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)

British Bankers' Association

1. The British Bankers' Association (BBA), London Investment Banking Association (LIBA) and the Foreign Banks and Securities Houses Association (FBSA) welcome the opportunity to comment on the issues raised by the OECD discussion draft. We also look forward to being able to respond on Part III re global trading when this is available. The three associations represent the large majority of UK and foreign owned banks and securities houses operating in the United Kingdom. Our representations have been drawn up by a working party including representatives of groups headquartered in eight countries, while the draft response was circulated for comment to over 300 banks and securities houses.

2. As the city with the greatest number of international banks in the world London's reaction to the proposals is very important. The likelihood is that taxable profits of foreign banks and securities houses operating in the UK will increase if the OECD working hypothesis were to be adopted. This could only be acceptable if all countries adopted the same measures and a home country credit was available for the UK tax payable. Our comments focus primarily on Part II and the specific issues for banks and securities houses, but we also address the general principles applicable to all entities.

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Summary Conclusions

4. Whilst we understand and sympathise with the desire to create a simple level playing field we have a number of serious reservations as to how the proposed working hypothesis (WH) approach can be made to work in practice. We welcome the open debate that has been opened by the discussion draft but firmly believe that a further lengthy period of study will be required in order to arrive at any acceptable and workable solution. We urge that no immediate action be taken before all aspects have been fully worked out.

5. Further work will need to focus on balancing practical reality and the need to minimise costs against the excessively theoretical approach adopted by the discussion draft in seeking to align branches and subsidiaries. There needs to be recognition that, whatever approach is adopted, perfect equality cannot be achieved. In particular we are concerned as to the degree of complexity and associated compliance costs involved in the WH's attempt to achieve this. Whilst the proposals are intended to be aligned with the regulatory regime they do in fact diverge in a number of material ways such that a separate set of records would have to be created. In the course of the further debate we would be particularly interested to discuss the option of having an approach that starts with the existing accounts and records and makes only minimal necessary adjustments.

6. We would also stress that the need for a level playing field means that no action should be taken by any individual fisc ahead of any international consensus emerging. Any implementation must also only be on a prospective basis to allow for necessary systems/law/treaty etc. changes. It is equally necessary for the commencement date to be co-ordinated. Without co-ordination there would be confusion, uncertainty and, inevitably, double taxation.

Detailed Comments

Part I

7. We agree that a review of the general application of Article 7 to determine the 'profits of an enterprise' is appropriate. We also welcome the reaffirmation (in para 13) that the existence of a PE gives no additional taxing rights resulting from the potential application of any 'force of attraction' principle. Thus the PE must have some active participation in the relevant business activity in order for a taxation liability to arise. In principle we support the adoption of the 'functionally separate entity" approach, and specifically welcome the recognition implied by this of the ability of a PE to transact e.g. to sell an asset, with another part of the legal entity for the purposes of calculating taxable profits. Thus the profits to be attributed to the PE are the profits that the PE would have earned at arms length as if it were a distinct and separate enterprise performing the relevant functions and applying the arms length principle under Article 7(2). However, as the report itself acknowledges, this is very difficult to apply consistently and accordingly we consider that it should be regarded as a high level framework only. A high degree of flexibility and pragmatism will be necessary to arrive at what we regard as the main aim of all parties – the avoidance of double taxation with an easily manageable, auditable and consistent system.

8. Thus we consider that the existing treatment of areas such as head office costs and intangibles should not be changed but that equally the adoption of a single credit rating is acceptable – whilst both may require a departure from the strict theory they do provide a workable and sensible result.

Part II

9. This part of the consultation paper explicitly deals with what is described as 'traditional' banking activities i.e. the raising and on-lending of money. It is recognised that it is only a partial view, as the forthcoming Part III will address the issue of global trading of financial instruments. We do not believe that a final view can be given until we have seen the full picture. However even without going into the area of global trading the WH risks over simplifying the activities of most internationally active banks. In particular the integrated nature of portfolio risk management raises significant question marks as to the allocation of profits by reference to WRA's alone.

10. The location of WRA's on a geographical basis is also by no means as simple in practice as the WH examples suggest. The trend in global banking is quite clearly towards central booking, or booking in a small number of locations and it appears almost inevitable that most assets would need to be split – and for tax purposes only. The underlying linkage with the regulatory reporting regime that the OECD is seeking would be lost. We also find it illogical that whilst the WRA's have to split between PE's in order to calculate the deemed capital requirement the Profit and Loss approach is different in that individual functions are to be rewarded. Such changes are also likely to result in a need for costly systems changes that would require significant lead-time for implementation.

