PUBLIC COMMENTS RECEIVED ON THE DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS – PART II (SPECIAL CONSIDERATIONS FOR APPLYING THE WORKING HYPOTHESIS TO PERMANENT ESTABLISHMENTS OF BANKS)

Australian Bankers' Association

Executive Summary

Capital allocation

1. The ABA welcomes the opportunity to comment on the OECD Draft and accepts that there is a need (viewed from a taxation perspective) for international banks to deploy/ attribute "capital" to various countries in which they operate. Further, it is clearly desirable that there be a consistent international approach to this issue.

2. All three of the approaches discussed in the OECD Draft are likely to lead to double taxation on a global basis; be highly complex and involve significant compliance burdens on taxpayers and administration costs on revenue authorities. They are "over-engineered" solutions to the problem. This submission comments on each of the approaches.

3. Non-bank multinationals operating internationally via subsidiaries rather than branches have (appropriately) considerable flexibility in where capital is located. The usual approach appears to be that this is governed by domestic thin capitalisation rules in various countries. This state of affairs is quite reasonable and appropriate. Multinational groups, subject only to minimum thin capitalisation/safe harbour requirements, should be (and generally are) allowed flexibility to make decisions on capital deployment (for commercial i.e. non-tax reasons) without interference from revenue authorities. Such reasons will include decisions (based on innovation and/or risk taking) to establish or expand businesses in particular locations.

4. The same approach should apply for banks operating globally via branches rather than subsidiaries; i.e. it is not unreasonable to allow banks to allocate capital as they see fit, subject only to satisfying minimum capital levels.

Other issues

5. In addition to the question of capital allocation, the ABA has also made comments on a range of other matters, but at this stage has not made any firm recommendations to the OECD, pending reconsideration by the OECD on the key question of capital.

ABA's Recommendations

Capital allocation

Recommendation 1: A modified quasi-thin capitalisation approach should be adopted internationally under which;

- A multinational bank will be required to maintain a specified minimum amount of capital in each jurisdiction in which it operates, including its home office.
- The ABA suggests that, in accordance with the BIS regulatory approach, capital be required equal to 4% of risk weighted assets in each jurisdiction in which the bank operates.
- Banks will be permitted to deploy remaining capital, as they believe appropriate.
- The OECD should promulgate the above with a view to achieving global consistency.

Recommendation 2: Considerable care (and lead time) will be required in the transition to any new regime – given the potential need to alter the relevant provisions of the OECD Model Convention (and/or the Commentary), renegotiate various bilateral double tax treaties and amend the domestic law in many countries.

Other issues

Recommendation 3: Because of the fundamental importance of capital allocation, the OECD should endeavour to reach agreement with the international banking community on this matter, prior to progressing other issues, which in some instances are interdependent upon the outcome of the question of capital allocation.

Part A: Capital Allocation

Introduction

6. This Submission, including the attached table, has been prepared by the Australian Bankers' Association ("ABA") as a response to the OECD's Discussion Draft on the Attribution of Profits to Permanent Establishment, released in February 2001 for comment ("OECD Draft").

7. The major focus of this Submission (Part A) is on the method of attribution of capital by a single entity (i.e. an international bank) to the various countries in which it operates via permanent establishments. Some comments (Part B) are also made on other aspects of the OECD Draft.

8. The ABA accepts that there is a need (viewed from a taxation perspective) for international banks to deploy/attribute "capital" to various countries in which they operate. Given the high levels of capital (generally, but not always, carrying dividend and other rights which are typically not deductible for tax purposes) maintained by banks, this must be seen as one of the key global tax issues facing banks and revenue authorities. This need is not over-ridden by the likely difficulties in achieving international consensus as to exactly what "capital" is, precisely how the attribution is to occur, or what should be done where insufficient capital is found to exist in a particular situation.

Problems with the OECD's approaches

General comments

9. All three of the approaches discussed in the OECD Draft are likely to lead to double taxation on a global basis; be highly complex and involve significant compliance burdens on taxpayers and administration costs on revenue authorities. They are "over-engineered" solutions to the problem. Set out below are some further brief notes on each of the approaches. This does not represent a complete analysis of either approach but merely highlights some of the issues that are summarised in the attached table.

