

**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)**

Ernst & Young¹

Overview

1. Ernst & Young submits the following comments in response to the OECD’s Discussion Draft on the Attribution of Profits to Permanent Establishment, Part II, Special Considerations for Applying the Working Hypothesis to Permanent Establishments of Banks (“Bank PE Draft”). The comments include an overall critique and a paragraph-by-paragraph critique of the Bank PE Draft.

2. Ernst & Young applauds the OECD’s effort to devise an approach which will tax economically similarly situated banking entities on a comparable basis. While the proposal that a bank branch be treated as a functionally separate entity is a theoretically plausible arm’s length analogy (the Working Hypothesis (“WH”)), Ernst & Young disagrees that this approach, as outlined in the Bank PE Draft, is a reasonably cost-effective approach for banks or taxing administrations to implement. Although Ernst & Young agrees that a functionally separate entity may be a plausible approach to apply in some situations, we disagree that in all of these situations the branch should be treated as the owner of all assets that it sells; for example, a branch may be more properly viewed as a service provider that earns a fee consistent with the performance of non-risk bearing activities. Moreover, we disagree with many other assumptions and conclusions drawn by the Bank PE Draft including the assumption that the risk bearing capabilities of a branch can be analogised to that of a separate legal entity.

3. Finally, Ernst & Young suggests that the OECD attempt to leverage the arm’s length guidance it has previously provided in The Taxation of Global Trading of Financial Instruments (“Global Trading Guidelines”). The Global Trading Guidelines address difficult issues such as joint ownership, attribution of profit from risk taking activities, and other matters which are in some instances similar to the allocation of income and expense issues faced by a bank branch.

The Need for Guidance

4. The OECD should strive to adopt a set of guidelines which are:
- cost-effective to implement for banks and taxing administrations;
 - applied consistently by all member countries;

1. By Robert E.Ackerman, Moises Curiel, Christopher Faiferlick, Perry Gold, Andrew Gunarsons, Peter Kocis, Kurt Neidhardt, Kevin Paterson, Emma Purdy, and Debra F. Taylor of Ernst & Young in Canada, Mexico, the United Kingdom, and the United States.

- respectful of non-tax regulatory requirements;
- consistent with the pragmatic business realities of an international banking operation in branch form; and
- flexible enough to deal with the various facts and circumstances faced by different banks.

5. Effective tax administration guidelines must balance the need for precision with the cost of such exactitude. International banks strive to earn profits while satisfying the regulatory requirements of a host of tax and non-tax authorities. In fairly allocating income subject to taxation among the various countries in which an international bank operates, the OECD should propose guidelines that recognise the various constraints faced by international banks. In so doing, the OECD should consider modifying requirements to adhere to the arm's length standard when the cost of compliance with this standard for international banks outweighs the benefits to the taxing administrations.

6. However, the very nature of the arm's length standard requires that taxing guidelines be flexible to meet the various facts and circumstances faced by different banks. The Bank PE Draft as currently drafted does not provide sufficient flexibility. The Bank PE Draft treats all branch sales activity the same and then attempts to provide mechanisms to account for various functions which may be performed by an entity other than the selling branch. This approach is needlessly mechanical and fails to recognise realistic arm's length alternatives, namely, a service provider model where the branch earns commissions for its selling activities.

7. As discussed below, the Bank PE Draft attempts to fit all situations encountered by banking branches into one model. As a result, the Bank PE Draft must deviate from the arm's length standard it initially posits, thus creating a hybrid model where in some instances the branch is treated as a functionally separate entity and as a branch in other circumstances. Although some of the deviations are arguably cost effective departures from the arm's length standard, it is only because the Bank PE Draft precludes the application of any other arm's length approach, such as a service provider model. The Bank PE Draft should reconsider a one-size-fits-all approach and consider adopting a more flexible approach which adapts to the facts and circumstances faced by a particular international bank.

Application of the Functionally Separate Entity Approach

8. When a banking operation chooses to expand its operations internationally, it may choose to establish a separate legal entity or operate through branch form. Probably more so than for any other industry, this choice results in real economic consequences to the bank. For example, a bank will generally require less capital to support a branch than a separate legal entity. As discussed below, the functionally separate entity approach must be carefully and consistently applied in order to produce results consistent with an entity that is in fact a branch; the functionally separate entity cannot be applied so rigidly as to assume away these real economic consequences. For example, should the branch be attributed the same amount of Tier 1 capital if it were in fact a legally separate enterprise? If so, how are the risk management benefits achieved from managing a branch's assets on a portfolio basis compensated; should there be a reduction in the allocation in Tier 1 capital or should there be the payment of a risk management service fee? There are real economic consequences that arise from branch activity which should not be posited away under a functionally separate entity approach.

Classification of Activities

9. The functionally separate entity approach is a reasonable proxy to isolate or ring fence the functions performed, assets employed and risks assumed by the branch. However, many of the conclusions drawn in the Bank PE Draft do not necessarily follow from this approach. For example, a branch should not be deemed the owner of an asset merely because it sold the financial asset to a client. The branch could be performing a routine sales activity for which it only deserves a commission fee. Under the Global Trading Guidelines, a sales activity can be viewed as a routine function deserving of only a commission fee or a critical activity requiring a share of the profit generated from the sale.² Likewise, the Bank PE Draft should explicitly provide for a broad spectrum regarding the classification of branch sales activity, i.e., from a broker of standardised assets to a marketer that designs specific assets to meet the peculiar needs of a client.

10. The Bank PE Draft also assumes that the branch assumes risk associated with the sold asset. This is not a reasonable assumption under the standard that only “people perform functions” as set forth in the Bank PE Draft. The assumption of risk in a banking operation is based on activities performed by a bank’s risk management department including the analysis and management of the risk. An advantage of operating in branch form is that these risk activities do not have to be performed at the site of the branch. Similarly capital needed to support such risks does not have to be raised by the branch. Under the functionally separate entity approach, a foreign operation could agree to sell financial assets on a commission basis and assume no risk or loss from the ultimate performance of the asset. The Bank PE Draft does not provide for this arm’s length option. If there must be a default or prima facie ownership standard (other than where the asset is booked for non-tax purposes), the risk taker, not the seller, should be deemed the owner of newly created financial assets.

Attribution of Economic Characteristics of the Whole Banking Enterprise to the Branch

11. The Bank PE Draft improperly attributes economic attributes, including network-like intangibles, of the whole banking enterprise to the branch. Irrespective of how long a branch has been in existence, the Bank PE Draft deviates from arm’s length principles by attributing economic characteristics such as credit rating and Tier 1 capital of the whole banking enterprise to the branch on a pro rata basis. There is no basis under arm’s length principles for a branch to “share and share alike” with the rest of the bank. Under arm’s length standards, branches with different economic capabilities should be expected to pay different arm’s length prices for access to the economic attributes of the whole banking enterprise.

Credit Rating

12. Under strict adherence to arm’s length principles, the Bank PE Draft improperly attributes the credit rating of the whole banking enterprise to the branch. A bank’s credit rating is based on a host of factors including its size, repayment history, reputation, relationships, and risk management strategies. A newly created branch with a small and undiversified portfolio of assets, if unrelated to the whole banking enterprise, would not be able to obtain the credit rating of the whole banking enterprise, unless the whole banking enterprise guaranteed the borrowings of the branch. Accordingly, a branch should compensate the whole banking enterprise for the lower credit rating it obtains if in fact arm’s length principles are to be applied.

2 Global Trading Guidelines, Para. 140.

13. The Bank PE Draft suggests that a branch would not be able to create some assets on a profitable basis unless it has the credit rating of the whole banking enterprise. So be it. The Bank PE Draft has not justified why it is more appropriate to relax the requirement of determining an arm's length credit rating for the branch, similar to what a legally separate and distinct banking entity would be required to pay in the market place. Admittedly, the burden for banks and tax administrations would be reduced by such across-the-board attribution. However, this is not the only option available under an arm's length approach. If the branch cannot profitably sell an asset without the credit rating of the whole banking enterprise, the better arm's length approach may be to treat the branch as a service provider. This latter approach is both consistent with arm's length principles and administratively cost-effective.

14. Certainly, variations from the arm's length standard should be supported when the reduction in the cost of compliance from such variation outweighs the loss in precision from following the arm's length standard. However, the Bank PE Draft makes no attempt to explicitly address this issue, nor does it consider, if there are other arm's length approaches which would not require the relaxation of some arm's length concepts for tax administration purposes. If the OECD does adopt the same credit rating for all branches approach, it should explicitly note that this is a deviation from the arm's length standard and is done so for the purposes of reducing the cost of compliance for both taxpayers and tax administrations.

Tier 1 Capital

15. The ability of a bank to raise capital depends significantly on its size. Larger banks have more options to raise capital on a lower cost basis than smaller banks. Attributing capital of a bank to a branch on a pro rata basis violates arm's length principles because it improperly assumes that the branch has contributed to the value of efficiently raising capital on a pro rata basis. At arm's length, a small unrelated banking operation would be willing to pay a portion of the savings it would achieve for having access to the whole banking enterprise's lower cost of capital. The Bank PE Draft does not address this issue.

