

COMMENTS RECEIVED FROM MERRIL LYNCH

OECD REVISED DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS - Part III (ENTERPRISES CARRYING ON GLOBAL TRADING OF FINANCIAL INSTRUMENTS)

Summary and Recommendations

- Separate Legal Entities: Financial Groups that operate in a separate legal entity format is the focus of this paper, not groups that operate in branch form. Global securities dealers generally operate via separate legal entities for a variety of non-tax business reasons, mainly the legal and regulatory requirements imposed by the local jurisdiction. In order to efficiently deploy regulatory capital, it is common for one member of the group to act as a capital/risk taker, and for other legal entities to provide a variety of services to the operation of a global business. In this respect, the business model is similar to a manufacturer – distributor relationship, where the actions of the distributor would generally not create a taxable presence for the manufacturer in the jurisdiction of the distributor.
- No Deemed Permanent Establishments: We recommend global trading rules should provide for a "one-step" allocation of profit or loss among the participants under the transfer pricing rules and should affirmatively state that once profit is appropriately allocated to a participant in one jurisdiction, then the activities of that participant would not create a or deemed permanent establishment (PE) of other participants in that jurisdiction.
- Anti-Abuse rule: The no deemed PE rules could, in the absence of anti-abuse rules, facilitate the allocation of inappropriate amounts of global trading profit to booking entities located in tax haven jurisdictions. The bulk of global trading business is conducted in the major trading jurisdictions that are OECD members, and regulatory and business (rather than tax) considerations generally drive the location of booking entities. Therefore, we believe that the potential for abuse is limited and could be addressed with a more targeted approach than the deemed PE rules.
- Treatment of Capital: Capital should be treated as a non-routine, high value function, and capital should not be resourced to the location of traders. The return allocated to capital should in all cases be dependent upon the type and degree of risk borne by the capital provider (e.g., market risk, credit risk, legal risk, operational risk), taking into account any contractual arrangement among the participants designed to shift risk away from the capital provider. For example, if the capital provider bears all of the market and credit risk associated with a global trading operation, then it would typically be allocated all residual operating profit or loss from the operation after compensation of the other participants.
- Expansion of Permitted Transfer Pricing Methods: We do not believe that the traditional OECD allocation methods of CUP, cost plus, resale price, or the transactional net margin method (TNMM), can be applied to allocate profit or loss from a global trading operation that does not involve identifiable transactions between the participants (a "non-transactional model"). We recommend that a new category of "profit allocation" methods be added to the proposed regulations. The existing profit split methods (with certain modifications discussed below) would be included in this new category, but other profit-

based service fee methods would also be included, such as the hedge fund method and the profit based compensation method.

I. Introduction

First of all we thank the OECD for their efforts in putting forth a conceptual framework to begin to understand, and begin to deal with, the issues surrounding the global trading of financial instruments. As a Multi-National Enterprise (MNE) with operations in 38 countries, Merrill Lynch believes that the dialogue between the OECD, member governments, and the business community that would be impacted by the OECD releases is a critical element in the creation of a global tax system that can be practically administered.

As we mentioned in our cover letter, we would welcome the opportunity to meet with the OECD to present, and discuss in detail, the contents of our submission.

The comments contained herein are focused on part III (global trading), and not part II (banks) for a couple of basic reasons. The first is that Merrill Lynch is primarily organized as separate legal entities in many jurisdictions due to non-tax drivers, primarily legal or securities regulatory reasons. A second reason is that we believe that the majority of the discussion in the area of global dealing to date has been bank-centric, and dealt with determining how to determine the profits attributable to an avowed branch should be attributed to branches and head office. We believe that organizations that operate via separate legal entities (most securities dealers) have not adequately put forth their views, and we seek through these comments to rectify the shortfall in the sharing of knowledge that we believe is required in order to develop an administrable global tax system.

Since global securities dealers generally operate via separate legal entities for a variety of non-tax business reasons, in order to efficiently deploy regulatory capital, it is common for one member of the group to act as a capital/risk taker, and for other legal entities to provide a variety of services to the operation of a global business. In this respect, the business model is similar to a manufacturer – distributor relationship, where the actions of the distributor would generally not create a taxable presence for the manufacturer in the jurisdiction of the distributor.

While our comments are directed primarily at part III (global trading), as we read part II (banks) we were struck by a certain oddity in the directions the two drafts seemed to be taking. Part II is based upon the premise that the avowed permanent establishment (PE – the bank branch) should be treated as a separate entity dealing at arm's length with the rest of the enterprise of which it forms a part – the separate enterprise model. Part III then examines entities that already operate in a separate entity model and attempts to create deemed PEs by viewing affiliated/associated enterprises as dependent PEs of the nonresident principal. It seems to us that the part III (specifically paragraphs 256 through 261) should not be attempting to create additional, burdensome filing requirements on Multi National Enterprises, but instead should be targeted at arriving at the correct transfer pricing result between the existing associated enterprises.