10. Non-bank multinationals operating internationally via subsidiaries rather than branches have (appropriately) considerable flexibility in where capital is located. The usual approach appears to be that this is governed by domestic thin capitalisation rules in various countries. It is not generally suggested that (despite the width of the wording) the associated enterprises articles in Double Tax Agreements (e.g. OECD Model Convention Article 9) should be regarded as requiring some "arm's length" carve-up of group global capital between subsidiaries in various countries. This state of affairs is quite reasonable and appropriate. Multinational groups, subject only to minimum thin capitalisation/safe harbour requirements, should be (and generally are) allowed flexibility to make decisions on capital deployment (for commercial i.e. non-tax reasons) without interference from revenue authorities. Such reasons will include decisions (based on innovation and/or risk taking) to establish or expand businesses in particular locations.

11. The same approach should apply for banks operating globally via branches rather than subsidiaries, i.e. it is not unreasonable to allow banks to allocate capital as they see fit, subject only to satisfying minimum capital levels.

12. There would appear to be no practical difference between Articles 7 and 9 of the OECD Model Convention as regards capital. If the OECD and revenue authorities think that global allocation of actual capital to branches of a bank is allowed/required under Article 7, why not mandate the same approach under the (very broad) wording in Article 9(1) for any multinational group (not just banks) operating via subsidiaries? The short answer must be that this goes well beyond what OECD members regard as reasonable or proper practice. It is left to individual countries to establish minimum (safe harbour) thin capitalisation requirements that will generally be based on the activities of the group actually undertaken in the relevant country.

Thin capitalisation approach

(Refer OECD Draft Part I, para 152; Part II, paras 67 and 83).

13. The most fundamental problem with this approach is that it ignores the fact that a global bank operating as a single entity will invariably require less capital (due to scale and ability to achieve greater risk diversification) than a series of separately capitalised entities operating in the same jurisdictions. Consequently, the OECD approach is likely, in many cases, to require a multinational bank to maintain capital for tax purposes (on a global basis) in excess of actual capital!

14. The ABA endorses the following comments by Professor Warren Hogan from the University of Technology, Sydney (as set out on page 2 of his paper " *A perspective on the Domestic and International Pressures Influencing the Operations of International Banks"* which was presented at an ATO Workshop on the Taxation of Branches of International Banks, held in Sydney on 20 & 21 March 2001):

> "As a consequence of the preference for simplicity, a bank will want to operate where possible through a branch structure rather than subsidiaries.

> A branch will have a more efficient capital structure than a subsidiary. The notion of efficiency is about the need for capital, equity and related instruments. **Capital requirements will be less for a branch than those of a subsidiary fostering the same kind of business**. Branch status allows a broader portfolio of risks off one larger capital base." (our emphasis).

15. The thin capitalisation approach is based upon identifying independent comparable banks to use as benchmarks. Actually finding suitable comparables and making relevant adjustments so as to properly allow for the different sizes and credit ratings of the comparables as compared to the bank PE being "tested" is likely to be an exceptionally difficult and subjective process. There would appear to be much greater likelihood of double tax disputes (as compared to a quasi-thin capitalisation approach) given that different tax authorities are likely to have different views as to the relevant comparables and adjustments to be made. This approach is likely to have dramatically higher compliance costs for banks and revenue authorities than either the quasi-thin capitalisation approach or the BIS ratio approach.

Quasi-thin capitalisation approach

(Refer OECD Draft Part I, para 152; Part II, paras 66 and 82).

16. This approach also suffers from the same key defect as the thin capitalisation approach. That is, it is possible (and in some cases most likely) that a bank may be required to maintain more capital for tax purposes on a global basis than it in fact actually has available. Although the problem is not as severe as with the thin capitalisation approach, the need to hypothesise that the bank operates as a separate entity in each jurisdiction still fundamentally fails to recognise the efficiency of capital, which arises due to global diversification of risk through a single entity.

17. The "forced" allocation of all residual capital to head office also, as with both other approaches, provides absolutely no flexibility or choice as to how or where capital is deployed for sound commercial purposes.

