness to tackle the complex questions addressed in the Discussion Draft and to endeavour to develop an international consensus, within the context of bilateral tax treaties, regarding the framework for taxing permanent establishments (“PEs”), including in particular branches of multinational banks. The Institute also commends the OECD for soliciting public comment on this topic and on the Working Hypothesis (“WH”) that is set out in the Discussion Draft. The Discussion Draft contains a thoughtful exposition of many of the issues and choices presented. Nonetheless, as this paper indicates, we have conceptual and practical concerns with certain of the conclusions and we believe that additional work needs to be done in order to develop a coherent and appropriate framework for taxing PEs of multinational banks.

3. Our principal concerns are the following:

- *Practicality and administrability.* The WH will be administratively burdensome and complex for taxpayers and tax authorities in practice because it will necessitate numerous substantial adjustments to the financial information that is maintained for regulatory, management and financial reporting purposes. We question the wisdom, necessity and practicality of the approach in the case of most traditional banking business.
- *Departure from arm’s length principle.* The WH is conceptually flawed and produces results that are inconsistent with the arm’s length principle. For example, the WH hypothesises each branch of a multinational bank as a separate entity that has the same credit rating as the bank and a proportionate amount of the bank’s “free” capital and debt capital that is based on the branch’s share of the bank’s risk-weighted assets. Yet this is demonstrably impossible in the case of virtually every multinational bank, because “the whole is greater than the sum of its parts.” Thus, there simply is not enough “free” capital in the bank as a whole to allocate among the various branches (and head office) in order for these hypothesised separate entities to achieve the credit rating of the bank as a whole. Moreover, using the Basel Accord’s regulatory capital standards as a proxy for allocating capital can produce severely distorted

results and will raise considerable administrative complexities. We recommend an alternative approach below that in our view has many of the advantages of the WH's approach but not the disadvantages.

- *Uniformity.* The WH leaves too much discretion to individual countries regarding many specific aspects of applying the WH. It is essential to achieve a greater degree of uniformity in order to minimise the risk of multiple (or less than single) taxation and reduce potential tax uncertainties, arbitrage opportunities, controversies and exposures.

4. Part II of this paper organises and summarises the principal elements of the WH for purposes of framing our comments. Part III contains a summary of our comments, while the remainder of the paper discusses our comments in greater detail.

Summary of the Working Hypothesis

5. The WH has the following principal elements:

- (i) PE as a “functionally separate enterprise.” The amount of profits of an enterprise attributable to a PE under Article 7 paragraph 1 of the OECD Model Treaty should be determined under the “functionally separate entity approach,” under which “the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length as if it were a separate enterprise performing the same functions under the same or similar conditions, determined by applying the arm’s length principle under Article 7(2).” [I-32]¹
- (ii) *Profits of the hypothesised separate entity PE determined under arm’s length principle.* The attribution of profits to a PE using the arm’s length principle under Article 7(2) should be based by analogy on the guidance on the application of the arm’s length principle of Article 9 (governing transactions between associated enterprises) given by the 1995 OECD Transfer Pricing Guidelines (the “Guidelines”). [I-40] Thus, a two-step analysis should be undertaken:
 1. Apply a functional and factual analysis to the PE in order to determine the functions, activities and conditions (including both internal attributes of the enterprise and the external environment in which the PE’s functions are performed) of the hypothesised distinct and separate enterprise constituting the PE, taking into account the assets used and risks assumed by the PE. [I-44-62]
 2. Determine the arm’s length profits of the hypothesised distinct and separate enterprise using the appropriate transfer pricing methods described in the Guidelines (*i.e.*, the traditional transaction methods (comparable uncontrolled price (“CUP”), resale price and cost plus), or, where such methods cannot be applied reliably, the transactional profit methods (profit split and transactional net margin (“TNNM”)). In general, inter-branch dealings would be recognised for this purpose. In appropriate circumstances, the PE and other part of the enterprise may be viewed as dealing with each other as co-participants under a cost contribution arrangement (“CCA”). [I-63-90]
 3. *Attribution of assets to PE.* The assets of the enterprise, including capital assets, intangibles and financial assets, should be attributed to each PE based upon use. [I-53]

1. References in this format are to the Part and paragraph of the Discussion Draft, in this case Part I paragraph 32.

Such use would be determined under a functional analysis that focuses on where the “people functions” are performed. [II-32] In the case of financial assets (such as loans owned by a bank), the assets would be “used” where the sales/trading function leading to their creation was performed, and may also be “used” where the risk management of those assets takes place. As a result, assets (including financial assets) may be treated as “jointly owned” by more than one part of the enterprise and may be treated as having been transferred, either permanently or temporarily, by one part to another. The internal dealings by which these transfers are deemed to take place would be taken into account (*e.g.*, as a sale, a license, or pursuant to a CCA). [I-91-121, II-51-52]

4. *Risks assumed by PE.* Similarly, the PE should be treated as assuming any risks inherent in, or created by, the PE’s own functions and any risks that relate directly to those activities (including credit risk, market interest rate risk and foreign exchange risk). [I-56, II-12] Because of concern that inter-branch dealings involving internal hedges of risks may weaken the existing defenses against tax-motivated transfers, the WH proposes to recognise such inter-branch dealings “only where there has been a transfer of economically significant functions and of the associated risk and profit potential.” [I-75]
5. *Credit rating of PE.* Among the internal attributes of the enterprise (“internal conditions”) that need to be taken into account in constructing the hypothesised distinct and separate entity constituting the PE of a bank is the bank’s credit rating. The WH consensus, based on disparate analyses, is that the same credit rating should be attributed to the PE as is enjoyed by the enterprise as a whole. [II-35-45]
6. *“Free” capital of PE.* In order to ensure an arm’s length attribution of profits to a PE, it is necessary to allocate to the PE an appropriate amount of the enterprise’s equity, or “free” capital (*i.e.*, the sum of the capital contributions by shareholders and retained profits) since, unlike debt capital, the cost of equity capital is not deductible for tax purposes. Since independent enterprises would need to allocate more capital to riskier assets, under the arm’s length principle the allocation of capital should be based on the risk-weighted value of the assets attributed to the PE. [I-128-129, II-46-53] “A promising possibility for achieving this aim would be to use, as a proxy for the arm’s length principle, the independently set and internationally accepted regulatory benchmarks of the Basel Committee.” [II-54] The amount of capital needed to support the risk-weighted assets attributed to the PE should be a proportionate share of each of the components of the regulatory capital of the whole bank (a “BIS ratio approach”),² although some countries of the Steering Group prefer to apply a “thin capitalisation” approach. [II-65-89] The amount of allowable interest expense of a PE (generally taking into account inter-branch borrowings) would be adjusted to account for the attribution of “free” capital to the PE. [II-90]
7. *Miscellaneous issues.* The WH identifies several important, albeit secondary, issues and considerations that need to be developed further, including (i) the extent to which

2. Under the “pure” BIS ratio approach, no further adjustments would be made. Under the “cleansed” BIS ratio approach, the debt/equity characterisation rules of the PE’s jurisdiction would be applied to “cleanse” the attributed Tier 1 and Tier 2 capital to determine which items would qualify for an interest deduction and which would be treated as “free” capital for tax purposes in the PE’s jurisdiction. The Discussion Draft recognises that double, or less than single, taxation may result due to variances in the debt/equity characterisation rules between different countries. [II-72-74]

inter-branch dealings (including hedging transactions) should not be respected under the arm's length principle due to a concern about tax-motivated transactions; (ii) the appropriate interest rate on inter-branch borrowings in a variety of situations, including from the treasury function, in agent/conduit situations and in respect of Tier 2 capital; (iii) the treatment of intangibles; and (iv) the appropriate compensation of (head office) management functions.

8. *Scope of the WH.* The WH “does not dictate the specifics or mechanics of domestic law, but only sets a cap on the amount of attributable profit that may be taxed in the jurisdiction of the PE.” [I-341] Moreover, the WH does not mandate a uniform approach with respect to the specific details of each issue addressed by the WH, but merely proposes a broad framework for application of Article 7 by various tax authorities. For example, the determination of which components of capital are treated as “free” capital and which qualify for an interest deduction would be determined under the domestic laws of the PE's jurisdiction. [II-74]

Summary of the Institute's Comments

6. *PE as a “functionally separate enterprise.”* The institute concurs with the WH that the “functionally separate entity approach” is preferable to the alternative, “relevant business activity,” approach considered in the Discussion Draft for interpreting Article 7(1). However, the Institute believes that the “functionally separate entity approach” also has considerable shortcomings, some of which are implicitly recognised in the Discussion Draft, which derive precisely from the condition of a PE as an undifferentiated part of the whole enterprise. As a result, we question whether a pure application of the functionally separate entity approach, in a manner consistent with the arm's length principle, is possible. We recommend that the WH acknowledge more explicitly the points of tension between theory and reality and address more directly how best to achieve a sensible taxation regime under the circumstances.

7. *Profits of the hypothesised separate entity PE determined under arm's length principle.* The Institute agrees that the arm's length principle of Article 9, as interpreted in the Guidelines, should provide guidance, by analogy, regarding the attribution of profits to a PE. However, the manner in which the WH proposes to fit a PE into the construct of a hypothesised functionally separate entity is in certain fundamental respects inconsistent with the business and economic realities of a PE and therefore, we submit, inconsistent with the arm's length principle. This is most evident in respect of the WH's treatment of capital attributable to the PE, as discussed below. In addition, we question the wisdom, necessity and practicality, in the case of most traditional banking businesses, of subjecting such businesses to the enormous complexities and administrative burdens of conducting functional and comparability analyses and disaggregating their operations for tax purposes as a result of such analyses.

