The OECD Committee on Fiscal Affairs (CFA) published on 17 March 1998, a revised and updated version of the discussion draft released on the 14th February 1997. The 1997 draft was produced by the Special Sessions on Innovative Financial Transactions (the SSIFT) as a first response to the challenges to traditional tax systems posed by the phenomenon of global trading. Global trading is the result of the interplay of dramatic technological changes (in information and communications technologies) and the spread of financial deregulation and liberalisation that have led to the creation of global financial markets. Financial firms have taken the opportunity offered by global markets to develop 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. In order to meet this demand, financial firms have increasingly organised themselves so as to be able to sell global financial products, 24 hours a day.

The business community was invited to comment on the first discussion draft. Comments were especially invited on the ways in which the tax issues posed by global trading were described and analysed and on whether the factual background described in the paper was accurate. Views were also sought on the options identified for governments to deal with those issues. Comments were received from a number of organisations and representative bodies from the general business sector, the banking and financial sector and professional firms covering the American, European and Asian regions.

The March 1998 document reflects initial reactions to these comments, as well as updating the analysis. The paper has been substantially revised, expanded and restructured, especially in the sections dealing with transfer pricing issues. These changes are intended to make absolutely clear that the transfer pricing analysis, and in particular the description of profit methods, follows the guidance given by the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Detailed consideration is given as to how to apply that guidance in the special factual circumstances of global trading.

This Article provides a brief overview of some of the responses from the business community and some of the major developments in the paper.

---

Section I : Introduction

The scope of the paper has been more tightly defined. The paper focuses on taxing the profits of the providers of financial instruments and on the tax issues that occur whenever financial products are offered to customers in more than one jurisdiction. Such activities are at the heart of the global trading problem, as they require the determination of transfer prices between associated enterprises or, where trading is conducted through permanent establishments, the attribution of profits. The discussion is therefore relevant to financial businesses with any kind of cross border activity (even within a single time zone) and not just to firms who “pass” their trading book around the world every day. The document does not however look at some ancillary issues, such as source or withholding tax rules for financial products.

Section II : Current situation

The description of the factual background on which the analysis on the paper is based was generally felt by the business community to be comprehensive and accurate, although some further factual description has been added. The use of the three types of models (Integrated Trading, Centralised Product Management and Separate Enterprise Trading) as analytical tools was also thought to be helpful. However, the paper now makes clearer that such models refer only to trading activities. The other main change to this section has been the added emphasis on functional analysis, and in particular a fuller description of the role of capital and the assumption of risk. The business community also as a whole shared the view that generally accepted tax principles can be applied to global trading problems, although further elaboration on how those principles can be applied to the special factual circumstances of global trading would be useful. Advance Pricing Arrangements (APAs), although useful for resolving global trading problems in some cases, are not felt to be sufficient on their own or as a substitute for a clear consensus on the application of general principles of taxation.

Section III : Application of the arm’s length principle

A new section on the application of the arm’s length principle has been created. This comprises the original part III of the old draft and the original part VI on profit methods. This restructuring helps make clearer that only profit methods based on the arm’s length principle can be used. The paper stresses that the “considerable guidance concerning the application of the arm’s length principle in the Guidelines can, and should, be followed in global trading cases.” The new section contains much new material and analysis demonstrating how the principles and methods of the Guidelines can be applied in practice to global trading cases. It is hoped such material will go some way to meeting the request from the business community for greater practical guidance. Specific issues regarding the application of the arm’s length principle to attributing profits to permanent establishments are dealt with in Section V. The section is divided into three parts and each is discussed in detail below.

(i) General application and methods

This part discusses in general how the guidance on the application of the arm’s length principle given by the Guidelines can be used to deal with the special factual situation of global trading businesses. It is felt that the Guidelines provide sufficient flexibility to cope with such cases. The performance of a functional analysis is recommended as a starting point. The paper then discusses how to take into account the other factors necessary to perform the comparability analysis mentioned by Chapter I of the

2 "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, OECD 1995"
Guidelines. It is noted that the ability to undertake the transfer pricing analysis on a combined group of similar transactions, rather than on each individual transaction, is likely to be helpful in global trading cases, where thousands of similar individual transactions are usually combined for risk management purposes into a single trading book or portfolio. Other areas of useful flexibility can be found in the concept of an arm’s length range and the fact that third party data can still be comparable, even if there are material differences with the data from transactions between related parties, provided that reasonably accurate adjustments can be made to account for those differences.