We believe that much of the difficulty associated with the issue of whether a dependent agent PE exists in a global trading relationship is inextricably linked to the difficulty associated with the issue of determining how to transfer price between two distinct functions - the capital function and the high value service provider (trading, perhaps marketing) function – in a traditional bank branch / head office setting. Our submission puts forth a proposition that there does exist a business enterprise that has existed, and indeed flourished in the past decade, that can be very instructive in analyzing how to transfer price between the

capital function and the high value service function. The business is the hedge fund industry. The business has grown from \$50 billion in the early 1990's to over \$600 billion today. It is clear from examining third party data that the hedge fund model is specifically directed at arriving at what the return should be for capital, as well as the high value service function provided by the traders/managers of these funds. We further believe that once the hedge fund method (or similar profit based service fee) is applied to value the service function from the capital function, the result arrived at will greatly reduce the tension in determining whether a deemed, or dependent agent PE exists.

Comments on Global Trading

A. *No Deemed Permanent Establishments and a "One Step" Allocation*

We recommend global trading rules should provide for a "one-step" allocation of profit or loss among the participants under the transfer pricing rules and should affirmatively state that once profit is appropriately allocated to a participant in one jurisdiction, then the activities of that participant would not create a deemed PE of other participants in that jurisdiction.

While paragraph 256 of part III says the report does not examine the issue of whether a PE exists under Article 5 of the model treaty, the following paragraphs go on to state that it is quite common for functions associated with a global trading business to be undertaken by dependent agents and that the profit attributable to the PE created by the dependent agent company is typically in excess of the arm's length service fee paid to that company. We do not believe that such a result is consistent with the goal of avoiding double taxation. In practice PEs are often not recognized in these circumstances on the basis that, even if they were, they would not attract any further taxation in the jurisdiction of the dependent agent. In contrast to a "one – step" allocation, the OECD suggests that the existence of the dependent agent PE should be formally recognized so that it is clear that that host country has taxing rights over two different legal entities – the dependent agent company and the PE of the foreign company created by the dependent agent company. We believe that such an approach will lead to tremendous expansion in the amount of tax returns filed, inevitable double taxation, and an overload to the affected Government competent authorities.

We recognize that there is a potential for abuse under the one-step allocation approach. Removing the deemed PE rules could, in the absence of anti-abuse rules, facilitate the allocation of inappropriate amounts of global trading profit to booking entities located in tax haven jurisdictions. Nonetheless, we do not believe that this possibility should preclude elimination of the rules in non-abusive cases. The bulk of global trading is conducted in the major trading jurisdictions (such as the U.K., Japan, other OECD countries), and regulatory and business (rather than tax) considerations generally drive the location of booking entities. Therefore, we believe that the potential for abuse is limited and could be addressed with a more targeted approach than a deemed PE route would take.

Further, we recognize that the question of attribution to a deemed branch arises under provisions of existing law and income tax treaties, when a participant in one country has the right to execute contracts on behalf of a second-country participant in a global dealing operation. However, we strongly believe that existing law in this regard should be modified with respect to global trading operations. Importantly, the major countries in which securities firms conduct global trading operations have not historically taken this approach as a matter of practice. In our experience, they instead seek to achieve an appropriate allocation of profit or loss among the entities involved in the global dealing operation. Once a profit allocation has been made to an entity located in their jurisdiction, they do not seek to reattribute that profit to a deemed branch or PE in another country (and vice versa). This means that when a U.S. firm allocates a portion of its global dealing profits to, for example, a UK subsidiary, the UK will tax that profit. The UK will not

consider whether a portion of that profit should be reallocated to the U.S. on the grounds that a U.S. affiliate is acting as the agent of the UK subsidiary. If OECD insists on such a reallocation, the result will be double taxation, unless all treaty partners take the same approach as to the existence of the deemed PE, as well as in determining the profit attributable to the deemed PE, which is unlikely in our view. In that event, little would be achieved other than increased administrative complexity and extensive competent authority activity that would eliminate the double taxation that otherwise would result.

We strongly oppose any approach that would attribute income allocated to a participant in one country to a deemed PE in a second country when traders are located in a participant in that second country. Instead, there should be a "one-step" allocation of profit or loss among the participants such that profit appropriately allocated to a participant normally would not be reallocated to a deemed PE in another jurisdiction.