8. *Attribution of assets to PE.* The WH's rules for attributing assets to PEs need to be clarified, refined and simplified. For example, if the sales/trading function leading to the creation of a financial asset is performed in one PE and its risk management subsequently takes place in another PE, it is unclear to what extent, if any, a deemed transfer of the asset has taken place and, if so, whether the first PE recognises taxable gain or loss.³ It is also unclear whether the purchase of a financial asset by one PE from another PE

3. The Discussion Draft indicates that the WH only determines the attribution of profits to a PE but defers to domestic law as to the consequences of a deemed transfer. [I-101]

As noted below, the Discussion Draft does not provide adequate guidance as to whether and to what extent credit evaluation and management functions are taken into account in determining where an asset is “used.”

(and the attendant shift in profit opportunity and risk of loss) would be given effect under the WH where the “people functions” have not changed; while the Discussion Draft suggests that booking locations are irrelevant where “people functions” occur elsewhere, traditional arm’s length principles generally would support recognising such a transfer. Also, in attributing “ownership” of an asset to where it is used,” both initially and thereafter, the WH does not specifically address the tax consequences of any implicit shifts in use of debt and equity capital of the enterprise arising from the original acquisition of an asset or any subsequent deemed shift in its use: Will such shifts be treated as deemed dividends and contributions from one PE to another (or alternatively as inter-branch loans) and, if so, what are the tax consequences?⁴

9. The Institute believes that it is impractical and unnecessary to disaggregate financial assets and attribute the “ownership” of portions thereof based on the extent to which sales/trading and risk management functions take place in a particular PE, nor is it practical or necessary to adjust such “ownership” as the location of the “people functions” relating to such asset changes. Rather, financial assets should be attributed to one location (preferably the location in which they are recorded for book purposes). The appropriate portion of the profit or loss from (the financial assets (taking into account any attribution of “free” capital) can then be attributed, via a fee for services, to the various locations in which the “people functions” were performed and in which associated risks are assumed. Thus, under a functional analysis, where the booking location performs none of the economically significant functions and does not bear any material risks, virtually all of the profits and losses attributable to the financial assets would be allocated via fees to the locations where the activities are performed and the risks are assumed, with the booking location retaining only such amount of profit as is attributable to its ministerial function as a booking location. Not only would such an approach be simpler, but it would also better comport with (the arm’s length principle.

10. *Risks assumed by PE.* The WH’s discussion of risks assumed by a PE is imprecise and could be misconstrued as being at variance with a principled application of the arm’s length principle. The Discussion Draft correctly observes that the acquisition of a financial asset involves the assumption of a number of different types of risks (including credit risk, market interest rate risk and market foreign exchange risk) [II-12], but it fails to fully take into account the distinctions between (i) creation of the risk (through the acquisition of the financial asset), (ii) evaluation of the risk in connection with its assumption, (iii) management of the risk and (iv) bearing of the risk. Depending upon the circumstances, each of the foregoing can be undertaken by a different PE and, under a functional analysis, each PE should be attributed an appropriate amount of profit or loss in respect of the foregoing. In particular, subject to the discussion below regarding tax-motivated transfers, a PE that truly *bears* a particular risk should be attributed an appropriate amount of profit or loss, regardless of where the various “people functions” associated with creation, evaluation and management of the risk are performed. Also, while various sales/trading personnel may be responsible for the creation, evaluation and management of different types of market risks, it is the bank’s credit officers who are responsible for the creation, evaluation and management of credit risk. Thus, the WH’s position that residual profit and loss should be attributed to the sales/trading functions seems to understate the critical role played by a bank’s credit officers in the creation, evaluation and management of credit risk, and also seems to blur the distinction between those functions and the economic and legal bearing of risk.

11. *Credit rating of PE.* The Institute agrees that the same credit rating should be attributed to the PE as is enjoyed by the enterprise as a whole because this comports with business reality, as noted in II-38 and

4. As suggested by the preceding footnote, presumably the WH does not intend to impose withholding taxes on deemed dividends or to impute interest on deemed loans, which is a sensible approach, although it draws into question why the WH treats a PE as a functionally separate entity for some purposes but not for others, at least some of which affect the profit and loss of the respective PEs (e.g., as to interest on deemed loans if debt and equity capital are “assigned” to separate entity PEs).

40. However, the Institute finds the alternative analyses set forth in II-41-44 to be faulty, and disagrees with the statement in II-45 that because all of those approaches have merit and lead to the same conclusion, it is unnecessary to definitively endorse one approach as the preferred approach for the WH. Quite to the contrary, because the Discussion Draft fails to properly analyse why the credit rating of the PE is the same as that of the enterprise as a whole, it glosses over the fundamental shortcoming of the “functionally separate enterprise approach” adverted to above and fails to acknowledge the WH’s departure from the arm’s length principle.

12. Specifically, the WH assumes that it is possible to treat each PE (including the home office) of a bank as a hypothesised separate entity, operating on an arm’s length basis, that conducts the activities, uses the assets and assumes the risks attributed to it under a functional analysis; has the same credit rating as the bank; and has the amounts of “free” capital, debt capital and interest expense as determined under the WH. Yet this is demonstrably impossible in the case of virtually every multinational bank, because “the whole is greater than the sum of its parts.” In other words, each PE of a multinational bank has the same credit rating as the bank only because they are all part of the bank; as soon as each PE is hypothesised as a separate entity, the credit rating of the bank and of each PE drops precipitously, and cannot be resurrected through an allocation of “free” capital pursuant to the WH. Conversely, a multinational bank *and its individual branches* generally can obtain financing (and engage in other financial transactions) at rates that are significantly more attractive than those which would apply to its branches if they were independent, separate entities with “free” capital as determined under the WH. Calling this phenomenon an “internal condition” of the enterprise that is automatically (or “harmoniously”) attributed to the PE [II-41, 44], or the result of a “passive” association between the PE and the enterprise [II-42], does not adequately explain how the resulting hypothesised separate entity can possibly be viewed as comporting with the arm’s length standard.

13. “Free” capital of PE. While in theory an independent enterprise would need to allocate more capital to riskier assets, in view of the fact that the WH’s attribution of “free” capital to a PE does not produce a hypothesised separate entity that comports with the arm’s length principle, we believe that there is little conceptual or practical justification for a risk-weighted allocation of “free” capital under a BIS ratio approach. Indeed, a risk-weighted allocation would comport with the arm’s length principle only if the amount of the PE’s allowable financing costs were increased significantly to take account of the higher financing costs that a separate entity operating under arm’s length conditions would incur (whether through higher interest payments to third-party lenders or through guaranty fees and royalties for the favourable credit rating and other intangible benefits that it enjoys by reason of being part of the bank). While consideration might be given to such an approach, it is likely not to be attractive as an administrative matter since significant transfer pricing disputes likely would arise between taxpayers and tax authorities regarding the appropriate adjustments for interbranch guaranty fees and royalties, and the interest rate on interbranch borrowings.

14. In any event, we believe that the Basel Accord’s regulatory capital standards do not provide an acceptable basis for attributing capital in accordance with the risk-weighted value of assets, for several reasons. First, as the Discussion Draft itself acknowledges, the Basel standards are very crude, and although the Basel Committee is considering proposals to refine the standards, the new framework is likely to rely on banks’ internal credit risk models as applied on a portfolio basis, which would not provide a workable approach that could be used to evaluate the relative risk of individual assets in specific locations for tax purposes.

15. Second, while the Basel standards appropriately and necessarily take into account all claims against a bank in determining the bank’s capital adequacy, including off-balance sheet exposures such as guarantees, letters of credit, loan commitments, swap obligations and other derivative contracts, taking

such off-balance sheet exposures into account for tax purposes would produce distorted and incongruous results.

16. Third, the Discussion Draft incorrectly assumes that banks' management accounting systems maintain the information necessary to apply the BIS ratio approach on an entity-by-entity and branch-by-branch basis, and that this information is reviewed by bank regulators and external auditors. In fact, however, because of the significant differences between the batik regulatory principles underlying the Basel Accord computation and the relevant tax rules, a substantial number of adjustments would need to be made if the Basel standards were to be used as a basis for tax allocations. These adjustments would be administratively burdensome and complex for taxpayers and tax authorities since often the necessary information to make (and audit) such adjustments would not be readily available. Moreover, these adjustments would be done solely for tax purposes and would not be verified for regulatory, management or financial reporting purposes.

17. As an alternative to allocating "free" capital in the manner proposed by the WH, and assuming a thin capitalisation-type approach is not adopted, the Institute recommends that consideration be given to allocating "free" capital based generally on the ratio of the PE's book assets to the enterprise's worldwide assets, in each case based on the enterprise's home country financial or regulatory accounting books. For the reasons discussed below, we believe that this approach has many of the advantages of a BIS ratio approach but not the disadvantages.

18. *Miscellaneous issues.* The miscellaneous secondary level issues identified by the WH are all significant and are worthy of careful additional consideration. The Institute's preliminary views regarding several of these issues are set forth below.

19. *Scope of the WH.* The Institute appreciates that the WH is intended to provide guidance regarding the interpretation of Article 7 of the OECD Model Treaty and not to dictate the specifics or mechanics of domestic law. It appears, however, that even with respect to the interpretation of Article 7, the WH proposes merely to set out an overall framework and to leave to the discretion of individual countries many specific aspects of applying the WH. In our view, the WH misses an important opportunity to foster greater uniformity among different taxing authorities and clarity regarding the rules for apportioning profits among different jurisdictions. Increased uniformity and clarity are desirable — indeed, essential — because they minimise the risk of multiple (or less than single) taxation of profits of multinational enterprises and reduce potential tax uncertainties, arbitrage opportunities, controversies and exposures. Therefore, we recommend that the WH provide more specific guidance on material issues.

