

THE TAXATION OF GLOBAL TRADING OF FINANCIAL INSTRUMENTS: A DISCUSSION DRAFT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Paris

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PREFACE

The attached Report was prepared by the Special Sessions on Innovative Financial Transactions which is a group of tax experts established by the Committee on Fiscal Affairs in 1994 to review the tax policy and administrative issues raised by financial innovation. The Report was discussed by the Committee on Fiscal Affairs in January 1997 at which time it was agreed to recommend to the Secretary-General to issue the Report under his responsibility as a general distribution document.

The Report describes the challenges posed to tax authorities by the development of Global Trading. The aim of the Report is to provide a basis for a discussion between tax authorities and between tax authorities and taxpayers on the issues raised by Global Trading. The Report describes these issues and identifies the options open to government to deal with them. The Report does not generally reach recommendations since this was not the intent at this stage of the project.

The Report is being issued as a general distribution document since the Committee is very much aware of the need to have input from the business community both in terms of comments on the ways in which the tax issues are described and on the options identified for governments to deal with these issues.

The Committee intends to use this Report to explore whether a multilateral consensus on how such activities should be taxed could be developed.

The views expressed in the Report should not at this stage be taken as necessarily reflecting the final position of Member governments.

Public comments on the Discussion Draft should be submitted in writing to the OECD Secretariat (Mr. Jeffrey Owens, Head, Fiscal Affairs, 2, rue André Pascal, 75755 Paris Cedex 16, Fax No: 01.45.24.78.52, E-Mail: jeffrey.owens@oecd.org) by the 15 April 1997.

EXECUTIVE SUMMARY

Technological change, the communications revolution, and the spread of financial deregulation and liberalisation have had a dramatic effect in globalising financial markets. Financial firms have developed innovative financial instruments, such as derivatives, to meet the global demand to finance trade and investment and to reconcile the often different demands of borrowers and investors.

Such innovation challenges traditional tax systems both as regards the taxation of the end users of innovative products and the providers of such instruments. A second challenge arises because financial firms have increasingly organised their activities on a global basis so as to be able to meet the demands of investors for global financial products, 24 hours a day. It is this phenomenon of global trading that the paper addresses.

The paper looks in some detail at the factual background to global trading. This covers the general business background, trends in the financial industry, the type of financial institutions involved and the products that they trade.

There is a detailed description of the various ways global trading businesses can organise themselves and the various functions which they must perform. These include sales, marketing, trading, risk management, systems control, accounting, settlement and other support functions.

The paper outlines the challenges posed to the traditional way of taxing such enterprises. A description of trading models is given and the application of traditional transaction methods to such trading patterns is reviewed, using the views set out in the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter referred to as the “TP Guidelines”).

Global trading is often carried on in branch form (or through agents) for reasons of capital adequacy and so the paper also reviews the difficulties of applying the existing rules to such situations. Particular problems arise as to the question of whether certain kind of activities carried on in a particular jurisdiction amount to the carrying on of business there through a permanent establishment. This question can be difficult to answer, given the integrated nature of much global trading. There are also many problems concerning the attribution of income and expenses to a permanent establishment of a global trading business. For example, to what extent should tax administrations recognise transactions within a single legal entity, such as mirror swaps between a permanent establishment and head office?

The core of the paper concerns the examination of the most difficult cases, where the different functions necessary to perform the global trading business are so integrated that it is difficult to evaluate them on a separate basis. The case for applying transactional profit split methods, as methods of last resort, is reviewed. The discussion draws on the existing guidance given in the TP Guidelines and examines how this can be applied in the special factual circumstances of global trading. The paper concludes that the special circumstances can be adequately dealt with by the application of existing tax rules and transfer pricing methodologies. However, it is felt that further guidance on the practical application of the rules would be very useful for both taxpayers and tax administrations.

The paper looks at current practices for actually applying the profit split method (in cases where it has had to be used as a method of last resort) and especially the use of factor formulae to arrive at an arm's length profit split. There is a detailed discussion of the factors that could be used when performing either a contribution or a residual profit analysis. These include compensation of marketers, risk managers and traders, measurement of capital/risk exposure, risk management and compensation of support staff.

There is also a brief consideration of other factors that could be used in such a formula and of how to best measure the different factors. The vital issue of how to weight the factors to produce an arm's length result is also explored.

The paper does not generally reach recommendations but that was not its intention. It aims to provide a basis for discussion of the issues raised by global trading. The description of the issues and the setting out of the options open to Governments to deal with them provided in the paper, is seen as a first step in forming a multilateral consensus on how to tax such activities. The Special Sessions is particularly aware of the need for input from the business community before taking the project further.

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GLOSSARY

Derivative instruments

These are described in detail at paragraph 4.

Global trading

This activity is described in detail at paragraphs 9 to 11.

Integrated trading model

This is described in detail at paragraphs 47 to 51.

Centralised product management model

This is described in detail at paragraphs 52 to 56.

Separate enterprise trading model

This is described in detail at paragraphs 57 to 59.

Trader

The role performed by such a person is described at paragraphs 70 to 80.

General sales staff / marketers

The different roles performed by these staff are described in detail at paragraphs 64 to 69.

Inter-branch transaction

A transaction within a single legal entity across an international border.

Inter-desk transaction

A transaction within a single legal entity within a single jurisdiction.

THE TAXATION OF GLOBAL TRADING OF FINANCIAL INSTRUMENTS

I. INTRODUCTION

1. It is by now a commonplace observation that financial markets have become increasingly globalised. This process allows more efficient allocation of savings and capital as those needing capital can offer securities to those investors who are most interested in those securities, whether those investors are in the issuer's domestic markets or purchasing the securities in the international markets. Similarly, those with surplus capital can invest that capital in products offered world-wide, allowing the investor to tailor its portfolio more exactly to its desired risk/return profile.

2. Financial institutions, mainly banks and securities firms, that act as financial intermediaries, have played a substantial role in the efficient operations of the financial markets. These financial institutions traditionally intermediate between those who want to invest surplus capital and those who need capital.

3. Increasingly, financial institutions do not simply intermediate between investors and borrowers by simply matching offsetting transactions and taking a margin in the middle, but rather seek to earn profits by directly managing the risks from a portfolio of transactions with customers. This pattern is well developed for businesses dealing in derivative instruments.

4. A "derivative" instrument is a contractual right that derives its value from the value of something else, such as a debt security, equity, commodity, or a specified index. The most common derivative instruments are forwards, futures, options, and notional principal contracts such as swaps, caps, floors, and collars. Unlike traditional debt and equity securities, these instruments generally do not involve a return on an initial investment.

5. One can appropriately view the business of being a derivatives dealer as assuming risks that customers do not have the expertise or the desire to manage for themselves or, alternatively, creating the means by which the customer can take on risks that it believes will complement its existing risk portfolio. The derivatives dealer makes its money by managing those risks more efficiently than the customer would have. This market has become quite important as the growth of international trade has exposed more companies to currency and other risks and increased volatility in the marketplace has made those risks more unpredictable.

6. The development of sophisticated derivative instruments has changed the nature of financial intermediation in other ways. Until recently, it was necessary for a financial institution to develop a single product that met the needs of both parties to the transaction. This is no longer necessary, as the issuer can sell a security that has the terms demanded by the investor, and then effectively modify the terms of the instrument by entering into a derivative transaction with another party (usually, but not always, the financial institution that arranged the transaction). Accordingly, the effect of developing new financial products is not limited to the market for derivative instruments as it facilitates even traditional bond offerings by allowing the financial institution to tailor transactions that meet the frequently disparate needs of the issuer and the investor.

7. Thus, financial intermediation now involves several types of business activities. These include underwriting and distributing products on a world-wide basis, acting as a market-maker in physical securities (i.e., the traditional bond and equity markets) and in derivative instruments, acting as a broker for client transactions on stock and commodities exchanges around the world, and developing new

financing products to meet the needs of the financial institution's clients. The income earned by the financial institution consists of interest and dividends received with respect to the inventory it is required to maintain in order to be a market-maker with respect to physical securities, trading gains from sales of that inventory, income from notional principal contracts and other over-the-counter (OTC) derivatives entered into with clients, fee income from structuring transactions, gains from dealing in liabilities, income from stocklending and repo transactions, and brokers' fees from exchange transactions executed for clients.

8. In order to meet the demands of its increasingly international client base, financial institutions developed the ability to execute client orders around the clock. In addition, they found that their inventories became vulnerable to market changes caused by events in other markets, so that they had to develop systems to adjust their positions in the case of major market movements during "non-business" hours.

9. The term "global trading" has become the catch-all phrase that focuses on the capacity of these financial institutions to execute customers' orders in financial products in markets around the world and/or around the clock. Entities that engage in global trading in this sense, i.e. market making, may also seek to profit by correctly forecasting the movement in market variables (such as interest rates, exchange rates or prices) that affect the value of their portfolio. This involves the deliberate exposure of the portfolio to changes in the market variables and is sometimes referred to as taking a "proprietary position".

10. Some entities manage proprietary positions on a global or 24 hour basis but do not make markets. However, in this paper the term "global trading" refers primarily to those entities that, at a minimum, engage in market making on a global or 24 hour basis.

11. Although the global trading entity typically has a presence in more than one of the three main time zones global trading issues arise whenever financial products are offered to customers in more than one jurisdiction (even within the same time zone).

12. Given the broad description of global trading, care must be taken to analyse the special factual circumstances of any particular case, before applying to it the necessarily general conclusions of this paper. It should also be noted that the paper focuses particularly on the difficult cases, where the trading pattern is the most global and integrated in nature.

13. The process of global trading consists of a number of functions, which generally can be categorised into trading, sales and marketing, management and supporting functions. Any combination of these functions can occur at any of the locations in which global trading takes place. For example, an office in New York may structure and sell to customers a product that is booked and managed in Tokyo.

14. As a result, global trading presents a number of challenges to traditional tax principles. These involve questions as basic as when the trading activities conducted in other countries, either directly or through affiliates acting as agents, constitute a permanent establishment, how to determine the income attributable to those permanent establishments, how to apply traditional transfer pricing methodologies to transactions between associated enterprises involved in an integrated business, and basic timing issues.

15. For example, rules regarding the attribution of profits to a permanent establishment may rely on rules regarding the source of the income. Many countries do not yet have rules regarding the source of income produced by notional principal contracts and other derivative instruments, which can constitute a significant portion of the income generated in a global trading operation. The source of other income generated by global trading, such as interest, dividends and gains from the sale of property, is often

determined under traditional rules which may no longer be appropriate. Those source rules frequently were based on notions regarding the location of the functions that gave rise to the income. Global trading confounds those expectations, because performance of the various functions undertaken in relation to global trading is routinely carried out in two or more locations.

16. Although several different jurisdictions may participate in a single transaction, domestic tax rules may not provide for the income generated by that transaction to be split between different jurisdictions. If global trading is conducted through branch form, transactions may be taxed, under domestic rules, on an “all-or-nothing” basis; if sufficient activity takes place in a jurisdiction, then all of the gross income from the transaction is taken into account for purposes of determining taxable income; if not, then none of the income from the transaction is taken into account. Expenses, including losses from transactions entered into to hedge the risk arising from the customer transaction, may be allocated against the gross profit arising from the transaction in order to determine the net taxable income. Unless the rules regarding expense or loss allocation are clear, this approach is unlikely to produce, in practice, a result consistent with the arm’s length principle.

17. Global trading conducted by associated enterprises raises similar issues, although they are often couched in terms of traditional transfer pricing problems. As can be seen from this report, it appears that there is often not a consensus on when and how different transfer pricing methodologies (including profit split) set out in the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereafter referred to as the “TP Guidelines”) should be applied to cases involving global trading.

18. As a result, current unco-ordinated approaches to global trading produce a significant risk of double (or under) taxation, whether such trading is conducted through branches or subsidiaries. This potentially occurs, under either the credit or the exemption method of tax treaties, whenever the computation of foreign source income which qualifies for a tax credit, or is exempted by the resident state, differs from the amount taxed by the source state. In the example in paragraph 13, United States and Japan could both decide that sufficient activity had taken place within its jurisdiction to tax the entire profit from the transaction. Double taxation is the almost certain result, unless the two have co-ordinated tax rules that allocate the taxing rights between them by determining the source of the income and the correct allocation of expenses to that income.