16. The Bank PE Draft needlessly requires that capital be attributed to all assets created in a branch even if the asset will be subsequently/instantaneously moved to or managed by another entity. In instances where the branch only provides a selling function, the Bank PE Draft should provide an option that the branch is providing a selling service for which a commission is adequate arm's length compensation. Such an option will reduce the compliance burden of tracking capital as the ownership of the asset changes and it will likely reduce controversy as banks will not have to explain why ownership of certain assets is changing.

Risk Weighting of Assets

17. In allocating capital, the Bank PE Draft provides that risk weighting of assets should be based on arm's length principles which will typically include a bank's own internal risk rating models. However, the Bank PE Draft does not provide banks with the flexibility to choose a regulatory approach or an internal risk approach. Even under the new Basel Accord proposal, banks will be provided with an option. Banks should have this same option, if for no other reason than to reduce its compliance costs of having to maintain two separate systems.

18. The Bank PE Draft has not adequately addressed the value added from managing assets on a portfolio basis ("portfolio effect"); this is a significant value added function which must be compensated particularly given that one of the advantages for a bank to operate a branch instead of a subsidiary is that it can reduce its capital requirements through the portfolio effect. The Bank PE Draft appears to recognise that the portfolio effect would be included in internal ratings models, which is an arm's length approach that is recommended. However, no other guidance is provided.

19. Curiously, the mathematical expertise needed to account for the portfolio effect is arguably more difficult than that required to account for a separate credit rating of the branch. If such an effort can be made for allocating internal risks, then these arm's length adjustments could be made for allocating credit ratings and cost of Tier 1 capital, all in the context of achieving a more precise arm's length result.

Allocation of Capital

20. Assuming in fact the branch is performing of all the risk related management activities for the financial assets, the Bank PE Draft discusses a number of possible methods to allocate capital of the whole banking enterprise to the branch. Each method is problematic.

21. The overall approach is to treat the branch as if it were a separate enterprise. This approach is potentially workable only if the risk weighting of the assets of the branch accounts for the portfolio effect, otherwise excess capital will be attributed to the branch. The three methods proposed by the Bank PE Draft, quasi-thin capitalisation approach, thin capitalisation approach, BIS ratio approach, all have advantages and disadvantages.

22. The quasi-thin approach allocates the legally minimum required capital to sustain the risk weighted assets. This approach is administratively easy to implement but may depart from the arm's length standard if separate enterprises are required to maintain different levels of capital.

23. The thin capitalisation approach requires a comparison of the branches portfolio of assets with that of separate enterprises operating in the jurisdiction; such an approach is costly and arguably not comparable if the separate enterprise is limited in its activities because of separate capital requirements.

24. The BIS ratio approach provides for a pro rata distribution of capital by comparing the branch's risk weighted assets to the whole banking enterprise's risk weighted assets and allocating capital on this ratio. The BIS ratio approach could work, but only if risk weighted off-balance sheet items are excluded in the allocation. However, to the extent that regulatory requirements vary by country, deviations from the arm's length standard will still result since the parent country's regulatory requirements will be implicitly placed upon the branch, rather than the regulatory requirements in the host country of the branch.

25. Ernst & Young suggests that the whole issue of capital allocation be placed on hold because of the current flux in the New Basel Capital Accord. The current draft of this accord is proposing the use of a more risk-sensitive approach to align internal economic capital with regulatory capital. Such an approach could alleviate many concerns resulting from current economic and regulatory differences in capital calculation. Given that the OECD should be proposing transfer pricing guidelines which reduce compliance costs for banks and tax administrations, a resolution of how regulatory capital will be determined for non-tax purposes should be allowed to take place before resolving issues regarding the allocation of capital for transfer pricing purposes.

Other Issues

26. The Bank PE Draft does not distinguish between a pre-existing branch and a newly formed branch. As currently drafted, a branch would earn the same net income despite how long it has existed and irrespective of whether it developed some intangibles to perform functions in the host country. A newly formed branch would likely generate a sizeable portion of its income from current international customers of the whole banking enterprise. In this situation, the branch, if it is deemed to be the owner of the new assets, should pay a commission to the whole banking enterprise for the customer relationship developed

by the whole banking enterprise. Alternatively, the branch should be viewed as a service provider that earns a routine return for servicing a current client.

27. If Tier 1 capital is to be allocated in some fashion, stewardship and capital structure costs which have not been allowed to be allocated under the OECD Transfer Pricing Guidelines must be allocated in a similar fashion. These costs are a critical component in creating an asset which reduces the interest expense of the branch. Tier 1 capital should not be viewed as completely free for transfer pricing purposes. All associated direct and indirect costs of raising such capital should be allocated to the branch.

28. The Bank PE Draft raises concerns of tax administrations that banks could manipulate the transfer of assets for tax-motivated reasons. If dealings are analysed under arm's length principles and income is allocated appropriately when assets are transferred, there should be no need for any tax-motivated analysis.

Conclusion

29. The Bank PE Draft has identified a number of significant implementation issues in applying the functionally separate entity approach to bank branches. Ernst & Young has identified other issues as well. The OECD should address these issues through solicitation of additional written comments. In addition, the OECD should consider meeting with banks, transfer pricing practitioners, and tax administrations to devise feasible solutions.

30. Considering the number of unresolved issues and the importance of devising a feasible approach, the OECD should issue another draft discussion paper after it has received additional comments from affected stakeholders.

31. Discussed below are specific comments Ernst & Young has for each paragraph in the Bank PE Draft.

Paragraph-by-Paragraph Commentary

32. Para. 1: No comment.

33. Para. 2: With respect to the phrase “technological developments in the late 20th Century have resulted in the ability and willingness of banks to undertake pro-active risk management as a means of maximising shareholder wealth and of dealing with risk-based capital adequacy requirements,” this phrase may suggest the type of risk-taking associated with market making positions that normally occurs in global dealing arrangements. Ernst & Young suggests that the change in risk management activities over the last decade is not a cause for a clarification in the permanent establishment treatment of banks that have the primary activity of borrowing and lending money; rather, the reasons should be: 1) the disparate treatment arising from functionally equivalent activities of a subsidiary or a banking permanent establishment can lead to inconsistent tax consequences within a banking enterprise, and 2) taxing administrations do not apply consistent rules in determining the proper quantum of income subject to taxation within their respective jurisdictions .

34. Para. 3: The term interest should be further defined. Interest should be defined in the context of “return to predominantly reflect the **time value of money.**”³ Interest currently has different meanings

3 See, e.g., Treas. Reg. § 4.954-2(h). See, also, Article 11, Para. 3 of the OECD Model Tax Convention (interest means income from “debt-claims” of every kind).

among the various OECD members. A consensus opinion on the term “interest” should be obtained and explicitly stated. For example, Ernst & Young suggests that guarantee fees be explicitly excluded from the term “interest” as such income does not arise from the “borrowing and lending” of money of a bank providing a guarantee fee, to the extent that current treaties have not otherwise explicitly carved out an exception.

35. Ernst & Young has limited its comments to financial assets that are traditionally created by banks. Complex financial instruments which are covered in the Global Trading Guidelines are not considered in our comments to the Bank PE Draft.

36. Para. 4: No comment.

37. Para. 5(a): Although eventually covered in the Bank PE Draft, current activities must be distinguished from pre-existing intangibles such as customer base which may have been transferred to a branch. Separate economic returns must be provided to current activity and the prior activity which is represented in the form of an intangible, such as pre-existing client contacts transferred to the branch.

38. Para. 5(b): Ernst & Young reiterates its general comment in Para. 5(a). In addition, separate economic returns must be provided to current sales/marketing activity and the prior sales/marketing activity which is represented in the form of an intangible, such as proprietary credit risk models developed outside of the branch.

39. Para. 5(c): Ernst & Young reiterates its general comment in Para. 5(a). In addition, separate economic returns must be provided to current activity and the prior activity which is represented in the form of an intangible, such as sales and trading models and other recorded best practices.

40. Para. 5(d): Ernst & Young reiterates its general comment in Para. 5(a). In addition, separate economic returns must be provided to current activity and the prior activity which is represented in the form of an intangible, such as pre-existing treasury systems.

41. Para. 5(e): Ernst & Young reiterates its general comment in Para. 5(a). In addition, separate economic returns must be provided to current activity and the prior activity which is represented in the form of an intangible, such as business process intangibles.

42. Para. 6: In general, current activities must be distinguished from pre-existing intangibles such as customer base which may have been transferred to a branch. Separate economic returns must be provided to current activity and the prior activity which is represented in the form of an intangible.

43. Para. 6(a): No comment.

44. Para. 6(b): Monitoring and measuring risk and profitability is dependent on how to attribute the bank’s overall risk management strategy to a branch. As suggested later, a pro rata allocation may not be consistent with arm’s length principles.

45. Para. 6(c): Managing risk is dependent on how to attribute the bank’s overall risk management strategy to a branch. A bank manages its risks on a portfolio basis wherein the risks associated with a particular asset are reduced if managed in conjunction with other financial assets. As suggested later, a pro rata allocation may not be consistent with arm’s length principles.