20. *Conclusion.* The Discussion Draft notes at the outset that the guiding standard in developing the WH should be "simplicity, administrability, and sound tax policy." [I-41]

21. Judged against that standard, we respectfully submit that there is considerable room for improvement.

22. While the arm's length principle is a simple concept to articulate, its application to the various PEs of a multinational bank raises a number of very complex practical and conceptual issues. Some of those issues — in particular the allocation of capital and determination of each PE's allowable interest expense — cannot be avoided. At least in the case of most aspects of most traditional banking businesses, however, we question the wisdom, necessity and practicality of conducting a full functionality and comparability analysis and disaggregating their operations for tax purposes. Moreover, the WH's approach to the attribution of assets to PEs is unnecessarily complex and unworkable. We urge the OECD Steering Committee to consider ways of simplifying the practical application of the WH.

23. The BIS ratio approach for allocating capital to PEs is flawed as a conceptual as well as practical matter and will result in unacceptable distortions in many cases. Moreover, while at first blush it may seem perfectly logical and simple to adopt for tax purposes the capital allocation method that is used for regulatory purposes, in fact it is neither logical nor simple to do so. Indeed, many banks will be required to set up separate information systems to capture and compute the necessary information, and to perform substantial adjustments to the BIS ratio numbers, in order to make them utilisable for tax purposes. These problems are likely to be exacerbated beyond remedy under proposed changes to the Basel Accord's capital adequacy standards, which would risk-weight portfolios rather than discrete assets, thereby making it virtually impossible to allocate capital to specific locations.

24. We believe that many of the perceived advantages, but not the disadvantages, of the BIS ratio approach can be achieved by allocating the "free" capital of a multinational bank to its branches based generally on the ratio of the bank's home country financial or regulatory accounting books. Such an approach should produce sensible and reasonable results and would be fair, administrably workable and readily verifiable.

Because a PE cannot be treated purely as a functionally separate entity, operating in conformity with the arm's length principle, "free" capital should not be attributed to a PE under a Basel Accord-based, risk-weighted assets approach⁵

The Functionally Separate Entity/Arm's Length Principle Model Does Not Adequately Explain the Reality of a Multinational Bank's Branches

25. The WH posits that each PE (and the head office) of a bank can be hypothesised as a separate enterprise (i) performing the same functions, using the same assets and assuming the same risks as the PE does in practice (as determined under a functional analysis), (ii) having the same credit rating as the bank, (iii) having an amount of "free" capital equal to its proportionate share, based on risk-weighted assets, of the bank's regulatory capital and a corresponding amount of the bank's debt capital, (iv) applying the appropriate transfer pricing methods described in the Guidelines with respect to inter-branch dealings and (v) on the basis of the foregoing, earning an arm's length profit.

26. The problem with the foregoing WH is that it is demonstrably inconsistent with the economic and business reality of virtually every multinational bank, because "the whole is greater than the sum of its parts." In other words, the bank's credit rating, which each PE enjoys by virtue of being part of the bank, is derived only because of the synergistic effect of the bank as a whole enterprise. As soon as each PE is hypothesised as a separate entity, the credit rating of the bank and of each PE drops precipitously, and cannot be resurrected through an allocation of "free" capital pursuant to the WH. There simply is not enough "free" capital in the bank as a whole to allocate among the various PEs (and head office) in order for these hypothesised separate entities to achieve the credit rating of the bank as a whole.

27. To illustrate, a US branch, having \$ 20 billion of assets, of a creditworthy multinational bank having \$ 500 billion of assets, generally will be able to borrow at the same cost of funds as the bank as a whole incurs, which generally will be considerably less than the cost of funds that would be incurred by a separate US bank having \$ 20 billion of assets and the same amount of equity capital that would be imputed to the branch under a BIS ratio allocation method. By virtue of benefiting from the credit rating of

5. Whereas the Summary of the Institute's Comments in Part III above was organised to correspond to the Summary of the Working Hypothesis in Part II, the discussion in the remainder of this paper follows a more thematic organisation. This part focuses primarily on the points summarised above.

the bank as a whole, the US branch will also be able to conduct activities (such as being a swaps dealer and issuing letters of credit) which often it could not conduct as a separate US bank.

28. Indeed, in many cases it would be impossible as a practical matter for a bank that wished to incorporate a branch as a subsidiary to adequately capitalise the new entity so as to enable it to conduct the same business, at the same attractive financing costs, as the branch conducts.

29. For example, the various branches of certain creditworthy multinational banks borrow at a “flat” LIBID interest rate,⁶ but would be required to borrow at a substantial spread above LIBOR if they were incorporated as subsidiaries, even if those subsidiaries had an apportioned amount of equity capital determined under a BIS ratio allocation method.

30. Many factors contribute to the “synergistic-mass phenomenon effect” of a multinational bank being greater than the sum of its parts, including sheer size, aggregate amount of capital at risk, diversification of risk, substantial amounts of low-cost core deposit liabilities that are often government-insured, client base, reputation, management and operating efficiencies, rating agency classifications and the market’s recognition that the bank’s home country government generally would not permit such a bank to fail.

31. This synergistic-mass phenomenon has been widely recognised, including in the “Subsidiary Requirement Study” prepared in December 1992 by the US Department of the Treasury and the Board of Governors of the Federal Reserve System pursuant to section 215 of the Foreign Bank Supervision Enhancement Act, which concluded (on page 1):

“In fact, a branch of a foreign bank is able to operate more efficiently than a separate subsidiary of a foreign bank, due to a number of factors: (1) the ability to deploy capital flexibly; (2) a lower cost of funding; (3) the ability to compete based on access to the worldwide capital base of its parent; (4) ability to engage in transactions with the home office without significant operational restrictions; and (5) lower transaction costs.”

The WH Fails to Adequately Explain Why the Hypothesised Separate Entity PE Has the Same Credit Rating as the Bank

32. The WH correctly observes that as a matter of economic and business reality, bank branches enjoy the same credit rating as the enterprise as a whole. [II-38] While that reality should be sufficient, under a functional and factual analysis, to support the WH that the hypothesised separate entity should have the same credit rating as the bank (see II-40), the Discussion Draft proposes several alternative analyses, in II-41-44. These alternative analyses depart from a rigorous functional analysis under the arm’s length principle of the Guidelines and instead posit certain theoretical “truths,” to wit:

- “The PE is bound to have the same credit rating as the bank as a whole because, under the WH, the capital of the bank is attributed ‘harmoniously’ to the [PE] based on the risk it assumes. So if the PE takes on more risk than other parts of the enterprise, it has more capital attributed to it so that the residual risk exposure, and therefore the credit rating, remains proportionately the same as the rest of the enterprise.” [II-41] This theory is belied by the reality described above, whereby the attribution of capital on a risk-weighted basis to a hypothesised separate entity PE is inadequate to invest that separate entity with the same credit rating as the bank.

6. LIBID is the London interbank Bid Rate, whereas LIBOR is the London Interbank Offered Rate.

- The PE should be attributed the same credit rating as the bank as a whole without having to compensate the bank for such credit rating by virtue of its “passive association with the bank. [II-42] As the Discussion Draft itself recognises, in II-43, while the distinction between “passive” and “active” association may be valid in the limited circumstances discussed in the Guidelines, it would severely undermine the arm’s length principle to attempt to use that distinction to justify the credit rating and capital structure attributable to bank branches when they are hypothesised as separate entity PEs.
- The credit rating should “be viewed as an ‘internal’ condition of the enterprise which should be treated as an ‘internal’ condition of the PE.” [II-43] This theory, too, is a departure from the arm’s length principle because it imputes a material economic condition to the hypothesised separate entity PE without any functional or factual analysis of the overall consequences of such imputation.

There is No Conceptual Justification for a Risk-Weighted Allocation of “Free” Capital Under a BIS Ratio Approach.

33. As discussed above, the Institute has no quarrel with the WH’s position that each branch of a bank should be attributed the same credit rating as the bank, since that conclusion is mandated under a functional and factual analysis. Our analysis departs from that of the WH in that we would proceed to apply the logical next step of a functional and factual analysis: If the branch is to be treated as a hypothesised separate entity having the same credit rating as the bank as a whole and if, as demonstrated above, such credit rating cannot be sustained under an arm’s length, functional analysis even if the branch is attributed capital under a BIS ratio approach, these circumstances suggest one of two alternative analyses.

34. The first alternative would deduce from the foregoing circumstances that the branch necessarily must be benefiting materially from credit enhancement and other intangible benefits being provided by the bank, and accordingly the branch should be paying a guaranty fee or royalty for such benefits. In other words, if the branch’s third-party financing costs are lower than what they would otherwise be as a result of the beneficial credit rating that it enjoys by reason of its association with the bank (and which would not be available to it as a separate entity, even with the “free” capital attributed to it under the WH), its internal financing costs need to be adjusted under the arm’s length principle. It would be economically incorrect, violative of the arm’s length principle and inconsistent with treating the branch as a separate entity, to conclude that no guaranty fee should be recognised on the grounds that the capital of the bank is available to all its branches.

35. This alternative, however, may not be attractive as an administrative matter since significant transfer pricing disputes likely would arise between taxpayers and tax authorities regarding the appropriate adjustments for interbranch guaranty fees and royalties, and the interest rate on interbranch borrowings. Moreover, this approach may not be entirely satisfactory as a conceptual matter because, although the imputation of additional financing costs to each branch is appropriate under the arm’s length principle, the head office’s entitlement to receive additional payments from the branches arguably would depend on whether the credit rating and intangibles should be considered to reside entirely in the head office or in the bank as a whole.