II. CURRENT SITUATION

II - 1. BUSINESS BACKGROUND

19. The tax issues involved in global trading began to come to the attention of tax administrators in the late 1980’s. Technological, economic and regulatory developments all contributed to the growth of the global financial business during that time period. These trends also will be relevant to its continued evolution and need to be taken into account in determining the appropriate tax treatment of global trading functions.

20. Technological advances allow managers, traders, marketers and operations personnel to track, price and measure risk resulting from thousands of trades occurring around the world on a “real time” basis. Financial intermediaries have invested enormous resources in developing systems that allow them to correlate risks and develop hedging strategies so that they can manage the risk they take on from their customers without subjecting the firms to unacceptable levels of absolute risk to market changes.

21. As an economic matter, the most significant development in the financial markets during the late 1980's was the broadening and deepening of the customer base. Increased international trade expanded the number of customers who were exposed to currency and other risks. Increasing volatility in the financial markets ensured that they would come searching for new means of neutralising that risk.

22. At the same time, larger amounts of capital became concentrated in the hands of traditional institutional investors such as insurance companies, pension funds, banks, governments, finance companies and, in the early 1990's, hedge funds. Governments and multinational corporations, which frequently have been borrowers in the past, now also provide liquidity to the market as investors, blurring traditional distinctions between "capital users" and "capital providers".

23. These institutional investors have contributed significantly to the globalisation of the financial markets, in many cases seeking out new markets in a quest for higher returns and for diversification. As even individual investors have become comfortable investing in foreign markets, they have sought out mutual funds investing in a particular country or region, or in a diversified international portfolio, the number of which has increased dramatically.

24. The development of software assisting in quantifying risk and valuing financial products has changed the way that end-users (even some relatively small businesses) use financial products. The increasing sophistication of such end-users means that "risk" may arise not only from core business operations, but also may be perceived as a failure to take advantage of a business opportunity, such as the possibility of borrowing in a different currency or a different market at a lower cost than in the domestic markets.

25. The use of derivative instruments, in particular, has expanded because such instruments allow the parties to a transaction to tailor their risk exposure. On the liability side, issuers may be able to lower the cost of funds by issuing debt into global capital markets in a different currency and entering into an appropriate derivative transaction with a financial institution to hedge the currency risk. Asset managers increasingly use derivatives to tailor the risk profile of a security or portfolio to their particular investment objectives. For example, an asset manager can choose to keep long-term exposure to a particular security while swapping away the short-term exposure by entering into a short-term single-stock equity swap.

26. Finally, favourable regulatory developments have allowed the expansion of activities in major capital centres. Markets have also developed in other countries that have kept pace with deregulation. These changes have allowed more financial intermediaries in countries outside traditional financial centres to provide an increasing variety of products to an expanding customer base both in domestic and foreign markets.

II - 2. FACTORS AFFECTING STRUCTURE OF THE BUSINESS

27. It is difficult to make generalisations about the structure of a global trading business because the manner in which the business is conducted is influenced by the type of institution doing the trading, the product being traded and that institution's business strategy.

(1) Type of Financial Institution

28. Global trading now is conducted by many types of financial institutions, although the commercial and investment banks tend to dominate the marketplace. These entities have the resources to develop or hire the necessary trading expertise and the capital base necessary to engage in global trading.

29. A strong capital base and credit rating are particularly important in the case of trading in “over-the-counter” (OTC) derivatives. Because counterparties are not dealing with an exchange, OTC derivative contracts involve significantly greater credit risks than exchange-traded contracts. Accordingly, market participants select their counterparties on the basis of creditworthiness. If the creditworthiness of a counterparty is in doubt, a market participant may require OTC transactions to be collateralised, making the transaction less profitable for the counterparty.

30. In this respect, banks enjoy a certain competitive advantage in the OTC derivatives business because they generally conduct their business in branch form. As a result, every transaction is backed by all of the bank’s assets. On the other hand, for regulatory and other reasons, securities dealers traditionally have operated internationally through subsidiaries. Because the subsidiaries must be independently capitalised, the credit ratings of each of these subsidiaries may be lower than the rating of a comparable bank, making it more difficult for the subsidiaries to compete directly for the OTC business.

31. In order to participate in the OTC derivatives business, some financial institutions that are not sufficiently creditworthy to engage in such transactions directly have established AAA-rated subsidiaries to act as market-makers in derivatives. Such entities may then enter into mirror transactions to transfer the market risk to the location, where it can be managed most effectively, while maintaining the credit risk in the subsidiary. The purpose of other special-purpose derivatives subsidiaries, such as those established by insurance companies, is primarily to avoid certain regulatory requirements that would apply to the parent company. In that case, the risk is managed in the subsidiary rather than being passed on to the parent.

(2) *Type of Product*

32. It is now possible to buy almost any financial product, including most currencies, many debt instruments (particularly government securities), and some equities and commodities, at any hour of the night or day. To that extent, it is possible to say that almost all financial products are traded globally. However, the level of global trading in products varies widely, with the deepest world-wide markets found in certain currencies and derivative instruments and the markets for equities perhaps the most localised.

33. Not surprisingly, these differences depend in large part on the demand for the product. Some products are used throughout the world, requiring marketers world-wide to be familiar with them. Others address the specialised needs of persons in a specific country, allowing the marketing effort to be more localised. These differences in turn may affect the manner in which a product is traded and marketed.

34. Some products, particularly physical securities, have a primary trading market where the bulk of trading in that product occurs. Traders will be drawn to that market because its greater liquidity will allow the traders to hedge their portfolios most efficiently. Accordingly, secondary markets for those products are relatively unimportant unless there is a major market disruption when the primary market is closed. The products most frequently described as having a primary market (sometimes called a “natural home”) are government securities. Although it is possible to trade US Treasury securities outside the United States, the primary market remains New York, just as the primary market for UK government bonds (“Gilts”) remains in London and the primary market for Japanese government bonds is Tokyo.

35. The market for derivatives appears to be less localised, making it more difficult to determine a natural home for a particular product. For example, anecdotal evidence suggests that more US dollar notional principal contracts are written in London than in the United States. The US market for US dollar notional principal contracts cannot, however, reasonably be described as a “relatively unimportant” secondary market, since it is the US market, including the market for US Treasury securities, that provides

the liquidity to hedge efficiently US dollar positions world-wide. It is probably more accurate to conclude that there are several important markets, but no primary market, for such financial instruments.

36. The most decentralised products appear to be spot and forward contracts in the most heavily-traded foreign currencies. This is a natural result of the increasing globalisation of trading markets, which increases the likelihood that a company located in one country will need the currency of another country to purchase inputs to its own production process or that it may agree to price the products it sells in a foreign currency in order to be competitive. Hedging such foreign currency exposures is an ordinary and increasingly important part of running any international business, the effect of which is a deep and liquid market from which almost all arbitrage opportunities have been eliminated. Accordingly, the average customer need look no further than its customary banker to get a competitive market price on these transactions.

37. There are other fundamental differences between the market for physical securities and the derivatives markets, the most obvious of which is the difference in the way transactions are structured. Financial institutions buy physical securities, carry them in their inventory, and sell them to other customers (although not necessarily in that order). Once the financial institution sells the physical security, it is no longer a party to the transaction. If another intermediary is involved, as is frequently necessary to comply with regulatory requirements, the financial institution can structure the transaction as a sale to that other intermediary and then a sale to the ultimate customer.

38. On the other hand, a financial institution acts as a dealer in derivative instruments by offering to enter into executory contracts with customers. In OTC derivative contracts, the “product” is created when the financial institution enters into the derivative contract with the end-user. The financial institution remains a party to the transaction until the transaction matures or the financial institution assigns its rights and obligations to a third party or enters into an agreement with the counterparty to terminate the transaction. Upon an assignment or a termination, there will normally be a cash payment to induce the assignee to take over a losing position or to compensate the party whose position is “in the money” for the gain that he would have been expected to realise over the remaining life of the transaction.

39. In some cases, the financial institution may act as a broker for a customer that wants to enter into exchange-traded derivatives contracts. In that case, the customer enters into the transaction with the exchange; the financial institution is not a party to the transaction. Accordingly, the financial institution does not have a “position” on its books from which it can earn trading profits. Its income from the transaction consists of the commission paid, usually in advance, by the institution’s customer.

(3) Business Strategies

40. Differences in business strategies, even as among those institutions that market and trade derivative instruments, may affect where and how business is conducted (and therefore the analysis of the business for tax purposes).

41. Institutions may have different goals in terms of geographic coverage. Some choose to cover all possible markets and client bases, while others choose to concentrate on their traditional client base in their home country (and perhaps affiliates of those clients located in other countries).

42. Another difference is the extent to which institutions are willing to take on risk. For example, one institution may choose (or be required by regulators) to run its business conservatively, incurring little in the way of unhedged risks, and earning most of its income from the dealer “spread” between the bid and

asked prices. Other institutions earn a significant portion of their income from taking unhedged, “proprietary” positions to generate significant trading gains. In general, regulators appear willing to allow securities dealers to incur a higher level of unhedged risks than they are willing to tolerate in the case of banks and insurance companies, which have obligations to retail depositors or policyholders.

43. Institutions also differ in their choices of instruments to market and trade. In some cases, the institution may believe that it will be more competitive if it develops a speciality, such as structuring OTC derivatives transactions to meet the individualised needs of the institution’s customers. This strategy, which has been followed by some of the best-known derivatives houses, is very labour-intensive and requires a large spread on each transaction in order to be profitable.

44. Other institutions that are market-makers aim to enter into a large number of fairly “plain vanilla” transactions. Although the profit on each transaction is reasonably low, there is also a relatively small level of risk and they can count on earning a fairly steady profit from the sheer volume of transactions.

45. Finally, other financial institutions do not view themselves as being primarily “market-makers”, but view their derivatives transactions as a necessary part of their business of being a full-service financial intermediary. In that case, a financial institution would normally hedge its customers’ positions and any profits would come from the institution’s ability to provide its customers with any of the basic products that a customer can expect.

II - 3. ORGANISATION OF TRADING ACTIVITIES

46. The various factors described above can combine in ways which result in an almost limitless number of different business structures. However, most structures can be represented along a continuum, with what has become known as the “Integrated Trading” model at one end, the “Separate Enterprise Trading” model at the other, and the “Centralised Product Management” model in the middle. Typical characteristics of these models are described in this section.

47. Integrated Trading (24 hour trading) has the following characteristics:

48. Traders in each trading centre (generally London, New York and Tokyo or Hong Kong) set prices and trade off a portfolio of positions called a “book” while the market is open in that location. Market makers may be located in or outside the trading centres.

49. While ownership is retained in one entity, when the markets close in a particular location, responsibility for trading the “book” is passed to the next trading location where the open positions form the starting point for trading. Traders in the new location may close positions passed to them and open new ones.

50. A committee in the institution sets overall trading limits but does not centrally manage the trading operations which are independent. Each location has a head trader who polices the trading limits set by the financial institution.

51. Many institutions trade foreign currency options (as opposed to spot and forward transactions) in this manner.

52. Centralised Product Management has the following characteristics:

53. All trading risk of a particular product is centralised and managed in one location. For example, trading in gilts may be managed by the London branch and trading in US Treasuries managed by the US branch. The decision where to locate the centralised trading location depends on a range of commercial considerations, e.g. market liquidity, ease of hedging, competition, business strategy, location of customers and skilled staff. Consequently, the location of the centralised trading location can change over time as the commercial factors themselves change.

54. The financial institution will rely on marketing operations in its other trading centres but will require the marketing location (referred to below as the originating office) to reverse the transaction with a trader in the centralised trading location through an inter-branch (or inter-company) transaction, thus transferring the trading risk to that location. Marketing personnel are not allowed to price or trade in a product.

55. The centralised trading location may or may not be where the natural home or primary market is located.

56. Physical securities appear to be most often traded under a centralised product management approach. However, this structure is also used for other products, such as certain derivatives.

57. Separate Enterprise Trading has the following characteristics:

58. Each trading location, whether in a subsidiary or branch form, operates as if it were a separate profit centre, with its own marketers and traders, and its own books that reflect products sold by that location. Different locations may pursue different trading strategies, and in fact may enter into trades with other trading locations. Accordingly, different branches of a bank may take opposite positions. A central committee sets overall trading limits for each location but does not control trading that is within the prescribed limits.