The choice of transfer pricing methods is also discussed in detail and it is concluded that the same criteria apply for global trading situations as for other transfer pricing cases. Therefore, traditional transaction methods should be used where they can be applied reliably but where they cannot be reliably applied, the profit split method as described in Chapter III of the Guidelines may have to be used. It is made clear that the analysis should start from the perspective of the method chosen by the taxpayer, although the tax authorities are not obliged to follow that method if it does not produce a result in accordance with the arm’s length principle. The paper concludes that owing to the sheer diversity of global trading businesses, tax authorities have been reluctant to sanction the use of the Transaction Net Margin Method (TNMM) because of concerns that it may not be possible to reliably apply the comparability standard. This may change as more experience is gained and currently some countries may wish to use the TNMM in some cases, albeit only in conjunction with other methods.

(ii) Analysis of global trading functions

This part analyses each of the significant global trading functions identified in Section II in turn and discusses the most appropriate way of applying the arm’s length principle so as to take into account the performance of that function. The functions analysed in details are grouped under four main headings; (1) Sales and Marketing, (2) Trading and Risk Management, (3) Support or Back Office and (4) Role of Capital/Risk assumption.

Ways of performing the functional and comparability analyses are discussed in detail, especially how to take into account “assets used” and “risks assumed”. The paper discusses the possibility of using data from the performance of comparable functions from other parts of the financial markets. The possibilities for applying the traditional transaction methods are also discussed in detail for each function, Emphasis is placed on how to make “reasonably accurate adjustments” to third party data to account for the differences between controlled and uncontrolled conditions, for example between routine and non-routine functions. There is also discussion of how to adequately take into account other significant matters affecting comparability, for example the business strategy of the firm. Evidence from the behaviour of the taxpayer may help in the analysis.

Although the revised draft provides considerably more guidance on how to apply traditional transaction methods, especially in relation to the role of capital and risk assumption, it is still concluded that it may not always be possible to reliably apply such methods in all global trading situations. For example, it may not be possible to make reasonably accurate adjustment to independent data to reflect differences in functions performed between the controlled and the uncontrolled situation. The section discusses the circumstances in which the profit split method, as described in Chapter III of the Guidelines may, have to be used to properly reward the performance of each of the identified functions.

Although the significant functions are grouped under the four headings described above, it may be that in some factual circumstances it is necessary for there to be some integration and co-operation between the different functions and locations. The section discusses how to reflect this interaction in the
transfer pricing analysis and whether it is possible to adequately take this into account when applying traditional transaction methods. It has been the experience of some countries that the circumstances of global trading in the controlled situations differs so much from that found between independent parties, for example in the degree of integration between functions, that it has not been possible to make reasonably accurate adjustments to account for those differences. Consequently, profit split methods have had to be applied. There is also some further discussion of whether, once it has been decided to use a profit split method, it should be the overall profits that should be split or whether it should be some subset of those profits. For example, should the marketing function receive a share of the initial profit on the deal, rather than the overall profit? The latter would include any profit/losses from subsequent risk management of the initial position introduced to the trading book by the marketer.

(iii) Profit Split Methods

Having discussed in the previous two parts when it may be appropriate to use profit split methods, the final part of this section goes on to discuss how such methods can be applied so as to be in accordance with the arm’s length principle. The paper confirms that in order to follow this principle, profit split methods must be applied in a manner consistent with the guidance given by Chapter III of the Guidelines. Global formulary apportionment methods are not permitted. The paper considers both the contribution and residual analyses and new material is added concerning the use of a residual profit split analysis.

The section also discusses the possible factors that can be used to divide the profit. The discussion on the factors involving the personnel of the firm (“people factors”) has been revised to take into account developments in the market and the concerns that the correlation between earnings of key personnel and profit earned for the financial firm may not be as strong as previously thought. The section on the risk factor is the one section of the whole paper which has been left unchanged. Further discussion on this key issue is necessary but will have to await the outcome of future work (see Section below). The section on other factors has been expanded to discuss intangibles, whilst material has been added on the weighting of factors. It is stressed that the factors should be based on a properly carried out economic analysis of the relative contributions of the factors to the earning of profit. The determination should be made as far as possible based on empirical data and external benchmarks. The offer of the business community to assist in researching the economic factors on which successful global trading is based is welcome. Finally, it is explained why it is not felt that “safe harbour” formulas would be appropriate, although greater guidance on this subject may be necessary.