36. A second, alternative analysis would recognise that due to the synergistic-mass phenomenon effect, the reality of multinational banks and their branches cannot adequately be explained or replicated by treating each branch as a hypothetical separate entity under the arm’s length principle. While a functional analysis can be applied to attribute to each branch the activities, assets, risks and credit rating (which, as

discussed above, is the same as that of the bank) appropriately attributable thereto, the allocation of “free” capital under the BIS ratio approach of the WH does not infuse the hypothetical separate entity with adequate capital to conduct its business and maintain its credit rating under an arm’s length analysis.

37. Thus, the conceptual underpinning of a risk-weighted capital allocation — which, as noted above, is “the arm’s length principle, [inasmuch] as independent enterprises would need to allocate more capital to riskier assets” [II-53] loses its coherence in the context of branches of multinational banks. In other words, while undoubtedly it is the case that enterprises that are engaged in riskier businesses require more capital than those engaged in lower-risk businesses if they wish to maintain the same credit rating, that abstract concept cannot be applied to branches of multinational banks in a manner that comports with the arm’s length principle because of the synergistic-mass phenomenon effect.⁷

38. Faced with the recognition that most multinational banks do not have sufficient “free” capital to adequately capitalise each branch in conformity with the arm’s length principle as if it were a hypothetical separate entity, this alternative analysis would simply seek to achieve a sensible, workable and fair allocation of a multinational bank’s “free” capital among its branches for purposes of determining its allowable interest expense. Thus, this alternative approach in effect would balance between the amoeba-like reality of a multinational bank and the need nonetheless to allocate “free” capital to each branch for purposes of determining its allowable interest expense.⁸

39. Viewed from this perspective, there is little conceptual or practical justification for an allocation of “free” capital based on risk-weighted assets. As a conceptual matter, as noted above, risk-weighting is justified only if and to the extent it reflects the arm’s length principle, which is not the case here. Moreover, a risk-weighted allocation would have the negative effect of distorting the profits of the hypothesised separate entity PE unless the amount of the PE’s deductible financing costs were increased significantly to take account of the higher financing costs that a separate entity operating under arm’s length conditions would incur (whether through higher interest payments to third-party lenders or through guaranty fees and royalties for the favourable credit rating and other intangible benefits that it enjoys by reason of being part of the bank). As indicated above, such an approach is not likely to be attractive as an administrative matter and, moreover, it still does not adequately account for the synergistic-mass phenomenon.

40. A BIS ratio approach is also not justified as a practical matter, for the reasons discussed below.

The BIS ratio approach for a risk-weighted allocation of capital produces inappropriate results and raises administrative complexities

The Basel Accord’s Risk-Weighting Standards Are Very Crude, and There Are No Objective, Reliable Alternatives

41. The Discussion Draft observes that in order to apply a risk-weighted allocation method, there must be available to multinational banks and tax authorities a suitable, standardised, objective method that is readily verifiable and administratively feasible for risk-weighting the assets that are allocated to each branch of a multinational bank under the WH’s functional analysis. The Discussion Draft suggests that “a

7. Moreover, as illustrated in several of the examples below, a risk-weighted allocation approach can produce bizarre and distorted results, which are most clearly evident where that approach would impute 100 percent debt financing to government securities that in fact are unleveraged and that represent the equity capital of the bank.

8. We believe that the alternative approach proposed below satisfies this criteria.

promising possibility for achieving this aim would be to use, as a proxy for the arm's length principle," the Basel Accord benchmarks. but then notes several potential problems with relying on the Basel Accord for this purpose. [II-54-64]

42. In our view, neither the existing Basel Accord nor the revisions thereto that are under consideration by the Basel Committee on Banking Supervision are even remotely suitable for this purpose.

43. The Basel Accord classifies all assets into one of five categories, based on the general nature of the asset (*e.g.*, sovereign debt, mortgage loans, corporate claims) and assigns a different risk weighting percentage (0, 10, 20, 50 or 100 percent) to each category. These rules are recognised as a "crude measure of economic risk, primarily because degrees of credit risk exposure are not sufficiently calibrated as to adequately differentiate between borrowers' different default risks."⁹ For example, all corporate and individual loans and bonds are assigned a 100 percent risk weighting, without regard to whether the asset is a AAA-rated note of a premier corporate credit, a high-risk junk bond or a consumer car loan. The Discussion Draft's suggestion that perhaps the distortions are sufficiently reduced "because the individual scorings are averaged over a large number of assets" (II-56) rings hollow when held up against the actual circumstances of multinational banks, whose various branches often have disparate business concentrations and risk profiles.

44. The Basel Committee on Banking Supervision and national bank regulatory authorities are considering proposals to refine the Basel capital adequacy standards. The new capital adequacy framework proposed by the Basel Committee would, in the case of sophisticated banks, rely on internal credit risk models to risk-weight assets on a portfolio basis (subject to supervisory approval and adherence to quantitative and qualitative guidelines). If it is eventually adopted, this approach would likely increase the accuracy of the risk-weight classifications. However, as the Discussion Draft acknowledges [II-60-63], this approach would be problematic for implementing the WH because (i) it would risk-weight portfolios (allowing internal set-offs and risk correlation among assets held in various locations) rather than discrete assets, thereby making it virtually impossible to allocate capital to specific locations, (ii) as a result of a lack of standardisation, it may prove difficult to verify and may therefore not be accepted by tax authorities and (iii) it would introduce even greater disparities among different institutions and countries than exist today, thereby complicating efforts to achieve uniform tax treatment and mitigate the risk of multiple (or less than single) taxation.

Taking Into Account Off-Balance Sheet Exposures for Tax Purposes Would Be Incorrect and Would Produce Distorted Results.

45. The Basel Accord was developed to determine whether internationally active banks have adequate capital as a bank regulatory, "safety and soundness" matter. Accordingly, all claims against such banks appropriately and necessarily are taken into account, regardless of whether such claims are liabilities that are reflected on the balance sheet or are off-balance sheet items, such as guarantees, letters of credit, loan commitments, swap obligations and other derivatives contracts. The Basel Accord determines how much capital needs to be maintained by a bank in order to support its on-balance sheet assets and off-balance sheet exposures.

46. Obviously, although a bank is required for regulatory purposes to maintain capital in a specified amount in order to support its off balance sheet exposures, it does not (and cannot) invest any funds in such

9. Basel Committee on Banking Supervision. "A New Capital Adequacy Framework,' p. 9 (June 3, 1999)

off-balance sheet exposures because by their very nature they are unfunded positions.¹⁰ Rather, the equity and debt capital of a bank directly corresponds to, and equals the sum of, its balance sheet assets. Indeed, the equity and debt capital of a bank funds its balance sheet assets and is invested in its entirety in those assets. By contrast, there is no necessary, direct correlation, either in amount or location, between the equity and/or debt capital of a bank, on the one hand, and its off balance sheet exposures, on the other hand.

47. Thus, there is a difference between (i) the assignment of a bank's capital among its assets and exposures for bank regulatory, "capital adequacy" purposes and (ii) the actual deployment of funds that represent such regulatory capital in the assets of the bank. Capital required to support off-balance sheet exposures of one business in one location may in fact be invested in assets of a different business in a different location.

48. Accordingly, while regulatory capital can be earmarked to support off balance sheet positions, the totality of a bank's equity and debt capital can sensibly and coherently be allocated only among balance sheet assets. Taking off-balance sheet exposures into account in allocating a bank's equity and debt capital among its PEs for tax purposes could easily produce the inexplicable result of a branch being allocated a greater amount of equity capital than its assets (as opposed to unfunded, off-balance sheet positions). More generally, taking off-balance sheet exposures into account would regularly produce distorted and incongruous results, with random effect, depending on the absolute and relative amount of off-balance sheet exposures in particular locations, compared to the absolute and relative amount of balance sheet assets in those and other locations. This would prejudice some banks while enabling others to implement artificial strategies to avoid an appropriate level of taxation.

49. By way of simple illustration of the issues raised if off-balance sheet exposures are taken into account for this purpose, assume that a French bank conducts only two businesses (i) a commercial lending business in France and (ii) a currency swaps business in London, New York and Tokyo that is fully hedged through swaps and other derivative contracts and has virtually no balance sheet assets. The regulatory capital that is necessary to support the swaps business funds, in part, the French commercial lending business (because the bank uses less leverage in that business than it otherwise might employ under regulatory capital standards).¹¹

50. Under the BIS ratio approach of the WH, equity capital would be allocated to the swaps business located in London, New York and Tokyo even though that business has virtually no balance sheet assets. What implications should follow? Where is the capital allocated to the swaps business deemed to be invested, and what rate of return on such capital should be imputed to the swaps business? Would the swaps business in each location be deemed for tax purposes to have made a loan to the French commercial lending business, and would each business location be required to include/deduct interest on this imputed loan? If so, what interest rate should apply?¹²

10. An exception to this statement is that to the extent an off-balance sheet exposure (*e.g.*, a swap or other derivative instrument) is marked-to-market for financial (or regulatory) accounting purposes, the related gain or loss would increase or decrease the amount of balance sheet assets (or, in the case of positions with negative net worth, may appear as a liability).

11. We acknowledge that this example presents a theoretical situation that is unlikely to exist in the real world, but it illustrates the flaw in the WH's taking off-balance sheet exposures into account and serves as a starting point for the more realistic variations discussed below.