59. Many banks organise their trading in spot and forward transactions of the most heavily traded currencies on a separate enterprise basis.

60. A bank may use a combination of the models described above for different parts of its operations. For instance, its foreign exchange book may be based on a separate enterprise approach while its trading in physical securities may be based on a centralised product management approach.

61. Also, it is important to emphasise that while these trading models are a convenient means of describing how global trading activities can be carried out in different ways, the global trading of a given enterprise may not fall neatly within any of the models. For example, trading authority may be neither completely transferred to one particular location nor located in only one jurisdiction. Thus, there could be close co-operation between the head office and the branch office in making trading decisions or the primary responsibility for the performance of the book may be located in one jurisdiction, with limited authority to trade the book passed to another jurisdiction.

62. Moreover, the way in which a product is traded may change over time. A financial institution may find that it must grant limited trading authority for the product to traders located outside the original centralised trading location in order to satisfy customer demand during non-business hours in the centralised trading location. In practice, the other trading location may often begin by fulfilling a “nightwatch” function. This is very limited as compared to normal trading and may simply involve monitoring the markets for major events during their trading hours. If such an event occurred, they would

not adjust the firm's position themselves but would be under instructions to wake up the head trader in the centralised location. In some firms the "nightwatch" function may also encompass some trading activities. However, these occur only within very strict pre-set limits or are restricted to the fulfilment of overnight orders requested by the main trading location. As the amount of trading discretion given to such traders increases, the centralised product management model begins edging toward an integrated trading model.

63. It should be remembered that global trading firms can use a variety of legal structures and forms to carry out their business. Some trade exclusively through branches, others through separate legal entities (which may act in their own right or as dependent agents of other entities), whilst others use a combination of branches and separate legal entities. This diversity can be found in all trading models. For example, firms that only use separate legal entities to conduct global trading can still organise their activities by reference to any of the three models or a hybrid of them.

II - 4. SALES AND MARKETING

64. In general, the sales or marketing personnel are responsible for all contacts with customers. Usually, such staff are assigned to a particular geographic area and, within that area, may specialise in clients in a particular industry. Such specialisation allows them to learn about industry-wide problems that may be addressed through the use of particular financial instruments.

65. It is the responsibility of the sales and marketing personnel to ensure that the product sold to the client meets the client's needs. Although this is a general requirement, different financial institutions address it in different ways. Generally, the approach reflects the institution's overall business strategy.

66. For example, those institutions whose strategy is to earn a fairly large spread on a few, highly customised derivatives transactions generally maintain a dedicated sales force, the members of which are very familiar with the products. In many cases, these marketers understand the rudiments of pricing and hedging and can work with the traders to develop new products. At the other extreme are those institutions that treat derivatives as just another of the basic banking products they offer their customers. These institutions largely rely on their general sales force, with very few, if any, dedicated marketers to act as a liaison to the traders. The tax issues resulting from the range of functions that can be performed by sales and marketing staff are discussed elsewhere in this paper, particularly in paragraphs 112 and 113. In the paper the term "marketers" refers only to the dedicated sales staff and not to the general sales personnel.

67. Usually, the general sales staff play little part beyond introducing the trade whilst the marketer is responsible for "running" the deal, including ensuring that the transaction receives all necessary clearances within the financial institution. Clearances may be required from the tax, regulatory and compliance departments, as well as from the credit department. New structures may require extensive consultations with the risk management department to ensure that it is possible to hedge the transaction in a cost-effective way.

68. Although the trader determines the price at which he is willing to take a deal onto his book, the marketer is frequently responsible for negotiating the price with the client because the trader often does not deal directly with the customer. Accordingly, in the initial stages of negotiating a specific transaction, the marketer obtains an indicative price from the trader or traders who ultimately will price the transaction. As negotiations with the client progress, the marketer will obtain the final price from the trader; the marketer must then execute the transaction at that price or better.

69. The extent of the mark-up over the trader's "final price" depends in large part on the sophistication of the client. One of the marketer's most significant contributions is determining the price that a client will be willing to pay. It is reasonably clear that there is not one single market price at the retail level at any particular time. The price prevailing in the inter-bank, or "wholesale", market often (but not always) is more consistent. Accordingly, the role of marketers in the wholesale market is much more limited. Some institutions committed to market-making dedicate one or more marketers to handle the entire wholesale market while other institutions do not use marketers in their wholesale business, but allow the traders to speak directly to the other institution.

II - 5. TRADING AND RISK MANAGEMENT STRATEGIES

70. As noted above, global trading involves dealing (that is, making a market), taking and managing proprietary positions. While marketers are involved in only the dealing aspect of the business, traders are involved in all these activities. Traders both provide marketers with the prices at which transactions will be entered into with customers and are responsible for the management of the risk that arises from those transactions once they are entered on the institution's books. Traders are often given the opportunity to earn trading profits by running unhedged positions that may result in substantial gain (or loss), while keeping the ultimate risk incurred by the institution within risk limits that are set by the institution's management.

71. A trader can perform those functions only if the risks incurred by the bank are organised into trading portfolios (or "books") of similar risks. For example, a trader responsible for US dollar risks should not have Swedish Kroner liabilities included in his trading book. The Swedish Kroner risks must be allocated to the trader who is responsible for Swedish Kroner risks.

72. This process is fairly straightforward in the case of physical securities. For example, one trader may be responsible for European equities, which may further be broken down into baskets of equities relating to high tech industries, transportation industries, etc. Similarly, in the case of commodities, one trader may be responsible for precious metals and another for oil, or the responsibilities may be further broken down into gold, silver and platinum on the one hand and West Texas crude and North Sea oil on the other. However, in either case, once the books are established, it is fairly easy to assign securities and commodities to the appropriate book.

73. The process is somewhat more complicated in the case of derivative instruments, largely because the cash flows in such instruments are not necessarily limited to a single type of risk. Therefore, in order to manage the risks arising from a transaction, the transaction must be "unbundled" into separate risk components so that they can be assigned to the appropriate trading books.

74. In this process, the risk from a single transaction may be assigned to several different books. For example, a financial institution may purchase a Deutschmark-denominated note paying 5%, the principal amount of which is tied to the performance of the German stock market index, DAX. This note involves fixed-income risk (the risk that Deutschmark interest rates will go up, reducing the value of the note), equity risk (the risk that the value of the DAX will decrease) and, depending on the institution's functional currency, possibly currency risk. These risks must be allocated to the appropriate books, usually by entering into inter-desk transactions negotiated by the traders. Accordingly, a sophisticated derivatives operation may require numerous inter-desk (and inter-branch) transactions simply in order to assign risks to the appropriate trading book.

75. Once the risks are entered into the appropriate books, it may then be up to the traders to increase the financial institution's profit on the transaction by managing the risk, thus generating "trading profits", which are distinct from the initial "dealer spread" on the transaction. Throughout the life of the transaction, the trader must decide whether and when to hedge the aggregate market exposure arising from a transaction, after netting the risk against all the other risk positions in the book.

76. A trader may decide to take a view on prospective market movements by leaving the residual risk unhedged, or may attempt to lock in the existing profits in his book by "hedging down" at the end of the trading day. The residual risk is likely to be hedged either in the over-the-counter market or through purchase of exchange-traded instruments. In any case, however, this process of hedging the residual risk (known as "net" or "portfolio" hedging) generally means that it is difficult to identify particular transactions as "hedges" of other transactions.

77. The trader's discretion is limited to a greater or lesser degree by the market risk limits that are imposed by all well-run financial institutions. Usually, a financial institution will measure several different aspects of risk in order to establish limits on the amount of market risk to which the institution can be exposed. Common measures include outright interest rate risk, foreign exchange risk, yield curve risk, swap spread risk or basis risk, and several different option risks, including volatility risk. The amount of risk is measured by reference to the effect on trading revenues of a specified hypothetical "extreme" move in market rates.

78. Most financial institutions with a significant trading presence calculate market risk exposure on at least a daily basis. The calculation of the amount of a financial institution's market risk exposure is generally verified by an administrative group separate from the trading function as it is an important control on the trading business.

79. Depending on the financial institution, there may be a single, institution-wide limit relating to a particular risk. Frequently, the overall limit is subdivided into separate limits that are applicable to particular trading books or to individual traders. The level of risk that a financial institution is willing to incur is one of the most important indications of the institution's overall business strategy.

80. Although the trading and risk management functions described in this section are usually carried out by the same person, described in this paper as a trader, they can be performed by different people or by different parts of the global trading business.

II - 6. INTERACTION WITH OTHER DEPARTMENTS

81. The marketers and traders, who generally are identified as "front office", rely on a number of other departments within the financial institution. Although their functions traditionally have been categorised as "back office" functions, many institutions now designate some of the departments, particularly funding, credit, accounting and product control, and intangibles development, as "middle office" functions in recognition of their increased importance in the context of global trading. Some institutions do not treat funding as a back office (or middle office) function at all, viewing the funding function as just another trading book, and therefore part of the front office.

(1) *Funding*

82. The Treasury function is the back office function that is most similar to the general trading activities of a financial institution. The Treasury book traders are responsible for ensuring that the financial institution has sufficient cash to meet its payment obligations but does not have excess cash that is not being used profitably.

83. The task of the Treasury book traders is complicated by the fact that the cash needs of the business fluctuate a great deal. This volatility results in part from the use of exchange-traded contracts and securities to hedge OTC positions. In that case, the cash needs of a particular book (and therefore the business) will depend on whether the exchange-traded or the OTC contracts are in the money. If the book has losses on the exchange-traded contracts and gains on the OTC contracts, its cash needs will be greater than in the opposite case because the institution will be required to meet margin calls with respect to the exchange-traded contracts that it would not be required to make if the losses were with respect to the OTC contracts. Thus, the cash needs of the book are not necessarily related to its overall profitability.

84. Many institutions now view the Treasury function as a separate profit centre and hire traders for the specific purpose of managing the institution's funding costs. In that case, the Treasury desk traders share in the bonus pool on the basis of the "profits" of the book, measured by the difference between the institution's outside funding costs and the "interest" and other "income" or "expense" arising from transactions with other trading books.

85. Inter-desk interest is notionally earned by the Treasury book which functions as a clearinghouse in matching cash needs of certain trading books with the excess cash generated by other trading books. The Treasury book trader is responsible for entering into any foreign exchange transactions necessary to convert a surplus run by one book into a form that can be used to cover a deficit in another book. Net deficits (which may be denominated in any currency in which the institution trades) must be met through external borrowings, while net surpluses generally are placed with banks overnight.

86. Other "income" and "expense" arises from the Treasury desk's internal hedging transactions. Although the institution may borrow in a range of maturities and a number of currencies, the Treasury desk traders generally are more comfortable managing short-term risk in the institution's functional currency. Accordingly, the Treasury desk trader generally will enter into a number of transactions with the other trading books that are intended to convert long-term interest rate or currency risk into short-term risks. For example, if a German bank issues long-term dollar-denominated debt, the Treasury book trader is likely to enter into a currency swap with the bank's dollar book to convert the risk into floating rate Deutschmark-denominated debt. (Floating rate debt presents "short-term" risk because the rate generally is set quarterly at the beginning of the accrual period.)

87. The Treasury desk generally is permitted to enter into hedging transactions with other entities. However, it usually is encouraged by management to enter into transactions with the institution's trading desks in order to maximise net hedging within the institution, thus lowering overall hedging costs.

(2) *Accounting/Product Control*

88. This area generally is responsible for financial and regulatory accounting and for the specialised accounting required for a trading business. This generally involves preparing daily trading revenue and market risk reports, the preparation of which requires the painstaking process of reconciling the positions shown in computer-generated reports with trade tickets entered during the course of the day's trading.

89. The existence of reliable product control capabilities was critical to the development of the complex trading and risk management strategies that fostered the explosive growth in global trading, particularly global trading in derivatives. Regulators are likely to pay attention to the product control function in coming years in light of recent well publicised problems at a number of financial institutions. In several cases, it appears that substantial losses could have been uncovered at an earlier stage if the product control function had been separated from the trading function.

(3) *Systems Development/Intangibles*

90. Computer systems are also critical to the proper functioning of a global trading operation. The valuation of products, the development of new products, the processing and settlement of trades, the real time global risk management of the portfolio, the management of credit and corporate accounting and reporting are all dependent on the availability of sophisticated computer-based systems. In many cases, financial institutions maintain large staffs of computer specialists to develop proprietary systems to link these different functions.