Section IV : Determination of the profit to be split from global trading

This section has not been revised dramatically, although further discussion has been added on whether gross or net profits should be used in the profit split analysis. The section also responds to the suggestion of the business community that tax authorities should simply follow the measure of profits used in the accounts. It is pointed out that although accounting principles may provide valuable guidance for some countries in formulating tax rules, there is not a global consensus for abolishing separate tax rules altogether. Member countries may be unwilling to follow some accounting principles, such as prudence, when computing taxable profits.
Section V. The application of the arm’s length principle to global trading conducted in a branch form

Global trading is often carried on by a single legal entity which operates in various countries in branch form (or through agents). Particular problems arise as to the question of whether certain kinds of activities carried on in a particular jurisdiction amount to the carrying on of business there through a permanent establishment (PE). The question is important. If there is not a PE in a particular jurisdiction, the non-resident legal entity cannot be taxed there. There were suggestions from the business community that to avoid the creation of multiple PEs, there should be a relatively high threshold for recognising that a permanent establishment exists in global trading cases, for example that only the presence of trading or risk management activities in a jurisdiction should create a PE. Other activities should be considered as “preparatory or auxiliary” within the meaning of Article 5(4). Similarly, there were suggestions that dependent agents conducting global trading activities should be treated as if they were independent agents thereby avoiding their activities creating a PE. Such treatment would be conditional on the agents being remunerated on arm’s length terms. However, it was not felt that a special case should be made for global trading cases and so the existing rules in Article 5 should continue to apply. One reason for this approach discussed by the paper is that the capacity in which the agent acts, dependent or independent, may affect the amount of the arm’s length remuneration.

The discussion on attribution of income is little changed, except that it concluded that there is no need to apply the approach of attributing the total profits of the enterprise described by Article 7(4). Some of the discussion on the recognition of internal payments, mirror swaps etc. has also been clarified. The whole question of the proper attribution of profit to a permanent establishment is under active consideration by the Committee on Fiscal Affairs. The experience in applying the existing rules to global trading cases has been helpful in reviewing the current position and will inform further work in this area.

Section VI: Conclusion

The conclusion that the existing tax principles can be applied to deal with the special factual circumstances found in global trading cases is unaltered. Strong support for this conclusion was also received in most of the comments from the business community. It is also re-affirmed that the traditional transaction methods should be the primary methods for applying the arm’s length principle of Article 9 but that the profit split methods of Chapter III of the Guidelines may need to be used. For example, where the activities of each location are so highly integrated, or conducted in so different a manner from how the activities are conducted between independent parties, that traditional transaction methods cannot be applied reliably.

Future Work

The publication of this document brings to an end the work of the Special Sessions on Innovative Financial Transactions (SSIFT) on this topic. This document is intended to provide a useful and detailed analysis of the difficult challenges posed by global trading and the options available to tackle them. Accordingly, it should be of assistance to both taxpayers and tax authorities in dealing with such problems, even though it should be noted that the views in this document should not at this stage be taken as necessarily reflecting the final position of Member Governments. Additionally, many of the difficult issues discussed, such as how to cope with the global integration of functions and co-operation between different locations, are not confined to the global trading sector. Many of these issues are of general relevance to the consideration of transfer pricing issues arising from electronic commerce.
The CFA intends to continue working in the area of global trading with the aim of producing a multilateral consensus on how global trading activities should be taxed. However, it is not envisaged that this document will be further revised but rather it will remain as a work of reference for the detailed analysis and discussion on which any final consensus will be based. The final form that any consensus will take has not yet been decided, although the Guidelines would be a natural place to publish final guidance, although necessarily of a less detailed nature than has been possible in a free standing document such as this.

Comments are still therefore required from interested sections in the business community, especially in connection with the general issue of how to take risk into account and more specifically on the inclusion of a risk or capital factor in the profit split method. The task of taking work forward on this issues has been given to a special group of Working Party No 6, which is the body responsible for transfer pricing issues and the OECD Transfer Pricing Guidelines.