12. Alternatively, given the relationship between these various PEs, might it not be appropriate to deem the swaps business as having distributed the capital back to the French head office (on the ground that although the swaps business needs capital, it does not need the funds represented by such capital) and as having

51. Now assume that instead of underleveraging its French commercial lending business, the bank's head office holds French government securities on an unleveraged basis. Should the rate of interest on the deemed loan by the swaps business to the head office be affected by whether the head office invests the proceeds in low-risk, low return government securities or in higher-risk, higher-return commercial loans? If the rate is not affected and the interbranch interest rate is greater than the yield on the government securities, can the overall result fairly be reconciled with how hypothetical separate entities would manage their affairs? If the rate is affected, is it feasible to trace the usage of the funds represented by such capital?

52. Alternatively, assume that the bank does not underleverage its French commercial lending business but instead utilises the capital allocated to its swaps business in London, New York and Tokyo to invest in and hold in each location UK, US and Japanese government securities, respectively, in an amount equal to the capital allocated to that location. How would the WH deal with this situation, in view of the fact that under the BIS ratio approach, the government securities would be deemed to be entirely financed with debt? Would the London, New York and Tokyo branches be allocated a portion of the bank's debt capital (and allowed an appropriate deduction for interest expense) and if so, where is the equity capital that was allocated to those branches deemed to be invested — in loans to the head office? While this result may be indicated under the BIS ratio approach, it would appear to be inconsistent with the WH's treatment of the branch as a hypothetical separate entity, since the branch in fact holds unleveraged balance sheet assets in an amount equal to its allocated equity capital.

53. If the results under the WH differ in each of the foregoing variations, it does not seem to be appropriate for tax considerations to influence a bank's decision-making as to the location and type of the government securities (or other assets with different risk weightings) that it holds. On the other hand, it does not appear to be satisfactory for tax purposes to always treat government securities as being financed entirely with debt capital, even when that is not the case, merely because such securities do not require any "free" capital for regulatory purposes.¹³ Tax authorities, bank regulators and the banking industry should all be concerned by the results suggested by the WH in the foregoing situations because of their random effect and potential for manipulation, as shown below.

54. In practice, of course, the circumstances are likely to be considerably more complex. While this may serve to mask some of the obvious issues noted above, it may produce other distortions, which could either unfairly prejudice or unfairly benefit a bank, depending on its situation and ability to arrange its affairs to take advantage of the rules. For example, assume that the French bank described above also conducts a commercial lending business in New York, London and Tokyo that is completely separate from its swaps business in those locations. Also assume that each branch funds its commercial lending business through a combination of local deposits and funding from the head office, with the amount of head office funding corresponding to the amount of equity capital allocable to the branch's commercial lending business under a BIS ratio approach.

55. It is appealing as a logical matter to view each branch in this example as (i) having an aggregate amount of debt and equity capital equal to its (funded) balance sheet assets (essentially, the assets of its commercial lending business), with its debt capital corresponding to its third-party deposit liabilities and its equity capital corresponding to its head office funding (so that no deduction would be allowed for the

agreed to pay a guaranty fee to the French head office for agreeing to provide capital as needed? If this alternative characterisation is dismissed, is it because the 'WH intends to override explicit or implicit decisions regarding the movement and deployment of funds, whether by distributions, contributions or loans between PEs and the head office of a bank, and if so, when and on what basis? In this regard, consider the discussion in footnote 4 and the accompanying text, above.

13. Although not as evident, the same concern can be expressed regarding any class of assets requiring less regulatory capital than other assets, such as mortgage loans.

internal interest expense but a full deduction would be allowed for interest paid to depositors),¹⁴ and (ii) having regulatory capital (but no corresponding hinds) earmarked for its swaps business by the head office. Nonetheless, under the WH, apparently the equity capital allocated to the swaps business in each branch would reduce the debt capital of the commercial lending business in that branch (and the amount of allowable interest on deposits) since that business contains the only material balance sheet assets of that branch.

56. As a result, the impact of the swaps business on the equity capital of the commercial lending business of each branch could vary dramatically from year to year, depending on the absolute as well as the relative amount of swaps positions held by each branch. Depending on the circumstances, these amounts in turn are potentially susceptible to significant fluctuations as a result, alternatively, of manipulation or of unforeseen business developments. For example, the bank's London swaps business might enter into several very large swaps (which it offsets with other swaps), either because of a decision to shift equity capital to London for tax purposes or because of attractive business opportunities.¹⁵

57. Whether or not the bank in the foregoing example can engage in effective planning regarding the absolute and relative amounts of off-balance sheet positions in each branch, the potentially significant shifts in equity and debt capital (and in the amount of allowable interest expense) allocable to the bank's commercial lending business in each branch is troubling, particularly because (i) that business in fact funds itself in each location with equity and debt capital corresponding to the amounts allocable to it under the HIS ratio approach and (ii) there are no other on-balance sheet assets representing the additional equity capital allocated to the branch. These distortions are the direct result of incorrectly taking unfunded off-balance sheet exposures into account under the BIS ratio approach.

The BIS Ratio Approach Raises Considerable Administrative Complexities

58. The Discussion Draft incorrectly assumes that the management accounting systems of multinational banks maintain the information necessary to apply the BIS ratio approach on an entity-by-entity and branch-by-branch basis, and that this information is reviewed by bank regulators and external auditors.

59. In fact, however, because of the significant differences between the bank regulatory principles underlying the Basel Accord computations (which, incidentally, differ in application in a variety of respects from one country to another) and the relevant tax rules, a substantial number of adjustments would need to be made if a BIS ratio approach were to be adopted to determine the amount of "free" capital of each PE under the WH. These adjustments would be administratively burdensome and complex for taxpayers and tax authorities since often the necessary information to make (and audit) such adjustments would not be readily available. Moreover, these adjustments would be done solely for tax purposes and would not be verified for regulatory, management or financial reporting purposes.

14. As the Discussion Draft acknowledges [II-55-164, II-90-94, II-125-135], difficult issues are presented under the WH regarding the appropriate treatment of inter-branch borrowings. Our preliminary observations concerning these issues are set forth below.

15. To cite another example, if a bank provides a guaranty of the counterparty obligations entered into by a special purpose subsidiary that is set up to serve as the derivatives booking entity for counterparty transactions entered into by the group (a common phenomenon), the bank may have considerable flexibility in selecting the branch that provides the guaranty (and to which the allocable regulatory capital would be assigned).

60. Areas likely to require adjustments include the following:

- 1) *Off-balance sheet exposures.* As noted above, the off-balance sheet exposures of the bank should properly be excluded in computing the relative amount of risk-weighted assets attributable to each branch, so that only on-balance sheet assets are taken into account. Thus, in order to properly apply a BIS ratio approach for tax purposes, a multinational bank would need to perform a completely independent set of computations of the risk-weighted assets of each branch, excluding off-balance sheet exposures.
- 2) *Determination at the level of the taxpayer bank entity vs. consolidated (solo/consolidated) basis.* In general, bank groups that are subject to the Basel Accord are required to apply Basel capital standards on a consolidated basis for the parent bank and each consolidated subsidiary, and, in addition, in many countries, for each subsidiary bank on a standalone (solo) basis. In certain countries, if stand-alone determinations are made for a subsidiary bank, they are done by excluding the capital and assets (including investments in subsidiaries) attributable to virtually all subsidiaries of the subsidiary bank and in effect treating those subsidiaries as sister companies, regardless of whether those subsidiaries are banks, securities firms or other financial institutions or, instead, are unregulated entities, and regardless of whether those subsidiaries are partnerships or disregarded entities for tax purposes. In other countries, the stand-alone determinations for subsidiary banks are themselves made on a consolidated basis, taking into account the capital and assets of the bank and its subsidiaries.

None of these approaches conforms to the conventional tax approach of treating each taxpayer as a separate entity whose assets include its investment in the equity (and debt) of its subsidiaries. Moreover, because of the various solo/consolidated regulatory capital rules, multinational banks regularly invest (or deploy) their regulatory capital in assets on a basis that does not necessarily correspond to the separate legal entity formulation that is relevant for tax purposes.

As a result, apart from the need to make tax-related adjustments based on information that may not be readily available, the disparity between the regulatory capital computations and the tax computations will require careful consideration and extensive guidance regarding the proper attribution of capital from one legal entity to another.

To illustrate one example of the complexity that would need to be addressed, how should the capital of a bank be determined for tax purposes if, for bank regulatory purposes under the Basel Accord, a bank properly takes account of capital that is maintained at the level of a parent or subsidiary entity (*i.e.*, is invested in funded on-balance sheet assets of that other entity) to support business activities of the bank (*e.g.*, where the bank funds its commercial lending business, which is its only business activity, entirely with customer deposits, because it can take account of the capital that is maintained by a parent or subsidiary entity)? If for tax purposes capital is shifted to a bank from a parent or subsidiary entity, what other balance sheet or income statement adjustments should be made? Should specific assets (and the related items of income and expense) be shifted as well, and if so, how should they be identified? Alternatively,

should the bank be treated as lending an amount equal to the shifted capital back to its parent or subsidiary (as the case may be), and if so at what interest rate?¹⁶

- 3) *Business line vs. legal entity basis.* Another practical problem is that many banks test their compliance with the Basel Accord's capital standards based on information that is reported on a business line basis, rather than on a legal entity-by-legal entity or a branch-by-branch basis. Thus, the information that would be necessary in order to apply a BIS ratio approach under the WH often would not be readily available and would require the development of *additional* information reporting systems. These information reporting systems would be maintained solely for tax purposes and would not be verified for regulatory, management or financial reporting purposes.
- 4) *Asset base disparities.* The tax rules of any particular country may treat the income generated by certain assets that are booked in a branch located in that country as not being taxable in that country and, conversely, may treat the income generated by certain assets that are booked elsewhere as being taxable. Adjustments would need to be made in the amount of equity and debt capital allocable to a branch for tax purposes to account for these differences between tax and regulatory accounting rules. Other adjustments would need to be made to account for differences between tax and regulatory accounting rules relating to securitizations and other transactions that may remove assets and/or liabilities from a bank's regulatory Financial statements or reduce regulatory capital requirements of the bank as a whole. Moreover, under the proposed approach of the WH for attributing financial assets to PEs (discussed below), there would be very little, if any, correlation between the computations that are proposed for regulatory purposes and those that would need to be performed for tax purposes.

