

## COMMENTS RECEIVED FROM BIAC

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

BIAC commends the OECD on the extensive and well-developed reports it has published for comment as part of its on-going work on the “Attribution of Profits to Permanent Establishments (the “Reports“)

project. This subject, although complicated as is demonstrated by the length and detail of the Reports, invokes important principles and applications of international taxation and deserves careful and detailed work. While disagreements may exist on various aspects of the Reports, BIAC recognises the tremendous work put into these endeavours by the OECD Secretariat and the Member states involved and appreciates the level of expertise manifest therein. BIAC welcomes this occasion to submit its comments and applauds this ongoing dialogue between the public and private sector. The following submission is divided into 4 parts, procedural concerns, substantive concerns, Banks and Global Trading. This paper supplements the BIAC paper dated October 3, 2001, that dealt solely with Parts I and Parts II.

#### Summary Points:

- Important questions and business comments remain unresolved in the Reports
- A broad international consensus among tax authorities and business is necessary to make rules in these areas workable and fair.
- Part I (Working Hypothesis) needs a review in light of the perspectives developed here and in the consultations generally
- Parts II and III are not ready for adoption and consultations with regard to them both need to continue and be regarded as ongoing
- Dependent agent issues in Part III should be segregated from those of Financial enterprises because they are of much broader application and the issues risk being obscured in the current presentation.

#### A . Fundamental procedural concerns:

As already stated by BIAC during the initial round of comments on the report covering Part II (Banks) in 2002, there are many important industry commentators to be heard and very seriously considered on this subject because the subject has both far-reaching and very specific applications. The comments submitted by various professional bodies regarding these Reports, including, without exclusivity, the FBE, IIB, BBA, LIBA, SBA and other organisations representing the banking and wider financial community are all well conceived. BIAC views its role in this process as helping to place some of the more technical remarks already submitted in a wider context, as well as serving as a coordinator for the business community as the project moves forward. In the text that follows, some issues raised by other professional bodies will be summarized and highlighted, which should, in no way, be interpreted as excluding any position put

forward by other professional bodies but not noted herein from being fully supported by BIAC. On the contrary, we strongly feel that the positions advanced by the various sectoral associations impacted by these Reports should be considered as representative of the highest quality professional expertise available on these matters in today's complex market environment.

BIAC welcomes the spirit of open dialogue that has been engendered up to now and urges a continuation of this process. BIAC supports the OECD's vision of a public hearing on these issues, but would also like to point out that, given the complexity of the issues under scrutiny, the process should not stop there, but it should be expanded to include further meetings at which the expertise of the business community is taken into consideration. BIAC cautions that, since Part I (Working Hypothesis General revised) and Part IV (Insurance) are still under review and yet to be published, the comments contained herein should not yet be taken as final. In fact, we foresee a strong likelihood that the forthcoming reports on Parts I and IV will have a very considerable impact on certain aspects of Parts II and III. BIAC would, therefore, like to propose that after these reports are issued, the OECD consider a further round of review and consultation with regard to the overall concepts and issues of permanent establishments covering the entire subject. The Reports might serve as the basis for a dialogue, similar to the TAG process with regard to e-commerce, whereby unresolved issues could be submitted to more in-depth analysis on an on-going basis by representatives of governments and the private sector, before being put before the appropriate bodies for final approval.

As has been clearly demonstrated in all Reports, the issues under consideration are indeed complex. Additionally, depending upon how they are resolved, there could be a significant potential for financial repercussions upon international business. Up to now, the Reports have outlined a range of possible business models and various possible approaches, from a tax perspective. Offering alternative tax approaches accurately reflects the fact that consensus on a path forward is not easily reached, even in light of the risk of double taxation. Yet, consensus on an accepted approach is nonetheless essential if the risk of double taxation is to be avoided, which, in the opinion of business representatives, clearly must be the guiding principle underlying this exercise. BIAC, therefore, urges governments not to rashly discard existing tax practices in this field in an effort to settle upon one or another of the approaches outlined in the Reports before a consensus view is reached. Furthermore, any changes contemplated should clearly take into account all necessary adaptations from a national legislative perspective as well as giving due consideration to international conventions. At the same time, business should be provided with enough lead time to make necessary adjustments.