BIS ratio approach

(Refer OECD Draft Part I, para 150, Part II, paras 68 to 81).

18. As presently formulated, this approach appears to provide no flexibility at all; i.e. no "range". Consequently, as even the OECD Draft indicates that it is not seeking to establish a uniform position on the equity/debt distinction (known to be one of the most difficult and intractable of international tax issues) there appears to be great risk of double tax disputes due to international disagreement on what exactly constitutes the "capital" which is to be allocated under this method. (It is acknowledged that at least this approach should not result in allocation of more capital than actually exists – this being a major shortcoming of the other two approaches).

19. This approach would appear to be a classic example of global formulary apportionment, which was roundly rejected by the OECD in the 1995 Transfer Pricing Guidelines. The OECD stated at para 3.59 as follows:

> "A global formulary apportionment method would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and

> mechanistic formula. There would be three essential components to applying a global formulary apportionment method : determining the unit to be taxed, i.e. which of the subsidiaries and branches of an MNE group should comprise the global taxable entity; accurately determining the global profits; and establishing the formula to be used to allocate the global profits of the unit. The formula would most likely be based on some combination of costs, assets, payroll, and sales."

20. Ensuing paragraphs in the Transfer Pricing Guidelines go on to explain why global formulary apportionment is a non-arm's length approach and why the OECD and member countries currently reject it. It seems remarkable that there is no commentary in the February 2001 OECD Discussion Draft which seeks to discuss/rationalise why the BIS ratio approach is not some form of global formulary apportionment.

21. It is difficult to imagine a more non-arm's length approach than that which will arise under the BIS ratio method. Under this approach, there will be a requirement to increase or decrease the capital to be attributed to a permanent establishment in a given country even where there has been absolutely no change in the functions, assets and risks of that PE. For example, the parent may raise additional capital as a "war chest" so as to facilitate take-over or expansion activity in the home country that has nothing to do with any permanent establishment in any particular country where the bank also operates. Even the OECD Draft (Part II; para 85) notes that;

> "…. an issue arises as to whether the advantage of the BIS ratio approach has been achieved at the expense of the arm's length principle."

22. The BIS approach will also require some extraordinary compliance efforts on behalf of the bank and each relevant PE. That is, it will be necessary for each PE to be aware of the global capital and global risk weighted assets of the bank and not just those details pertaining to the PE. This is likely to cause at least as much difficulty, if not more, than the possible need to calculate worldwide profits which was rejected by the OECD in paragraph 28 (Part I) of the Discussion Draft.

An alternative: modified quasi-thin capitalisation

23. In the ABA's view, the preferred international model would be one based on the OECD's quasi-thin capitalisation approach, but with some important modifications. The ABA's preferred model is described in this submission as the "modified quasi-thin capitalisation" or MQT approach. The ABA believes that the MQT approach represents the best trade off in satisfying the (at times competing) suggested principles and goals of capital attribution (as set out in the Appendix).

24. The modified quasi-thin capitalisation approach can be stated as follows:

- A multinational bank will be required to maintain a specified minimum amount of capital in each jurisdiction in which it operates, including its home office.

- The ABA suggests that, in accordance with the BIS regulatory approach, capital be required equal to 4% of risk weighted assets in each jurisdiction in which the bank operates.

- Banks will be permitted to deploy remaining capital, as they believe appropriate.

25. The key differences between ***modified*** quasi-thin capitalisation and the ***OECD's*** quasi-thin capitalisation approach are:

- Under MQT, the bank is not required to allocate all residual capital to head office; it can (appropriately) choose where it deploys its own funds.

- MQT does not involve an "independent banking enterprise" hypothesis. (Under the OECD quasi-thin capitalisation approach, the need to make this hypothesis may mean that the bank is required to allocate more capital for tax purposes than it actually holds).

- It is suggested, under MQT, that a single global ratio (4% of risk weighted assets) be used, rather than each country adopting its own minimum capital requirement based on its local regulatory requirements for locally incorporated banks. In principle, the locally incorporated bank hypothesis is flawed and will greatly increase the risk of global double taxation.

