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

Japanese Bankers Association

1. This letter is being submitted on behalf of the member banks of the Japanese Bankers Association to request your consideration with respect to the Discussion Draft on the Attribution of Profits to Permanent Establishment, which was prepared for public comments in February this year. The Association represents more than 180 banks, including those operating not only in Japan but also in various international financial markets around the world.

Question of the suitability of applying Article 9 of the OECD Model Treaty (Associated Enterprises) to "dealings"

2. It is our position that a PE and its enterprise are inseparable and that no profit is born from inter-branch transactions. They may recognise the original cost of their transactions, but this does not necessarily mean that they regard it as profit because such transactions are merely, yet naturally, conducted for internal purposes. Our position is in line with the business reality in which a PE is deemed to be part of an enterprise and various elements such as prices, contracts, market conditions, and resources are considered by this business reality. Standard systems used for corporate accounting, regulatory oversight and corporate management also support our position.

3. This leads to our belief that the working hypothesis's ("the WH") "functionally separate entity approach," which assumes a markup as a basis for the "dealings" under a broad interpretation of the arm's length principle of Article 9 of the OECD Model Treaty, completely disregards business reality. Under that approach, the markup that accompanies the "dealings" would be treated as profit, and attributable to the relevant PE. This treatment is, to put it mildly, contrary to the understanding of most taxpayers.

4. The "dealings" should not be regarded as transactions that bear profits. A broad interpretation of the arm's length principle of Article 9 of the OECD Model Treaty to tax the "dealings" would undermine a PE's functions. Even if the arm's length principle should ever be applied to the "dealings", decisions on how and to what extent the principle should be applied must still be based upon sound economic observations.

5. Different tax treatment of PEs such as differences for branches and subsidiaries would be one of the important considerations on which businesses would make investment decisions. The proposed application of the arm's length principle to PEs, which would treat them exactly the same as subsidiaries, would not only entail more administration costs for businesses than warranted, but also give them fewer choices and hamper their activities.

6. Moreover, a broad interpretation of the arm's length principle of Article 9 of the OECD Model Treaty would end up forcing businesses to specify the "dealings" only for the sake of calculating the profits

that should be attributed to the PE. Additional administrative costs just to keep track of the arm's length prices of individual dealings would likely be immense.

Consistency of attribution of assets based on the functions of PE to Article 11 of the OECD Model Treaty (Interest)

7. Article 11 of the OECD Model Treaty stipulates taxation on interest as in;

> 11(2) However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.
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> 11(4) The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

8. The WH in the Discussion Draft mentions a case, "For example, where significant functions, such as risk management, are transferred such that the asset should be treated as jointly owned by the parts of the enterprise that created the asset and the parts of the enterprise that subsequently manage the risks associated with that asset (see below). In such cases, the asset would be treated as partly attributable to the part of the enterprise that created the asset and partly attributable to the part of the enterprise that is performing the risk management functions." [para. 52]

9. Under the WH, in a case whereby the London branch of a bank that is headquartered in Japan arranges a new loan to a resident of the UK and the risk management functions of which are transferred to that branch's head office in Japan, the assets should be partly attributable to the London branch and partly to the head office in Japan.

10. Interest that arises from assets attributable to the head office in Japan would be subject, as a matter of normal business practice, to the withholding tax of the UK under Article 11, paragraph 2, of the OECD Model Treaty. On the other hand, interest that arises from assets attributable to the London branch, being not subject to the withholding tax of the UK because of Article 11, paragraph 4, of the OECD Model Treaty, would be treated as attributable to the London branch under Article 7 of the OECD Model Treaty and considered to be the UK taxable profit.

11. As different articles and/or paragraphs of the OECD Model Treaty could be applied to different parts of the interest and/or profit, it would be a hard task to maintain a consistent application of the articles and/or paragraphs and the appropriate tax-related administration for the deals unless those concerned including those doing the withholding have a clear understanding about whom the asset should be attributed to at the time of the transaction. Moreover, the situation would become even more complex if an existing asset were transferred along with the transfer of functions or the transfer of profit and risk in an implicit manner.