11. Functional analysis of a traditional banking activity. We have no comment to make on the conceptual analysis as set out in paras. 5 onwards, other than to note that we consider such principles to be difficult to apply in practice.

12. Para 10 refers to the functional analysis examining the use of any intangible asset, and in particular refers to the marketing intangible represented by the name, reputation, trademark or logo of the bank. We question whether any meaningful value can be attributed to this in the context of a lending business with an undifferentiated commodity – money. No compelling reasons have been provided to justify any change to existing practice for intangibles. Any change in this area it should only be made following further, detailed and reasoned consultation.

13. The paper also suggests that changes might be required to the current approach of allocating out head office costs, in particular that a mark up might be appropriate in certain circumstances. In theory we can see that there is an argument for saying that some of these are similar to third party services and so should be charged accordingly. However there is a greater degree of integration between branches and head office than would typically be seen between parent and subsidiary and to alter the present approach would introduce an unnecessary degree of artificiality. The present approach works reasonably well in practice and there would be no benefit in changing it.

14. We consider that, as addressed in paras 12 onwards, the key driver of profitability is the assumption (and management) of risk. The availability of capital primarily acts as a constraint on the volume of business rather than on profitability per se.

Application of the WH to banks operating through a PE

15. Whilst accepting the underlying logic of the functional analysis we think that this is likely to lead to difficulties in application. To some extent this is recognised by the acknowledgement of the 'split function business'. It is also unclear what 'weight' should be given to the various factors involved and hence what their reward should be. Whilst we consider that it is a departure from the theoretical basis of a hypothesised distinct and separate enterprise we do though agree that the presumption of a single credit rating for the bank as a whole is appropriate, as a simplifying assumption.

16. A central aspect of the proposal is the allocation of 'free capital' as appropriate to a PE. We regard this issue as the key, important area where an internationally agreed solution is vital. Other issues are relatively peripheral. In essence the proposal is to allocate the bank's free capital pro rata to its WRA's.

17. The OECD paper refers to free capital and defines it as contributions of equity by shareholders and retained profits. It also refers to tier 1 and tier 2 capital. There is implicit recognition that not all tier 1 capital is free capital but in general the paper assumes that all tier 1 capital is free capital whereas all tier 2 capital is not free capital. This needs clarification.

18. The regulatory distinction between tier 1 and tier 2 is not a distinction between free capital and non-free capital. The actual distinction can be characterised as being based on the certainty or permanence of the individual categories making up the two tiers. Both tier 1 and tier 2 capital can contain both free capital and non-free capital. Furthermore, some free capital does not rank as capital at all for regulatory purposes (albeit in limited circumstances) whilst some assets reduce regulatory capital. Appendix 1 to this response summarises the different elements of the Basle capital base calculation.

19. What is required for tax purposes is neither a distinction between free capital (as defined) and non-free capital, nor a distinction between tier 1 and tier 2. Rather, it is necessary to identify and allocate capital to the hypothesised separate entity and then consider the tax consequences. An allocation to a PE of actual capital may therefore be a departure from the arm's length principle but as noted it could represent a reasonable approximation.

20. In principle we would agree that this would represent a reasonable approximation. It has the advantage of being based on an objective set of independent criteria that should facilitate the creation of a level playing field and avoidance of double taxation.

21. In passing we note that the WH appears to assume that no capital is ever allocated by a bank to a PE. The paper proceeds on the basis of a disallowance of interest expense that has been charged locally to a PE. Where capital has in fact been allocated to a PE and the amount is in excess of the pro rata amount we presume that it would follow that an additional local deduction would be allowed.

22. We are also unclear as to the situation where the PE is wholly funded locally and has no funding from its Head Office. If the intention is that a proportion of the actual third party interest relating to a deemed capital base should be disallowed then the legal and treaty basis needs to be clarified.

23. We do, however, have significant reservations about the practicalities of the proposals for allocating WRAs to PEs. As there is no internal requirement for such an allocation the WH will necessitate creation and maintenance of separate tax records – with consequent implications for compliance costs, audit trails and risk of error. This will be particularly so if the WRAs have to be split between locations. This would require a detailed analysis to be done of a very large number of transactions Unless a reasonable degree of approximation is allowed then it will be impossible to administer in practice.

24. We would appreciate clarification of a couple of aspects related to the use of WRAs in the WH. Firstly the WH is silent on the point but could be read as covering both on and off balance sheet WRAs. As off balance sheet WRAs don't require funding we consider that it should be made clear that the WH applies only to on balance sheet WRAs. Secondly in order to avoid double counting we assume that only external WRAs are to be recognised. Thus if a PE acted only as a deposit taker with all the funds lent back to its head office it would have no WRAs and hence no allocated capital. It may, of course have profit allocated to the PE for the service performed. Once again we would be grateful for confirmation that we have interpreted the WH correctly.