26. Because of the regulatory underpinning, a modified quasi-thin capitalisation approach for banks is likely to be "tighter" and more controlled/controllable for revenue authorities than is the case for thin capitalisation rules applying generally to non-bank corporations. The three possible approaches in the OECD Draft would subject banks to unreasonable and unacceptably high levels of "control" by revenue authorities.

Application of the preferred approach

27. Although clearly preferable to the approaches raised by the OECD, even the modified quasi-thin capitalisation approach will represent a dramatic change for most banks and revenue authorities and will require much careful consideration, refinement and "testing" before implementation.

28. Merely some of the matters requiring attention are as follows:

- Risk weighted assets will need to be calculated for each branch/permanent establishment. Many banks may not currently need to undertake such calculations, so care needs to be taken with the timing of any new rules, detail actually required etc, so as to minimise compliance burdens and costs. Further, different countries are likely to have different approaches to defining/measuring risk weighted assets.

- Internal deals (e.g. interbanch funding and various derivatives on interest rates, currencies, credit and other risks/prices) will need to be factored into the analysis. Where undertaken on an arm's length basis, perhaps they should be recognised as "assets" of the relevant branch – although there is an obvious need to avoid double counting from a global perspective.

- Even the BIS recognises that the current approach to credit risk weighting is somewhat "crude" and is likely to change.

- The country in which a permanent establishment is located may have no minimum regulatory capital requirements for a branch, but may have such rules for a subsidiary. Rules for a subsidiary based on a proportionate scale (i.e. the capital requirement is based on a certain % of risk weighted assets) may be able to be applied to a branch (for tax purposes) in that country without significant difficulty. However, it may be necessary to ignore/reduce any absolute minimum requirement applying to a subsidiary (i.e. flat amount of capital) which is designed to ensure that the entity has sufficient financial clout so as to be able to open for business. Such capital requirements will generally be satisfied by the bank as a whole; i.e. on a global basis. It is recognised that this is likely to be a contentious issue and that there may

be some possibly unavoidable differences between branches and subsidiaries that could arise in the capital attribution process.

- Some form of global co-ordination/co-operation amongst revenue authorities and governments would be beneficial so as to achieve as much consistency as possible, thereby minimising double tax disputes.

- An increase or decrease in the attribution of income on capital between head office and a branch may better facilitate operation of competent authority proceedings (and, hopefully, ultimate resolution without double taxation) than would be the case where one country (for example) simply disallowed a proportion of all of a branch's (domestic) funding costs i.e. this may not provide a sufficient nexus to establish a double tax dispute between the revenue authorities in each country.

Principles for Capital Allocation

29. All capital allocation approaches need to be measured against a set of principles to determine both the optimal approach and consider the trade-offs between different options. ABA considers that following principles are appropriate:

1. Avoid/minimise the risk of international double taxation or less than single taxation.

2. Adopt the arm's length standard, as far as possible, and avoid global formulary apportionment.

3. Treat branches, as far as possible, like subsidiaries.

4. Consistent treatment, as far as possible, between interpretation/application of DTA provisions dealing with associated enterprises (OECD: Art 9) and permanent establishments (OECD: Art 7).

5. Allow banks the same flexibility to deploy capital for commercial (non-tax) reasons as is the case with other types of taxpayers and generally allow for particular facts/circumstances to be considered. (Provide a reasonable range/room to move without failure/penalties: avoid a "knife edge").

6. Simplicity.

7. Certainty.

8. Low compliance burdens/costs.

9. Ease of Revenue authority audit and administration.

10. Overall reasonableness/fairness of outcomes (for banks and tax authorities in home countries and branch countries).

30. The Appendix to this Submission includes a table that summarises the ABA's views on the extent to which the various approaches satisfy these principles.

Australian Developments

31. The Australian Government is currently in the process of introducing a domestic thin capitalisation regime.

32. The initial thin capitalisation model that was to apply to banks was entirely consistent with the BIS approach. However, after consultations the Australian Government abandoned this approach having reached the conclusion that it was inconsistent with the commercial practices of banks and provided no certainty to taxpayers (ABA's view).

33. As part of the 2001/2002 Federal Budget, the Treasurer announced that the thin capitalisation regime applying to banks would require all banks to hold equity capital equivalent to 4% of domestic risk weighted assets. Domestic banks have an additional requirement to hold further equity capital equivalent to Tier 1 prudential capital deductions.