The OECD's efforts in transfer pricing generally, and global trading in particular, should minimize, and where possible eliminate, double taxation. They should also reduce the need for taxpayers to rely on the Advance Pricing Agreements (APAs) and competent authority programs to resolve double taxation issues in the global dealing context. Any approach that requires allocation to a deemed PE undermines these objectives. A securities firm would have no choice but to seek the assistance of the APA and competent authority programs to avoid substantial overtaxation of their global dealing operations.

On the topic of international double taxation, the OECD has always weighed in strongly against it, by stating clearly in paragraph 1 of the January 2003 Model Tax Convention that the "harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that all double taxation presents to the development of economic relations between countries." We believe that it would be a shame if the member countries, as well as non-member countries which are heavily influenced by the OECD views, wind up asserting a deemed dependent agent PE pursuant to paragraphs 256 through 261 of part III, as this would lead to the exact situation that the founding principles of the OECD were set up to avoid.

In addition, regarding the APA process, we are concerned that the APA process has created a private body of law that effectively forces a profit split upon global dealing participants based upon an outdated view of the functions and risks involved in a global trading business. Our understanding of the U.S. experience with APAs is that a three-factor profit split methodology was used in most APAs to attain a practical, results-oriented result. It is also our understanding that there was not a large amount of underlying economic analysis supporting the transfer pricing methodology ("TPM") arrived at in initial APAs.

B. Treatment of Capital

We believe that capital should be treated as a non-routine, high value function, and capital should not be resourced to the location of traders. The return allocated to capital should in all cases be dependent upon the type and degree of risk borne by the capital provider (e.g., market risk, credit risk, legal risk, operational risk), taking into account any contractual arrangement among the participants designed to shift risk away from the capital provider. For example, if the capital provider bears all of the market and credit risk associated with a global trading operation, then it would typically be allocated all residual operating profit or loss from the operation after compensation of the other participants.

On the other hand, if the capital provider had arranged with the other participants to bear none of the market risk but only credit risk (like a lender), then capital could be allocated a market-based interest-rate type of return. Numerous other variations are possible between these two extremes. Designating all capital as "routine" implies a standardization that simply does not exist and fails to recognize that the capital provider is the residual risk taker where it retains all market, credit, and operational risk. We are

encouraged that the OECD has not adopted the view of capital as routine. The return allocated to capital should vary, however, as in the case of other participants, according to the risks assumed by the capital provider and the value of its contribution to the overall operation (and taking into account the fact that the cost of carry amount, or funding cost, has already been allocated to the capital provider).

C. Treatment of Losses

The OECD guidelines should explicitly provide that the profit allocation methods do not necessarily require the sharing of losses among all participants, although sharing of losses may be appropriate depending upon the circumstances. The use of a method that requires two or more separate legal entities to share net profits and losses in any instances could constitute a partnership or joint venture under member country tax principles, which would have enormous unanticipated consequences.

D. Product-by-Product Methodology - Segmentation

One possible way to deal with losses among associated enterprises when one entity is the capital provider and the other affiliates are service providers is through “segmentation” of the transfer pricing computation. Segmentation would allow for a transfer pricing methodology (TPM) for each global trading business, provided the global trading business is operating under the centralized product management paradigm described in paragraph 28. Segmentation would get away from a “one big pot” TPM which causes a smoothing of income and expense across jurisdictions, which would not be the best practice if a global trading business was operated under a centralized product management system. A brief example best describes how segmentation can deal with losses in a centrally managed global trading business.

Example: A global trading business books all positions in the UK entity, which provides all of the capital for the global trading business. Trading services are provided by traders in the UK, US, and Japan. The business has a calendar year tax period, and through the 11 months ended November, the global trading business has a loss of \$100 million. During December the UK traders enter into a series of profitable trades that generate \$60 million of profit, bring the full year loss to \$40 million. The UK trading team successfully argues that they should be well compensated.

Using a non-segmented (“one big pot”) approach, and a TPM that relies heavily on trader compensation as a factor in a profit split, there is a perverse result by which the UK entity attracts more of the global \$40 loss than the US or Japan due to the compensation paid to the UK traders, as well as the reliance on trader compensation as a key factor in a profit split. However, if a segmented TPM was applied, there would be 3 transfer pricing calculations by segmenting the centrally managed books in the UK, the US and Japan. The result would be that the losses in the US and Japanese books would not drag down the profitable UK business.