12. In order to make sure that confusion of this sort does not arise, what needs to be clarified is to whom an asset should be attributed based upon simple guidelines with regard to the functions of different

parts of an enterprise. One idea might be for the interest that arises from assets attributable to the London branch in the above case to be made subject once to the withholding tax of the UK under Article 11, paragraph 2, of the OECD Model Treaty, after which Article 7 of the OECD Model Treaty would be applied. Article 11, paragraph 4, of the OECD Model Treaty, however, stipulates "The provisions of paragraph 2 shall not apply" in this case so the idea could conceivably be considered inappropriate. There must be an indisputable agreement among all parties concerned, at the time of interest payment, and not retrospectively, to whom the asset should be attributed based upon function. Otherwise such situations could not be properly handled. In short, objective criteria should be established to make the task of asset attribution clear and simple at the time of the transaction.

13. As the above case indicates, it is our concern that the attribution of assets to a variety of parts within an enterprise could result in an inappropriate consequence based on an interpretation of Article 11 of the OECD Model Treaty unless the tax systems of all countries concerned are in harmony with regard to the way asset attribution is to be made.

14. Turning to accounting, it is not a usual practice to attribute, based upon functional analysis, a portion of an asset to that part of the enterprise that created the asset and another portion to that part of the enterprise that is performing the risk management function. Such a practice, were if ever implemented, would place a heavy tax burden on taxpayers such as banks from added administrative complexities that are solely for tax purposes.

Credit rating of the PE

15. In this section, the application of the WH to banking businesses will be examined in relation to the assessment of the credit rating of the PE. The consequences of the WH are not only inconsistent with the arm's length principle, which is a basis of the WH, but also out of line with the WH's idea that the tax results of branch PEs and subsidiary should be the same. The attribution of "free" capital to the PE and consideration of its credit rating for the purpose of levying the same amount of tax on branch PEs and subsidiary ones might affect the decision making of the business on whether a certain operation should be carried by the subsidiary or the branch of the bank.

16. There seems to be two assumptions that are inconsistent in the WH. One is that the whole of the bank's assets and capital would be available to meet any claims against a PE in the context of assessing the credit rating of the PE, while the other is that only the PE's own assets and capital would be considered for attribution of "free" capital to the PE. This inconsistency in the WH implies that the PE would have two different risk dimensions.

17. Moreover, the WH assumes in the rating analysis that "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," not taking into account the arm's length principle, while the arm's length principle is apparently embraced for the attribution of "free" capital. This illustrates that the extent to which the arm's length principle is applied depends on the situations being discussed in the WH.

18. Although the WH argues that no discrepancy between the tax results of the PE as a branch and the tax results of as a subsidiary would emerge as long as the PE were hypothesised as being a distinct and separate enterprise engaged in the same or similar operations under the same or similar conditions, this is not the case as will be discussed below.

Example 1

19. Suppose that there are (i) a subsidiary whose debt is guaranteed by the bank("a guaranteed subsidiary"), (ii) a subsidiary whose debt is not guaranteed("a non-guaranteed subsidiary") and (iii) a PE as a bank branch ("a branch PE"), all of which carry out the same operation under the same condition and that the risk weight of both subsidiaries' and the branch PE's assets are heavier than the average risk weight of the whole bank.

20. The interest expense of the guaranteed subsidiary would be less than that of the non-guaranteed subsidiary because the credit rating of the non-guaranteed subsidiary is lower than that of the guaranteed subsidiary, which enjoys the credit rating of the whole bank. However, the guaranteed subsidiary would have to pay guarantee fees, which are additional costs for the guaranteed subsidiary, to the parent bank under the arm's length principle. Thus, the total amount of expenses with respect to the debt of the guaranteed subsidiary (*i.e.*, interest expense plus guarantee fees) would be the same as that of the non-guaranteed subsidiary. As a result, the pre-tax profit of the guaranteed subsidiary would be the same as that of the non-guaranteed subsidiary, and the tax levied on both subsidiaries would be the same. This means, in other words, that the tax results of both subsidiaries would be almost the same, being based on their ratings in the end, irrespective of the guarantee.