Possible alternative approaches to determining the "free" capital of a multinational bank's approaches

61. For the reasons set forth above, we believe that the BIS ratio approach does not provide a suitable basis, either as a conceptual or as a practical matter, for determining the "free" capital of a multinational bank's branches. As an alternative, we recommend that further consideration be given to one of the two approaches described below.

Thin Capitalisation-Type Approach

62. The Discussion Draft describes several variations of a thin capitalisation-type approach¹⁷ and indicates that some countries of the Steering Group prefer such an approach. [I-152-153, II-65-90] Nonetheless, the Discussion Draft concludes that such an approach is problematic because (i) it may lead to double, or less than single, taxation since it is "possible for more, or less, capital than the enterprise as a

16. Indeed, the complexities raised by the disparities between the solo/consolidated regulatory capital rules and the separate entity tax rules are similar to those discussed above in relation to off-balance sheet exposures. and the prospects for a resolution that is consistent with the arm's length principle appears equally remote.

17. Under the "thin capitalisation" approach, a PE would be required to have "the same amount of capital (including free' capital) as would independent banking enterprises carrying on the same or similar activities under the same or similar conditions in the jurisdiction of the PE." [II-67] Under the "quasi thin capitalisation" approach, the PE would be required to have "at least the same minimum amount of capital required for regulatory purposes (regulatory minimum capital) as would an independent banking enterprise operating in the host country jurisdiction" [II-66]

whole possesses to be attributed amongst its various parts;” III-82-83] (ii) it is difficult to compare the hypothesised separate enterprise PE to the “same or similar” small independent banking enterprise for purposes of a quasi thin capitalisation approach because “small independent banks may not be comparable to a PE that is part of a large banking enterprise;” [II-67]¹⁸ and (iii) the effect of allocating only the regulatory minimum capital to a branch under the quasi thin capitalisation approach is that any excess capital would be allocated to the head office, which is inappropriate once “all the assets and all the associated risks of the bank (including the extraordinary’ and unforeseeable risks) have been attributed to the various parts of the bank, including the head office, under the functional analysis.” [II-70]

63. We agree with those countries of the Steering Group who believe that the problems associated with the various types of thin capitalisation approach have been overstated, and that this approach is superior to the BIS ratio approach on the grounds of administrative simplicity. [II-88] We also believe that the functional analysis proposed by the WH may allocate insufficient capital to the head office because (as discussed below) it does not fully recognise the manner in which various types of risk are evaluated and borne by different parts of a multinational bank, including usually the head office. Moreover, we believe that the functional analysis proposed by the WH may understate the overall contribution of the head office to the enterprise, in terms of strategic and tactical management of all aspects of the bank’s activities and risks; home country identification, regulatory environment and stability; access to a stable deposit base that is a source of inexpensive funding; the (usually implicit) guaranty of the bank’s liabilities by its home country government, which generally would not permit such a bank to fail; management of the bank’s access to the capital markets management of the bank’s public profile; historical context and other intangibles. Accordingly, we believe that further analysis is warranted on the question whether a quasi thin capitalisation approach (or some variation thereof) appropriately allocates excess capital to the head office to account for these factors.

Allocation of “Free” Capital Based on Relative Amount of Book Assets in Each Branch

64. If a decision is made not to adopt a thin capitalisation-type approach as an alternative to the BIS ratio approach proposed by the WH, the institute recommends that consideration be given to allocating the “free” capital of a multinational bank to its branches based generally on the ratio of the book assets of each branch (or head office) to the bank’s world Wide assets, in each case based on the bank’s home country financial or regulatory accounting books. We believe that this approach has many of the advantages of the BIS ratio approach but not the disadvantages.

65. Like the BIS capital numbers, a bank’s home country financial (and regulatory) accounting numbers are objective, verifiable, audited numbers that have been prepared for substantial non-tax purposes and have been reviewed and accepted by independent auditors, bank regulators and, in many cases, capital market investors and rating agencies. Indeed, banks prepare their BIS capital numbers based on their financial and regulatory accounting books. Thus, these numbers should be readily accessible to banks and to tax authorities, and reliance on these numbers should minimise controversies.

66. A compelling reason why a bank’s home country financial (or regulatory) accounting numbers are a more appropriate starting point than BIS capital numbers is that the accounting books do not include off-balance sheet exposures and do not risk-weight assets. As explained above, the BIS ratio method can produce unacceptable, random distortions by taking account of off-balance sheet exposures. Moreover, using a bank’s home country financial (or regulatory) accounting numbers would avoid most of the other

18. It is odd that the Discussion Draft does not acknowledge that the lack of comparability between a hypothesised separate entity PE and the branch of a multinational bank is the fundamental flaw in the WH, as discussed above.

administrative complexities, discussed above, arising under the BIS ratio approach, since the financial (or regulatory) accounting numbers are available on a separate legal entity and separate branch basis. Furthermore, as discussed above, there is no conceptual or practical justification for risk-weighting assets once it is recognised that a risk-weighted allocation method cannot produce results that comport with the arm's length principle in the context of a multinational bank.

67. In contrast to the BIS ratio method, which is predicated as a conceptual matter on treating each branch as a separate entity dealing at arm's length (see II-53), the alternative approach described in this section merely seeks to achieve a sensible, workable and fair allocation of a multinational bank's "free" capital among its branches for purposes of determining its deductible interest expense, based on the rationale discussed in above. Thus, the proposed alternative approach in effect balances between the amoeba-like reality of a multinational bank and the need nonetheless to allocate capital to each branch for purposes of determining deductible interest expense.

68. Under the alternative approach proposed in this section, although a bank's equity and debt capital generally would be allocated ratably in accordance with the relative amount of book assets in each branch, in certain discrete circumstances it is appropriate to permit a direct tracing of debt (and the related interest expense) against identified assets financed thereby (and the related income thereon. One such set of circumstances involves the financing of government securities through sale-repurchase ("repo") agreements, securities loans and similar arrangements. In these circumstances, only the excess of the carrying cost of the securities over the proceeds of the traced financing would be taken into account as an asset under the allocation formula.

69. The rationale for direct tracing in such circumstances is that in fact such assets can be, and are, funded on a matched basis with virtually no "free" capital required. Indeed, if the interest expense attributable to such directly leveraged securities positions were to be scaled back as a result of a formulaic allocation of "free" capital, banks would regularly incur tax liability on the income from such positions that is greater than the pre-tax profits from such positions. thereby making it uneconomic to conduct many conventional, important business operations involving government securities.¹⁹

70. Direct tracing in the foregoing circumstances also is consistent with the Basel Accord's zero-risk weighting of government securities, which implicitly acknowledges that no "free" capital is necessary in respect of government securities because they can be funded virtually entirely through self-collateralized borrowings in the securities repo market (or via similar funding transactions). However, in contrast to the WH, which posits that government securities are in fact always self-funded by a bank, the proposed alternative approach takes account of the manner in which the government securities are in fact funded, and accommodates the possibility (illustrated above) that a bank may be holding "free" capital in government securities in order to have sufficient regulatory capital to conduct other business activities, such as activities that involve significant off-balance sheet exposures, and therefore requires significant regulatory capital but virtually no funded assets,

19. A clear example of such a problematic situation is presented by a "matched book" repo business, in which a government securities dealer in effect acts as a clearinghouse between customers wishing to "repo out" securities (thereby obtaining financing at attractive short-term borrowing rates) and customers wishing to "reverse in" securities (in effect, lending on a short-term, high-credit quality basis). Although the dealer acts as a principal, its profit is a very small spread, reflective of a high-volume, low-commission business. In practice, the securities dealer's leverage in a matched book repo business is virtually 100%. If however, equity capital is imputed under a general allocation method, the resulting disallowance of deductible interest expense often will result in tax liability in excess of the pre-tax profits from the business.

71. We believe that it would also be appropriate to provide for direct tracing in the case of integrated financial transactions that are properly identified and that satisfy other suitability conditions, where the same rationale that supports direct tracing of debt to repoed government securities also is applicable.

72. Finally, we believe that in the case of swaps and other derivatives that are marked-to-market and therefore become on-balance sheet assets or liabilities (see footnote 10), the aggregate liabilities (if any) attributable to the marking-to-market of any such derivatives that have a negative value should first be traced against, and reduce, the aggregate amount of on-balance sheet assets attributable to the marking-to-market of such derivatives, in order to minimise the potential for random distortions similar to those discussed above.