#### B. Fundamental substantive concerns:

BIAC reiterates its position that the guiding principle behind these efforts should be to ensure that neither double taxation nor complete non-taxation takes place. In addition, the effort should be directed to maximizing practicality and administrability, and minimizing and focusing compliance burdens and costs, and documentation requirements. A fundamental concern for the business community is that the solutions proposed in the Reports published thus far may not necessarily fulfill these requirements, especially with regard to the previously discussed Parts I (PE as a Working Hypothesis, still under review) and Part II (Banks). At the same time, the revisions undertaken by the OECD on Part II (Banks) do not go far enough to alleviate these concerns, and, in particular, we noted that most of the reasoned objections from the business community have either not been taken into account at all, or only taken into account to a small degree. BIAC would like to stress that the comments it made, alongside other professional representative organisations in the first round of consultation, both in their written and oral forms are still relevant and should be seriously reconsidered by OECD. Our concerns are further validated by our close reading of Part III: Global Trading of Financial Instruments.

In certain respects, the revised Report II (Banks) can even be considered a step backward from the previous version of Part II since it does not move to agreed positions. A valid consensus has yet to emerge with regard to many issues. Flexibility is to be appreciated, but the absence of consensus on certain aspects of the report, as well as a certain ambiguity which has now emerged, again leaves the door open to selective “cherry-picking“ by different countries. This clearly increases the risks of double taxation among the countries. For example, this is especially true with regard to the issue of an agreed method for the attribution of capital (including free capital) to PEs (Revised Part II (Banks)). As expressed in the Report, it is entirely possible that, as a consequence, “[e]ach OECD Member country is likely to adopt only one of the agreed approaches to attributing capital and may require taxpayers to follow that approach in their jurisdiction when computing the profits of a PE under the arm's length principle. Double taxation may potentially arise....” (Para 123, Revised Part II (Banks)). Solely by relying on the mutual agreement procedure presents a weak and insufficient remedy.

In the absence of consensus, BIAC strongly urges OECD participants to accept the proposition that taxpayers should be entitled to apply any one of the approved attribution methods, as long as the method chosen is consistently applied or, if a method is changed, the taxpayer has a reasonable and, perhaps, compelling reason for doing so. More explicit recognition should be given to the fact that a taxpayer's result should be acceptable as long as it falls within the arm's length range as determined under the arm's length standard of the 1995 Transfer Pricing Guidelines. If, given the lack of consensus, taxpayers are not allowed the “method of choice”, subject to a standard of consistency across jurisdictions, an additional compliance burden will arise, along with a climate of uncertainty, and thus the risk of double taxation increases substantially.

This heightened risk of double taxation, coupled with a lack of consensus with regard to any approved approach (a situation which runs counter to the underlying philosophy of the OECD), compounds the already high risks faced by taxpayers due to the sheer magnitude of today’s high volume financial transactions as well as any retroactive effects. BIAC, therefore, believes strongly that an efficient and binding mechanism for dispute resolution must be put in place in cases where differing approaches are taken by the governments involved. This is particularly true in situations involving multiple jurisdictions, not just the traditional two, as is the case presently for both international banking operations as well as the global trade in financial instruments. In our opinion, reliance to the mutual agreement procedure is clearly insufficient in these circumstances. Much stronger arbitration procedures, or other binding dispute settlement methods where clear and binding decisions are made mandatory, are clearly needed to minimize the real risks of double taxation.

Given the lack of consensus in certain fields, it might be useful to explore further, as an interim measure, the idea of creating a small subgroup of those countries which have traditionally been either the home country or the host country to operations in the fields of international banking and global trading of financial instruments. It might prove easier for a more limited group of countries such as this to reach consensus on such a complicated and far reaching sets of issues. This should, in no way, imply our advocating a two-track approach to the issues resolution, but simply reflect our view that a gradual build up of understanding and agreement on certain approaches among countries in similar circumstances might eventually lead to consensus among a broader group of OECD participants over time.

Consideration might also be given to the possibility of, first, developing a consensus on the most appropriate approach, and then allow for certain reservations to be made by specific dissenting countries,

similar to the approach used with the OECD Model Tax Convention. This might also lessen certain concerns in the business community since, at the very least, additional certainty about the position of different countries would be available.

Notwithstanding the possibilities discussed under paras., 8, 9 and 10 (Revised Part II (Banks)), BIAC, in the absence of agreement with regard to the approach to be taken on the issue of capital attribution, urges that OECD member countries accept the notion that, as far as is possible, the taxpayer should be allowed the choice of an approved approach, so long as it is consistently applied.