91. In the past, most pricing models were variations of the Black-Scholes option-pricing model or straightforward applications of forward pricing. These basic models frequently were subject to modifications suggested by the traders. Over time, the model itself became proprietary and was viewed as a substantial factor in the institution's success. On-going research, such as the Los Alamos project commissioned by the US Internal Revenue Service, is looking at other approaches to valuing derivatives using the latest mathematical techniques. It is too soon to predict whether the industry will become standardised around a new basic model or whether proprietary models will proliferate.

(4) *Credit*

92. The credit department's primary responsibility is to analyse new customers and establish appropriate credit limits, monitor the credit exposure throughout the life of a particular transaction and review the total credit exposure compared to the established credit limit. Many institutions have centralised the credit function so that the total credit risk from all of the institution's dealings with a particular counterparty (including lending transactions) are managed in one location. In the case of derivative transactions, credit exposures will change over the life of the transaction as the market value changes. That is, the credit exposure to a counterparty is often almost zero at the inception of a derivative entered into at current market rates. However, as market rates change, one party is "in the money" and has credit exposure to the counterparty to the extent of the inherent gain in the transaction. If the financial institution is in the money, it runs the risk that it will suffer a credit loss if the counterparty is unable to make the payments required with respect to the transaction.

93. Credit limits imposed by regulators or by the institution's directors may limit the ability of the institution to write new business. In that case, the credit department and marketers may suggest terminating some existing transactions with the counterparty in order to enter into new transactions. As credit limits have become more of a problem, some institutions have decided to dedicate traders to "credit risk management" to eliminate those transactions with a relatively lower profit (i.e., those with the smallest spread) to allow the institution to enter into other transactions with the counterparty where the profit margin may be higher.

(5) *Other Support Functions*

94. The back office performs various other functions, the relative importance of which varies depending on the type of trading business conducted. The operations department is responsible for the confirmation, processing and settlement of trades as well as trader support on the trading floor. The compliance and legal departments are responsible for ensuring compliance with regulatory requirements (which are increasingly complex as the business becomes more global) and for structuring, executing and documenting transactions (which also become increasingly complex as the products become more tailored to the needs of particular clients).

II - 7. RISK OF DOUBLE OR LESS THAN SINGLE TAXATION

(1) *Use of Ordinary Auditing Procedures*

95. Except for the relatively few cases in which a taxpayer engaging in global trading has requested (and concluded) an Advance Pricing Arrangement (APA), as described below, the tax administration must rely on ordinary examination or auditing procedures to satisfy itself that the method chosen by the taxpayer is acceptable. In this context the authority should take some account of the internal controls and checks undertaken by the taxpayer as already discussed at paragraph 88 above. In many jurisdictions, tax authorities are only just beginning to audit the first returns presenting significant global trading issues, whilst taxpayers have already had to decide on their global trading transfer pricing methodology with little specific guidance as to what tax administrations find acceptable.

96. Although countries believe that the generally accepted principles of international taxation should apply, multilateral discussions of how those principles should be interpreted in the specific case of global trading are in their infancy. At the moment, countries interpret these principles very differently, resulting in a significant risk of double taxation or less than single taxation. Accordingly, it would be highly desirable to reach some international consensus so that double, or less than single, taxation can be avoided.

97. There are several aspects of global trading that distinguish it from more traditional dealings in goods and services and that increase the risk of double, or less than single, taxation. First, global trading is, by definition, conducted internationally and around-the-clock. Accordingly, it is almost universal practice for a dealer to delegate a certain amount of marketing or trading authority to its affiliates in other jurisdictions. This may raise significant permanent establishment issues, such as whether the affiliate is acting as a dependent or independent agent within the meaning of Article 5 of the Model. Second, global trading frequently is conducted in an integrated manner, making it difficult to allocate profits among trading jurisdictions. Even in cases where the taxing authorities can agree on a method of allocating the income, differences in the calculation of the profit to be allocated can result in timing differences that, in the case of profit splits, can turn into permanent differences. For example, there are bound to be problems of over or under taxation where one country computes the profits on a mark-to-market basis and the other uses an accruals or realisation method. Third, global trading relies heavily on capital, but that capital is highly mobile, making it relatively easy, at least in theory, to transfer expected profit or loss from one jurisdiction to another. Such transfers may be difficult for auditors to detect in practice because global trading frequently involves complex financial products and, in most cases, there are no comparable transactions to serve as a benchmark. Finally, unlike traditional businesses, there are no consistent accounting or regulatory standards.

98. Because of these characteristics, it is becoming increasingly difficult for tax authorities to satisfy themselves that they are taxing an appropriate portion of global trading profits. Compounding this problem is the fact that not all countries have clear domestic rules that allow them to tax only part of the income from a transaction. If the activities of a branch in a country that applied an all or nothing approach met a minimum threshold, then all of the income of the branch would be subject to tax in that country. In contrast, if the activities fell below the threshold then none of the income would be taxed in that jurisdiction.

99. This “all-or-nothing” approach may result in an arm’s length allocation of net profits if the taxpayer is allowed to deduct an appropriate amount of expenses, including hedging losses, in determining the amount of its taxable income. This process is complicated when losses are recognised for tax purposes in a jurisdiction other than that in which the gain from an offsetting position is recognised (generally referred to as “split hedges”). Split hedges may arise, for different reasons, under either the centralised product management model or the integrated trading model.

100. In the centralised product management model, split hedges may arise if tax authorities do not recognise inter-branch transactions that are used to transfer trading risk to the centralised trading location, where the risks are managed. Because, as discussed above, many institutions use “net” hedging strategies, it is impossible to trace the gain or loss from any particular transaction to the offsetting gain or loss on the customer transaction it hedges. Accordingly, financial institutions generally want each taxing authority to recognise inter-branch transactions as a proxy for their actual third-party transactions.

101. However, taxing authorities may be reluctant to recognise inter-branch transactions, since it can be difficult to prove that those inter-branch transactions are at arm’s length (except in the case of spot and forward contracts in certain heavily-traded currencies). Some taxing authorities also generally do not recognise inter-branch transactions as giving rise to profits or losses for tax purposes, although they may take the transactions into account in determining the correct attribution of profit of the enterprise to the permanent establishment in question. Unless all of the countries in which the institution does business are willing to recognise inter-branch transactions, the institution’s use of inter-branch transactions will lead to distortions in the amount of income recognised in a particular jurisdiction.

102. In the integrated trading model, split hedges may arise because any of the locations may enter into customer transactions or hedges. In that case, there are not even any inter-branch transactions that might be used as a proxy.

(2) *Use of Advance Pricing Arrangements*

103. Bilateral (and multilateral) Advance Pricing Arrangements (“APAs”) provide a useful “safety valve” in the absence of clear consensus on the concrete application of general principles as they allow the relevant taxing authorities to reach an agreed result in particular cases. There is a discussion of the use of APAs in the 1995 TP Guidelines. An APA is an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria (e.g. method, comparables and appropriate adjustments thereto, critical assumptions as to future events) for the determination of the transfer pricing for those transactions over a fixed period of time (see paragraph 4.124 et seq. in the TP Guidelines for more details). In countries that do not have an APA regime in their domestic tax law, the Mutual Agreement Procedure (MAP) provided in bilateral tax treaties has a similar effect to the APA. Therefore, references herein to APAs also include MAPs. However, many countries have little experience with APAs or are prevented by their domestic law from entering into APAs, so they are not a complete solution.

104. An APA allows taxing jurisdictions to develop income and expense allocation models that are suited to the facts and circumstances of a particular global trading operation. The APA process may help both the tax authorities and the taxpayer(s) save time and resources and provides the benefit of certainty in the otherwise difficult assessment of tax liability of global trading operations. The APA may also give tax authorities greater understanding of the way in which such businesses are conducted and the resulting tax issues. However, the tax authorities may not have the resources necessary to enter into APAs with all the taxpayers who want them.

105. To gain the certainty which an APA can provide, the taxpayer must enter into APAs with all the tax authorities of the countries in which the operation is conducted. Tax authorities should make maximum use of information exchange provisions or mutual agreement provisions in their tax treaties in order to facilitate APAs and promote international consensus. Tax authorities might also increase the benefits to taxpayers by making the process more transparent, for example by clarifying document requirements. In this regard, the US Internal Revenue Service issued Notice 94-40 to describe the allocation methods used in the first few global trading APAs that it concluded with taxpayers. The APA process will become even more streamlined if internationally acceptable guidelines for APAs can be developed.

106. Although APAs are purely voluntary, the benefits described above may provide an incentive for taxpayers to request APAs. Nevertheless, some taxpayers conclude that the costs of obtaining an APA outweigh the benefits. Such costs include not only out of pocket expenses but also “opportunity costs” (e.g. the cost of disclosing information to the tax authority). Thus the APA approach is insufficient to cope completely with global trading, and ordinary auditing procedures remain vital.

107. To summarise, there seems to be a general consensus that the issues raised by global trading should be resolved by reference to the generally accepted principles of taxation that are provided in the OECD Model Convention, Commentaries, and TP Guidelines. This is regardless of whether the issues are resolved in a traditional way or in advance by using APAs. However, the generally accepted principles of taxation that are provided may require elaboration to deal with this relatively new and highly specialised business. Most countries also feel that the OECD could usefully provide guidelines as to the operation of the existing rules in the highly specialised field of global trading. Accordingly, the discussion below emphasises the issues that arise from applying the generally accepted principles of taxation.

III. GLOBAL TRADING MODELS AND THE APPLICATION OF THE ARM'S LENGTH PRINCIPLE

108. The members of the Special Sessions agree that the arm's length principle in Articles 7 and 9 of the Model Convention should govern the taxation of global trading. This section deals with the application of the arm's length principle in the case of global trading in general. In Section IV attention is paid to specific issues regarding the application of the arm's length principle when the global trading is operated in a branch form.

109. In arriving at an arm's length price, the 1995 TP Guidelines encourage the use of traditional transaction methods which therefore should be applied to global trading cases whenever possible. As a starting point it may be helpful to examine the three basic organisational models of global trading: integrated trading, centralised product management, and separate enterprise to see if there is a need to use, as a last resort, methods other than the traditional transaction method.

110. Traditional transaction methods are normally the most appropriate method where global trading is organised on a separate enterprise model, where each location acts as if it were a separate legal entity in respect of all the various activities comprising global trading. For example, branches engaging in foreign currency transactions (spot and forward) frequently act on this basis. In such cases, there generally is no need to consider methods other than traditional transaction methods, as each location should earn the appropriate overall profit provided that all transactions, whether third party, intra-company, inter-branch or inter-company, are at arm's length, and it should be relatively straightforward to test this, because of the availability of comparable transactions with unrelated parties. There are other types of global trading businesses that may be organised in the same way, but for which comparable transactions are not available, raising questions as to whether the inter-branch transactions should be respected, or whether other methods should be explored.

111. In theory, traditional transaction methods should be applied to the pure centralised product management model, although in practice there can be difficulties in finding comparable uncontrolled transactions. As the centralised trading location is taking the full responsibility for trading and hedging, it should receive the profits attributable to those activities but other locations should be rewarded for their provision of services, such as sales. Between unrelated parties, the reward for performing the basic sales function would be by way of a commission and so comparable data may be readily available for some functions. The guidance on direct charge services should be followed in appropriate circumstances. However, problems can arise when, over time, more complex marketing or trading activities are carried out away from the central location, so that the organisational structure moves away from the pure centralised product management model and more towards the integrated trading model.

112. In transactions between unrelated parties, the amount and type of the reward would depend on the level of services provided, which may be related to the type of product. For example, some general marketers merely act as brokers in respect of standardised products and they would be rewarded by a simple fee, e.g. a number of basis points. At the other end of the spectrum, some marketers are so highly specialised and closely involved in the process of developing and structuring products that they insist on a share of the total trading profits, although the parties might call this a commission.

