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Working Party No. 6 on the Taxation of Multinational Enterprises

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

**Case Study B: Attributing Financial Assets: Importance Of The Sales/Trading Function. Example Where
Loan Booking Jurisdiction Is Not In Line With Functional Analysis**

*This document is FOR DISCUSSION on Thursday 11 April pm at the Meeting to be held on 11 and 12 April 2002
at the Headquarters of OECD, 75106, Paris, Room 1, New Building.*

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CASE STUDY B: ATTRIBUTING FINANCIAL ASSETS: IMPORTANCE OF THE SALES/TRADING FUNCTION. EXAMPLE WHERE LOAN BOOKING JURISDICTION IS NOT IN LINE WITH FUNCTIONAL ANALYSIS

A. Issues for Discussion

1. The WH is based on attributing financial assets in the first instance based on where the functions leading to their creation were performed. The WH emphasises the importance of the sales/trading function in making this determination, although does admit the possibility of an asset being considered as jointly owned where other key functions, such as risk management are performed in another location. The banking community, although supporting the functionally separate entity approach in principle, was not generally in favour of attributing financial assets based on a functional analysis. Instead they favoured following the booking location with some exceptions e.g. for abusive cases.

2. However, some of the suggestions made by the banking community indicated the need for the booking location to reward the other parts of the enterprise for the functions they perform by service fees, including an appropriate allocation of capital. This may be worth exploring to see how different the result of such an approach would be from the result obtained from applying the WH. One difference may arise from whether it is possible to treat one part of the enterprise as bearing the risk even though it does not perform any of the people functions related to risk management.

3. The above issues are best illustrated by considering two examples. The first example looks at the case where a banking enterprise centralises the booking of certain portfolios of loans in a branch with a favourable regulatory climate. The second looks at the situation where elements of the sales/trading function are carried out in different locations.

B. Example 1 - Centralisation of booking for regulatory reasons

4. Bank B has its Head Office in Country A. Certain types of foreign currency loans with customers in Country A would require minimum reserve requirements if booked in Country A making the loans prohibitively expensive. This problem can be avoided if the loans are actually made by the branch of Bank B in Country C as there is now no minimum reserve requirement and so the loans can be priced competitively.

5. The branch in Country C carries out the following activities in respect of the loans making up the portfolio of foreign currency loans:

- raising funds for the loans on the instructions of the Head Office and in accordance with Head Office specifications,
- sending the loan contracts to the customers following Head Office instructions and again in accordance with Head Office specifications,

- sending the loan contracts when returned by the clients to the client account manager in Head Office for checking and final approval.

6. All other functions related to the making of the loan - marketing, assessing the credit and other risks, deciding on the interest rate to be charged, negotiating the other terms of the loan etc are performed by the Head Office.

7. The branch in Country C records the loan on its books and sets aside equity capital equivalent to 4% of the amount of the loan in accordance with local regulatory requirements.

Questions related to Example 1.

8. Under the WH, the loan would be attributed for tax purposes to the Head Office in Country A. This would mean that all the associated income and expenses would be attributed to the Head Office and the loans would also be treated as Head Office assets for capital attribution purposes. This raises the following questions:

a) Are there any dealings between Head Office and the branch in Country C that would have to be taken into account?

b) What is the nature of those dealings in terms of functions performed, assets used and crucially risks assumed? What does the branch actually do?

c) Is the favourable regulatory environment in Country C a factor that needs to be taken into account and, if so, how?

d) What would be the difference if, as suggested by many commentators, the booking location was not moved but a service fee was paid from the branch to the Head Office? Would the service fee taken into account the attribution of capital and, if so, how?

e) Would it make any difference if the branch also managed the risks associated with the foreign currency loans?

C. Example 2 - Elements of the Sales/trading function carried out in different locations

9. Bank B also has a branch in Country D, which is in charge of client development in that country. The branch in Country D has entered into a number of loan agreements with local customers. For all these loans, the Head Office has been responsible for assessing the credit and other risks, deciding on the interest rate to be charged and more generally it is the Head Office that defines the loan policy that must be followed by the branch when negotiating with a customer. However, it is the branch in Country D that has all contact with the client, undertakes the negotiations within the parameters set by the Head Office

Questions related to Example 2

10. The above example raises a number of interesting questions both about how the WH should be applied and whether applying the WH produces the correct policy result.

- a) Under the WH, where should the loans be attributed for tax purposes? To the Head Office? To the branch in Country D? Jointly attributed between Head Office and Branch in Country D? If jointly attributed, how would the proportion to be attributed to each location be determined?
- b) Under the WH, where should the risks associated with these loans be regarded as borne? By the Head Office? By the Branch in Country D? Jointly? How should this determination be made? Does the determination of where risks are borne necessarily follow the attribution of the asset described above?
- c) If the loan is attributed to the Head Office, what dealings should be recognised and how should they be remunerated?
- d) In case the loan is attributed to the Branch in Country D, what dealings should be recognised and how should they be remunerated?
- e) If the loan is attributed jointly to the Head Office and to the Branch in Country D, what dealings should be recognised and how should they be remunerated?
- f) How should the attribution of capital be taken into account in the above situations?
- g) Would the outcome be significantly different in the above situations?
- h) Does the result of applying the WH in this situation give the right policy result? For example, in order to preserve a level playing field between PEs and subsidiaries, should Bank B have the flexibility to decide whether it will attribute these loans for tax purposes to the Head Office in Country A or to the Branch in Country D? Similarly, should the bank also have the flexibility to assign the bearing of the risks associated with these loans to Head Office, the Branch in Country D or another part of the bank, regardless of where the loan is booked or where the associated risk management functions are performed?