46. Para. 6(d): Managing a branch’s funding position is dependent on the bank’s overall funding activities. Economies of scale and other best practices create economic efficiencies which should not be allocable to a branch on a pro-rata basis under an arm’s length approach.

47. Para. 6(e): Sales/trading activity on a bank wide basis may be based on economic efficiencies only available from large scale and integrated activities. Allocation of costs on a pro-rata basis may over state the economic return due to a branch because it will be implicitly attributed a cost efficiency that it could not achieve if it were in fact a functionally separate entity.

48. Para. 7: With respect to back office functions, these functions are not necessarily “adding less economic value” if these functions provide value through the reduction in costs obtained through centralisation, specialisation, and economies of scale. For example, the development of computer systems to perform banking operations and improve information flows is a highly valuable activity. In fact, the concentration of this type of activity within one entity is a risk bearing endeavour, which requires an economic return.

49. With respect to risk management, Ernst & Young agrees that this is an area of “particular significance,” and suggests that further analysis be provided by the OECD to determine how to allocate this valuable function.

50. Para. 8: Although eventually recognised, Ernst & Young suggests that the OECD recognise that intangibles are also valuable assets of a financial institution in this paragraph. Ernst & Young further suggests that in the context of the borrowing and lending of money, intangibles frequently provide a significant portion of profit realised through economic efficiencies such as cost savings arising from specialisation and centralisation of core activities.⁴

51. Para. 9: Ernst & Young believes that computer systems are more properly classified as an intangible asset than a physical asset because the software that runs the computer system is usually more valuable than the hardware upon which it runs.

52. Regarding comparability analysis, Ernst & Young disagrees with the universal characterisation of the example which suggests that “retail Internet and telephone banking services are cheaper than branch based services.” There are many instances where retail Internet cannot substitute for branch based services. Functions such as maintaining client relations, introducing clients to new products, etc. cannot effectively be performed in all instances through retail Internet channels. Many banks consider retail banking to be a complimentary form of retailing, not a wholly substitutable form for bank office retailing. Ernst & Young suggests a facts and circumstances test be used to determine the relative value of various distribution channels.

53. Para. 10: Ernst & Young agrees that intangible assets should be considered and suggests that these assets be viewed in the same primary context as other assets of the financial institution. The value of all assets should be based on a function analysis considering all facts and circumstances. Under such an analysis, intangibles may frequently be deemed to be more valuable than traditional banking assets.

54. Para. 11: Ernst & Young suggests that a functional analysis that analyses the inter-relationship between capital and risk cannot be performed in the same manner as it would be for non-financial institutions. For example, banks can diversify risks differently than non-financial institutions. In addition, non-financial institutions are effected by market risks differently than banks.

4 Bank for International Settlements, Basle, Switzerland, Publication No. 18, “The Management of Banks’ Off-Balance-Sheet Exposures,” March 1986, available at <http://www.bis.org/publ/bcbasc134.pdf>, par 1 states “[t]he margins available for many types of conventional on-balance-sheet business have been diminishing ...”

55. The ability of a bank to raise capital depends significantly on its size, except with the notable exception in Germany where smaller banks have the ability to raise capital on equal footing with larger banks. Larger banks have more options to raise capital on a more cost effective basis than smaller banks. Attributing capital of a bank to a branch on a pro rata basis violates arm's length principles because it improperly assumes that the branch has contributed to the value of efficiently raising capital on a pro rata basis.

56. Para. 12: The assumption of risk by a branch should not be deemed to occur on a pro rata basis. Credit risk is in part a function of a bank's ability to raise capital expeditiously and cost effectively. Everything else equal, a larger bank will have a higher credit rating (lower borrowing costs) than a smaller bank because of its greater capital raising flexibility.

57. Market interest risks generally can be more effectively managed internally by larger banks than smaller banks because of the larger variety of assets and their corresponding terms.

58. Para. 13: Country risks and other risks associated with the banks lending activities will have a material effect on the profitability of a portfolio of financial assets. Ernst & Young suggests that all relevant risks should be explicitly listed. For example, liquidity risk, operating risk, legal risk and reputation risk should be included.

59. Para. 14: No comment. Comments on allocation of credit risk are discussed later.

60. Para. 15: Credit ratings are an important factor in determining the profitability of a financial institution. Measuring credit ratings is subject to varied opinion. In the U.S., the Federal Deposit Insurance Corporation ("FDIC") does not release its credit ratings of banks. Many private firms in the U.S. measure credit ratings of banks on an integrated basis, frequently disagreeing as to the credit rating of any particular bank. Moreover, credit ratings can change quickly. As noted, credit ratings are based in part on reputation and prior profitability, which create an intangible. Additional guidance is required to measure credit ratings of an integrated bank enterprise as compared to a functionally separate entity. The credit rating should be treated as a type of network intangible the value of which is created by numerous components. Under arm's length principles, the credit rating of any particular branch should be calculated based on the branch's individual contribution to its share of the network component.

61. Para. 16: Credit ratings can be hypothetically calculated on a stand-alone basis. A branch may pragmatically rely on the whole of the bank to carry non-performing assets. Ernst & Young suggests that such implicit guarantees should be compensated under arm's length principles. Alternatively, if the calculation of credit ratings is too difficult to perform for each branch, the more appropriate arm's length approach may be to treat the branch as a service provider that does not own assets, particularly in instances where the branch performs routine functions.

62. Para. 17: No comment.

63. Para.18: Banks operating in countries with different capital requirements may have different levels of profitability. Such differences should affect branches in the same manner as it would affect a subsidiary.

64. Para. 19: Consistent regulatory treatment of capital is required for consistent application of arm's length transfer pricing principles to a branch.

65. Para. 20: Ernst & Young agrees as a general rule that off-balance sheet liabilities are attributed capital on a risk weighted basis. However, allocation of capital should not be made to off-balance sheet liabilities which are financial instruments more appropriately covered by the Global Trading Guidelines.

Accordingly, a revised Bank PE Draft should make clear that attribution of capital is not warranted for those assets covered by a more specific transfer pricing regime.

66. Ernst & Young will assume throughout the Bank PE Draft that capital is not allocated to financial products or instruments more appropriately covered by the Global Trading Guidelines.

67. Para. 21: Ernst & Young suggests that the non-transfer pricing tax consequences attributed to Tier 1 and Tier 2 capital notionally allocated under the WH should not be altered to account for the taxation rules of the host country. Such a requirement needlessly adds compliance burdens to banks and tax administrations. The OECD should for principles of administrative ease provide that the non-transfer pricing tax consequences are unaffected by the notional allocation of capital to the branch.

68. Para. 22: No comment.

69. Para. 23: No comment.

70. Para. 24: No comment.

71. Para. 25: Ernst & Young objects to any characterisation that regulatory arbitrage or competition is akin to a form of harmful tax competition. Regulatory requirements are an input cost like any other factor of production. Arbitrage is the means by which long term economic efficiency is achieved. Financial institutions that take advantage of regulatory arbitrage opportunities should have these transactions respected so long as the transactions have the minimum business purpose and economic substance required under current domestic tax laws. The booking entity should be attributed a portion of the cost savings realised from favourable regulatory conditions. The exact portion will depend in part on what parties at arm's length would negotiate.

72. Para. 26: As suggested, operating costs are also an important factor in a bank's profitability. With increased bank competition, a financial institution's ability to minimise operating costs may be an more important aspect of it maintaining its profitability.

73. Para. 27: No comment.

74. Para. 28: Ernst & Young endorses the OECD's view that a functional analysis for an associated enterprise and a branch should generally result in the same tax consequences, if in fact similar functions are performed and similar levels of risk are assumed. Differences arising from the business form chosen that need to be examined include:

- the whole bank's obligation to bear losses with a branch as opposed to an associated enterprise;
- country specific differences, e.g., branches operating in Japan cannot earn losses, yet subsidiaries can;
- differences in non-tax regulatory requirements including capital requirements; and
- risk management techniques.

75. The difference in form has real economic consequences on the operation of the bank. The Bank PE Draft must not assume these difference away by treating the branch as a functionally separate entity which is deemed to have notional assets (e.g., credit rating and Tier 1 capital), if under arm's length behaviour an unrelated party would not be able to obtain these assets without some type of compensation.

76. Para. 29: No comment.

77. Para. 30: Ernst & Young disagrees that the booking of a financial asset in a particular jurisdiction, is in and of itself, without economic meaning. If a bank's booking activity is respected by other non-taxing authorities, it should be viewed as an arm's length activity. The proper focus should be determining what portion of profit is attributable to the booking entity. Such profit may be low, however, it is not non-existent. There is no minimum activity threshold or bundling requirement in the Guidelines which must be met before functions are considered to have economic substance.

78. Para. 31: Ernst & Young contends that this paragraph should be expanded to include the possibility that the branch is a service provider that does not own any financial assets. The paragraph as drafted suggests that a branch must always be the owner of the assets created in its jurisdiction.