E. Expansion of Permitted TPMs

We do not believe that the “traditional” allocation methods in the OECD guidelines- the CUP, cost plus, resale price, and the transactional net margin method (TNMM), can be applied to allocate profit or loss from a global trading operation that does not involve identifiable transactions between the participants (a “non-transactional model”). Further, we do not recommend that either the traditional methods or the profit split method be expanded beyond their original scope to address these situations. Rather, we recommend that a new category of “profit allocation” methods be permitted. The existing profit split methods (with certain modifications discussed below) would be included in this new category, but other profit-based service fee methods would also be included. Together, these profit allocation methods would address situations in which the participants combine their resources to create and sell a financial product to an unrelated customer and to manage the associated risk. It is our experience that an unspecified method may

well be the best method – indeed, the only possible method. Due to the high degree of integration across participants in global dealing operations, there are difficulties in evaluating TPMs under traditional transactional methods. This difficulty argues for the use of other approaches, including a new category of “profit allocation” methods that would allow for other profit based service fees.

None of the traditional methods work, however, in the case of a global trading operation that follows a "non-transactional" model, i.e., an operation in which two or more participants combine their resources to create and sell a financial product to an unrelated customer and to hedge any risks associated with the product. In this situation, there are no separately identifiable transactions between the participants. The product in question is not sold from one participant to another and then resold to the customer. Rather, the participants contribute various elements -- such as capital, trading, product design, and marketing -- to the creation and sale of the product and to the management of associated risks, and the resulting profit or loss is then allocated among them via service fees. This type of joint effort is characteristic of the global trading operations conducted in a variety of financial products.

Profit and loss from this type of global trading operation typically is not allocated on a transaction-by-transaction basis with reference to particular customer transactions. Rather, profit or loss derived by the operation as a whole over some period of time is typically allocated among the participants based on the relative value of their contributions to the joint effort over that period of time. The traditional methods, with their focus on comparing specific controlled transactions with specific uncontrolled transactions, simply do not apply where the amounts being allocated arises from a grouping of customer transactions entered into over a period of time.

We believe that the profit split method is inadequate in several respects. First, while some securities firms do choose to share profits and losses among all participants, not all firms choose to do this. In particular, the business operations of some securities firms are conducted in a manner such that it would be inappropriate to share losses as well as profits. For example, regulatory constraints in particular countries often prevent a regulated participant from sharing in losses booked in a related participant. Alternatively, the business arrangement among the participants may be that one participant bears all residual loss (and receives all residual profit) from the operation, while the other participants receive only a share of positive profit, if any. By requiring the sharing of losses in all circumstances, the proposed regulations effectively impose a partnership arrangement on the participants. In fact, the business arrangement among them may be very different.

A potential rationale for precluding the allocation of losses to the function of providing capital is the view that capital is a "routine" contribution that requires that it receive a market rate of return. It is quite common, however, among securities firms for the capital provider to receive all residual profits and losses from a global trading operation (as its return for bearing the risk of the operation) while other participants receive a fee or some type of profit-based compensation. To address the problems outlined above, we recommend a wider range of "profit allocation" methods. The profit split methods previously considered -- with certain modifications described below -- would be one type of profit allocation method. In addition, various profit- based service fee methods should be permitted, such as a profit-based trader compensation method, including a hedge fund method.

A profit based compensation method is intended to address the situation in which the capital provider bears all or substantially all of the risk associated with the global trading operation and the other participants receive profit-based compensation for providing trading and possibly marketing functions. This situation often arises when the other participants are regulated entities that are not permitted to share, or choose not to share, in losses realized by the capital provider. The trading function would typically receive profit-based compensation, which might be determined as a percentage of positive profit (if any), as a dollar amount determined by reference to the traders' bonus compensation, or in some other manner. If the

trading function were located in more than one participant, the total amount allocated to the trading function would be divided among those participants according to the relative value of their contribution using a factor such as headcount (appropriately weighted) or trader compensation.

The marketing function could be compensated either with a sales commission or in a manner similar to the trading function. The appropriate type of compensation would depend upon the degree to which the marketers were involved in designing and tailoring the financial product. A marketer who had little or no input in product design would normally be compensated with an arm's length commission, determined under traditional transfer pricing principles, while a marketer who was integrally involved in tailoring a product to the needs of particular customers might receive a profit-based compensation. We have included an example of a profit based compensation method as Appendix A.

F. Hedge Funds

Hedge fund arrangements demonstrate that, in the real world, capital is not a routine function because the capital provider is the residual risk taker. Assuming that capital's contribution is viewed to be non-routine, hedge fund data serves as the basis for a profit based compensation method, described above, that gives the trading function profit based compensation, and leaves the capital provider with residual profit or loss.