### C. Part II of the Report: Banks

As noted above, BIAC regrets that so few of the points made during the previous comment period as well as at the public hearing which followed, were not accepted by the OECD. We will not summarize all the points made at that time, but we would like to reiterate our belief that the positions we have taken continue to have substantive value and should not be summarily dismissed only to be revisited at some future time.

In addition to the grave consequences stemming from disagreements over a single method for allocating capital to PEs, we question whether or not the use of a “thin capitalisation” method of capital attribution will lead to erroneous results and, again, increase the potential for double taxation. As stated in the OECD report, the possibility exists that under a “thin capitalisation” approach, it is perfectly possible that either more or less capital than the enterprise as a whole possesses is attributed among its various parts... Double, rather than less than single taxation, is more likely to occur under a thin capitalisation approach...“ Overall, we concur that under this analysis, the risk of double taxation is highly probable due to the “whole being less than the sum of the (notional) parts.“ We believe that the initial draft advocated the “capital allocation” approach specifically in order to avoid double taxation. We, therefore, contend that the thin capitalisation approach should be excluded from the list of “approved” capital attribution methods under the Working Hypothesis. Moreover, we reiterate that the most appropriate method of capital attribution is that which follows a “capital attribution” approach by reference to the relative RWAs, or possibly book values of assets, attributable to the various PEs. We believe that the effect of any surplus capital which supports the business of the head office, or of another PE, is excluded from the outset. We urge the OECD to reconsider its definition of free capital and to “haircut” the capital to be allocated between the various PEs, while at the same time, taking into account the specific head office factor. After taking into account such essential “haircuts“, we agree that the capital should then be allocated based on the various RWAs. In our view, this “modified capital allocation” method, applied on a consistent basis, best reflects the aim of the arm’s length standard, while avoiding the risks of double taxation.

A further area of concern is the question of disallowing interest paid by a particular PE to third parties when there is no (or insufficient) interest between the internal parties. It is suggested that such a disallowance may be calculated with reference to the imputation of “loans” between the treasury location and the PE in question. We believe, however, that Article 7 of the Model Tax Convention does not allow for such imputation of notional transactions. Generally speaking, BIAC also has grave concerns about the OECD’s overall approach to imputing “notional transactions.“ The OECD’s seeming disregard for the actual dealing of PEs and the substitution of other dealings therefore has been noted several times previously. In BIAC’s opinion, these increasingly expansive views with regard to the imputation of notional dealing are very dangerous and diverge from the fundamental arm’s length approach. We do not concur with the OECD’s view that this only happens in rare circumstances, a view which does not give proper consideration to the effects of foreign exchange rate fluctuations.

BIAC would also like to reemphasize its support for the points previously made concerning the questions of Credit Rating and Guarantee Fees. While we agree in general with the fundamental premise that the creditworthiness of a bank is fundamental to its overall profitability, and further that a PE might be deemed to have the same creditworthiness as the overall bank, we continue to disagree that this necessarily leads to double counting when the capital of the entity is then allocated to the branch without any adjustments. The points made explicitly in the presentation of the Japanese Bankers Association during the OECD consultation meeting in April 2002 is still very persuasive. Our Japanese colleagues clearly illustrated that, without the acceptance of a deemed guarantee fee, the permanent establishment would be more heavily taxed than a subsidiary. This presents a fundamental inconsistency, if, under the Working Hypothesis, branches would need a capital attribution consistent with the actual capital of a subsidiary (which fund themselves at their own appropriate funding rate), while no funding margin on borrowings from a head office or payment of a guarantee fee is to be allowed for the PE, given the same credit rating. This answer would seem to signal a change in the stated objective of the Working Hypothesis, i.e., the initially stated aim of achieving neutrality between PEs and subsidiaries. In the OECD's original draft of the paper, it was firmly stated that a failure to achieve neutrality between branches and subsidiaries "would be unacceptable on tax policy grounds.... [as it would produce] ... a discrepancy between the tax results of a branch and of a subsidiary carrying on similar operations." The response of the OECD to the substantive comments provided by the business community has not resulted in the amendment of the Working Hypothesis to better fit the original objectives, but, instead, appears to have led the OECD to alter the stated aims of the Working Hypothesis. It is now simply stated in Paragraph 5 that "the aim of the Working Hypothesis is not to achieve equality of outcome between the branch and subsidiary in terms of profits". Yet, this position, we believe, clearly undermines the fundamental purpose and integrity of the Working Hypothesis. BIAC feels strongly that a central objective of the exercise be to achieve, even if only broadly, a consistence whereby a branch and a subsidiary are in the same economic position. We, therefore, strongly urge the OECD to adopt the position that once a PE has had its share of the entity's capital allocated, an appropriate guarantee fee should be allowed for deduction from the PE's profits. This should especially be the case if a thin capitalisation scenario becomes an accepted method.