34. Australia's domestic thin capitalisation regime will therefore be consistent with the minimum BIS prudential capital standards.

Part B: Other Issues

Factual and functional analysis of a traditional banking business

35. The ABA believes that the descriptions set out in paragraphs 5 and 6 of the OECD Draft require some reworking. In particular, the terminology used in this part of the Draft is more appropriate in a context of global trading rather than in the traditional business of borrowing and lending money. For example, the references to "sales" and "trading" would not normally be the appropriate terminology to describe the origination and creation of loan assets.

36. The last sentence in paragraph 7 of the OECD Draft correctly recognises that "*banks normally have committees which set risk limits on a cascading basis*". However, this committee/cascading approach in many cases goes beyond simply setting limits. That is, depending upon the size of a loan, it may be necessary for a branch in one country to seek formal approval/commitment from a regional office or head office in another country. This has great significance given the importance which the OECD is placing on the "sales/ trading" function. Further comments on this issue are made below.

37. In various places in the Draft (for example at paragraph 25) there is excessive pre-occupation and concern with the "booking" of assets and in particular the inference that such activity is being distorted by "*regulatory competition and arbitrage*". The ABA believes that the OECD is overstating the extent of any such "problem". As explained further below, much greater weight should be given to the location at which a loan asset or indeed any other banking asset is "booked".

Banks operating through subsidiaries

38. The OECD states at paragraph 28 of the Draft that "it is not believed that there are any particular problems with applying the (Transfer Pricing) Guidelines to banking transactions between associated enterprises". The inference from this comment is that the OECD sees no particular reason to prescribe rules as to how a multi-national bank should allocate capital to subsidiaries in different countries, given that the OECD does not generally seek to provide any such rules for associated enterprises (i.e. other than banks) for the purposes of Article 9 of the OECD Model Double Tax Convention. That is, capitalisation in relation to banks operating through subsidiaries will be effectively left to the operation of domestic thin

capitalisation regimes in OECD Member countries. It is difficult to see why the OECD is seeking to be so prescriptive in relation to banks operating through branches rather than subsidiaries, as regards the question of capitalisation.

Solo vs. consolidated capital attribution

39. The ABA notes that at paragraph 81 of the Draft, the OECD seeks comments on the use of a "solo" basis for determining the total amount of capital that can be attributed.

40. In line with the ABA's view that a modified form of quasi-thin capitalisation should be adopted by the OECD and Member countries, it is recommend that this should be undertaken on a consolidated basis; i.e. having regard to all of the operations of the bank (branch(es) and subsidiaries) in a given country. This should provide the greatest level of comfort to revenue authorities and at the same time will minimise compliance costs and provide an appropriate amount of flexibility for multinational banks as to precisely which entity holds the relevant capital in a given country.

Attributing functions to a bank branch

41. Paragraph 32 of the OECD Draft states that:

> "Looking at the description of the functions necessary to create a new financial asset, or to subsequently manage that asset, at paragraphs 5 and 6 above, it can be seen at all of the functions are performed by personnel: "people functions". So the functional analysis should be able to determine which of those functions are performed by the PE by looking at whether the people performing those functions are located in the PE."

42. The ABA believes that this comment by the OECD dramatically understates the growing importance of e-commerce and the increasing ability of banks to automate/systematise certain functions. For example, with high volume/low value transactions such as personal credit cards and other low dollar value/"commodity" type financial transactions, it is becoming increasingly possible for banks to reduce the need for human intervention at many stages of both the creation and management of financial assets and liabilities. Customers will increasingly be able to apply for such transactions over the Internet, with increasingly sophisticated computerised systems being capable of much of the subsequent processing and "decision making".

43. The ABA notes that in February 2001 the OECD's Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for the Taxation of Business Profits released a Discussion Paper entitled "Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions". Paragraph 2 of the Discussion Paper notes that it is a first attempt at exploring the interpretation and application of Article 7 to a PE carrying on "retail e-commerce activities". Paragraph 15 of the Discussion Paper notes that "*the principles applied in this discussion paper with regard to "e-tailing" could equally apply to other forms of e-commerce but would need to be adapted to the particular fact situation*.