We believe that a high degree of comparability exists in the capital and trading functions in hedge funds and global trading operations. Hedge funds are similar to a derivative department's operations in a number of ways. First, hedge funds are engaged in trading and pursuit of arbitrage opportunities rather than in long term investing. Second, the pursuit of arbitrage activities implies significant attention to managing the fund's exposure to risk. Most hedge funds have market Beta that is less than one, which implies that funds are less risky than the market (e.g., S&P500). This risk profile is consistent with the emphasis that a global trading business places upon risk management. Third, many hedge funds are international in their focus, which mirrors most banks and securities dealers business in trading in both dollar and non-dollar derivative products. Fourth, hedge funds, unlike mutual funds, are permitted to use derivatives, short selling and investments in complex financial products. Thus, hedge funds trade products that are very similar to those traded by securities dealers in their global trading. The main difference between hedge funds and global trading operations would be the degree of marketing that occurs in a global dealing operation, which will exceed the marketing performed by hedge funds.

In addition to the functional similarities detailed above, both the derivative department and the hedge funds operate in sophisticated, highly liquid, capital markets. These are the types of markets in which the efficient market hypothesis is most likely to hold. The crucial implication of the hypothesis is that assets with the same expected risk should yield the same expected return. This implies that the return to capital invested in hedge funds with expected risk profiles similar to that of a global trading operation should be equal to that earned by hedge funds.

Typically hedge fund managers charge a fee for assets under management and earn an incentive fee, which is a percentage of the fund's profits. Based on information obtained from the hedge fund industry, the asset management fee is typically roughly equal to the hedge fund's costs which include some degree of trader base compensation, and the fund management's profits are equal to the incentive fee. Also, funds typically operate subject to a "high-water mark", which means that management will not receive an incentive fee until the fund has recovered past losses. We have analyzed a proprietary database of hedge fund information to form our discussion in this section. From the data on the management fees, incentive fees and overall profitability of the funds, a profit split can be inferred between capital providers and hedge fund management.

Economic theory predicts a positive relationship between the level of market-correlated risk and the expected return of an asset. Toward that end, the hedge funds' portfolio beta is likely the best proxy for risk. The analysis performed indicated that the return to capital invested is sensitive to the beta of the investment, as predicted by economic theory, but that capital's share of the profits does not differ significantly as beta changes. The analysis demonstrated that the median of capital's share of profits is about 75% to 80%. The insensitivity of the median of capitalization results to the size of the portfolio or to the riskiness of the hedge fund portfolio provides further proof that allocating 75% to 80% of the profits to capital is consistent with the arm's length standard. The remaining 20% to 25% of operating profit would compensate the high value trading function. The 75%/25% to 80%/20% split would be performed only after the global dealing entities operating expenses have been compensated as part of step one in the hedge fund TPM method. It should be noted that this split between capital and trading has held firm during the recent volatile economic times. The chart below depicts the annual return for certain benchmark equity indices around the world for the period between 1998 and 2002.

Country	Index	<u>1998</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
United States	S&P 500	26.7%	19.5%	-10.1%	-13.0%	-23.4%
Brazil	Bovespa	-33.5%	151.9%	-10.7%	-11.0%	-17.0%
Canada	TSX Composite	-3.2%	29.7%	6.2%	-13.9%	-14.0%
Australia	All Ordinaries	7.5%	12.1%	0.1%	6.5%	-11.4%
Hong Kong	Hang Seng	-6.3%	68.8%	-11.0%	-24.5%	-18.2%
Japan	Nikkei 225	-9.3%	36.8%	-27.2%	-23.5%	-18.6%
France	CAC 40	31.5%	51.1%	-0.5%	-22.0%	-33.7%
Germany	XETRA	18.4%	39.1%	-7.5%	-19.8%	-43.9%
United Kingdom	FTSE 100	14.5%	17.8%	-10.2%	-16.2%	-24.5%

We have attached a report prepared by Deloitte & Touche that analyzes the split of profits between hedge fund investors and hedge fund managers that we believe will be of great assistance to OECD in understanding the appropriate split between capital and services. We understand that other commentators view a hedge fund method as a CUP, and while we do not agree strictly since a CUP is a transactional-based method, we view that analogy as a practical solution, which could be more palatable to certain OECD members.

G. *Traders as Athletes (High Value Service Providers)*

The Wall Street Journal of December 17, 2002, contained an article describing the value of the trading function to Goldman Sachs. The article described that, while traders could make \$10 million or more annually, the general compensation for traders on the team amounted to about 10% of the gains they make for the firm. The percentage could be higher if the trader performed other functions. This percentage makes clear that traders, while extremely important to the performance of a global trading business, are

nonetheless service providers that do not receive anywhere near the lion's share of their trading results, nor do traders suffer as much when losses are incurred by the capital provider. In this situation, traders compensation is somewhat analogous to the compensation of artists or professional athletes – extremely integral to the success of the record company or the sports team, but nonetheless a service provider, and not the residual risk taker. The 10% figure for compensation also provides an insight into why traders sometimes leave the larger dealers to form hedge funds where their costs are generally covered by the fee for assets under management, and the traders can receive the general 20% of operating profit as compensation. We believe that helping the OECD understand that traders are highly compensated service providers will demystify the myth that has developed that the trading function is the pre-eminent function in the global trading business which should be accorded the largest share of the profits. We believe that this myth originally developed during the initial Advance Pricing Agreements. As we have mentioned above, our understanding is that the initial APAs were practical, results-driven exercises, and lacked the economic analysis required to determine how to appropriately transfer price a return between the service providing function (trading) and the capital provider.