113. In the middle of this spectrum are those marketers who act as more than simple brokers but who are not as involved in structuring products. Some countries consider that a commission or service fee that is computed without reference to profits is still appropriate, whilst others consider that their reward might be a profit share, as opposed to such a commission or service fee, but that it might be limited to a share of the initial profit on the customer transaction. The rationale behind the latter view is that they would be rewarded in this way if they performed the same services for unrelated parties because their activities are so integral to the earning of the initial spread on the deal. This approach to compensating a marketer is not appropriate if the marketer either gains from, or is penalised by, the subsequent activities of the traders/risk managers in managing the position, in which they play no part. Some countries also believe that because their contribution is limited to bringing in the customer, they would not share in any overall trading profits, but also would not run the risk of sharing in any trading losses. However, only the first of these marketing arrangements commonly occurs between unrelated parties, making it difficult to find appropriate comparables.

114. There is a similar problem in deciding whether a location which starts to undertake some kind of limited trading activity under the control of the central location, should still be rewarded by way of arm's length commissions from that location, as opposed to receiving a share of the overall profits.

115. The question remains as to whether in any particular case, traditional methods, based on the provision of inter-company services to the centralised product location, can still be applied where there is

some level of integration between functions. There is a need for guidance as to exactly what level of activity is necessary for a location to receive a profit share, or a share of initial profits, rather than a service fee or commission computed without reference to profits and, where a profit share is considered appropriate, how the share is to be quantified. It is suggested that further work needs to be done on this topic within OECD. The work would be facilitated by input from the private sector that compares, in a detailed fashion, the functions carried out by independent third parties with sales and marketing personnel and describes the continuum from highly centralised trading (at one end), sharing of limited decision making concerning trading (in the middle) and complete transfer of trading authority (at the other end).

116. In the integrated trading model, as in the separate enterprise model, each location has the capacity to perform the full range of functions necessary to conduct the business. The difference is that in the integrated trading model, the functions with respect to a particular transaction may be split between locations whereas, in the separate enterprise model, the trading occurs in the same location as the marketing of each transaction. Accordingly, in the integrated trading model each location cannot act independently but must co-operate with the others in order to successfully enter into a transaction and subsequently manage the resulting risk. Therefore, it is not possible to identify any specific transactions between the different locations to which traditional methods could be applied.

117. In reality, the actual operations may be a hybrid that does not fall completely within one of the three models but may include aspects of the others. Moreover, the manner in which global trading is conducted may change over time as the business evolves. For example, a product may start being traded on a fully integrated basis outside of its original “natural home”, as trading authority is delegated, or the “natural home” may change in the long run.

118. The starting point of a transfer pricing analysis of trading, under any of the trading models, seeks to identify the different contributions made by the different functions of a global trading business, such as trading and marketing, and reward them separately by an appropriate fee, using one of the traditional transaction methods. The results of this exercise may appear in the books of the enterprise. There are, however, difficulties in arriving at the appropriate fee in the absence of comparables and due to the fact that there are a huge number of transactions and that any one transaction may be linked to others. Moreover, in some centralised product management models and in all integrated trading models, a fee calculated on the basis of a separation of the trading and marketing function, will not fully reflect the co-operation between the marketers and traders which is essential in order to produce the global profit. In some cases it may be possible to deal with this problem by making adjustments to the fee. For example, the analysis could identify a comparable commission for performing a basic sales function which could then be increased to reflect the additional functions performed by the marketer who is more integrated into the global business. Care should also be taken to ensure that the business strategy of the taxpayer is taken into account and that the functions are looked at on a case-by-case basis. For example, the importance of the trading function will be greater if the business aims to make a market for particular products, as opposed to simply supplying them as part of a strategy of providing a “full service” to its customers (see paragraphs 44 and 45).

119. A number of tax authorities believe that in some global trading cases that they have examined there has been such a high level of integration between the various locations and functions that traditional transaction methods could not reliably be applied. See Part II of this paper for a fuller description of such integration. Therefore, they think it necessary to use the profit split as a method of last resort. Whilst the majority of such cases were those where the integrated trading model was followed, there were some cases where trading resembled a hybrid between the integrated and the centralised product management model. For example, although some functions such as risk management were completely centralised, others such as trading authority were delegated outside the central location to some extent. It is the experience of

other countries that the problems they have experienced have been capable of resolution by reference to traditional methods, although they have not so far encountered examples of fully integrated trading.

120. When global trading is conducted by associated enterprises, allocating profits among the locations in different jurisdictions is a transfer pricing issue. Countries agree that the detailed discussion of profit split methods in the 1995 TP Guidelines (including when they are to be applied) should be followed in such cases. This suggests that where global trading operations are highly integrated, so that transactions cannot be evaluated on a separate basis, then the profit split methods described in Chapter III of the TP Guidelines may need to be used.¹ Care must be taken to ensure that the method used in practice is in conformity with the arm's length principle and attention paid to the various caveats discussed in the Guidelines. In particular, as the Guidelines indicate, global formulary apportionment methods would not be acceptable.

121. Although the broad legal basis for using profit split methods as described in Chapter III of the Transfer Pricing Guidelines is clear, countries consider that there can be considerable practical problems in achieving an international consensus as to how and when they are to be applied to global trading cases. The paper discusses these issues further in Sections V and VI.

IV. APPLICATION OF THE ARM'S LENGTH PRINCIPLE TO GLOBAL TRADING CONDUCTED IN A BRANCH FORM

122. As discussed in Section II-2, global trading may be operated in subsidiary form, in branch form, or in a combination of the two. Experience shows that the choice of legal form often depends on regulatory and legal considerations specific to each country rather than on tax considerations. Therefore, some countries believe that operations that are economically identical should produce similar tax results, whether conducted in branch or subsidiary form. Other countries agree with this general principle but also believe that the legal form of the trading operations affects their economic substance, which should be reflected in the tax treatment.

123. According to Article 7, the portion of the total profit arising from the business carried on by an enterprise through a permanent establishment that is attributable to the permanent establishment, having regard to the arm's length principle, may be taxed in the jurisdiction in which the permanent establishment is situated. Therefore it cannot be over-emphasised that the arm's length principle should be maintained when operations are conducted in branch form. It has been suggested that the application of traditional transaction methods to global trading seems to be more difficult in the case of operations conducted in branches rather than in subsidiaries. This may well create a practical difficulty in identifying the taxable profits attributable to each jurisdiction in which integrated global trading activities are conducted.

124. In this section the paper focuses on the issues that arise in the application of the arm's length principle to operations conducted in branch form where the threshold question is whether the activities of an enterprise carried on, directly or indirectly, in another jurisdiction constitute a permanent establishment. Then it considers issues that arise from the different taxation rules applicable to branches and subsidiaries in the Permanent Establishment, Business Profits and Associated Enterprise Articles of bilateral tax conventions, including different countries' interpretation of those provisions.

¹ 1995 TP Guidelines 3.5 - 3.6.

IV - 1. PREPARATORY OR AUXILIARY ACTIVITIES/MERE PURCHASE

125. Taxpayers generally cite two different provisions of the Model Convention in arguing that activities they perform directly in another jurisdiction do not rise to the level of a permanent establishment. Paragraph 4 of Article 5 of the OECD Model Convention lists preparatory or auxiliary activities that are not considered as constituting a permanent establishment. Paragraph 5 of Article 7 provides that no “profits shall be attributed to a permanent establishment by reason of the mere purchase...”

126. It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which do not. However, as the Commentary to paragraph 4 of article 5 discusses, the decisive criterion is whether or not the activity forms an essential and significant part of the activity of the enterprise as a whole. Given the integrated nature of global trading, some countries have suggested that it may be appropriate to have a lower threshold for the recognition of a permanent establishment, while it seems inappropriate to totally eliminate the threshold. Therefore, some guidance is necessary to determine whether any aspect of global trading businesses constitutes only preparatory or auxiliary activities such that a permanent establishment is not considered to exist in the jurisdiction in which such activities are carried on. In this regard, special attention should be given to the functions of back office supporting activities.

127. Paragraph 5 of Article 7 provides that “no profits shall be attributed to a permanent establishment by reason of the mere purchase...”. Member countries generally agree that the provision of paragraph 5 of Article 7 regarding “mere purchase” should not become an impediment to the application of profit split methods to global trading. The analogy used for mere purchase assumes a transaction of goods in which one location (agent) merely purchases goods and the other location (principal) does the rest. In this case, the provisions of Article 7 attribute the whole profit, both income and expenses, from the transaction to the latter location. In global trading where there is a considerable degree of integration and co-operation among locations, the transaction-of-goods paradigm is irrelevant as the distinction between agent and principal blurs. Furthermore, since the purchase of a financial product is as much a customer transaction as the sale of a financial product, it is difficult to recognise any transaction as a “mere purchase”.

IV - 2. AGENTS

128. One of the most difficult issues presented by global trading is whether the activities of one enterprise constitute a permanent establishment of another enterprise. This issue arises when a dependent agent of an enterprise engaged in global trading performs functions relating to global trading which could satisfy the conditions stipulated in paragraph 5 of Article 5 of the OECD Model Convention to become an agent permanent establishment of the other enterprise. In some cases, global trading by associated companies is conducted by a dedicated agent which is itself a wholly owned subsidiary of the global trading group and concludes contracts in the name of the booking enterprise. In other situations, a company may conduct global trading through an agent whose discretion to enter into contracts in the booking enterprise’s name appears limited, but whose actions suggest that the booking enterprise seldom intervenes. The resolution of this matter depends on the facts and circumstances of each case but guidance is given in paragraphs 32 and 33 of the Model Commentary. In particular, it should be remembered that the test is whether the agent has the authority, in substance, to conclude contracts on behalf of the enterprise. For example, it does not matter if the contract is in fact signed by someone else or in another country.

129. This issue has become more important because of the trend for firms undertaking global trading to book all contracts in one global “booking vehicle” to allow for efficient usage of capital and netting provisions. In cases where the booking vehicle is a special purpose subsidiary, restrictions are generally put on its activities in order to obtain a favourable credit status from the rating agencies and so it performs no other global trading functions. For example, the management of risk is passed back to the trader originally involved in the deal by means of a mirror swap. If the agent carries on other activities, as well as concluding global trading contracts in the name of another enterprise, the question is whether the agent is still acting as a dependent, as opposed to an independent agent of the type mentioned in Article 5 (6), and so can still be deemed to be a permanent establishment of the global trading enterprise by virtue of Article 5 (5). Article 5 (6) specifically states that a permanent establishment will not be deemed to exist merely because the enterprise carries on business through a broker, or any agent of independent status acting in the ordinary course of its business.

130. Global trading in subsidiary form may well be conducted in such a way that the trading activities are performed by one enterprise, marketing activities by others, and contracts made with third parties are booked in a different enterprise. If the booking enterprise in these cases is deemed, in accordance with the provisions of paragraph 5 of Article 5 of the OECD Model Convention, to have a permanent establishment in respect of activities that the other locations undertake on its behalf, the paradigm changes from Article 9 to Article 7 (or to a combination of both). This will bring complicated issues of branch taxation - such as the all-or-nothing principle or the treatment of internal payments discussed below - into what purports to be a pure related enterprise case. This change may bring larger tax revenue to the tax authority of the jurisdiction in which the agent PE is situated because the tax authority may extend its taxing rights to the profits booked in other countries or may deny the recognition of internal payments made by the agent PE to the booking enterprise in other jurisdictions. Accordingly there is increased danger of conflicting claims to the book profits among the tax authorities and hence of double taxation. If the compensation to the dependent agent for the services it performs is an arm’s length amount there is an issue whether this would result in allocation of an appropriate and sufficient amount to fully reward the activities undertaken in the local jurisdiction. If so, the risk of inconsistent taxation would be greatly diminished. Moreover, the impact will be minimal when the arm’s length method can be applied consistently, regardless of whether trading is conducted in a branch or in a subsidiary form.

IV - 3. ATTRIBUTION OF INCOME

131. Once the threshold of whether the enterprise has a permanent establishment in the country is crossed, the profit attributable to that permanent establishment may be taxed in the jurisdiction in which the permanent establishment is situated. Then the issue would be whether the allocation method would apply to branches in the same way that it is applied to subsidiaries.

132. The commentary to Article 7 (paragraph 24) provides that the amount of profits from a business activity attributable to a permanent establishment should be determined on a separate account basis whenever reasonably practicable. Paragraph 2 of Article 7 states that the allocated profits should be based on the arm’s length principle and paragraph 3 allows the deduction of expenses incurred for the purpose of that permanent establishment regardless of the place in which those expenses were incurred - thereby producing net profits approximating to what a separate enterprise would have earned. However, the integrated nature of global trading can make it difficult in practice to use separate accounting as envisioned by Article 7. This is because for its own management purposes, the enterprise will often only need to keep a single set of accounts for each global book and has no need, other than for tax purposes, to draw up separate accounts for each jurisdiction in which it trades. This is even more the case when the trading in a jurisdiction takes place through a dependent agent.