79. Para. 32: The statement that all functions are performed by people appears at odds with the OECD's conclusion that a computer server, without people, can perform functions in a permanent establishment.⁵ The requirement that people be located in the permanent establishment should be dropped as it leads to the improper inference that the activities of people is always more than the provision of a service. As currently written, the Bank PE Draft attributes supporting assets, and thus risk taking, which would not necessarily occur if the branch were operating as an unrelated third party on behalf of the home bank.

80. Para. 33: Ernst & Young suggests that the phrase "if all the functions listed at paragraphs 5 and 6 were performed by the PE, there would be little to take into account under the second step of the WH" (comparability analysis), may be misleading to taxing authorities. Valuable intangibles may have been transferred which require a significant return to the owner of intangibles. Although Para. 34 recognises that assets must be considered, Paras. 33 and 34 do not provide enough emphasis on the potential value of intangible assets. The paragraph should also make it clear that even in the event that all paragraphs 5 and 6

5 Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions, February 2001. For example, see paragraphs 8, 48, and 114.

functions are performed by a branch, which we suggest is highly unlikely, that it does not follow that all profits arising from the financial assets are attributable to the branch.

81. Para. 34: Ernst & Young suggests that not all important intangibles have been identified in this paragraph or in Para. 10. A valuable intangible that has been excluded is a network intangible. In many instances, the ability of a branch to make a sale or provide other services to a client is dependent upon the existence of related banking offices throughout the world. But for this network, the branch may have never made the sale. The OECD must address how to allocate profit to this important intangible. Ernst & Young suggests that this issue cannot be appropriately addressed by assuming that all entities share equally in network intangibles.

82. This paragraph also suggests that in all instances regulatory capital must be allocated to sales/trading activity occurring in the branch. This paragraph should caveat that if the initially assumed risk is simultaneously transferred elsewhere within the bank, that capital attribution will not be required, as provided later in Para. 163. Instead, the branch should be viewed as a service provider that earns a commission for its selling activities.

83. Para. 35: No comment.

84. Para. 36: Ernst & Young believes the hypothetical in this paragraph is misleading because it treats the branch as an integrated part of the whole banking enterprise which is contrary to the WH that the branch (or permanent establishment) will be treated as a separate enterprise (entity). The Bank PE Draft has not justified why it is more appropriate to relax the requirement of determining an arm's length credit rating for the branch, similar to what a legally separate and distinct banking entity would be required to do in the market place. Admittedly, the burden for banks and tax administrations would be reduced. However, this is not the only option available under an arm's length approach. If the branch cannot profitably sell an asset without the credit rating of the whole banking enterprise, the better arm's length approach may be to treat the branch as a service provider.

85. Para. 37: Ernst & Young agrees that a separate entity carved out from a network of banking affiliates will in most instances have a credit rating that is lower (thus have higher borrowing costs) than what the credit rating of the whole banking enterprise is. Ernst & Young suggests that the example is misleading in demonstrating why a branch should be attributed the credit rating of the whole banking enterprise. A branch should not be presumed to have the ability to lend to all potential customers if its hypothetically stand-alone credit rating is not sufficient to service such customers. Like small banks throughout the world, the branch may be required to service higher risk and/or smaller customers in order to earn profit on borrowing and lending transactions. The OECD's current interpretation of the WH attempts to make the branch into something its not.

86. Ernst & Young suggests in instances where a branch lends to a customer which expects to be charged a rate of interest less than what the branch would pay for borrowed funds on a stand-alone basis, the branch should be deemed to be a service provider on behalf of the whole banking enterprise. The basis being that the branch cannot provide the financial asset on its own accord, and thus, it must be deemed to be a broker that earns a commission for facilitating the transaction. Consequently, the branch would not assume any risk, and no capital would be attributed to the branch for this service. This result is consistent with the arm's length standard. Moreover, it is also feasible to administer.

87. Para. 38: Ernst & Young disagrees with the statement that:

[i]n fact, 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. To postulate that Article 7 requires that the branch should not enjoy that credit rating, but should be treated as having a lower rating than the enterprise as a whole, would produce an unrealistic, perhaps perverse, attribution of profit.”

88. The Bank PE Draft postulated the functionally separate entity approach. The WH cannot be inconsistently construed; under the WH the branch is a separate entity with all the benefits and burdens that arise from such classification. Just as attributing the whole banking enterprise’s credit rating to a legally separate and distinct entity violates arm’s length principles, so too should such attribution of the credit rating to a branch which is deemed to be a separate entity. Economic commerce is replete with examples of where unrelated parties pass on opportunities to service customers when the firm is unable itself to meet the needs of the customer. The branch should be viewed as a separate entity which creates some of its own financial assets, and other instances it provides a brokering service to the whole enterprise in situations where it does not have the hypothetical wherewithal on a stand-alone basis to create the financial asset.

89. The Bank PE Draft has not made any compelling justification why this standard should be relaxed. As previously stated, the lower cost of compliance for banks and tax administrations has not been demonstrated particularly given that an acceptable arm’s length approach exists, i.e., the branch as a service provider.

90. Para. 39: The consensus of the OECD that the branch should have the same credit rating as the whole banking enterprise, will lead to tax controversy in other transfer pricing situations. A whole banking enterprise’s credit rating is a type of network intangible. Various activities, assets, functions, and enterprises throughout the whole banking enterprise created this valuable intangible over time. To merely attribute the lower credit rating to a branch provides it with an economic benefit to which it is not entitled to under arm’s length principles. The branch must either pay an arm’s length charge for access to this intangible, or it must be viewed as a service provider in instances where it cannot service a customer without access to this network intangible.

91. Suppose an existing banking operation in Country A, Localbank, has a credit rating of BBB which allows it to borrow funds on a short term basis at 5.2%. Superbank, an internationally recognised bank, ranked in the top ten banks based on assets, has considered starting operations in Country A to meet some of the needs of its existing international customers. Superbank could set up its own branch or subsidiary. Superbank because of its large size, history of impeccable risk management, and other intangibles, has a more favourable credit rating, e.g. AA, which allows it to borrow the same short term funds at 4.9%. If Superbank acquired Localbank and converted it into a branch to service Localbank’s current customers and Superbank’s current customers, Localbank should not be able to claim that it is entitled to the lower credit rating under the WH. Localbank has done nothing to earn this superior credit rating and lower borrowing costs. Superbank acquired a riskier set of assets when it acquired Localbank and it should be compensated under arm’s length principles for allowing Localbank to have access to the lower cost of funds. Ernst & Young contends that the principles of this example must be applied if the WH is to be applied in a consistent and uniform manner.

92. Para. 40: For purposes of applying the WH, Ernst & Young disagrees that there is any relevance to the statement “[i]t is a fact that third parties, credit agencies etc., do not perceive a PE as having a separate credit rating from the bank as whole. This is no doubt based in part on the fact that potentially the whole of the bank’s assets and capital are available to meet any claims against the PE.” The perception of third parties of about the legal structure of an enterprise that has been assumed away has never been a basis for determining arm’s length pricing. The Bank PE Draft should not mix the concepts of separate entity and integrated entity in applying the WH. Either the branch is a separate entity for all aspects or it is not; there can be no hybrid arm’s length analysis, unless a compelling justification is made for tax

administration purposes for both banks and tax administrations. Such a justification must include an analysis that no alternative arm's length approach is feasible.

93. Nevertheless, if these third party perceptions are valid in determining arm's length pricing, then the branch should pay for the implicit guarantee perceived by the third parties. The implicit guarantee could be calculated in a number of ways, including the reduction in borrowing costs of the branch if it were to be viewed as a separate entity, as illustrated in the example above.

94. If the OECD is correct in its analysis, scores of intangibles will have no value for transfer pricing purposes in other contexts. For example,

- Favourable supply contracts – a head office may have negotiated a most-favoured contract with a supplier for the lowest price offered by the vendor based on a certain volume ordered by the head office and/or other separate entities. A branch, assumed to be a separate entity, could not obtain these prices from the vendor on a stand-alone basis because it could not purchase sufficient volume on its own to garner these discounts. At arm's length a separate entity would be willing to pay some portion of the cost savings it receives from having access to the most-favoured pricing contract. Extending the OECD's rationale on credit rating attribution to this situation would result in the separate entity not paying for access to this valuable supply intangible.
- Network intangibles – a local delivery company wants to offer its customers worldwide delivery options. The local delivery company could pay unrelated parties on a package-by-package basis for this service. These costs would likely be higher than if the delivery company agreed to become a member of a worldwide delivery company. If in fact the local delivery company becomes a member of a worldwide delivery company, the resulting cost efficiencies would be attributed to the formerly local delivery company without any payment of an access fee or network intangible fee.

95. Thus Ernst & Young respectfully disagrees with the Bank PE Draft's proposed conclusion that the permanent establishment "must be hypothesised with the same credit rating as the bank." Ernst & Young contends that such a hypothesis will critically undermine the legitimacy of the WH.

96. Para. 41: The conclusions in this paragraph are not substantiated. Ernst & Young suggests that the attribution of the credit rating of the whole banking enterprise does not "naturally flow from the way the PE is hypothesised as a distinct and separate enterprise." Ernst & Young would have thought just the opposite conclusion would have been drawn by some of the OECD countries given how separate entities must pay for access to intangibles outside of the financial institution sector.