As stated earlier, we urge the OECD to consider the discussions on Part II as part of an on-going dialogue, which will be fruitful for both governments and the business community. As the discussion on Part II unfolds, there are many further points which would benefit from joint attention, or, for example, timing issues (e.g., the timing of the ration of capital to RWAs), exchange rates, and questions related to overriding home country vs. host country differences.

#### D. Part III of the Report: Enterprises carrying on global trading of financial instruments

The above comments on Part II, with regard to capital attribution, credit rating and guarantee fee, are equally applicable to Part III (Global Trading). Part III, more so than Part II, describes the wide variety of business models that lead to a comparable variety of possible tax approaches. In many circumstances, an accurate portrayal of these various business models ("integrated trading, centralised product management, separate enterprise trading") is more difficult because of the wider variety of factual environments. Hence the appropriate taxation methodology is more difficult to determine than is the case in Part II. This situation increases the risk that different, and even conflicting, approaches taken by various tax authorities will lead to double taxation. As in Part II, it is essential that the tax authorities be willing to accept a "method of choice" by the taxpayer, as long as it stays within the accepted method and is consistently applied. It should be further noted that, even though the basic descriptions of the three business models may be valid simplifications, actual situations, as well as variations and combinations among these models,

could render the situation still more complex. Another point to be made with regard to global trading is that the nature of the business is very dynamic, both in changing regulatory requirements as well in the pace of change in reigning business models. One of the fundamental points we feel should be recognized by tax authorities is that these changing business models are not tax driven, but are an outgrowth of evolving business and professional needs, as well as the rapid changes in the system and technological environments, all of which occurs in a business environment exposed to intense competitive pressures.

With regard to the questions of risks raised in paragraph 82 ff of the Part III Report, BIAC believes that the issue should be analysed differently than it is in the Report. We concur that the essence of trading in financial instruments fundamentally consists of the assumption and management of risk, but the various categories of risks should be distinguished, as they tend to vary in importance as well in character. Whereas the management of market risk is the essence of financial trading, operational risk is not. Therefore, operational risk and other risks covered in paragraphs 93-95 should not be analogized to credit and market risk because, in BIAC's opinion, such risks do not create profits by themselves. This should be recognized when drawing conclusions with regard to taxation. Furthermore, credit risk is becoming more and more a market risk per se, which can be traded and managed through the use of credit derivatives. In our opinion, this is in one of the most essential points requiring further treatment in the Report (paragraphs 245-250). Tax authorities must come to recognize the legitimacy of the internal transfer of risks through the use of credit derivatives, or, through other methods of hedging. This should also be the case when the entities involved use "mirror swaps" to transfer credit risk, since this can be priced under standard credit derivatives procedures. As a rule, we urge the tax authorities to fully accept and recognize internal credit transfers, even between branches.

Another important question is whether the analysis of Part II regarding the ownership of capital and allocation of such capital to the entities (subsidiaries/PEs through a dependent agent approach) is appropriate in the global trading context under paras 137ff. From our perspective, it may be well worth revisiting this issue in the future to take into consideration a "hedge fund type" model, which is a somewhat analogous situation. In the absence of finding an equitable solution through the application of a hedge fund type model a PE in the jurisdiction of the trader might be treated as a dependent agent which could be an unfortunate result. A hedge fund model might produce a suitable third party price for measurement of the remuneration of the trader, which would likely take the form of a profit-related fee. In any event, BIAC believes that these aspects merit considerably more discussion than currently found in the Report, and we look forward to exploring these issues at greater length in the future with OECD.