133. In any case, even if accounts were drawn up at the end of the trading day in each location, they would be fairly meaningless in a highly integrated global trade. This is because the book consists of a number of aggregated transactions, which for reasons of risk management have been pooled for purposes of operating portfolio hedging. It may in certain cases therefore not be feasible to track transactions originated in one location over their lifetime and so say how much profit they made. Even if this were possible, it still would not settle the matter, as the fact that the transaction was put on the book in one location does not mean that all the profit was earned there. This is because the earning of the total profit is likely to have resulted, at least in part, from the integration and co-operation of the various functions and locations as described in detail in Sections I and II of this paper. It may not, therefore, be meaningful to say that the profit on any transaction necessarily “belongs” to any one location or function. Consequently, in such cases, it is not always possible to say that the separate accounts of any location accurately reflect its arm’s length profit, even if they include service fees paid to other locations for their contributions.

134. Paragraph 4 of Article 7 allows a jurisdiction to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts provided that the following conditions are met:

- (i) Such apportionment is customary in the jurisdiction (in other words, the statutory domestic rules allow such apportionment and it is customary to do so in that jurisdiction); and
- (ii) The result from such an apportionment is in accordance with the arm’s length principle contained in Article 7.

Although this provision is not intended to address the issue of global trading, it could assist some countries by providing a basis for dealing with the special circumstances of integrated trading, where it is not possible to draw up meaningful separate accounts, by allowing an apportionment of profits rather than an attribution of income on a separate enterprise footing. In what follows, these two conditions of paragraph 4 of Article 7 are considered within the context of applying profit split methods to global trading:

- (i) As for the first condition of whether such apportionment is allowed and is customary, the domestic rulings of the member countries vary. Some countries have domestic provisions that allow such apportionment. Others do not.
- (ii) The second condition for meeting the principles contained in Article 7 is that the profit split should be applied in accordance with the arm’s length principle as described above. As the trading and marketing activities are so integral to the ability of the global entity to make profits, if they were performed by a wholly independent enterprise, the reward might well be calculated by reference to a share of the global profit.

135. However, other countries believe that all the methods described in the Transfer Pricing Guidelines are authorised elsewhere in Article 7. They believe that, despite the difficulties referred to in paragraphs 119 and 120 above, it is possible to determine the arm’s length profit of the permanent establishment by using profit split methods based on the principles of Articles 7(2) and (3), and for these to be consistent with the profit split methods described for associated enterprises in the TP Guidelines. In particular, although it is the profit of a particular trading book which is split, rather than individual transactions, these methods are permitted, provided the individual transactions could be combined in accordance with the principles set out at Chapter I, Part C iii) of the Transfer Pricing Guidelines. Therefore, as long as the trading book consists only of an aggregation of similar and linked transactions,

then a profit split method approved by the Guidelines can be used, without resorting to the approach envisaged by Article 7(4).

IV - 4. TREATMENT OF INTERNAL PAYMENTS

136. Payments between subsidiaries for the use of capital or intangibles are recognised for both the payer and the recipient to the extent that they are at arm's length. Paragraph 3 of Article 7 discusses the different treatment of expenses incurred for the purposes of permanent establishments. An important difference is that the permanent establishment has the advantage of "using" the capital or intangibles of the enterprise and need not maintain capital or intangibles of its own.

137. The Commentary to the OECD Model Convention deals at length with the issue of internal "payments". This issue is particularly important in the context of global trading as the volume of internal "transactions" entered into in the operation is massive. The Commentary clearly authorises a deduction for payments made as an appropriate contribution towards the actual cost of that capital or intangibles. Paragraph 3 of Article 7 also permits the permanent establishment to deduct expenses that are incurred for the purposes of the permanent establishment, regardless of the place in which they are incurred. However, it is less clear in which circumstances the deduction may be increased to cover a mark-up over the actual costs.

138. With respect to intangible rights, the Commentary to the OECD Model Convention states that "the rules concerning the relations between enterprises of the same group (e.g. payment of royalties ...) cannot be applied in respect of the relations between parts of the same enterprise"² This is because legal ownership of the intangible cannot be attributed to any particular part of the enterprise. Accordingly, the costs of creating intangible rights are regarded as attributable to all parts of the enterprise making use of the intangible. Therefore, the current view reflected in the OECD Model Convention and its Commentary is that internal or intra-entity payments made by a PE in consideration for the use of intangibles (as opposed to a contribution towards the cost of developing an intangible) are not recognized.

139. With respect to "interest payments", the Commentary states the majority view that such payments are not generally deductible but that special considerations apply to internal payments made by different parts of a financial enterprise (e.g. a bank) in view of the fact that the making and receiving of advances is closely related to the ordinary business of such enterprises.³

140. The above statement incorporates two different positions within the OECD.⁴ The majority of countries considers it necessary to take account of internal payments of "interest" in ascertaining the arm's length profits of a branch of a lending institution. On the other hand, the United States and Japan are of the view that the conclusions reached by the majority go too far. Those two countries allow the permanent establishment an interest deduction that corresponds more closely to the amounts paid to third party lenders. The core difference between the two positions is whether any mark-up to represent profit to another part of the enterprise is permissible. The former directly recognizes the payments made within the same enterprise (with mark-up) whereas the latter only indirectly recognizes, under certain conditions, a fraction of the amount paid by other parts of the enterprise to the third party provider as the expenses of the branch (no mark-up).

2 Paragraph 17.4 of the commentary to Article 7

3 Paragraph 18.3 of the commentary to Article 7

4 This question is discussed in detail in the OECD 1984 publication entitled "Transfer Pricing and Multinational Enterprises -- Three Taxation Issues".

141. Australia as a general rule does not allow a mark-up for profits on internal payments. This is reflected in its observations on the Model Commentary.

142. Unlike a traditional bank, global traders in financial products do not engage in raising and lending interest bearing funds. Rather they borrow money just to cover their trading and inventory positions like any non financial trading or manufacturing concern. For this reason some countries believe that internal “interest” payments incurred in connection with global trading should not be recognized, even if they accept the majority view of the treatment of lending institutions.

143. The variation in treatment seems to widen with respect to internal payments made pursuant to innovative financial instruments. Several countries that recognize internal “interest” payments would not recognize payments on internal “notional principal” contracts, while some that do not recognize internal “interest” payments will recognize internal “swap” payments in appropriate circumstances. It has also been suggested that all countries should recognise arm’s length internal global trading “transactions”, for the purposes of computing the arm’s length profits of a permanent establishment, even if they would not do so for internal “interest” payments.

144. The Model Convention and Commentary provide no guidance in this area because the internal payments made pursuant to mirror “swaps” are not “interest” payments, but rather are a method for moving risk within an enterprise engaged in some form of global trading. Of course, they also may move future trading profit or loss between different trading locations. Accordingly, the issue is whether the internal notional principal contract provides for an allocation of income that is consistent with the arm’s length principle.

145. One popular form of internal notional principal contract is the so-called “mirror swap”. In a mirror swap, the branch marketing a transaction with a third party enters the real transaction on its books and then enters into a matching internal “transaction” with the trading location that will manage the trading or market risk arising from the real transaction. There is usually a slight difference in terms that leaves a “spread” in the marketing branch, for example a number of basis points on an interest rate swap, but most of the profit from the transaction with the third party is recognized by the trading branch. The spread is intended to reward the marketing branch for having found the customer and is analogous to a marketing commission or sales credit. Due to the large number of transactions the spread is not usually negotiated individually for each transaction but is often set at a fixed level depending on broad categories of instruments.

146. Some countries believe that the mirror “swap” is almost certainly never the appropriate method for allocating income because it leaves an arbitrary amount in the hands of the branch performing marketing functions. The fact that spreads are usually not negotiated individually means that the fee earned by the marketing branch will not fully reflect the differences between marketing, for example, a simple fixed for floating US dollar interest rate swap that took two minutes to conclude and a complicated cross currency equity swap with an equivalent notional principal amount that took three months to negotiate and structure. They also believe that in such cases simply using the direct method of accepting the mirror swap as an arm’s length “transaction”, will not result in an arm’s length allocation of profits in truly integrated businesses, for the reasons already outlined at paragraph 132 and 133 above. They therefore favour disregarding the mirror and applying other transfer pricing methods; either an arm’s length commission, or a profit split, depending on the circumstances..

147. Other countries believe that provided the internal “transactions” match equivalent real transactions with third parties, then the application of this direct method of determining the profits of the permanent establishment is straightforward. They point out that if the price of each mirror “swap” is set

individually and after a full evaluation of the specific functions performed, assets employed and risks assumed, then there should be no theoretical problem in deciding whether or not it is at arm's length.

148. Lastly, for service fees, the commentary allows recognition of “service” fees charged within the enterprise. In certain cases, e.g. where the provision of services is the main activity of the permanent establishment and the services provided are the same type of services performed for third parties, a mark-up over cost is accepted as appropriate. Therefore it is necessary to consider in detail the nature of services provided between parts of the enterprise.

V. DETERMINATION OF THE PROFITS FROM GLOBAL TRADING

149. This section discusses the actual application of profit split methods, whether to branches or subsidiaries, where such methods have had to be used as methods of last resort. As discussed above this is only likely to be relevant where the integrated trading model is employed or in hybrids between that model and the centralised product management model. The feature of such hybrids is that key functions such as trading and marketing are very integrated so that it is not possible to evaluate them on a separate basis.

V - 1. THE SCOPE OF ACTIVITIES AND REVENUES

150. Questions arise as to which activities and revenues related to global trading should be taken into account in the profit split. The issues can be categorized into two points. The first issue relates to whether activities that have a remote connection with global trading should share in the profits. That issue is most important where a location engages in a limited range of activities (or perhaps only one). The second issue is what revenues should be included in the profits to be split.

(1) Back Office and other Non-Trading Activities

151. Countries seem to share the view that trading, marketing, management, and major supporting activities should share in the profits to the extent that they are integral to the realization of the global trading profits. For example, marketers who actively co-operate with traders (as opposed to general salespeople who do not) should be entitled to a share of the global trading profit.

152. Some countries, however, argue that activities that are less integrated into the global business should be compensated using an acceptable method following the Transfer Pricing Guidelines other than a profit split. The question is at what threshold does an activity become so integral that it should instead be rewarded by a share of global profits? They believe that this determination must be made on a case-by-case basis because the same activity may perform different functions when global trading is conducted under different organizational models so that a single rule to apply in all cases could easily produce arbitrary results.

153. Other countries disagree, because of the limitations of the service fee approach discussed earlier and/or because of the practical difficulty of distinguishing those activities that are “integrated” from those that are not. For example, most countries believe that systems and product development could be categorized as performing integral parts of global trading which should be rewarded with a share of the global profits. Countries disagree, however, as to whether certain back office functions such as product control are such an integral part of a global trading business as to be appropriately rewarded by a share of the global trading profits. The issue of whether or not an activity is integral to global trading is factual in

nature and so can only be resolved on a case-by-case basis. However, reference to the comparability standard in the Guidelines, i.e. what would have happened between independent enterprises in a similar situation, may be helpful.

(2) *Revenues*

154. There is general agreement that revenues unrelated to global trading are to be excluded from the scope of the profit split method. This holds true for cases in which the same location is engaging in both global trading and other activities. There can be problems in deciding which activities of that location are sufficiently related to global trading to be included.

155. There is an issue as to whether the revenues of a treasury book should be taken into account in the global profit split. As noted above, these revenues could include interest or other income from investing surplus cash or capital and gains or losses from hedging transactions. The resolution of these issues affects the aggregate amount of profits from global trading which is to be allocated among the locations.