H. AIG Financial Products Arrangement

AIG Financial Products Corporation ("AIG-FP") was a joint venture between American International Group ("AIG"), an AAA-rated U.S. insurance company and Howard B. Sosin. Both AIG and Sosin were capital providers to AIG-FP, Sosin in the amount of \$10mm cash and subordinated debt, and AIG not through contribution to capital but instead via an, in effect, risk transfer arrangement whereby it guaranteed all of the financial obligations of AIG-FP. This gave AIG an 80% interest in the equity of AIG-FP, and Sosin a 20% interest. Sosin, in addition to being a capital provider, also hired a team of professionals to conduct the business of AIG-FP. AIG-FP was formed to create and market a broad range of derivative and other complex financial products. Sosin and the employees provided trading, product design, marketing, research, risk management, middle office and some back office functions.

As compensation for the functions and risk of the parties involved in the joint venture, distributable profits were split between AIG and Sosin, with Sosin's share being used to compensate his team. There was a sharing of profits and losses. Generally, out of the distributable profits for a year, 10% was retained in AIG-FP as an increment to the equity accounts of the two shareholders, AIG and Sosin. Of the remaining 90% of distributable profits, 62% was allocated to AIG, and the other 38% was allocated to Sosin's side. Of the 38%, roughly 25% percent was deferred and paid out in the subsequent two years under a complex formulae, such amounts being held back in case there were losses to be absorbed in the subsequent years. The joint venture was very successful, generating roughly \$1billion of distributable profits over the five years of its existence.

The significance of this arrangement is that it forms a true arrangement between unrelated parties, similar to a hedge fund arrangement, although AIG-FP did involve marketing of financial products which is not a function normally conducted by a hedge fund, but would be a function performed in a global trading operation.

The amount provided to Sosin for trading and marketing (effectively 34% when his equity stake is taken into account) was unique and a bit rich in our view, as we believe that anyone else would not receive an amount as high as 34%. Investors Dealers Digest in their April 12, 1993 edition concur with this view, as they described "Sosin's previous contract is said by industry sources to be crafted strongly in favor of Sosin."

Appendix A – Profit Based Service Fee Method

This method is intended to address the situation in which the capital provider bears all or substantially all of the risk associated with the global trading operation and the other participants receive profit-based compensation for providing trading and possibly marketing functions. This situation often arises when the other participants are regulated entities that are not permitted to share in losses realized by the capital provider. The trading function would typically receive profit-based compensation, which might be determined as a percentage of positive profit (if any), as a dollar amount determined by reference to the traders' bonus compensation, or in some other manner. If the trading function were located in more than one participant, the total amount allocated to the trading function would be divided among those participants according to the relative value of their contribution using a factor such as headcount (appropriately weighted) or trader compensation.

Example of the profit-based compensation method:

Two alternatives are included to illustrate the different ways that marketers might be compensated, depending upon the degree to which they participate in product design.

Assume that UKCo, a U.K. corporation, and USCo, a U.S. corporation related to UKCo, conduct a global dealing operation in notional principal contracts. UKCo and USCo are subsidiaries of a U.S.-based securities firm. USCo acts as the counterparty for all transactions with customers and records \$2,000 of gross revenue from those transactions. USCo also incurs \$100 of expense in operating the back office, and USCo is charged \$500 in cost of carry by the firm's internal treasury department. USCo also employs two senior traders at a cost of \$70, and three marketers at a cost of \$30. UKCo employs four senior traders and eight junior traders at a cost of \$300, and seven marketers at a cost of \$70.

The participants determine that the back office function is appropriately compensated using a cost-plus-10% approach. Under Alternative A, the marketing function is compensated using an arm's length sales commission approach on the grounds that the marketers have a limited role in product design. Under Alternative B, the marketing function is allocated profit-based compensation on the grounds that the marketers play an integral role in product design. The trading function receives profit-based compensation under both alternatives, and the provision of capital is allocated all residual operating profit to reflect the fact that the capital provider bears all of the risk of the global dealing operation.