97. Furthermore, there is no support for this attribution based on the premise that bank capital would be "harmoniously" attributed to the branch. The statement "if the PE takes on more risk than other parts of the enterprise, it has more capital attributed to it so that the residual risk exposure, and therefore the credit rating, remains proportionally the same as the rest of the enterprise" is simply not correct. On a stand-alone basis, if a small bank decided to put all of its assets into one category of very risky assets, the fact that capital increased in accord with the regulatory requirements for holding such assets, would not suggest that the risk profile of the small bank remains unchanged. Implicit within the regulatory risk requirements is an effort by banks to diversify their financial asset portfolios.⁶ Diversification occurs through holding

6 Bank for International Settlements, Basle, Switzerland, Publication No. 8, "Measuring and Controlling Large Credit Exposures," January 1991, available at <http://www.bis.org/publ/bcbasc121.pdf>. Para. 8 which provides in relevant part:

different types of assets, with various interest rate structures (fixed v. floating), in different geographic areas,⁷ and so forth. Moreover, like insurance companies or entities that self insure, the larger the bank, the less volatile its risk profile becomes because it has more assets to spread any loss over.⁸ It is economically inaccurate to attribute the risk profile of a permanent establishment on a pro rata basis to the whole banking enterprise.

98. Moreover, although the statement that a permanent establishment should receive more capital if it has more assets is generally correct (not factoring into account portfolio risk issues), there is no connection between this statement and justifying the branch should have the same credit rating as the whole banking enterprise. This statement only supports the fact that if additional capital is not raised when the branch acquires more assets, the credit rating of the whole banking enterprise and the branch will go down. If there is a difference between the credit rating of the branch and the whole banking enterprise, this spread will continue if additional capital is not acquired when additional assets are created.

99. Para. 42: Ernst & Young disagrees that Para. 7.13 of the Guidelines provides relevant support for attributing the credit rating of the whole banking enterprise to the permanent establishment. The first sentence of the paragraph, which is not included in the current working draft, states “an associated enterprise should not be considered to receive an intra-group service when it obtains incidental benefits attributable solely to its being part of a larger concern, and not to any specific activity being performed.” This reference is inapplicable for two reasons: 1). a credit rating is not a service, it is an intangible derived over time based on the performance of the whole banking enterprise and the size of its asset base; 2). the credit rating is not an “incidental” service. As the OECD suggests in paras. 35 and 43, the credit rating is a “crucial factor in the ability to raise funds.” Accordingly, reliance on Para. 7.13 of the Guidelines is inappropriate and should be stricken.

100. Par 43: No comment.

101. Para. 44: The term “internal condition” is an undefined term which is not contained in the Guidelines or its updates. Ernst & Young restates its prior comments about why the credit rating of the whole banking enterprise should not be automatically attributed to the permanent establishment.

102. Para. 45: With all due respect, it is not “clear” that any of these views lead to the conclusion that the credit rating of the whole banking enterprise should be attributed to the permanent establishment. The

The disadvantage of using the capital weights is that they were in general devised as an appropriate measure of banks’ credit risks on a “basket” basis. Since a large exposure measure is concerned with concentrations of risk, the measure of exposure needs to reflect the maximum possible loss from the failure of a single counterparty. The Committee has therefore concluded that to use the capital weights for measuring credit concentrations could significantly underestimate potential losses.

7 *Id.* at Para. 24, which provides in relevant part:

... credit concentration can take the form of over-average exposure to particular economic or geographical sectors, making the lending bank vulnerable to a weakness in a particular industry or region. It is therefore important that banks systematically identify and measure their exposures to different sectors and regions so that the management is aware of the risks being run and can if necessary adjust the balance.

8 Bank for International Settlements, Basle, Switzerland, Publication No. 8, “Measuring and Controlling Large Credit Exposures,” January 1991, Paras. 1 and 2, which states in relevant part:

Diversification of risk is a key precept in banking. A significant proportion of major bank failures have been due to credit risk concentration of one kind or another. ...

Experience suggest that credit concentrations, on the other hand, can result in substantial losses without necessarily any commensurate increase in prospective returns.

Steering Group should revisit this issue and propose a method which allocates under arm's length terms what credit rating a permanent establishment should have, or alternatively, treat the branch as a service provide entitled to fees for functions it performs. We also believe that the Bank PE Draft is creating unfavourable precedent which could lead to controversy related to other intangibles which could be argued to be "internal conditions" of a MNE or which could be "passively" attributed to related entities.

103. Para. 46: In allocating an appropriate amount of "free" or Tier 1 capital to the permanent establishment, other associated costs must be allocated as well, including:

- Costs, both explicit and implicit, associated with raising the Tier 1 capital such as capital generation costs, annual shareholder meeting costs (direct and executive time) and other costs normally not attributable under the Guidelines because such costs are either stewardship costs or capital structuring costs; and
- Supervision and market discipline costs. Under the New Basel Capital Accord, supervision and market discipline are two additional pillars to capital maintenance needed to manage a bank's risk profile.⁹ The costs associated with these activities must also be allocated on a basis equal to the Tier 1 capital allocation.

104. Currently, such capital raising costs may not be allocated under the Transfer Pricing Guidelines and many countries including the U.K. and the U.S. would not allow such allocations to branches operating in their jurisdictions, except in the U.K. it is possible that some of the costs could be allocated to a permanent establishment operating in the U.K. if the expenses could be characterised as "executive and general administrative expenses" under an applicable treaty. In addition, clarification is needed under current transfer pricing rules as to whether supervision and market discipline related costs are services which may be allocated.

105. Para. 47: Although the statement is accurate in a general sense, it is irrelevant and misleading to discuss how a branch is regulated for non-tax purposes when the WH requires a separate entity analysis. The Basel Concordat provides guidelines for how subsidiaries or separate entities should be supervised for solvency purposes.¹⁰ Although a parent bank cannot be indifferent to a subsidiary, the effect of excessive risk or insolvency of a subsidiary will have a different effect on the parent bank than a similarly situated branch. Of particular distinction is the joint responsibility of the host country in regulating the foreign subsidiary. In such situation, the host country's supervisory authority will establish capital requirements consistent with its own rules.

106. Differences apply for liquidity management as well.¹¹ If the WH is to have meaning, it must be applied as consistently as possible, which we contend means attributing capital to the permanent establishment as if it were a separate entity. As with a credit rating, the Bank PE Draft has not made any tax administration argument that justifies relaxing arm's length principles in allocating Tier 1 capital.

9 Bank for International Settlements, Basle, Switzerland, Basel Committee on Banking Supervision, Overview of the New Basel Capital Accord, January 2001, Para. 4, which is available at <http://www.bis.org/publ/bcbsca02.pdf>.

10 Bank for International Settlements, Basle, Switzerland, Principles for the Supervision of Banks' Foreign Establishments, May 1983, Section. IV.1. provides that:

The allocation of responsibilities for the supervision of the solvency of banks' foreign establishments between parent and host authorities will depend upon the type of establishment concerned.

11 *Id.* at Section IV.2.

107. Example to Para. 47: No additional comment.

108. Para. 48: Ernst & Young supports the general contention that allocation of profits performed under transfer pricing principles should not depend upon whether a banking operation in a foreign jurisdiction is in branch form or subsidiary form. Ernst & Young would suggest that the separate entity analysis must apply for all purposes. However, Ernst & Young disagrees with the implication that free capital must be allocated in every instance where a financial asset is sold by the branch. As previously discussed, there may be many instances where the more appropriate arm's length approach is to treat the branch as a service provider which earns a commission fee.

109. Para. 49: Ernst & Young agrees that in instances where a branch borrows funds to support the creation of assets, it should be also notionally attributed capital for tax purposes. However, Ernst & Young has concerns about the arm's length nature in which the attribution of Tier 1 capital occurs.

110. Para. 50: No additional comment.

111. Para. 51: Ernst & Young reiterates its early comments and suggests that financial assets are not always created by the permanent establishment to the extent that it is not economically capable of creating the asset, e.g., because the branch is not entitled to the superior credit rating of the whole banking enterprise. In these instances, no capital would be allocated as the permanent establishment would only be a service provider. See Para. 163. In other words, Ernst & Young suggests that not all sales activity be attributed to the permanent establishment, particularly in situations where risk management and other value-added functions are performed outside of the branch jurisdiction. The Bank PE Draft actually increases the cost and complexity of tax administration because of all the tracing of activities and ownership that must occur if the asset is subsequently transferred. Further comment on this concern is provided below under joint ownership of financial assets.

112. Para. 52: Ernst & Young agrees that financial assets can be subsequently disposed of by the permanent establishment, and accordingly, capital would follow the financial asset. However, Ernst & Young disagrees with the suggestion that a permanent establishment that only sold the financial asset, but bears none of the risk management responsibilities, should receive any portion of the Tier 1 capital.