V - 2. DEDUCTION OF EXPENSES

156. The 1995 TP Guidelines state that profit split methods generally are to be applied to associated enterprises by combining and dividing their operating profits. Applying the profit split in this manner ensures that both income and expenses of the MNE are attributed to relevant associated enterprises on a consistent basis.⁵ Therefore, to the extent that expenses properly relate to global trading, so that they should be allocated in the same manner as income, it seems appropriate to deduct these expenses from the gross trading profit and then allocate the net profits. The TP guidelines continue, however, that occasionally it may be appropriate to carry out a split of gross profits and then deduct the expenses incurred in or attributable to each relevant enterprise (excluding expenses taken into account in computing gross profits.)⁶ Using the latter method also ensures that one jurisdiction does not have to make enquiries where expenses have been incurred in another jurisdiction in order to check that they are allowable under its tax rules.

157. Some countries believe that the determination of how an expense is allocated depends on how the factors for the allocation of profits are determined. They argue that items reflected in the factors should not also be allocated in accordance with income because the reason an expense is used as a factor in splitting the global profit is that it has already been the subject of an arm's length determination. They suggest that the mathematical effect of deducting such an expense in order to arrive at the global profit to be split, can mean that this expense will be no longer allocated on an arm's length basis. So, for example some countries believe the expenses of the front office staff should be deducted locally, after profit has been allocated to each location. In their view, directly allocating such expenses to the locations that incurred them rewards efficiency. In other words, the effect of deducting expenses from gross income and then allocating the operating profit is to penalise local efficiency because the benefits of the efficiency are spread to other locations.

158. However, other countries believe that the profit to be split and the factors to be used for the profit split should be determined separately, since there is no direct relationship between the two. Compensation is simply used as a surrogate for activity or value. The profit to be split should be

5 Paragraph 3.17

6 Id.

determined by the relationship between the activities and the profit, and the factors should be determined to achieve a result in accordance with the arm's length principle.

159. These countries argue that expenses be separated into "global expenses" and "local expenses" depending upon the activities to which the expenses relate. "Global expenses" are those that relate primarily to the global aspect of the taxpayer's activity and therefore generally can be allocated in the same manner as income. "Local expenses" are expenses that relate primarily to the local costs of doing business in that location and do not contribute directly to the global business. "Local expenses" are deducted after the profit split is applied.

160. Although this distinction between "global expenses" and "local expenses" is conceptually clear, in practice the distinction is not so obvious and countries differ as to where the line should be drawn. Japan, for example, believes that there is significant difficulty in dividing the expenses into global and local because of the integrated nature of the activities each location performs. Accordingly, Japan thinks that global expenses should be interpreted broadly, including not only direct and indirect costs but also general administration expenses incurred by the home office or the other locations engaged in activities that have a direct relation to the overall profitability of the world-wide operation. Although the expenses for one location may be higher than those for other locations, the reason for an enterprise to conduct business in that location is that the office contributes to the overall profit of the enterprise. Therefore, a category of expenses should be treated as local expenses only in cases where the amount of expense incurred in one location is excessively large in comparison to other locations, or not in line with the comparative profitability of the location. If local expenses are not deducted only because they are excessive compared to other locations, this could result in the high cost location realising a loss even though having an office in that location is a necessary part of the enterprise's business strategy and therefore directly contributes to its overall profits.

V - 3. CALCULATION OF THE AMOUNT OF PROFITS

161. Some countries believe that the application of profit split methods increases the burden on taxpayers since it is difficult to get enough relevant information. However, global trading is different from other businesses where this argument may carry more weight, because the profit split method is only used where each location trades off a common book. Accordingly it should not be difficult to determine the world-wide trading profits.

162. Many financial institutions determine their financial position on a mark-to-market basis. However, this does not necessarily mean that a result calculated on this basis would also be accepted by all tax authorities for tax accounting purposes. Currently, some countries accept mark-to-market accounting for taxation purposes while others rely on accruals or realisation bases of accounting. Unless tax authorities in each relevant taxing jurisdiction compute the world-wide profit on a consistent basis, it is almost certain that the global trading profits will be subject to over- or under-taxation.

163. Even if all countries adopt mark-to-market accounting for taxation purposes, there are differences in the way it might be applied which could result in under-, over-, or double taxation. For example, differences in the way in which credit risk is reflected in the valuation will result in different measures of profits.

164. Despite these limitations, it is desirable to reach a general consensus, because the calculation of the profit to be split is the starting point of the application of any profit split method. Some countries believe that one way to resolve the problem is to respect the method used in the jurisdiction in which the

book is kept (i.e. where legal ownership with respect to the positions is located) and apply the profit split to the amount of profits calculated by that method. Others do not see this as either logical or practical.

VI. PROFIT SPLIT METHODS

VI - 1. INTRODUCTION

165. This section discusses the practical use of profit split methods with particular reference to the factors that should be included in a formula to allocate profits among the locations fully involved in integrated global trading, where it is accepted that the profit split method is the appropriate transfer pricing or attribution method. This covers both the integrated trading model (as described at paragraphs 47 to 51 above) and the hybrid models described at paragraphs 61 and 62 above. This is relevant not only in the context of applying profit split methods in ordinary auditing procedures, but also in the context of APAs. Currently, taxpayers have no multilateral guidelines to help them draw up profit split methodologies which will be acceptable to tax authorities in the specific circumstances of global trading.

166. In accordance with the 1995 TP Guidelines, a profit split method is only acceptable if the factors used to allocate world-wide profits will produce a result consistent with what would have been realised if the parties were independent. The Guidelines however also admit the difficulty of finding comparables and list several possible methods that could be used for the allocation. One such method is a contribution analysis, under which the combined profits are divided according to the relative value of the functions performed by each of the participating associated enterprises. Another approach, known as a residual analysis, divides the combined profits in two stages. The first ensures the participants are given a sufficient allocation to provide them with a basic return relating to the functions performed, but would generally not account for the return that would be generated by any unique and valuable assets of the participants. The second stage allocates any residual profit in accordance with how this would have been allocated between independent enterprises based on an analysis of the facts and circumstances.

167. If a functional analysis is used, it is essential that the functions necessary to earn global trading profits are included, valued and appropriately rewarded. If a residual method were to be applied to a global trading case, the first stage would be to reward the less integrated functions, such as general sales and some (or perhaps all) of the back office. The type of reward would depend on the nature of the functions but often would be determined by traditional transaction methods, such as arm's length service fees. Once these had been deducted from the total profit, this would leave a residual profit (or loss) attributable to the performance of the globally integrated functions. This would be split between the various locations, frequently by means of a factor formula. The choice and application of the profit split method must depend on the facts and circumstances of each case. In particular, care must be taken not to apply a factor formula developed for one product line to other products where the factual situation differs.

168. The residual method may be particularly useful when trading is conducted on a hybrid model as first of all the non-integrated functions can be rewarded thereby leaving a residual profit attributable to the integrated functions. This is the equivalent of the profit attributable to the "unique and valuable attributes" referred to above. The residual profit can then be split by reference to an appropriate profit split methodology. This formula will differ from that used where global trading is carried out on a fully integrated trading model as the formula only needs to reflect the integrated functions. The non integrated functions have already been rewarded in the calculation of the residual profit.

169. It is crucial that consideration be given to ensuring that the factors best represent the facts and circumstances of each case. The current commentary to the OECD Model Convention provides little guidance with respect to global trading. It states that the “criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure.”⁷ It also says that “in the case of banking and financial concerns the proportion of total working capital may be the most relevant criteria.” However, some believe that the best analogy is not traditional banking, but “enterprises providing services or producing proprietary articles with a high profit margin,” for which turnover may be a more appropriate factor. Perhaps the most useful comment in the section is that “it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use the method which in the light of all the known facts seems most likely to produce the (arm’s length) result.”⁸ Accordingly, it is necessary to look beyond a financial institution’s allocation of working capital to other factors in determining how to divide the profits of a global trading operation.

170. There are three considerations that must be balanced in determining the allocation of profits. The first consideration is the extent to which the factors reflect the facts and circumstances of the particular operation (and therefore approximate the division of profits that independent enterprises would have expected). The second is the ease with which the factors could be manipulated by taxpayers for tax purposes. The third consideration is the extent to which the factors ease the burden on taxpayers and tax authorities because they are objective and relatively simple to calculate or evaluate.

171. In April 1994, the US Internal Revenue Service issued Notice 94-40 which described in general terms its early experience with APAs concluded with taxpayers engaged in fully integrated global trading. The APAs described in the Notice used a profit split method that utilized factors intended to ensure that profits were divided according to the economic activity of each location and its contribution to the overall profitability of the world-wide business.

172. The Notice identified three general types of factors which represent the contribution of various functions to the production of worldwide profits in the case of a fully integrated trading operation: (i) the relative value of the trading location (the “value factor”) which was measured with reference to the compensation paid to traders at the trading location, (ii) the risk associated with the trading location (the “risk factor”) which measures the potential risk to which a particular location exposes the worldwide capital of the organization, and (iii) the extent of the activity of each location (“activity factor”) which was measured by reference to the compensation paid to key support people or the net present value of transactions executed at a trading location.

173. This Notice provides a starting point for identifying and analysing allocation factors. However, the Notice by its own terms is merely a historical account of the early experiences of the United States in developing a method of allocating profits for one limited trading model in the context of an APA. The discussions of this Working Group are the first attempt to develop international guidelines as to how global trading profits should be taxed and how to apply profit split methods either in the context of an APA or in ordinary auditing. The following sections review the types of factors that might be considered for use in profit split formulae.

7 Paragraph 27 of the commentary to Article 7

8 Id.

VI - 2. COMPENSATION OF TRADERS AND MARKETERS

174. The majority of countries agree that traders' compensation should be used as a factor that reflects the relative value, or the relative contribution, to the world-wide profit of the trading activity. A number of countries also point out that there is a similar link between specialised marketers' compensation and the contribution of the marketing function, and therefore it would be appropriate to include the marketers' compensation as well as that of traders as an allocation factor. Some countries have also included some managers' compensation in a more general "front office" factor. The question is whether to include only day to day managers or to extend the concept to include high level or strategic management. Another question is whether to include in this factor some "middle office" staff such as systems developers, economic forecasters and product engineers. An alternative is to include such items in the back office factor and to measure separately the trading and marketing factor as the "front office" factor.

175. Both traders and specialised marketers' performance is the key to the profitability of global trading. They require adequate compensation for their performance and, if not rewarded adequately, often move to an enterprise which does so reward them. In the rather specialized field of global trading, the compensation negotiated with wholly independent enterprises would also seek to measure the relative contribution of traders to the realized profits. Therefore, the traders' and marketers' compensation generally reflects the arm's length value of the function that the traders perform. However, if this relationship breaks down for any reason, then an alternative measure, such as the number of employees may need to be considered.

176. There are two issues that need to be addressed here. The first issue is how to deal with an enterprise that incurs an overall loss. It has been argued that compensation is not a good allocation factor because, where losses arise, there is no necessary correlation between the compensation of traders and marketers and their contribution to the business. Some countries propose solving this problem by adjusting the compensation (such as using the inverse proportion of compensation paid to traders and marketers in a particular location) in the allocation factor or ignoring compensation as an allocation factor entirely.

177. The second issue relates to possible geographical differences in the level of average compensation. There seems to be a general agreement that there are significant differences in compensation levels between countries and that, in theory, adjustments may be needed to exclude any variations caused entirely by local factors such as cost of living.

178. There are a number of possible ways to tackle this problem. The first is to ignore the geographical effect on the grounds that there is no completely satisfactory evidence that the cost of living is not comparable in the major global trading centers. The second is to focus only on the part of compensation that reflects the value of the traders' (or marketers') performance, e.g. the bonus element. This appears to be administratively simple, but in fact may be difficult to apply in practice because performance-related payments could be made in other forms (e.g. tangible goods) or from other sources (e.g. under a dual contract) and the bonus element of the total salary package may vary, not because of performance, but for other reasons such as cultural differences and employee expectations. The third way is to apply available indices to correct for purely geographical differences. However, care should be taken to apply indices that reflect circumstances specific to global trading and not simply the relative performances of the national economies. Moreover, only those portions of the compensation that reflect differences in the cost of living should be adjusted.

179. In the view of some countries, however, it does not appear appropriate to make a cost of living adjustment to the factors because the justification for using traders' compensation as an allocation factor is the assumption, based on empirical evidence, that it correlates with profit. Such an adjustment would

undermine that assumption, and could lead to proposals for further adjustments such as the differences in business tradition regarding the manner in which traders are rewarded. It could be argued that traders in some countries are compensated more highly than traders in others regardless of the cost of living. Furthermore, any such adjustments increase the administrative burdens on taxpayers and the taxing authorities.