21. The borrowing terms of the branch PE, to which no "free" capital is attributed, would be better than that of the subsidiary because of the former's credit rating, which is the same as that of the whole bank, although the branch PE has to fund all the debt, the amount of which is the same as the asset. On the other hand, the subsidiary would need to fund only the debt, the amount of which in this case is the same as the asset minus the capital, although the borrowing terms are worse than those of the branch PE. In this way, the interest expense of both the subsidiary and the branch PE would be almost the same, and the pre-tax profits for both of them would in practice be almost the same.

22. However, if the WH were applied to example 1 above, the profit of the branch PE interpreted according to the WH for tax purposes would be more than that of the guaranteed subsidiary (or the non-guaranteed subsidiary) as defined by the WH for tax purposes. The allowable deductions of the branch PE for tax purposes would be less than those of the guaranteed subsidiary (or the non-guaranteed subsidiary) for tax purposes under the WH. This is because not all the interest expense of the branch PE would be allowed to be deducted for tax purposes since "free" capital is to be formally allotted or endowed to the branch PE. Thus, the profit interpreted according to the WH of the branch PE would be more than that of the guaranteed subsidiary (or the non-guaranteed subsidiary), and the tax levied on the branch PE would be more than that of the subsidiary under the WH.

Example 2

23. Suppose that there are (i) a subsidiary and (ii) a PE as a bank branch ("a branch PE"), both of which carry out the same operation under the same conditions, and that the risk weight of the subsidiary's and the PE's assets are both lighter than the average risk weight of the whole bank.

24. The interest expense of the subsidiary would be less than that of the branch PE because the credit rating of the subsidiary is better than that of the branch PE and because "free" capital is allocated to the subsidiary. In this case, the subsidiary would not pay any guarantee fees to the parent bank because the credit rating of the subsidiary is better than that of the whole bank. This would lead to a situation where the pre-tax profit of the subsidiary would be more than that of the branch PE.

25. However, if the WH were applied to example 2 above, the profit of the branch PE recognised under the WH would be more than its pre-tax one. This is because not all of the interest expense of the

branch PE would be allowed to be deducted for tax purposes as “free” capital is supposed to be formally allotted or endowed to the branch PE under the WH. This is in contrast with the profit of the subsidiary, both kinds of which would be the same as all the interest expense can be deducted in either case. Therefore, the tax levied on the branch PE would not be equal to that of the subsidiary. In addition, the bigger interest payment of the branch PE due to its lower credit rating than that of the subsidiary would result in unequal tax amounts between the branch PE and the subsidiary.

26. The consequences of example 1 and 2 illustrate that a discrepancy between the tax results of the subsidiary and the branch PE might well emerge if the WH were put into practice. This is a contradiction with the arm’s length principle, which is a basis of the WH.

27. Moreover, further discussion is necessary whether the same tax should be levied on the subsidiary and the branch PE, based on the WH’s assumption that “free” capital should be attributed to the branch PE and that only the PE’s assets and capital would be available to meet any claims against the PE.

28. In the case of example 1, there is no need to attribute “free” capital to the PE and to assess the credit rating of the PE based on the assumption made for tax purposes because profit under the arm’s length principle for both of the branch PE and subsidiary would be almost the same as indicated in example 1. Rather, as a result of applying the WH, the burdensome attribution of “free” capital and a more complex assessment of the credit rating would force the bank to pay additional but totally unnecessary and meaningless management costs.

29. In the case of example 2, if the capital would be attributed to the branch PE and the branch PE were assessed based on the assumption that only its assets and capital were available to meet any claims against it, the amount of the tax levied on both of the branch PE and subsidiary would be the same. Even so, the effective tax rate (*i.e.* the tax ratio to financial pre-tax profit) of the branch PE must be higher than that of the subsidiary because pre-tax profit of the branch PE is lower than that of the subsidiary. The result could affect the decision making of a business on whether an operation should be carried out by a subsidiary or a branch PE because there would be an advantage to use the subsidiary.