44. Whilst banks are generally subject to greater levels of regulation and control than exists with the simple retailing of physical products, such as CD's, books, videos etc., it is still nevertheless the case that banks will increasingly be able to offer financial assets and liabilities to customers in various countries through electronic commerce which minimises the need for human intervention at various steps in the creation/management of an asset or liability.

45. The ABA believes that the OECD Draft needs to be reviewed and rewritten to properly link in with the approach being taken by the OECD in relation to e-commerce. In particular, it will be of vital importance to determine to what extent capital needs to be allocated, if at all, to a permanent establishment of a branch which constitutes a computer server (controlled by the bank in a particular country) and via which financial assets and liabilities are being created, and to some extent managed, without any human intervention in the country concerned. At this stage, the ABA has no fixed views on this matter and believes that considerable further discussion is required with the international banking community before the OECD even reaches a tentative conclusion.

Perceived importance of the sales/trading function

46. At paragraph 34 of the OECD Draft it is stated that:

> "In terms of risks assumed, it is the performance of the sales/trading functions that lead to the initial assumption of the greatest risks (credit risk, operational risk and market risk)."

47. Whilst the ABA broadly agrees with this assessment, it does not agree that the OECD can draw the prescriptive conclusion discussed below as to where assets should be "attributed". Further, also as discussed below, the "sales/trading" function is highly complex in a bank and particularly for larger loans will invariably be performed at various locations.

Attributing a credit rating to a bank branch

48. At paragraph 38 of the Draft, the OECD states:

> "Bank branches enjoy the same credit rating as the enterprise as a whole, which enables them to borrow and on-lend at a profit on the same terms."

49. In practice, this is in fact not always correct. That is, there are clearly examples where rating agencies will view a bank branch as having a different credit rating from the overall entity that has its headquarters in another jurisdiction. This arises due to variations in sovereign risk between jurisdictions. In jurisdictions where the sovereign risk is higher, the credit rating of the branch may be lower than the head office. Even where the credit rating is identical, a higher sovereign risk will require a higher allocation of capital to cover that risk.

Attribution of assets to particular branches

50. Paragraph 51 of the OECD Draft makes the following assertion:

> "Following the analysis at paragraphs 8 and 32 above, the assets of the bank are initially attributed by reference to a functional analysis, based on where the assets are used. For the financial assets of the bank this will be based on where the sales/trading function leading to their creation were performed."

51. Similar assertions are also made in paragraphs 120 and 140 of the Draft.

52. The ABA believes that the OECD has simply asserted the above conclusion and that it has not been properly rationalised. By contrast, consider paragraphs 84 to 86 of that part of the OECD's 1984

report (Transfer Pricing and Multinationals – Three Taxation Issues) dealing with multinational banking enterprises. In the 1984 report, the OECD recognised that there was a range of activities of "decisive economic importance" and the OECD, in the ABA's view correctly, avoided any prescriptive approach to determining where a loan asset should be attributed. It all depends upon the facts and circumstances.

53. There are a number of difficulties with the OECD's latest thinking. Firstly, not enough attention is paid to important functions other than sales/trading. Secondly, and of particular significance, is the fact that especially for "larger" loans, branches will invariably need to obtain final approval/commitment from regional office or head office in another country. The inference from this is that the sales/trading function will either be considered to have occurred in the regional office or the head office or at the very least will be considered to have partially occurred in that country. This is going to inappropriately skew the attribution of capital. Thirdly, paragraphs 138 to 140 of the OECD Draft indicate that where the sales/trading function has been split between particular countries it is necessary to (somehow) attribute the financial asset and therefore the associated capital to the various branches. No explanation or details are given as to how this might be done. In practice, the ABA believes that this will give rise to massive uncertainty and will be a huge compliance burden for multi-national banks.

54. By contrast, the ABA believes that there should be a strong presumption (rebuttable in extreme cases) that the location at which a loan has been booked by a bank for financial accounting and regulatory purposes is in fact the correct location of the loan for tax purposes. In the ordinary course of events, the branch where a loan is booked will typically perform the great bulk of the relevant sales/trading functions. Further, the branch where the loan has been booked will ordinarily be the branch which will carry the credit risk on any default on the loan and will ordinarily be the branch which has undertaken the relevant funding and bears funding related risks.