VI - 3. RISK

180. There is obviously a relationship between risk and expected profits. Conventional finance theory suggests that, assuming that financial institutions are risk averse, the larger the risk to which an asset is exposed, the larger the expected profits should be. Therefore some countries argue that the risk taken on by a trading location should be considered as one of the factors that represents the relative contribution of that location to the production of world-wide profits from global trading. This is because one of the key qualities of a global trading firm is the ability to assume all types of risk, as without this customers will simply not deal with it. The ability to assume risk is a function of capital, although the global trader does not necessarily need to have a large capital base itself. Instead it could use guarantees from a well capitalised affiliate or a credit enhanced special purpose vehicle as described in paragraph 31 above.

181. The Guidelines counsel that it is necessary in order to arrive at an arm's length determination, to consider the functions performed (taking into account assets used and risks assumed). However, there is no consensus on what the risk factor, is intended to measure. Some countries believe that the factor should measure risk exposure; others believe it should measure risk management. Others believe that both risk management and risk exposure need to be included somewhere in any formula, if they are both important in any particular global trading business. These aspects of risk are discussed below. Unless otherwise stated, risk in this section refers to market risk.

182. Countries are split as to whether to include risk exposure as an allocation factor.

183. Countries that do not favor using risk exposure as an allocation factor make the following arguments:

- First, they argue that it is difficult to determine which location really bears the risk. Here, the distinction between risk management and risk exposure frequently is not appreciated. The mere fact that risk of any kind is managed in a location does not mean the risk is borne in that location. Especially in global trading, risk can easily be shifted among parties by hedging transactions. Under either the integrated trading model or centralized product management model, the initial exposure of the position entered into by the location (or the amount of risk that is contributed to the entire global trading operation) could be managed by another location. Furthermore, the risk may be shared by the trading locations. This happens naturally in the case of trading by one entity through branches. In the case of global trading through separate enterprises, risk may be shared through guarantees. In either case, it would be impossible to determine who really bears the risk
- Second, countries averse to using risk exposure as a factor believe that in cases other than simple traditional securities trading where the determination of risk exposure is quite easy, it is difficult to determine risk exposure. They argue that there is considerable difficulty in calculating risk exposure arising from certain complex derivatives. As risk management is crucial in global trading, enterprises invest a huge amount of money to develop standards for the calculation of risk exposure. Tax

authorities generally do not have the resources necessary to do their own calculation of risk and may not even be able to evaluate the methods used by the traders.

- Third, some countries argue that large risk exposure does not necessarily entitle one to a larger share in the realized profits. Larger exposure to risk may simply mean excessive speculation by the location; the expected average profit may be large but there may actually be a loss from the position. Allocating a larger share of the profits to such a location rather than to those pursuing more conservative strategies (lower, but more reliable, profits) will be over-rewarding speculation. Furthermore, since risk exposure does not always guarantee corresponding profits, it would be better not to use it as an allocation factor.

184. Countries in favor of including risk exposure as a factor believe that risk exposure, which measures the extent to which the capital of the financial institution is put at risk, is a useful means of measuring the contribution of capital to the profitability of the financial institution. They do not accept the arguments of those opposed to using risk exposure as a factor for the following reasons:

- First, they believe that in most cases it is possible to determine who is bearing the risk of a particular transaction. They admit that initial risk exposure may not be indicative of who actually is bearing the risk of a particular transaction. This should not stop it being included as one way of measuring the concept of risk, provided the other elements are also included. In any case it may be possible to trace that transaction to the location bearing the risk. For instance, where a business uses the centralized product management model of market risk management, transactions entered into in one location may be traced to the location managing the market risk for that particular product. Risk can easily be shifted between, or may be shared by, different locations. Therefore, a functional analysis needs to be conducted to determine what has happened to risk. So if risk is actually borne by a well capitalised affiliate, then it should receive the appropriate reward. On the other hand, a purely arbitrary allocation of risks, (for example, that all the credit or market risk of an enterprise is borne in a single permanent establishment), should not be followed. In such cases, the reward for assuming and bearing risk should be allocated according to the true situation as revealed by the functional analysis.
- Second, countries who support including risk exposure believe that measuring the various types of risk inherent in a particular derivative instrument is not an insurmountable task. Although most countries may not have the resources to develop their own methods of measuring risk exposure, countries can look to the methods developed by financial institutions to the same ends. The approach of starting the transfer pricing analysis from the perspective of the method chosen by the taxpayer, is in fact advocated by the TP Guidelines. As alluded to above, financial institutions have every reason to develop systems that measure risk exposure as accurately as possible. Where such systems are developed for business reasons, and not merely to satisfy tax authorities, many tax authorities feel confident in looking to such systems as accurate measures of risk
- Third, countries advocating including risk exposure as a factor believe that there is a correlation between risk exposure and expected profit. Such countries accordingly believe that speculation should be rewarded in this context.

185. Risk management is regarded as one of the most important functions in global trading. Because a financial institution engaged in global trading can net a larger pool of risks against each other and manage the smaller residual risk, each trading location can realize the same amount of profits for less risk than an equivalent financial institution not trading globally. The riskier the book, the harder it is to manage and the more important it is to manage it well in order to preserve the profit from the open

(unhedged) transactions initially entered into by the trading location. Some countries believe that the management of risk is an important function for which the trading location should be rewarded when allocating profits under any trading model. Other countries, while admitting the importance of risk management in the centralized product management model, believe that it is less important to consider the role of risk management in a truly integrated trading model in which each location has full responsibility for the management of risk. This is because if the factor is included, then any way of measuring it will be bound to produce a roughly equal split amongst all the relevant locations. This still has an effect on the overall result, see paragraph 195 below.

186. There seems to be a need for further discussion of the factors that could capture the contribution made by the risk management function. Suggested measures include initial risk exposure, compensation of dedicated risk managers (as opposed to traders) and the financial institution's risk limits.

187. If one or more risk factors are to be used, care should be taken to avoid unintentionally double counting a function. For example, if risk exposure is measured by looking at the risk assumed by a particular location, this could be viewed as another aspect of the marketing function, as it only considers where the deal was originated. By contrast, as risk management is carried out by traders or dedicated risk managers, this could be viewed as another aspect of the trading function, especially as their salaries have already been included in the computation of the front office function. Therefore, there is a danger of double-counting or over-weighting either the trading or marketing function, according to which risk factors are chosen and what weightings they are given. More work is needed on these difficult issues and input from the private sector on this topic will be sought.

VI - 4. BACK OFFICE

188. Back office activities include various types of activities, some of which constitute significant parts of global trading, and some of which are quite remote from its main activity. Since activities of key back office staff such as product control staff play significant roles in determining the profitability of the whole operation, it may be necessary to give consideration to those activities. One possible measure of the contribution of such activities is the amount of compensation to key staff. Because their functions are essential for global trading, it is likely that their compensation is also performance related, providing the same justification for use of this factor as for using traders' and marketers' compensation. The relationship between other activities (such as employee training and clerical functions) and profitability may be more remote, which may indicate that these activities should not be reflected in an allocation factor. There currently is no consensus on which activities to include in the scope of global trading.

189. One solution is to exclude remote activities from the scope of the profit split and to compensate these functions using the commission approach. Some countries have suggested that it may be difficult to find a comparable uncontrolled price because these back office activities usually take place within the same enterprise. However, other countries believe that comparables can be found outside the global trading context (i.e. investment funds) eliminating this problem. As noted in Section IV-1 above, it is difficult for tax authorities to determine which activities constitute an integral part of global trading operations and which activities do not. In view of these administrative difficulties, some countries believe that the compensation of all back office staff should be reflected in an allocation factor. Although the compensation of back office staff may not completely correlate to their contribution to the earning of global profits, it could be considered a way of measuring overall activity in a location. In addition, inclusion of this factor might provide for a relatively stable shared profit and therefore compensate for some of the fluctuations that might be caused by changing compensation for traders and marketers.

190. Other countries believe that it is probably best to deal with the question of the role of back office activities on a case-by-case basis. They still feel, however, that given the nature of a profit split methodology, there are considerable dangers in including these expenses as a factor as it can give a disproportionate profit to this function, even when the factor is given a relatively low weighting. For example, if a global trader makes \$200 million in a year and incurs back office expenses of \$5 million, even if the back office profit share is only 10%, costs would be marked-up 300%. A 300% mark-up is clearly excessive if the back office function consists mainly of routine items such as processing and settlement of trades. Accordingly, they argue that relatively routine functions may be more appropriately rewarded on some kind of cost plus basis.

191. Another issue raised by certain countries regarding the possible inclusion of back office activities as an allocation factor is whether compensation for back office staff should be the only factor or whether other administrative expenses should be used as allocation factors. They argue that the relationship between the level of activities and the amount of expenses differs depending on the type of business. They believe that back office expenses other than compensation (such as depreciation or other facility-related expenses) should be used as allocation factors. This determination could be made on a case-by-case basis.

VI - 5. INTANGIBLES

192. In order to compete in a cut throat environment, financial enterprises engaging in global trading stress the need to develop proprietary intangibles, e.g. computer programs, systems, or trading methods. Therefore, some countries have suggested that this might be reflected in the factors to ensure that an appropriate amount of profits are allocated to the location which actually developed these programs, systems or methods.

193. However, as the OECD Model Convention does not recognize inter-branch royalty payments in the case of global trading performed in branch form, it would theoretically be wrong to consider intangibles as an allocation factor. Intangibles owned by the enterprise are recognized as belonging to a whole corporation and not to a particular location. For these reasons, countries generally agree that intangibles should not be included as an allocation factor.

VI - 6. OTHER FACTORS

194. Several countries have suggested that factors other than those described above be used in allocating profits from global trading operations. For instance, countries have suggested that factors include a measure of volume (such as number of transactions or notional amounts of contracts written at a particular location), capital, and management. Further study is necessary before deciding whether any of these factors should be incorporated into a profit split formula.

VI - 7. CHOICE AND WEIGHTING OF THE FACTORS

195. Because after performing a functional analysis, it is very unlikely that each factor contributes equally to the whole profit, countries generally agree that it is appropriate to weight factors according to their relative contributions to the overall profitability of the global trading operations. The weights given to the factors should be determined on a case-by-case basis to ensure that the profit split method results in an arm's length allocation, which distinguishes it from global formula apportionment. Whatever type of profit split method is employed (whether based on a residual or on a contribution analysis) it is essential

that functions are fully evaluated in order to arrive at an arm's length result. This is discussed in detail in Chapter III of the TP Guidelines. Choosing a smaller range of factors designed to identify differences in performance between locations, rather than ensuring that all significant factors are included, could lead to the exclusion of factors which are likely to be equally divided between locations, thus affecting the overall result by altering the weighting given to the other factors.

196. However, there is no consensus on the method for determining the weights. Moreover, some countries believe that no satisfactory basis for assigning weights has yet been articulated. Therefore, it is very difficult to decide whether the weights used in any specific case are appropriate. Without such guidance, taxpayers and tax authorities are left with a subjective test that is susceptible to manipulation. One approach to counter partially such abuse is to use more than one method of measuring a particular factor. It has been suggested, therefore, that Member countries pursue further study on the issue with a view to developing a set of objective, yet flexible, criteria for weighting factors.

VII. CONCLUSION

197. Global trading of financial products is an emerging phenomenon associated with the development of innovative financial instruments which presents new challenges to tax authorities. Because Articles 7 and 9 of the OECD Model Convention provide the governing principles, the traditional transaction methods of taxation or attribution of income principle should be the primary methods for analysing global trading. However, experience shows that the activities of each location engaging in global trading are often so highly integrated that traditional transaction methods may not fully be capable of reaching appropriate results.

198. The paper has attempted to put global trading issues in context, by means of a detailed analysis of its factual background. It has focused on the circumstances in which there are difficulties in applying traditional transaction methods so that, as a last resort, profit split methods may have to be applied. The paper has also discussed a number of possible ways of applying profit split methods but has not yet reached firm conclusions. Further work is needed and the Special Sessions believes that OECD could usefully provide guidelines as to the operation of the existing rules in this area, to aid both taxpayers and tax administrations. The Special Sessions believes it is the most suitable body to take on the task and to help it in its deliberations, it invites representations from the private sector.