25. We also have concerns about the proposal to allocate the whole of the actual capital of a bank. We understand the argument that it would be inappropriate to allocate the Basle minimum, as most banks will operate at a level in excess of that minimum. The actual capital will reflect any of a number of factors; an additional requirement imposed by the relevant regulator, a commercial decision to operate at a higher level or a temporary excess, caused perhaps by a capital raising ahead of a major investment. The first two of these we would accept as legitimate for allocation, as they would partially cancel out the benefit from the higher credit rating attributable to such capital levels being used to derive the interest rate applicable to the PE. However it is harder to see why the benefit of a temporary excess should be so allocated, as this is likely to derive from head office decisions (dividend policy, acquisition and disposal strategy) with no relevance to its PE's as hypothesised distinct and separate enterprises.

26. Consideration should also be given to some form of safe-harbour alternative, based on the difficulty, if not impossibility, of administering the WH approach even if simplifying assumptions were to be made. Smaller branch banks, in particular, might find it attractive simply to avoid the costs of a full calculation. In broad terms the case for a reasonable safe harbour is that, recognising the difficulties in trying to calculate actual free capital for tax purposes on a consistent basis across the world.

27. Any safe harbour cap would necessarily be a reasonable but arbitrary amount above the regulatory minimum, we consider that a cap of 4.5% or 5% should be more than adequate.

28. Paragraph 138 of Part I of the draft report indicates that an objective of the WH should be to achieve neutrality between residents and non-residents (the contrary being unacceptable on tax policy

grounds). However we do not believe that the current proposals achieve this aim. Taking the UK as an example, under the current regime UK branches may have only a modest amount of free capital attributed to them, but the quid pro quo is that they benefit from the entity's overall credit rating (and hence its associated funding rate). UK subsidiaries require their own free capital, but will fund themselves at their own appropriate funding rate (or, alternatively, may pay a guarantee fee to the parent to achieve its lower funding rate). However, under the WH proposals, UK branches would have a capital attribution broadly in line with the capital of a subsidiary. It appears that no funding margin on borrowings from the head office (or payment of a guarantee fee) is to be allowed, due to the attribution of the same credit rating. This therefore appears to make it disadvantageous for foreign banks to operate through branches rather than subsidiaries (when a branch network may be preferred for commercial reasons) and hence the stated goal of neutrality would not be achieved.

29. The OECD paper does not deal with the deductions that are required to arrive at regulatory capital. In reality deductions from capital generally arise from head office decisions and are attributable to the head office on any functional analysis. Where, exceptionally, a branch decides locally to invest in a subsidiary then actual capital provided to the branch should be set against the deduction. It is the net capital (as shown in Appendix 1) that should therefore be allocated. Clarification is therefore required on this point.

30. We would also welcome further discussion on the practicalities of the calculations involved. As is to be expected, the consultation paper illustrates the proposals with very simple examples and these provide no guidance as to how various important timing issues would be addressed. For example, at what point is the ratio of capital to WRAs to be measured, only as at the year-end? If not, will some form of weighted average be required? Such a basis would significantly increase the complexities involved. The guiding principle here must be to require nothing that is not already necessary to meet the underlying regulatory reporting requirements. We assume that whatever basis is adopted, the same exchange rates will be required to be used in calculating both the capital and assets sides of the equation.

31. The WH also proceeds on the basis that there is only one clear set of Basle rules being applied. In practice individual regulators apply some discretion and hence there are variations. We presume that the applicable rules should be as applied by the home country regulator but this needs to be made clear so as to ensure consistency of treatment globally for the bank and avoid the potential for double taxation arising.

32. The paper proposes alternative means of 'cleansing' the capital allocation. We consider that the correct approach is to allocate on what is referred to as the 'pure' basis i.e. to include the whole of the bank's net capital base including both Tier 1 and Tier 2, less deductions – which would therefore in effect also be allocated pro rata. This correctly reflects the fact that any independent bank would so arrange its capital structure, and incur higher interest rate costs on the subordinated debt element in Tier 2.

33. Once the whole of the net capital has been allocated any adjustment for tax deductibility should then be made on the basis of the tax regime applicable to the country of the entity's lead regulator. This achieves certainty and consistency of treatment, whilst recognising that any tax treatment which influences the type of capital raised will be that applicable to the entity's home state. We recognise that this could result in similar payments potentially having different treatments for a local PE as against a subsidiary but regard this as part of the necessary quid pro quo to achieve a workable solution overall.