The WH's rules for attributing financial assets to PEs need to be clarified, refined and simplified

73. Under the WH, the assets of a multinational bank, including capital assets, intangibles and financial assets, would be attributed to each PE based upon use. [I-53] Such use would be determined under a functional analysis that focuses on where the “people functions” are performed. [II-32] In the case of financial assets (such as loans), the assets would be “used” where the sales/trading function leading to their creation was performed, and may also be “used” where the risk management of those assets takes place. As a result, assets (including financial assets) may be treated as “jointly owned” by more than one part of the enterprise and may be treated as having been transferred, either permanently or temporarily, by one part to another. The internal dealings by which these transfers are deemed to take place would be taken into account (*e.g.*, as a sale, a license, or pursuant to a CCA). [I-91-121, II-51-52]

74. The WH's rules for attributing assets to PEs need to be clarified, refined and simplified.

75. For example, while not clear, the WH could be interpreted to provide that if the sales/trading function leading to the creation of a financial asset is performed in one PE and its risk management subsequently takes place in another PE, a transfer of a portion of the financial asset from the originating PE to the risk-managing PE (equal to the respective interests of each PE in the profits from the asset, as determined under the arm's length principle) is deemed to have taken place. While not clear, the WH suggests that, depending on domestic law, the originating PE would recognise taxable gain or loss on the deemed transfer. [I-101]²⁰) Regardless of the possible merits of such a system as applied to the fixed tangible assets of a PE (such as its manufacturing assets), in the context of financial assets of a multinational bank these consequences are completely impractical. Moreover, in our view they are not necessary.

76. It is also unclear whether the purchase of a financial asset by one PE from another PE (and the attendant shift in profit opportunity and risk of loss) would be given effect under the WH where the “people functions” have not changed. Evidently out of a concern for tax-motivated transfers, the Discussion Draft suggests that booking locations are irrelevant where “people functions” occur elsewhere and there has not been a “real and identifiable event, such as a change in use of the financial asset.” [II-151] However, traditional arm's length principles generally would support recognising such a transfer assuming the transferee location is thereafter bearing risks of ownership of the asset (although obviously the locations where the “people functions” are occurring would need to be adequately compensated).²¹

20. It is also unclear in the foregoing example whether the analysis (and the amount of gain or loss recognised by the originating PE) changes depending on whether it was contemplated from the outset that the risk-management would take place in the second PE or whether the shift occurs at a later date.

21. See also below.

77. More generally, in attributing “ownership” of an asset (whether financial or tangible) to where it is “used,” both initially and thereafter, the WH does not specifically address the tax consequences of any implicit shifts in use of debt and equity capital of the enterprise arising from the original acquisition of an asset or any subsequent deemed shift in its use. Thus, it is unclear whether such shifts would be treated as if there have been deemed dividends and contributions from one PE to another (or possibly, in the case of shifts in debt capital, deemed loans from one PE to another) and, if so, what the tax consequences of such deemed capital shifts would be. In our view, it would be an unnecessary and severely complicating step — as well as completely inconsistent with the amoeba-like reality of a multinational bank described above -- to treat each branch as a hypothetical separate entity for purposes of imputing tax consequences to implicit shifts in the use of debt and equity capital from one PE to another. On the other hand, as indicated in footnote 4 above, this sensible approach to the issue draws into question why the WH treats a PE as a functionally separate entity for some purposes but not for others, at least some of which affect the profit and loss of the respective PEs (e.g., as to interest on deemed loans if debt and equity capital are “assigned” to separate entity PEs).

78. The Institute believes that it is impractical and unnecessary to disaggregate financial assets and attribute the “ownership” of portions thereof based on the extent to which sales/trading and risk management functions take place in a particular PE, nor is it practical or necessary to adjust such “ownership” as the location of the “people functions” relating to such asset changes. Rather, financial assets should be attributed to one location, which we believe should be the location in which they are recorded for book purposes. The appropriate portion of the profit or loss from the financial assets (taking into account any attribution of “free” capital) can then be attributed, via a fee for services, to the various locations in which the “people functions” are performed and in which associated risks are assumed.²² Thus, under a functional analysis, where the booking location performs none of the economically significant functions and does not bear any material risks, virtually all of the profits and losses attributable to the financial assets would be allocated via fees to the locations where the activities are performed and the risks are assumed, with the booking location retaining only such amount of profit as is attributable to its ministerial function as a booking location. Not only would such an approach be simpler, but it would also better comport with the arm’s length principle. Moreover, such an approach would more closely conform the tax balance sheets of the hypothetical separate entity branches with their balance sheets as prepared for financial and regulatory reporting purposes, which should make it easier to calculate the amount of “free” capital allocable to each branch, either under the WH’s BIS ratio approach or under the alternative approach recommended above.

The WH does not appear to adequately address the evaluation and management of credit risk or the distinction between risk management and risk bearing

79. Although the Discussion Draft contains a general description of the functions performed in evaluating and managing credit risk, it is not clear whether the WH fully accounts for the central role played by the credit officers of a multinational bank — as distinguished from its loan officers, sales force and traders — in the origination and management of financial assets.

80. Thus, the Discussion Draft includes within the sales/support functions (preliminary stage) certain credit-related functions (evaluating credit risk of new business, establishing creditworthiness of a client, checking overall credit exposure of the bank to a client), and also includes within the sales/trading functions other credit-related functions (deciding whether or not to advance monies and, if so, on what

22. However, because the fee would simply be a mechanism for allocating the aggregate profit in respect of a financial asset among different locations of a single entity, it would be inappropriate to impose VAT or similar non-income tax charges on such imputed fees.

terms, deciding what levels of credit risk to accept, considering whether collateral or credit enhancement is needed). [II-5-6] In addition, the WH consistently focuses on the sales/trading functions as the creator of the financial asset and hence as its “owner” and recipient of the residual profit attributable thereto. [II-34, 138-144]

81. While various sales/trading personnel may be responsible for the creation, evaluation and management of different types of market risks and for structuring, negotiating and pricing specific transactions, it is the bank’s credit officers who are responsible for the creation, evaluation and management of credit risk. Thus, the WH’s position that residual profit and loss should be attributed to the sales/trading functions appears to understate the critical role played by a bank’s credit officers in the creation, evaluation and management of credit risk, which is an essential component of every customer transaction. Significantly, the credit-related functions involve evaluations and decisions regarding a specific customer as well as on a broader scale (*e.g.*, by geographic, industry and type of product), and may be conducted by senior, mid-level and staff personnel in the lending branch, the branch with the principal customer relationship and the head office.

82. The Discussion Draft also seems to blur the distinction between the “people functions” associated with the evaluation, creation and management of credit, market and other risk, on the one hand, and the economic and legal bearing of risk, on the other hand. The Discussion Draft correctly observes that the acquisition of a financial asset involves the assumption of a number of different types of risks (including credit risk, market interest rate risk and market foreign exchange risk) [II-12], but it is unclear whether the Discussion Draft fully takes into account the distinctions between (i) creation of the risk (through the acquisition of the financial asset), (ii) evaluation of the risk in connection with its assumption, (iii) management of the risk and (ix) bearing of the risk. Depending upon the circumstances, each of the foregoing can be undertaken by a different PE and, under a functional analysis, each PE should be attributed an appropriate amount of profit or loss in respect of the foregoing. In particular, subject to the discussion below regarding tax-motivated transfers, a PE that truly *bears* a particular risk should be attributed an appropriate amount of profit or loss, regardless of where the various “people functions” associated with creation, evaluation and management of the risk are performed.

83. To illustrate the point, it is not unusual for the group within the bank that is responsible for evaluating and managing credit risk in respect of a loan or other financial asset (typically, the commercial banking division credit group in the branch with the principal customer relationship) to actually bear the counterparty credit risk, pursuant to written internal procedures or agreements. Thus, if a counterparty defaults, the loss is not shown in the management accounts of the business division that negotiated, acquired, booked and/or manages the market risk of the financial asset (and does not affect the compensation of the traders and market risk managers, who were not responsible for evaluating and managing the credit risk).

84. Rather, the loss is reflected in the books of the branch of the commercial banking division whose credit group evaluated and assumed the credit risk. Often the credit risk associated with a financial asset is evaluated and borne by a business division in the same branch as the market risk is evaluated and borne, but at times it is not. While the practices of various banks differ from one another, in some banks the business division that acquires a financial asset and manages its market risk actually pays a fee to the commercial banking division for credit analysis and bearing the counterparty credit risk, which usually is based on standard “loan spreads.”

85. We recommend that the WH clarify that in general it is appropriate to compensate particular business groups within a bank for evaluating and/or assuming credit risk. We believe that the phenomenon described above, in which the responsibility for counterparty credit risk is separated from the responsibility for market risk is similar to the growing phenomenon whereby credit risk is assigned to and borne by third

parties through credit derivatives, guarantees, insurance and other transactions. Accordingly, so long as the arrangements comport with the arm's length principle, they should be respected under the WH, subject to the discussion below regarding tax-motivated transfers. Of course, in evaluating whether a business division in a particular location is truly bearing particular risks and whether the compensation it is receiving therefor is arm's length, all relevant facts and circumstances should be taken into account, including any offsetting hedging or loss protection arrangements.

Miscellaneous issues

Tax-Motivated Transfers

86. As noted above, because of a concern that inter-branch dealings involving internal hedges of risks may weaken the existing defenses against tax-motivated transfers, the WH proposes to recognise such inter-branch dealings "only where there has been a transfer of economically significant functions and of the associated risk and profit potential." [I-75]

87. The Institute is supportive of the need for effective defenses against transactions that lack economic or legal substance and are undertaken for tax purposes, but believes that such defenses are inherent in the arm's length principle, properly applied, since that principle applies a functional and factual analysis to determine the arm's length profit that would have been earned by separate enterprises. The above-quoted statement from the Discussion Draft can be read as simply emphasising this point, and if so, that proposition should not be controversial. If, however, the statement is intended to articulate a new, stricter standard, we believe that standard should be more fully explicated and examined to ensure that it is understood and is compatible with the arm's length principle and sound tax policy.