113. Ernst & Young also disagrees with the statement "[s]ubsequent transfers of assets initially attributed to a PE would lead the asset to be wholly attributed to another part of the enterprise, provided those transfers are recognised for tax purposes following the guidance given in section D-2 (iii)(c) below." First, as previously discussed, there is no recognition for the possibility that the branch is a service provider. Second, the provision creates undue administrative burden for banks which routinely own certain types of assets in a centralised fashion. Third, controversy may be needlessly increased if tax administrations are allowed to second guess subsequent transfers.

114. Para. 53: Ernst & Young restates its opposition that capital is allocated to the nominal value of a financial asset; if none of the risk management/liability remains with the financial asset sold by the permanent establishment, then no capital should be attributed to it either.

115. Ernst & Young agrees that capital should be allocated based on risk weighted basis consistent with arm's length principles. However, Ernst & Young disagrees with the assumption that the branch should be allocated Tier 1 capital at the same cost as the whole banking enterprise. As previously discussed, larger banks are able to acquire capital at a lower cost than smaller banks. Since the branch is hypothesised to be a functionally separate entity, if it were an unrelated to the whole banking enterprise, its cost of acquiring capital would be greater than the whole banking enterprise. As such any allocation of Tier 1 capital should be burdened with an arm's length charge for access to the lower cost of capital. Otherwise,

the branch will be receiving a benefit that an unrelated separate banking enterprise in the host country would not have, thus resulting in extra profit subject to taxation in the host country.

116. Para. 54: Ernst & Young suggests that the Basel Committee standardised risk weighting approaches are at best approximations which a banking enterprise may wish to adopt for ease of tax compliance. Ernst & Young suggests that whole banking enterprises be provided with the flexibility to choose the risk weighting system which is either regulatory based or which is based on internal analysis of the actual risks inherent in the financial assets. Without this choice, banks will frequently be subjected to risk weighting their assets for non-tax purposes and tax purposes, which is an unnecessary tax compliance burden.

117. Para. 55: Ernst & Young agrees that one option of risk weighting of assets could be under the 1988 Basel Accord. Another option could be the internal risk weighting system which has been suggested under the current draft of the Basel Accord which will become effective in 2005.¹² Since some whole banking enterprises have sophisticated risk management systems, the option to use internally derived risk-weighting should be an option made available to these whole banking enterprises and their permanent establishments. The OECD should not propose just one system. Whole banking enterprises should be allowed to choose among options which are consistent with how the risk weight assets for non-tax purposes.

118. Para. 56: Ernst & Young agrees that use of the Basel Accord risk weighting categories is less than precise. Ernst & Young suggests that this is another reason why internal risk weighting measures should be an option available to a whole banking enterprise in determining the capital needs of a permanent establishment.

119. Para. 57: The lack of other risks in the banking book is yet another reason to allow banks to choose internal risk rating systems as these systems will account for the material risks that affect the profitability of the banking book.

120. Para. 58: No comment.

121. Para. 59: Ernst & Young supports the position that a bank should be able to choose an internal risk model. If the bank is making economic decisions based on this model, it is arguably more in line with the arm's length standard than a regulatory based model.

122. Para. 60: Ernst & Young agrees that a portfolio based approach to measuring risks is inconsistent with the arm's length principle in the same manner attributing the whole banking enterprise credit rating to the permanent establishment violates the arm's length standard. The management of risk on a whole banking enterprise basis creates an intangible, a portion of the value of which should be earned by the risk managing entity, similar to how an insurance company might earn income if it did not earn investment income from the assets it receives. The risk weighting should be on a separate entity basis. This will necessarily mean that more capital will initially be attributed to the permanent establishment, assuming in fact, that it ends up managing and bearing the risk associated with the new financial assets. However, the branch should return a portion of this nominal capital to the whole banking enterprise for risk reduction arising from the management of its risks in a larger portfolio.

123. Finally, if the permanent establishment is merely the nominal owner, i.e., agent or conduit of the financial assets, no capital should be attributed to the permanent establishment.

12 The New Basel Capital Accord (Consultative Document), Basel Committee on Banking Supervision (January 2001) available at <http://www.bis.org/publ/bcbsca03.pdf>.

124. Para. 61: No comment.

125. Para. 62: Ernst & Young agrees with this statement and reiterates that the branch should not be given the implicit benefit of additional capital because portfolio risk benefits are not taken into account. Under the WH, the risks of the branch are being managed outside of the host country to one degree or another, this results in a benefit to the branch. The corresponding cost to this benefit can be reflected in a reduced allocation of Tier 1 capital to the branch.

126. Para. 63: Ernst & Young agrees that internally developed risk measurement models will more likely provide arm's length results. Countries adopting the arm's length principle should not be allowed to reject such internally developed models. Whole banking enterprises should not be burdened with the requirement of obtaining relief from Competent Authority to use these internally developed models; rather the member countries should be required to accept valid internal risk measurement models in lieu of regulatory risk weighting models.

127. Para. 64: Ernst & Young requests that the OECD specifically discuss how the portfolio effect from managing assets should be factored in allocating Tier 1 capital. It appears from paragraphs 60 through 64 that the portfolio effects should be taken into account. Ernst & Young suggests that the mathematical expertise needed to make this adjustment is no less than the mathematical skills needed to calibrate the credit rating of a branch based on the credit rating of the whole banking enterprise or to calibrate the cost of Tier 1 capital to account for the branch's smaller size.

128. If the portfolio effect is not taken to account, it is possible that the amount of notional capital allocated to the branches of bank could be greater than the actual capital of the bank. The effect of this would be for the taxing jurisdiction of the home bank to lose part of its tax base to the tax administrations of the branches on a collective basis.

129. Para. 65: No comment.

130. Para. 66: Ernst & Young suggests that the quasi thin capitalisation approach may not be the best approach because it is based on minimum capital standards not actual standards in the host country. Under a functionally separate entity approach, the capital requirements of the branch should be based on what conditions it would have faced as a separate enterprise.

131. Par 67: Ernst & Young suggests that the thin capitalisation approach is more in line with the WH/separate entity approach. Issues of comparability may be legitimate, but such issues are not a basis for rejecting the thin capitalisation approach. In particular, Ernst & Young disagrees that the risk profile of the small bank should reduce the comparability of the thin capitalisation approach. If the risk weighting of assets for the branch is based on arm's length principles, the amount of assets requiring capital should be reduced by the portfolio effect. However, once the amount of these assets is determined, these assets should be subject to the same capital requirements as other banking enterprises.

132. Ernst & Young agrees with the statement "... small independent banks may not be comparable to a PE that is part of a large banking enterprise. They are likely to carry on different types of business, to have different risk profiles and to have different types of customers than the PE to which they are being compared." Ernst & Young believes these differences are due in part to an independent bank's inability to obtain a high or strong credit rating and its ability to manage risk on a global basis, value drivers which should not be attributed to the permanent establishment, if it is assumed to be a separate entity.

133. Para. 68: Ernst & Young supports an allocation of capital that is reflective of the risks of the whole banking enterprise being collectively managed. Risks assumed and managed by the branch, if any, should also be risk weighted as part of the whole banking enterprise, which will have the effect of reducing

the amount of capital allocated to the branch. This reduction in capital could be viewed as a proxy for the value added by the centralised risk management functions performed outside of the branch. As previously discussed, the allocated capital should include an access charge to the branch for providing it with lower cost of capital than it could acquire on its own.

134. Para. 69: Ernst & Young disagrees that discrepancies between a branch and truly separate legal entity will be eliminated by the allocation of capital as proposed or as Ernst & Young suggests it should be modified. The amount of capital attributed to the branch should be less than what a legally separate enterprise will require for at least two reasons:

- for non-tax reasons, the separate enterprise cannot diversify its risks to the same extent as the branch, and thus the separate enterprise will have to acquire a larger amount of capital to cover the risks associated with its assets because the risk weighting of assets for the branch will be lower than that of the separate enterprise; and
- for non-tax reasons, the separate enterprise will have to pay higher transactional costs to acquire capital to cover its risks.

135. As a result the branch will be allocated less free capital than what the separate enterprise must maintain. Thus the gross profit margin of the branch will not be as high as the separate enterprise in Situation 2 of Example 48; nor should it be if the branch is receiving value-added risk management functions from having its risks managed as a part of the whole banking enterprise's portfolio.

136. Para. 70: Excess capital improves the credit rating of the whole banking enterprise. A facts and circumstances analysis as to the risks reduced from such excess capital should be performed. Ernst & Young would oppose any proposal that would both allocate the credit rating of the whole banking enterprise to the permanent establishment as well as allocating Tier 1 capital on a BIS approach.

137. Para. 71: The permanent establishment should not be entitled to favourable costs of Tier 2 capital, if such favourable costs are attributable to the credit rating of the whole banking enterprise. The permanent establishment should be deemed to have to pay for its Tier 2 capital on a stand-alone basis subject to the credit rating it would have as a separate entity.

138. Para. 72: The pure BIS ratio approach is not consistent with the arm's length standard because it provides Tier 2 capital on advantageous interest terms (see comments to par 71 above).