55. The ABA believes that the most appropriate course of action is for the branch which has booked the loan to be regarded as the "owner" of the loan asset for capital attribution purposes. The branch that has booked the loan should simply be required to reward each other branch that has had some involvement in the creation or management of the loan asset, on an arm's length basis for the relevant activity concerned.

56. The ABA considers that the above approach is reasonable, particularly having regard to the fact that any subsequent transfers of financial assets (i.e. from one branch to another) will be required to be substantiated at appropriate market values. In this regard, the ABA endorses the broad thrust of the OECD's comments in paragraphs 150 to 153 of the Draft which appear to sanction transfers of existing financial assets provided the market value requirement is met.

Role of internal transactions – and in particular credit derivatives

57. The ABA considers that the OECD Draft does not do justice to the importance of internal transactions within a multinational bank and that there is undue emphasis given to the view that such dealings may be "tax motivated" (see for example paragraph 104 of the Draft).

58. Much further consideration is required to be given by the OECD to the important role which internal transactions play within the bank and the implications thereof for both capital allocation and transfer pricing more generally.

59. For example, it is becoming increasingly common for multinational banks (for sound commercial reasons) to centralise credit risk in one or more locations, through the use of intra-entity or inter-entity credit derivative transactions, which would ordinarily be undertaken on an arm's length basis. A branch in country A may undertake the majority of the relevant sales/trading functions on a corporate loan (albeit that the loan is ultimately approved by head office) and be regarded as the relevant location at which the

loan is "booked". However, credit risk management for the bank may be located in country B and the bank in question may enter into an intra-entity credit default swap, or other credit derivative transaction, with the risk management unit in country B. Broadly speaking, it could be expected that the branch in country A would pay part, but not all, of the margin over its cost of funds to the branch in country B as an arm's length fee for the assumption of the credit risk by country B.

60. The ABA's view is that such transactions should generally be respected for tax purposes. In particular, the internal transaction should be recognised as giving rise to income and expense provided it is undertaken on an arm's length basis. Further, notwithstanding the internal credit derivative, country A should be regarded as the "owner" or the underlying corporate loan asset; e.g. for the purposes of determining where interest income should be booked and where, prima facie, any bad debt write-off should be taken. (Where a bad debt does occur and full internal risk protection has been sought, then the branch in country A will have offsetting income being the receipt of compensation from the risk management unit in country B).

61. The critical question for consideration is how and where capital should be attributed in respect of this transaction. Given that country B is effectively bearing the underlying corporate credit risk, it should be the branch that is required to hold capital and not the branch in country A. Precisely how this result is achieved (and the extent to which intra-entity dealings are recognised as "assets" in the risk weighted asset calculations that will be required for capital attribution purposes) requires further detailed and careful consideration by the OECD. What would <u>not</u> be appropriate is for the OECD to simply conclude that the underlying loan in fact "belongs" to country B, as this would not correctly reflect the roles of the various branches and the nature of the internal transaction which has been entered into. In particular, in the ordinary course, the branch in country A will have had a significant role in loan origination, funding and ongoing loan management and as a result will continue to earn a margin over and above the payments made to the branch in country B.

Treatment of subordinated debt

62. The ABA notes that in paragraphs 91 to 94 of the Draft, the OECD considers at some length the question as to how interest bearing debt in Tier 2 capital, and in particular subordinated debt, should be dealt with for international tax purposes. The ABA recognises that there are some important and potentially difficult issues to be dealt with in this regard, and at this point has no firm view as to how the matters in question should be resolved. Rather, the ABA's main focus at this point is in respect of the most appropriate approach to capital attribution per se, with subordinated debt being a secondary issue. Once there is greater clarity as to whether the OECD is prepared to revise its preferred BIS ratio approach, then the ABA would welcome the opportunity for further consideration as to how a question of subordinated debt should be dealt with; i.e. within the context of the OECD's revised approach to capital attribution.