34. The paper refers to the implications of 'solo-consolidation,' for capital adequacy regulatory purposes, on the proposed tax treatment. In practice we understand that the utilisation of the regulatory solo-consolidation option varies significantly country by country (and hence attach at Appendix 2 the rules currently applicable to UK regulated banks for reference in relation to our comments) but where adopted its impact can be very material. We consider that as this is an integral part of the regulatory regime, for

both capital and weighted risk assets, on which the tax treatment is to be based, it should be adopted., Not to do so would lead to material difficulties in the application of the WH.

35. In particular, in the absence of the regulatory treatment being followed for tax, the deduction of the investment in solo-consolidated subsidiaries would result in the parent bank having little or no capital to allocate. The effect would therefore be that the various PE fiscs would be presented with no allocation of capital. In principle this would present no problem but there must be significant risk that it would not be accepted by the local fisc, given the overriding logic of the WH that a hypothetical separate entity would have some capital to support its activities. Clearly in the eyes of the regulator it does, as a result of applying the 'solo-consolidation' regulation, and this needs to be matched by recognition in the WH.

36. The paper recognises that the present (1988) Basle regime is rather dated and there are discussions in hand to amend its measurement of risk and associated capital requirements. We have a concern that in progressing with the current WH there is an insufficient degree of 'future proofing'. As noted above we see considerable difficulties in applying the present WRA based approach but the revised Basle approach is, for example, likely to put more emphasis on operational risk as a driver for capital requirements. It is not currently possible to say how this will be applied but it appears likely that it would be harder still to allocate on a geographic basis. As part of the further debate necessary on the WH this issue needs to be addressed, and resolved before any WH is adopted. It would not be acceptable to have an interim solution based on the existing rules imposed for what is likely to be only a short period of time before the new Basle risk measurement approach is adopted. Whilst the overall amount of capital required to support the risks is not expected to change materially the proportion to be allocated to operational risk is expected to be significant. In addition the incidence of operational risk is unlikely to be symmetrical to WRAs . It is likely that there would be material differences in the application of the currently proposed WH and accordingly to avoid this the WH needs to be reconsidered in the light of the likely new Basle proposals. The acceptability to the fiscs of netting and models specific to individual banks also needs to be explored in the course of this further debate.

Appendix 1

BIS CAPITAL BASE

TIER 1 (CORE CAPITAL)		
Permanent shareholders' equity		5,000
Tier 1 preference share capital etc.		2,000
Other Reserves - per financial accounts		10,000
Total reserves - per financial accounts		12,000
- regulatory adjustments		(20)
Reserves, Tier 1 preference shares & RCIs		11,980
Minority interests		(200)
Less : Property valuation deficiency		(140)
Goodwill & Other intangible assets		(140)
TOTAL TIER 1 CAPITAL		16,500
TIER 2 (SUPPLEMENTARY CAPITAL)		
Fixed asset revaluation reserves		10
General provisions		1,500
Hybrid capital instruments (primary perpetual debt)		3,000
Subordinated debt :		
Other perpetual debt		50
Term debt		4,000
Amortisation		(50)
Other non-qualifying		(10)
Minority interests in Tier 2		-
TOTAL TIER 2 CAPITAL		8,500
TIER 3 (TRADING BOOK CAPITAL)		
Short term subordinated debt		0
Minority interests in Tier 3		0
TOTAL TIER 3 CAPITAL		0
GROSS CAPITAL BASE		25,000
DEDUCTIONS		
Investments in associated companies		(300)
Investments in subsidiary companies per accounts	14,500	
Less solo consolidated subsidiaries	5,000	(9,500)
Investments in the capital of banks and investment firms		(40)
Off-balance sheet items of a capital nature		(5)
Subsidiary's holdings of Group paper		(50)
Own shares held in trust		(5)
Loans for initial expenses & first loss facilities		(100)
TOTAL DEDUCTIONS		(10,000)
NET CAPITAL BASE		15,000

Appendix 2

Solo-consolidation requirements

Per Bank of England Notice, December 1990

"The Bank is prepared to consolidate certain subsidiaries in computing the 'solo' ratios, specifically where **all** of the following apply:

1. the subsidiary is at least 75% owned;
2. either the subsidiary is wholly funded by its parent bank or all of its exposure to risk is wholly in respect of its parent bank;
3. the management is under the effective direction of the parent bank;
4. it is clear that there are no potential obstacles to the payment of surplus capital up to the parent bank, in particular taking account of overseas exchange controls, potential legal and regulatory problems and taxation; and
5. there is sufficient capital in the bank's own balance sheet to fund its own investment in those subsidiaries which are to be solo consolidated."