139. Para. 73: Ernst & Young requests that the OECD discuss in its next draft how branches which are allocated tier 1 capital for non-tax purposes greater than the amount allocated for transfer pricing purposes should treat this excess distribution.

140. Para. 74: Ernst & Young agrees that debt/equity issues arising in non-transfer pricing tax consequences are outside of the scope of this WH. Ernst & Young suggests that the non-transfer pricing tax consequences attributed to Tier 1 and Tier 2 capital notionally allocated under the WH should not be altered to account for the taxation rules of the host country. Such a requirement needlessly adds compliance burdens to banks and tax administrations. The OECD should for principles of administrative ease provide that the non-transfer pricing tax consequences are unaffected by the notional allocation of capital to the branch.

141. Para. 75: No comment.

142. Para. 76: No comment.

143. Para. 77: A proportional allocation of favourable debt financing, Tier 2 capital, violates the arm's length standard because the permanent establishment would not have been able to obtain the financing of such debt on its own accord as a separate entity. Consequently, application of either the pure or cleansed BIS ratio approaches will result in the branch obtaining more favourable financing than it would have had it in fact been a legally separate enterprise.

144. Para. 78: Ernst & Young agrees that interest charges for dealings should be consistent with attribution of Tier 2 capital and the branch's access to any other form of financing

145. Para. 79: No comment.

146. Para. 80: The calculation of a solo entity return will in fact be burdensome and complicated. The fact of the matter is that banking regulators of parent corporations with subsidiaries "consider" the solvency of the subsidiaries under the premise that a parent bank would not jeopardise its credit rating and reputation by letting a separate but related entity fail. Accordingly, the capital and risks of the subsidiaries affect the capital required to be maintained by the parent corporation. It would be a difficult task to apportion the capital requirements of the bank between the single enterprise and the related subsidiaries.

147. Para. 81: Ernst & Young opposes solo basis reporting for the reasons stated above.

148. Para. 82: No comment.

149. Para. 83: No comment.

150. Para. 84: No comment.

151. Para. 85: No comment.

152. Para. 86: Ernst & Young agrees that financial institutions should have the ability to pick administratively convenient proxies for arm's length results. Ernst & Young does not necessarily agree that the BIS approach is always such a valid proxy.

153. Para. 87: Ernst & Young disagrees that the BIS approach should be the default approach for the reasons noted above.

154. Para. 88: No comment.

155. Para. 89: No comment.

156. Para. 90: Ernst & Young agrees that an adjustment should be made if the actual allocation of capital is not consistent with the amount required under the WH.

157. Para. 91: Ernst & Young agrees that the permanent establishment should bear an arm's length portion of Tier 2 capital. There are regulatory benefits to a banking enterprise in issuing such capital. The permanent establishment should bear the costs of such capital in the same proportion that it receives the benefits of Tier 1 capital attribution.

158. Para. 92: Ernst & Young suggests that the capital structuring decisions made by the whole banking enterprise should not be attributed to the permanent establishment on a pro rata basis, if the WH is to be applied strictly; thus a blended rate approach should be rejected. Instead, the permanent establishment should be required to pay an arm's length interest charge on Tier 2 capital similar to independent

enterprises in the host country. This interest rate will be dependent upon the stand-alone credit rating of the permanent establishment.

159. Para. 93: Ernst & Young disagrees with this approach. The allocation of Tier 2 capital should be based on what the permanent establishment would have had to pay in interest charges itself on a stand-alone basis for this type of capital.

160. Para. 94: Ernst & Young contends the interest rate expense for the Tier 2 capital should not be the rate of the whole banking enterprise, but rather, the interest rate the permanent establishment would have paid had it used its own credit rating to borrow these funds.

161. Para. 95: No comment.

162. Par 96: Ernst & Young agrees that this is the appropriate standard. Dealings should include all access to funds. The arm's length charge for the use of funds should not be deemed to be the actual cost of the whole banking enterprise.

163. Para. 97: No comment.

164. Para. 98: No comment.

165. Para. 99: No comment.

166. Para. 100: No comment.

167. Para. 101: Ernst & Young generally agrees that for purposes of allocating profit, an asset is not used where it is necessarily booked. There are a number of consequences from this statement. First, a permanent establishment may sell and book a financial asset but have no other responsibilities or duties to manage the asset. For example, the branch may not have the underlying credit rating to borrow funds to finance the transaction on a profitable basis. In this instance, the permanent establishment would be providing a service and would not be the owner of the asset. See Para. 163.

168. Ernst & Young contends that where an asset is booked may have some effect on the amount of risk borne for the financial asset. For example, the local laws where the financial asset is booked may affect the risk borne by each of the parties. Accordingly, where the booking occurs may have an effect on the allocation of profit, albeit a small allocation

169. Para. 102: No comment.

170. Para. 103: Ernst & Young suggests that it will frequently be the case that there will be joint ownership of financial assets initially created by a permanent establishment, particularly in the context of risk management provided by parts of the whole banking enterprise outside of the permanent establishment, in those cases where the permanent establishment is not more properly viewed as a service provider.

171. Para. 104: No comment.

172. Para. 105: Ernst & Young supports the use of comparable transactions when available. However, comparables for value-added risk management functions will most likely not exist. Taxing authorities should not expect to find such comparable data for such functions. Accordingly, more than one transfer pricing method may be required, or some type of profit split method similar to those used by global dealing operations may be appropriate.

173. Para. 106: No comment.

174. Para. 107: Ernst & Young suggests that currently not all member OECD countries consider “money to be a global commodity.” Some OECD taxing authorities contend that slight differences exist between countries and that quantifiable adjustments must be made based on the situs of the borrower.

175. Ernst & Young contends that comparables will be more difficult to find if the risk attributes of the financial asset are not based on standard industry norms.

176. Para. 108: Ernst & Young generally agrees with the paragraph but disagrees with the contention that independent parties would always perform risk functions together with other financial asset management and creation functions. As noted by the OECD in Para. 67, small independent banks may not sell and manage the same type of financial assets as the permanent establishment. It is likely that the financial assets created by a permanent establishment could only be sold if the risks associated with such assets are managed on a global basis, thereby, reducing the risk of the asset to an acceptable level. Such risk management is actually encouraged by the various bank regulatory bodies.

177. Para. 109: Ernst & Young would only note that default risk for an entity will depend in part on the local law chosen by the parties, and such choice of law, could have a material affect on the riskiness of the financial asset.

178. Para. 110: Ernst & Young supports the contention that not every aspect of every “dealing” can be documented. Such a requirement would create a needlessly expensive compliance requirement for whole banking enterprises. Ernst & Young agrees that taxing authorities should be able to deduce arm’s length relationships from the actual conduct of the permanent establishment and the rest of whole banking enterprise. Ernst & Young suggests that non-tax related documentation or statements from knowledgeable banking officials should be deemed adequate to support such deductive analysis.

179. Para. 111: In deducing the risk attribution within a whole banking enterprise, taxing authorities should look to representations made by the whole banking enterprise to banking supervision officials who are charged with monitoring the risk profile of the bank.

180. Para. 112: Ernst & Young agrees that regulatory and other local market differences may have a material effect on the profitability of a financial asset and that material adjustments may be required to comparables.

181. Para. 113: No comment.

182. Para. 114: Ernst & Young supports the proposition that aggregation may be the more appropriate way to view the creation and management of financial assets. Ernst & Young would suggest that comparables, if they exist, must be similarly aggregated to provide meaningful arm’s length evidence. To the extent that such comparables do not exist, aggregated dealings may be best analysed under transfer pricing models used in a global dealing context.

183. Para. 115: No comment.

184. Para. 116: No comment.

185. Par 117: Ernst & Young restates its prior comments concerning the creation of a financial asset by a permanent establishment and has no additional comments.

186. Para. 118: Ernst & Young restates its prior comments concerning the attribution of free or Tier 1 capital to a permanent establishment and has no additional comments.

187. Ernst & Young contends that a permanent establishment must be allocated the support, back office, middle office, and other related activities it would have incurred had it been a separate entity established in the permanent establishment jurisdiction. These costs should be allocated under the arm's length principles currently provided in the Guidelines. In addition, the OECD should address whether capital structuring costs that a separate entity would have otherwise incurred should be allocated from the whole banking enterprise to the various branches.

188. Par 119: Ernst & Young agrees that split functional analysis will be frequently required. Ernst & Young would suggest that such an analysis will be the norm.

189. Para. 120: Ernst & Young does not agree that a permanent establishment will be the "owner" of a financial asset in all circumstances. To the extent the permanent establishment did not have the economic wherewithal to sell the financial asset without its association with the whole banking enterprise, it should be deemed a service provider and receive arm's length compensation in these situations. See prior comments and Para. 163.

190. Ernst & Young suggests that a permanent establishment's local cost of borrowing may require an intercompany payment by the permanent establishment to the whole banking enterprise to the extent its borrowing costs are reduced because of its association with the whole banking enterprise. If an unrelated party at arm's length could not have obtained the same cost of borrowing as the permanent establishment, such an adjustment is required in order to consistently apply the WH.