Alternative A:

The return allocated to the back office function performed by USCo is \$110 (110% of \$100 cost). The participants then determine that an arm's length commission for the marketing function would be 10% of gross revenue, or \$200. This amount is divided between USCo and UKCo using a headcount factor that weights all marketers equally. Thus, USCo is allocated \$60 ($\$200 \times 3/10$) and UKCo is allocated \$140 ($\$200 \times 7/10$).

The participants have further determined that the trader function will be compensated with a percentage of positive overall profit, in addition to having its costs reimbursed. (Thus, USCo will pay a fee of \$300 to UKCo to reimburse UKCo for its trader costs.) Based on the value of the trader function to the operation, the participants have agreed that its percentage of positive profit will be 40%. In this case, operating profit remaining to be allocated is determined to be \$820 (\$2,000 gross revenue less \$110 back office return, \$200 in total marketing return, \$370 in total trader expense and \$500 cost of carry).

Thus, 40% of \$820, or \$328, is allocated to the trader function. This amount is divided between USCo and UKCo using a headcount factor that weights senior traders more heavily (1.75) than junior traders (1.00). (The weighting is designed to measure the relative value of the contribution made by senior and junior traders to profitability) Thus, USCo is treated for this purpose as employing 3.5 traders and UKCo is treated as employing 15 traders. Of the \$328 allocable to the trader function, USCo is allocated \$62 ($\$328 \times 3.5/18.5$) and UKCo is, allocated \$266 ($\$328 \times 15/18.5$).

Finally, capital is allocated all residual operating profit. This amount is determined to be \$492, equal to \$820 less \$328 in return allocated to the trader function. The total operating profit allocated to each participant is therefore:

USCo:	\$62	+	\$492	=	\$554
UKCo:					\$266

The overall result of the TPM would allocate the \$930 of pre-tax net profit \$336 to UKCo and \$594 to USCo, as follows:

Result of TPM	Total	USCo	UKCo
Back Office Function	\$110	\$110	\$0
Marketing Function	\$200	\$60	\$140
Trading function	\$328	\$62	\$266
Capital function	\$492	\$492	\$0
Cost to Carry-reimbursement	\$500	\$500	\$0
Trading function reimbursement (cost)	\$370	\$70	\$300
Expenses:			
Cost to Carry	(\$500)	(\$500)	
Operating Expenses/Back Office	(\$100)	(\$100)	
Traders' Expenses (Compensation)	(\$370)	(\$70)	(\$300)
Marketers' Expenses	(\$100)	(\$30)	(\$70)
Results of TPM	\$930	\$594	\$336

Alternative B:

As in Alternative A, the return allocated to the back office function performed by USCo is \$110 (110% of \$100 cost). In this case, however, the participants determine that the marketing function is sufficiently integral to the entire operation that it should be compensated in a manner similar to the trading function, i.e., with a percentage of positive overall profit, in addition to cost reimbursement. Based on the value of the marketing function to the overall operation, the participants determine that its percentage of positive profit should be 30%. (In addition, USCo will pay a fee of \$70 to UKCo to reimburse UKCo for its marketing costs.)

In this case, operating profit remaining to be allocated is determined to be \$920 (\$2,000 gross revenue less \$110 back office return, \$100 in total marketing expense, \$370 in total trader expense and \$500 cost of carry). Thus, 30% of \$920, or \$276, is allocated to the marketing function. This amount is divided between USCo and UKCo based on their relative costs, intended to serve as proxies for relative value of the marketing function in the two entities. Thus, USCo is allocated \$83 ($\$276 \times 30/\100) and UKCo is allocated \$193 ($\$276 \times 70/\100).

As in Alternative A, the trading function is allocated a return equal to 40% of positive overall profit, in addition to cost reimbursement. (Thus, USCo will pay a fee of \$300 to UKCo to reimburse UKCo for its

trader costs.) This amount is \$368, or 40% of \$920, and USCo is allocated \$70 ($\$368 \times 3.5/18.5$) and UKCo is allocated \$298 ($\$368 \times 15/18.5$). Capital is allocated all of the residual operating profit, which in this case is \$276, equal to \$920 less \$276 allocated to the marketing function and \$368 allocated to the trader function of total operating profit allocated to each participant is therefore:

$$\begin{array}{rclclclcl} \text{USCo:} & \$83 & + & \$70 & + & \$276 & = & \$429 \\ \text{UKCo:} & \$193 + \$298 & = & \$491 & & & & \end{array}$$

The overall result of the TPM would allocate the \$930 of pre-tax net profit \$492 to UKCo and \$438 to USCo, as follows:

Result of TPM	Total	USCo	UKCo
Back Office Function	\$110	\$110	\$0
Marketing Function	\$276	\$83	\$193
Trading function	\$368	\$70	\$298
Capital function	\$276	\$276	\$0
Cost to Carry-reimbursement	\$500	\$500	\$0
Trading function reimbursement	\$370	\$70	\$300
Marketing function reimbursement	\$100	\$30	\$70
Expenses:			
Cost to Carry	(\$500)	(\$500)	
Operating Expenses/Back Office	(\$100)	(\$100)	
Traders' Expenses (Compensation)	(\$370)	(\$70)	(\$300)
Marketers' Expenses	(\$100)	(\$30)	(\$70)
Results of TPM	\$930	\$438	\$492

Appendix B – Deemed PE Problems

The practical problems caused by an approach that requires an allocation of income to a deemed PE can be illustrated by using an example in the U.S. proposed global dealing regulations. Example 3 in Regulation Section 1.863-3(h) applies only to capital treated as a routine contribution in a residual profit split with deemed branches, and is summarized as follows:

Example 3. Residual Profit split - deemed branches.

UKco, conducts a global dealing operation in derivatives, directly and through a U.S. subsidiary (USsub) and a Japanese subsidiary (Jsub). UKco is the counterparty to all transactions entered into with third parties. UKco, USsub, and Jsub each employ marketers and traders who work closely together to design and sell derivative products.

USsub also employs personnel who perform back office services. The global dealing operation maintains a single common book for each type of risk, and the book is maintained where the head trader for that type of risk is located. However, UKco, USsub, and Jsub have authorized a trader located in each of the other affiliates to risk manage its books during periods when the primary trading location is closed. This grant of authority is necessary because marketers, regardless of their location, are expected to sell all of the group's products, and need to receive pricing information with respect to products during their clients' business hours, even if the booking location is closed. The global dealing operation has generated \$180 of operating profit for the period.

Because employees of USsub have authority to enter into contracts in the name of UKco, UKco is treated as being engaged in a trade or business in the U.S. through a deemed QBU. Similarly, under U.S. principles, UKco would be treated as being engaged in business in Japan through a QBU. UKco determines that an arm's length compensation for the back office is \$20, arm's length compensation for the risk to which UKco is subject as counterparty is \$40, which is allocated to UKco as compensation for acting as counterparty.

UKco attributes \$120 to the trading function, and further allocates that amount 40% to UKco, 35% to USsub, and 25% to Jsub. Accordingly, \$48 is allocated to UKco, \$42 is allocated to USsub, and \$30 is allocated to Jsub.

In this example, the \$40 allocated to UKco as compensation for the use of capital is sourced according to where the capital is "employed". The \$40 is considered to be employed where the traders are, that is sourced 35% to UKco's deemed QBU/PE in the U.S. and 65% to non-U.S. sources.

The example is troubling for a variety of reasons. It leaps to the conclusion that UKco has a U.S. trade or business, and then goes on to state the UKco also has a Japanese trade or business. The example compensates UKco \$40 out of operating profit of \$180 for providing capital (without explaining the method used to arrive at the \$40). and resources it based upon the relative values of the other non-routine functions. The resourcing is an effective reallocation of the TPM result since the regulations would require UKco to file a US tax return and pay direct U.S. tax on the amount resourced.

The results flowing from this example would require UKco to file a U.S. tax return and pay U.S. tax on the \$14 (35% of the \$40) attributable to the capital deemed to be employed by the U.S. traders and marketers. This is in addition to the \$62 (\$20 for Back Office + \$42 Trading) that was allocated to USsub as part of the TPM. Thus, the U.S. would tax \$76 of the \$180.

Note that if Japan were to take the same approach, UKco would be required to file a Japanese return and pay Japanese tax on \$10 (25% of the \$40) attributable to the capital used by the Japanese traders and marketers. In addition to the \$30 that is allocated to Jsub for the trading services provided under the TPM, this would subject \$40 of the \$180 to Japanese tax.

Moving to the UK, as a result of the TPM, UKco would have taxable income of \$88 (\$40 for Capital + \$48 for Trading services). If we stop there, there is **\$204 of income subject to tax, in excess of the \$180 of total operating profit.** In order to avoid double taxation, the UK would have to agree to allow the US and Japan to tax the amount attributable to the capital that UKco has made available to USsub and Jsub.

In one sense, any reallocation to that deemed QBU would be redundant, since the activities performed by the QBU (the activities performed by USsub in UKco's name on behalf of the swaps dealing operation) are the very activities that justified the allocation of operating profit to trading and other functions performed by USsub.

The example, however, suggests that amounts allocated to UKco as a return to capital should be reallocated to UKco's US QBU for purposes of sourcing based on the "employment" of UKco's capital by USco's traders. This approach negates the importance of capital by resourcing the return to capital based upon where trading services are performed. In summary, it makes the trading function a "super factor" by effectively reallocating and resourcing the capital component back to the trading function.