Treasury functions and internal movement of funds

63. Paragraph 130 of the OECD Draft suggests that "*given the wide range of treasury operations it is likely that a variety of methods will need to be employed*" to deal with the situation where funds are transferred between different parts of a bank.

64. As a general comment, the ABA believes that the OECD has overstated the relevant difficulties and over-complicated the required response. In the vast majority of cases it will be possible to use the "comparable uncontrolled price" ("CUP") methodology and as a result to identify and apply appropriate arm's length comparables having regard to relevant inter-bank/wholesale markets etc.

65. That is, the ABA is particularly concerned with the OECD's comment in paragraph 130 of the Draft that:

> "at the other extreme, where there is considerable integration of treasury functions, it may be that it is not possible to apply reliably traditional transaction methods. Transactional profit methods will need to be applied."

66. Insufficient justification is given by the OECD for such assertions. Once again, the ABA believes that it will ordinarily be the case that the comparable uncontrolled price method can in fact be applied. Even if there was some need to adopt the OECD's approach, insufficient details have been provided to enable banks, as a practical matter, to distinguish between treasury operations which are "routine" as compared to those which are "integrated". No guidance is given as to how the relevant profit methods might be applied in these particular circumstances.

Head office services

67. The broad effect of paragraphs 154 to 158 of the OECD Draft (and paragraphs 122 to 127 of Part I of the Draft) is to seek to achieve greater uniformity in treatment of intra-entity and inter-entity services, including the consistent use of the "cost plus" methodology; i.e. including an appropriate profit mark-up.

68. In principle, the ABA generally welcomes the OECD's approach. However, given the current divergence in actual practices of Member and non-Member countries (particularly in the Asian region), it will be vital that there is international agreement and commitment to any new approach so as to negate or at least minimise the risk of international double tax disputes. Further, there appears to be a risk in some countries that withholding taxes may arise in circumstances where profit mark-ups are added to charges for services. Such withholding taxes are inappropriate, and once again international agreement that such taxes should not arise is highly desirable. Unless there is some clear international agreement for the use of the cost plus approach (without withholding taxes applying to profit mark-ups – or indeed to the underlying charge itself) it may be necessary as a practical matter to continue the current approach which is to generally require intra-entity services to be allocated at cost rather than on an arm's length/cost plus type basis.

69. The ABA notes that views are particularly sought on some specific issues set out in paragraphs 125 and 126 of Part I of the Draft. The ABA is not generally concerned with the conclusions reached in those paragraphs.

PRINCIPLES OF CAPITAL ATTRIBUTION	OUTCOMES UNDER THE APPROACHES IN THE OECD FEB 2001 DISCUSSION DRAFT			ABA's APPROACH:
	THIN CAP	**QUASI THIN CAP**	**BIS RATIO**	**MODIFIED QUASI THIN CAP**
1. Avoid/minimise the risk of international double taxation or less than single taxation	●	●	●	●●●
2. Adopt the arm's length standard, as far as possible, and avoid global formulary apportionment	●●●	●●	●	●●
3. Treat branches, as far as possible, like subsidiaries	●●	●●	●	●●
4. Consistent treatment, as far as possible, between interpretation/application of DTA provisions dealing with associated enterprises (OECD: Art 9) and permanent establishments (OECD: Art 7)	●●	●●	●	●●
5. Allow banks the same flexibility to deploy capital for commercial (non-tax) reasons as is the case with other types of taxpayers and generally allow for particular facts/circumstances to be considered. (Provide a reasonable range/room to move without failure/penalties: avoid a "knife edge")	●	●	●	●●●
6. Simplicity	●	●●	●●	●●●
7. Certainty	●	●●	●●	●●●
8. Low compliance burdens/costs	●	●●	●	●●
9. Ease of Revenue authority audit and administration	●	●●	●	●●
10. Overall reasonableness/fairness of outcomes (for banks and tax authorities in home countries and branch countries)	●●	●●	●	●●●
Totals (unweighted!)	**15**	**18**	**12**	**25**

Legend

●●● reasonably high chance of achieving principle/goal

●● moderate chance of achieving principle/goal

● reasonably low chance of achieving principle/goal

(THAT IS: THE MORE "DOTS" THE BETTER!)