With regard to the question of a profit allocation to cover the compensation of the individuals who perform the trading functions for purpose of the profit split application, BIAC believes that due regard should be given to differences arising from such things as varying levels in the cost of living, the competitive environment of the market, etc. This consideration, however, should not lead to the creation of a burden to a taxpayer to develop and keep track of sophisticated methods which are difficult to administer. Perhaps the simplest way forward here is to come up with an agreed benchmark among tax administrations.

With regard to losses, BIAC firmly believes that a guiding principle should be that all ordinary and necessary deductions must be allowed, and tax authorities must ensure the deductibility thereof. This might be a difficult problem, and, therefore, further analysis may be necessary. The formula for the profit split method does not easily accommodate the loss allocation, possibly requiring modification of the formula, or perhaps even avoiding some of the factors otherwise employed. The problems associated with a loss allocation might be minimised, however, if the overall method of functional analysis is simplified by

reducing the functions that need rewarding. Volume-based factors could still play a significant role. In such circumstances, for example, it might be appropriate to reward marketers on a profit-share basis when there are profits, while in a loss scenario, compensation would come in the form of some sort of sales commission, thus allowing the trading functions to share the loss. These brief remarks highlight some of the difficulties encountered with loss allocation in this area, and they should lead to the conclusion that, perhaps, it is impossible to have just one loss allocation method (“one size fits all”). Taxpayers should be granted some leeway to construct sensible loss allocation methods based on their particular circumstances. In any case, BIAC firmly believes that, in spite of any difficulties encountered, tax deduction for losses must be allowed.

One of the most critical areas contained in Part III of the Report concerns the issue of the dependent agent PE (paras 256 ff). To a large extent, this involves the financial industry’s global trading activities, especially in view of legal structures sometimes mandated by regulatory constraints, but it has much a much wider application to other segment of industry as well since it purports to be based on broad theories. We, therefore, believe it is essential that the issues associated with dependent agent PEs are analysed much further, in particular in light of the fact that neither the revised Part I (general issues) nor the contemplated Part IV (insurance) have yet been released. We, therefore, would like to propose that the issue be segregated from the present report so as to subject these problems to additional, in-depth analysis. Clearly, there are fundamental issues with regard to dependent agent PEs in need of careful study but which are beyond the scope of the global trading in financial instruments. These issues rub shoulders with the entire spectrum of increasingly integrated business models generally in addition to global trading, especially with regard to the endlessly innovative world of e-commerce. BIAC therefore urges the OECD to place these issues under more careful scrutiny and to consider the possibility of organizing an extra session to focus thereon.

Because of foreign exchange issues, regulatory, credit and/or capital constraints and in the light of the fact that the external “activities“ (contracts) of the global entity are effected through subsidiaries in a host country, the global trade in financial instruments requires that trades be booked and reported not in the subsidiary or a branch located in the host country, but rather in the head office of the parent company. Profits therefore appear *prima facie* in the head office of the parent company, whereas the host country’s subsidiary will show a profit based on service fees paid to it for services rendered. In these instances, a question can be raised as to whether this situation could not be adequately addressed by using a proper and sensible transfer pricing methodology without having to go further down the path of the dependent agent PE. The dependent agent PE approach will instead create; in addition to the subsidiary’s own position as an „independent“ tax subject, the separate tax subject of the dependent agent PE as a further branch of the parent company. This will almost certainly lead to a series of extremely complex jurisdictional, filing headaches and penalties for having potentially missed filing obligations, overlooked questions of group consolidation and branch consolidation etc. Furthermore, the tax consequences will vary depending on whether the home jurisdiction uses an exemption method or a credit method with regard to foreign branch profits and double taxation. Also not to be dismissed are other taxation issues, especially indirect taxes like VAT or even, in some instances, withholding taxes.

It is the position of BIAC that substantial technical and practical problems arise with the dependent agent PE approach developed in Part III. It is essential that we get both the technical as well as the practical analysis right so as to avoid insurmountable problems down the road. The technical analysis performed in the Report is a good starting point for further analysis, which should also include a thorough exploration of possible „hedge fund models“ as a solution to certain problems posed, especially with regard to issues of capital uses. We therefore urge OECD to further study any issues there under in a much wider scope,

taking in to consideration the detailed substantive comments submitted by various professional organisations representing the financial industry on various technical matters, as well as any practical issues involved. At the same time, the OECD should broaden the scope of the discussion by including other industry sectors, which will very likely be greatly impacted by any developments in this field as well.