30. Such a difference in tax liabilities is due to the broader interpretation of the arm’s length principle applied to the branch PE, to which “free” capital would be attributed based on the assumption of the WH even though the arm’s length principle was originally and is usually applied to transactions between an enterprise and an associated enterprise that owns the capital.

Attributing “free” capital to the PE

31. In Article 9 of the OECD Model Treaty (Associated Enterprises), the arm’s length principle is applied to transactions between an enterprise and an associated enterprise that owns the capital but not to transactions between the PEs. A broader interpretation of the arm’s length principle is to apply it to the transactions by the PEs and to interpret the attribution of “free” capital to the PE, but this is not persuasive. The idea conflicts with the reality of a PEs’ functions.

32. The Discussion Draft suggests using the Basel Accord’s Risk-Weighted Standards for attribution of “free” capital to the PE, but we do not believe this to be suitable because the Accord’s Risk-Weighted Standards are very crude. Another adversity arising from paying insufficient attention to business reality is a potential situation in which risks that are offset from a pair of hedging deals between PE’s might emerge as two separate risks that can lead to the growth of greater undeductable interest payments in the end.

33. The Basel Accord is currently being modified to allow the use of a bank’s own inhouse credit-risk model, which risk-weighs assets on a portfolio basis, in lieu of the current risk-weighted

standards. This new approach, which would require a well risk-managed institution to have less capital, strongly suggests a shortcoming in the proposal because the attribution of “free” capital to the PE on the basis of the Basel Accord’s Risk-Weighted Standards would have no way to include the concept of portfolio.

34. Other subjects needing further discussion with respect to using the Basel Accord to calculate taxable profits, are:

1. Whether some adjustment should be made to the attribution of “free” capital to the PE in accordance with future changes, if any, in the Basel Accord.

2. Whether co-ordination should be made to make sure that the home-country regulatory framework in banking is consistent with the attribution of “free” capital to the PE, which is subject to worldwide capital standards.

Harmonisation with domestic tax rules

35. Many countries whose tax treaties with other countries are based on the OECD Model Treaty choose Article 23B (Credit Method), for elimination of double taxation, instead of Article 23A (Exemption Method). So long as all the tax levied on the profit of a branch of a multinational bank in the host country is allowed to be credited from the tax levied in the home country of the multinational bank on the worldwide profits (earned from all the operations) of the enterprise, there should be no double-taxation problem. However, because the domestic tax rule of the home country usually has a limit on the maximum amount of credit allowed for the tax levied in the host country from the tax in the home country, multinational banks could be often required to pay more tax than it normally would have to. Given this situation, if a new method were introduced based on the WH, in which the tax would be levied on profits attributed to a PE of a multinational bank as a result of the attribution of “free” capital to the PE, it would result in an even further increase of the tax burden on a multinational bank. Although the WH says that the “lack of a common interpretation and consistent application of Article 7 can lead to double, or less than single taxation,” the measures based on the WH could well cause an increase of the tax for multinational banks unless internal tax rules are amended and the interpretation of the WH is brought to be in harmony with domestic tax rules so as to eliminate any double taxation.

Conclusions

36. The application of the WH to the banking businesses, a hypothesis that is derived from Article 7 of the OECD Model Treaty (Business Profits), needs further development and consideration, because: (i) applying the arm’s length principle, which is stipulated in Article 9 (Associated Enterprises), to “dealings” between an enterprise and a PE seems to disregard the business reality of the PE; (ii) attributing assets to the PE, where operations are being performed, based solely on the PE’s function might cause a misapplication of Article 11 of the OECD Model Treaty (Interest); (iii) there seems to be an inappropriate application of the arm’s length principle to the assessment of the credit rating of the PE; (iv) attributing “free” capital to the PE might affect the decision making as to whether an operation should be carried out by the subsidiary or the branch; and (v) under the current inharmonious situation of tax rules the WH could well cause an increase of the tax for multinational banks.