88. Two additional points are worth noting in this connection. First, inter-branch dealings involving internal hedges of risks are a widespread, essential tool for effectively and responsibly managing risks at multinational banks. These internal dealings enable banks to unbundle the various risks inherent in a particular financial asset or liability (*e.g.*, as to interest rates, currencies, equity markets, counterparty credit), aggregate (and internally offset) those risks by category and manage the net exposures in each risk portfolio. The internal hedges are undertaken for substantial business reasons, carefully monitored by internal auditors, reviewed by independent external auditors and bank regulators, and maintained on a mark-to-market basis. Any new standard directed against tax-motivated transfers must not upset such bona fide interbranch dealings.

89. Second, as discussed above, we recommend that the WH attribute "ownership" of a financial asset to the location in which the asset is recorded for book purposes, and that, consistent with the arm's length principle, the WH respect transfers of a financial asset from one location to another. For the reasons previously discussed, we believe that a functional analysis would provide appropriate protection against tax-motivated transfers because, where the booking location performs none of the economically significant functions and does not bear any material risks, virtually all of the profits and losses attributable to the financial assets would be allocated via fees to the locations where the activities are performed and the risks are assumed, with the booking location retaining only such amount of profit as is attributable to its ministerial function as a booking location. Thus, if an asset is transferred from one ministerial booking location to another but the economically significant functions continue to be conducted elsewhere, virtually no taxable gain or loss should arise as a result of the transfer.

Determining the Amount of Allowable Interest Expense on Interbranch and Third-Party Borrowings

90. As the Discussion Draft acknowledges [I-155-164, II-90-94, II-125-135], difficult issues are presented under the WH regarding the appropriate treatment of inter-branch loans (internal “interest” dealings) and the manner in which the amount of allowable interest expense claimed by a branch is determined.

91. In developing an approach to this question, it is useful to recognise several aspects of the internal movement of funds and internal “interest” dealings. First, as the Discussion Draft notes, these funds movements serve a variety of important business purposes, are organised in a variety of different forms and with varying terms, and are substantial in amount and number. To the extent possible, the WH should accommodate the business structures selected by a bank and afford banks latitude in determining the appropriate function, structure and terms of the funds movements, particularly since, in our experience, the structures and terms of funds movements within banks are set up under business principles similar to the sort of functional and factual analysis envisioned by the WH in II-127-128. Moreover, given the magnitude in amount and number of such dealings, it would be very burdensome to require banks to apply different standards for tax purposes.

92. Second, broadly speaking, these internal funds movements can be viewed as serving three general functions: (i) achieving management, financial, administrative and other efficiencies in accessing and deploying funds from both within and outside the bank, by centralising these functions in the head office and/or branches’ treasury divisions; (ii) serving as a device for shifting equity and debt capital from the head office to and among branches; and/or (iii) enabling one branch to access third-party financing on behalf of another branch in a conduit capacity related to a structured transaction or other investment in discrete financial assets.

93. While practices vary among banks, typically, the treasury divisions provide funding and receive excess funds from other business divisions on a daily basis, and charge (or receive) interest on a short-term LIBOR-based rate (or similar rate) that reflects the particular treasury division’s incremental borrowing costs plus a small spread to cover administrative costs. In effect, the treasury divisions act as a clearinghouse for accessing the bank’s incremental, short-term capital sources. In view of the fact that the credit rating of each branch is treated under the WH as the same as that of the bank, this arrangement appears to be appropriate and should be accepted under the WH.

94. However, because the internal movement of funds also serves as a device for shifting equity capital to and among branches, the internal “interest” on such dealings should be subject to adjustment to reflect the allocation of equity (and Tier I and 2 debt) capital to a branch. Indeed, we believe that any reduction in the liabilities of a branch that is necessitated by an allocation of equity capital to the branch should first be made to inter-branch borrowings, since the third-party borrowings reflect actual arm’s length funding costs of the branch ‘whereas the interbranch borrowings reflect both the accessing of the bank’s incremental, short-term capital sources (which are reflected in the typical LIBOR-based rate on such borrowings) and longer-term capital sources (which typically are not taken into account in fixing such rate).

95. Reducing inter-branch borrowings rather than ratably reducing both inter-branch and third-party borrowings also minimises potential uneconomic (and unhedged) mismatches between liabilities and assets.²³

23 . See also the discussion accompanying footnote 14 above.

96. As for the manner in which the higher interest rate on interest-bearing debt in Tier 2 capital should be attributed among the various branches [II-91-93],²⁴ we recommend that the WH allow banks flexibility in how the appropriate adjustment is made, since this should depend on the particular circumstances, including the method used for setting the interest rate on internal borrowings.

97. Implicit in the Discussion Draft, as well as in our comment above, is that an adjustment in the amount of allowable interest expense of each branch should be made only in respect of the higher interest rate on interest-bearing debt in Tier 2 (or Tier I) capital, not in respect of variations among branches in the interest rates on third-party liabilities that are not in Tier 2 (or Tier I) capital. We believe that any effort to produce a constant interest rate for borrowings by all branches would be exceedingly complicated and would result in significant uneconomic (and unhedged) mismatches between liabilities and assets.

98. A related important and complex area on which the WH should provide uniform guidance is how internal hedging transactions should be taken into account in determining the amount of allowable interest expense of each branch.

99. Finally, we agree with the Discussion Draft that where a functional and factual analysis indicates that a branch is acting in an agency or conduit capacity on behalf of another branch, the financing costs should be directly traced to the “principal” branch and the conduit branch should merely receive a fee for the limited services performed and risks assumed. [II-159—169]

Intangibles and Head Office Management Functions

100. We agree with the WH [I-109-121] that the previous OECD position that notional payments (*i.e.*, royalties) for the use of intangibles will not be recognised for tax purposes is “overly prescriptive” and should be abandoned. However, we also agree that complexities may arise in identifying the “owner(s)” of the intangibles and dealing with deemed transfers of partial or full interests therein, similar to the problems discussed above in relation to financial assets. In general, the challenges presented by intangibles appear similar to those presented by the capital allocation issue, and emanate from the amoeba-like nature of a multinational bank (or other enterprise) and its PEs, which does not allow for a neat, principled application of a hypothesised separate entity approach.

101. With respect to general management activity and support infrastructure provided by the head office, the Discussion Draft takes the position that the Guidelines provide adequate guidance. [I-122-127, II-154-158]. While we do not disagree with the general approach of the Guidelines on this matter, we believe that the Guidelines and the Discussion Draft should more explicitly acknowledge, and provide appropriate compensation for, the significant contribution of a multinational bank’s management to the profitability of the enterprise, in terms of strategic and tactical management of all aspects of the bank’s activities and risks, its access to the capital markets and its public profile.

The WH should foster greater uniformity

102. The Institute appreciates that the WH is intended to provide guidance regarding the interpretation of Article 7 of the OECD Model Treaty and not to dictate the specifics or mechanics of domestic law. It appears, however, that even with respect to the interpretation of Article 7, the WH proposes merely to set out an overall framework and to leave to the discretion of individual countries many specific aspects of

24. The same issue arises with respect to any components of Tier I capital that may be treated as debt for tax purposes.

applying the WH. In our view, the WH misses an important opportunity to foster greater uniformity among different taxing authorities and clarity regarding the rules for apportioning profits among different jurisdictions. Developing such uniformity and clarity will itself involve complexities due to differences among countries with regard to their respective tax and bank regulatory rules. Nonetheless, increased uniformity and clarity are desirable indeed, essential — because they minimise the risk of multiple (or less than single) taxation of profits of multinational enterprises and reduce potential tax uncertainties, arbitrage opportunities, controversies and exposures.

103. One important step in achieving uniformity is the use of a bank's home country rules as the starting point for determining the amount of "free" capital allocable to each PE, whether those rules are the BIS capital rules as applied by the bank's home country regulators or the home country's financial or regulatory books.

104. Unlike the Discussion Draft (in II-74), however, we believe that more serious consideration should be given to the feasibility of having the WH adopt a definition of "cleansed" Tier I and Tier 2 capital that would be accepted by the various tax authorities as the bank's "free" capital for this purpose. If a workable resolution of the separate entity vs. consolidation issues discussed above is achievable, the definition of "free" capital might begin with either (x) Tier I capital or (y) Tier I and Tier 2 capital, as determined under the Basel Accord by the bank's home country regulators. The foregoing amount would be "cleansed" by subtracting those components that are considered debt under principles set forth in the WH.

105. Alternatively, a bank's "free" capital could equal the difference between its worldwide assets and its worldwide liabilities, in each case based on the bank's home country financial (or regulatory) accounting books, in which case consideration should be given to whether adjustments should be made with respect to any types of liabilities that are not treated as debt for tax purposes under principles set forth in the WH.

106. The WH should also endeavour to achieve greater uniformity by providing additional guidance regarding the determination of the amount of allowable interest expense on inter-branch and third-party borrowings, taking into account hedging transactions, as discussed above.

107. In addition, the WH should seek to achieve greater uniformity regarding the attribution of assets and profits among PEs. Our general recommendations regarding the attribution of assets are set forth above. Two other aspects of the problem are worth noting. First, the WH should address the circumstances in which stock of a subsidiary is treated as an asset of a branch and the manner in which the capital attributable to the subsidiary is taken into account in determining the profits of the branch and the subsidiary, since the practices of different countries on this question vary. Second, the WH should provide additional guidance regarding appropriate transfer pricing methods for the performance of services by different PEs of multinational banks since the Guidelines provide very little practical guidance on many common situations.

108. In any event, because it is unlikely that complete uniformity in tax treatment among different countries can be achieved, it is important for the WH to adopt as a principle that, for purposes of Article 23 of the OECD Model Treaty, any taxes paid to a country in respect of income of a branch should be creditable in the home country, and that for this purpose the home country should accept the other country's characterisation of the amount and nature of the branch's income.