191. Para. 121: Ernst & Young agrees that all supporting dealings should be compensated on an arm's length basis. Ernst & Young suggests that the language of the paragraph be changed as it suggests that other related entities are always just service providers. There will be many instances where the supporting functions are entitled to profits, and as result a different transfer pricing method, such as a residual profit split, may be more appropriate. See Para. 144.

192. Para. 122: Ernst & Young agrees with the general sentiment of this paragraph and would add that rewards to other entities within the whole banking enterprise may require the allocation of profit, not just a service fee, analogous to the division of rewards in a global dealing operation.

193. Para. 123: Ernst & Young generally agrees with this paragraph but contends that in situations where the risk of loss on the asset is fully transferred outside of the permanent establishment, the permanent establishment should no longer be deemed to be the owner of the asset, but rather should be provided arm's length compensation consistent with its residual functions.

194. Para. 124: Ernst & Young agrees that arm's length principles from the Global Trading Report should be applied to the permanent establishment's sales activities where applicable.

195. Para. 125: No comment.

196. Para. 126: No comment.

197. Para. 127: Ernst & Young suggests that detail needed to support a treasury functional analysis may not be as labour-intensive as suggested by the paragraph as currently drafted. Functional analysis should be reasonably descriptive but should not rise to the level of an operational manual.

198. Para. 128: Ernst & Young contends that internal interest rate charges to permanent establishments should be in the context of the permanent establishment as a separate entity with its own capital structure based on the allocation of Tier 1 capital necessary to support the creation of financial assets. The permanent establishment should not be attributed the credit rating of the whole banking enterprise.

199. Para. 129: No comment.

200. Para. 130: Ernst & Young contends that a cost contribution arrangement (“CCA”) should not be deemed to exist, unless in fact, the related parties have so structured such an arrangement. Deeming a CCA would inappropriately treat the treasury function as a cost centre when in fact it is a very important part of a banking operation which should receive appropriate arm’s length compensation.

201. Para. 131: Ernst & Young restates its prior comments concerning the attribution of Tier 1 capital to a newly created financial assets, to the extent the permanent establishment is not in fact a service provider.

202. Para. 132: Ernst & Young restates its opposition to attribution of the whole banking enterprise’s credit rating to the permanent establishment because such a result is wholly inconsistent with arm’s length principles and undermines the validity of the WH.

203. Para. 133: Ernst & Young agrees that the allocation of foreign exchange risk should be borne by the entity assuming such risk. However the OECD has not suggested how sustained losses should be supported in this context or in other areas where losses arise from an asset owned by the branch. The OECD should suggest how this issue should be reconciled in a subsequent draft.

204. Para. 134: Ernst & Young contends that if there is economic substance with respect to any intercompany dealing, the dealing should be respected even if there are resulting tax consequences which may be favourable to one related entity or the other.

205. Para. 135: No comment.

206. Para. 136: Ernst & Young has previously commented on the substantive points in this paragraph and restates that if the permanent establishment does not have the economic ability to support the financial assets, it should not be deemed the owner, but instead a service provider that received an arm’s length fee. See Para. 163.

207. Para. 137: Ernst & Young supports the analogous use of the transfer pricing methods illustrated in the Global Trading Report, and suggests that such transfer pricing methods be used where applicable. The OECD should strive to have the transfer pricing methods used for banking permanent establishments to be as similar to those of global trading operations.

208. Para. 138: No comment.

209. Para. 139: Ernst & Young submits that many permanent establishments may sell financial assets only because of their association with the whole banking enterprise, which has developed the relationship with the client. In such situations, the significant function should be deemed the client relationship which may make an office outside of the permanent establishment the owner of the financial asset. Ernst & Young agrees with the statement that support functions provided to facilitate the sale should be compensated with a sales commission or service fee, if these functions are routine in nature.

210. Para. 140: Ernst & Young disagrees with the general characterisation that joint ownership of a financial asset will be the exception. Ernst & Young contends that risk management provides a significant value component to many financial assets, and without such risk management capabilities, a permanent establishment would not be able to sell financial assets. Accordingly, the permanent establishment will often be a joint owner of the asset, if not a service provider. Although, Ernst & Young believes joint ownership may be attributed under a value added approach, we disagree that the value added analysis should be limited to the sales and trading function. Ernst & Young contends that the value drivers for many financial assets will be predominantly due to risk management techniques. Accordingly, joint ownership should be based on all value added drivers, not just sales/trading value added functions. Ernst & Young would also suggest that the range of joint ownership be limited. The example provides a 60/40 split. Joint ownership should not be deemed in situations where the value added is minimal, e.g., 15%.

211. Para. 141: No comment.

212. Para. 142: No comment.

213. Para. 143: No comment.

214. Para. 144: Ernst & Young supports the use of the residual profit split method because the facts and circumstances of many dealings in a whole banking enterprise will show that there are many value added functions for which reliable comparables are unavailable. In these situations, the residual profit split may provide the most reliable arm's length allocation of profit.

215. Para. 145: No comment.

216. Para. 146: No comment.

217. Para. 147: Ernst & Young supports allocating profit to value added risk management functions under the same principles outlined in the Global Trading Report.

218. Para. 148: No comment.

219. Para. 149: Ernst & Young conceptually agrees that attribution of capital should be allocated to functions to the same extent profits are allocated.

220. Para. 150: No comment.

221. Para. 151: Ernst & Young agrees that for transfer pricing purposes that a change in the performance of functions listed in paragraphs 5, 6, and 7 is required in order for a financial asset to be transferred. The Bank PE Draft should clarify that "recognition" of such a transfer is only for transfer pricing purposes and no other tax purpose.

222. Para. 152: Ernst & Young suggests that the term "deemed disposal" of the asset be more clearly explained that the deemed disposal is for transfer pricing purposes only and no other tax purposes.

223. Para. 153: If a transfer of assets occurs at arm's length, this should be deemed to be of sufficient economic substance to preclude taxing authorities from disregarding the transaction because of consequential tax results, in the same vein that unrelated parties realise tax results from the disposition of assets.

224. Para. 154: No comment.

225. Para. 155: Ernst & Young opposes adjustments to the cost base of the head office that provides value added services to a permanent establishment under the premise that the permanent establishment could have obtained such services from an independent party in a jurisdiction with lower costs. Many services include embedded intangibles which are compensated through the attribution of costs. Unnecessary tax controversy will arise if taxing authorities are allowed to substitute low cost providers in determining arm's length service charges.

226. Para. 156: Ernst & Young believes that many services provided by the head office will include embedded intangibles. The value of such embedded intangibles should be included in the arm's length charge to the branch if in fact the branch is the owner of the financial asset. Of course, if the branch is merely a service provider, head office services provided to the branch would be charged differently depending on whether the head office is the owner of the financial asset.

227. Para. 157: Ernst & Young contends that a CCA should not be deemed to exist, unless in fact, the related parties have so structured such an arrangement

228. Para. 158: CCAs should not be deemed to exist by tax administrations. For example, a group of branches that acquire funds through the treasury function in the head office should not be deemed to be in CCA whereby each branch does not have to pay for any intangible value created by the treasury function in sourcing funds.

229. Para. 159: No comment.

230. Para. 160: Ernst & Young suggests that agency and conduit functions be more explicitly defined. For example, an agency or conduit function is performed by a permanent establishment in instances where the permanent establishment, if it were truly treated as a separate entity under the WH, could not sell the financial asset based on its own economic resources. In these instances, the permanent establishment should receive compensation for the service it provides, no more, no less. Strict application of the WH will alleviate the concerns of some members that an entity may not be earning its fair share of profits.

231. Para. 161: Ernst & Young agrees with the premise that WH, if consistently applied, will be a "useful tool" for distinguishing between a dealing or a service. Ultimately, such distinction will depend on which entity bears the risk of loss from such activity as the Bank PE Draft suggests in paragraph 163.

232. Para. 162: Ernst & Young agrees that such determinations should be based on a facts and circumstances basis looking at the value added of all the functions. Ernst & Young disagrees that the sales/trading function should necessarily be ascribed as a "principal" activity. In fact, Ernst & Young contends that many of the sales activities of branches are limited by the risk policies set forth by the head office. In these situations, the sale activity should not be viewed as the "principal" activity.

233. Para. 163: Ernst & Young agrees that another entity fully undertaking the risk management functions can subsume any ownership interest that might be created by the sales/trading functions; any entity that sells a financial asset but bears none of the corresponding financial risk should only earn a commission or service fee. In fact, Ernst & Young contends that the Bank PE Draft should reconsider its prima facie test of what creates ownership of an asset. Instead of sales activity, Ernst & Young would suggest that the entity that assumes the risks of the new financial asset should be considered the owner of the asset.

234. Para. 164: Ernst & Young is concerned that dealings will not typically have the same level of documentation for non-tax purposes as transactions among associated enterprises. This lack of documentation may provide too much discretion to tax administrations to "deduce the economic relationships" between the head office and a branch acting in agency or conduit capacity.

- 235. Para. 165: No comment.
- 236. Para. 166: No comment.
- 237. Para. 167: No comment.
- 238. Para. 168: No comment.
- 239. Para. 169: No comment.