

**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)**

KPMG

Introduction

1. KPMG welcome the OECD’s Discussion draft on the attribution of profits to permanent establishments (“*Discussion Draft*”) and is grateful for the opportunity provided to respond to the proposals it contains. This response has been prepared by the KPMG Bank Tax Group with specific reference to Part II of the *Discussion Draft*, i.e. in relation to internationally operating banking enterprises. While many of our comments may be of general application, we believe special considerations apply to the banking sector and it is therefore appropriate to deal with these separately.

2. The attribution of profits to permanent establishments is an area of difficulty where our clients face a constant risk of double taxation. Therefore, we applaud the OECD’s efforts in opening up the topic for debate. By coming forward with concrete proposals to modernise the approach as to how the principles embodied in Article 7 of the Model Tax Convention are to be applied in practice they have created an historic opportunity to achieve a degree of consensus amongst the OECD which must not be lost. It is important, therefore, that the momentum is maintained following the issue of the report and that the discussions do not lose sight of the overall objectives through an over-concentration on detail.

3. In our view the final approach to be adopted needs to meet three key overriding objectives:

- (i) It should minimise double (or less than single) taxation.
- (ii) It should be relatively simple to operate in practice. The more complex the approach the higher the risk that the primary objective of minimising double taxation will not be met.
- (iii) Finally, taxpayers should be given certainty that the critical elements of the new approach will be accepted by their local tax authorities. Again, the risk of double taxation will increase significantly if local tax jurisdictions ignore the final result in practice or choose to apply it in an idiosyncratic way.

4. Whilst we believe that the working hypothesis (“WH”) and the approach adopted in the *Discussion Draft* is a large step forward to achieving the above objectives we have concerns about some of the detail of the proposals. We have elaborated further on these concerns below but would like to emphasise at this stage that our primary concern is that some of the suggestions made in the *Discussion Draft* will lead to a very high compliance burden upon taxpayers. The compliance burden risks making the proposals unworkable in practice and will not guarantee that double taxation will be avoided as the very detail means that there is considerable scope for disagreement between the various tax authorities. Our clients have made it clear to us that this is their key concern in respect of the *Discussion Draft*.

Executive Summary

5. The issues under discussion are complex. It is recognised that there are no easy solutions and it is easy to lose sight of overall objectives through over-attention to detail. Before any changes to the existing regime are adopted they need to be assessed objectively to see if they are likely to reduce significantly the risk of double (or less than single taxation). If this test is passed satisfactorily the proposed changes need in addition to pass the test of practicality. Can they be implemented in practice without imposing a disproportionate compliance burden compared to the anticipated benefits? If not, they should not be implemented.

6. The proposals need to achieve consensus but at the same time need to be clear enough on the specific details to prevent individual tax administrations from developing differing interpretations as to how the rules apply in practice. If this is not achieved taxpayers will still face uncertainty and the risk of double taxation.

7. We accept that the separate enterprise principle is the logical way to approach intra-entity transactions and welcome the rejection of the “force of attraction” principle. However, if this is to be applied in practice, further work needs to be done. Firstly, the *Discussion Draft* does not provide enough specific detail on when “dealings” are recognised. Further work needs to be done in this area and more specific guidance needs to be given. This problem is particularly acute in the context of global trading and this should be borne in mind when testing the application of the Working Hypothesis (“WH”) to global trading. In particular, global trading increasingly tends to centralised booking and the interaction of capital allocation, split functions and the recognition of internal dealings needs to be carefully evaluated.

8. Secondly, it would be extremely unfortunate if the application of the separate enterprise principle leads to an enterprise being unable to obtain a deduction for the costs incurred in the course of its business. We have a concern that this might happen in practice – for example, if the “independent enterprise” test is applied too rigidly to head office costs. Just as (from the standpoint of the fiscal authorities) an enterprise should be subject to tax on the sum of its worldwide income, it should equally have the opportunity to obtain a deduction for costs it has incurred in order to earn that income. It would be inappropriate if the WH was interpreted by tax authorities effectively as giving them the right to assess how efficient a company was and thus by extension seeking to strike out legitimate costs simply on the grounds that they were excessive compared to those which a more efficient company would have incurred.

9. The use of the Basel Accord to allocate capital for tax purposes to branches of banks needs to be explored further. We would strongly recommend that regulatory specialists who have detailed knowledge of the records currently kept by banks to meet their regulatory requirements need to be involved in this work. Our preliminary view is that a modified version of the suggested approach might be workable in practice. The modifications are as follows: first, capital should be allocated based on booked assets. The requirement for detailed functional analysis to determine where assets belong for the purposes of allocation of capital should be abandoned. Clearly, tax authorities should be able to reallocate assets to branches which have been booked elsewhere solely for tax purposes. However, the assumption should be that the calculation should be based on the assets recorded in the branch accounts. Second, off balance sheet items should be ignored for the purposes of this calculation. Finally, the attribution of the entire enterprise’s capital may produce inappropriate results and adjustments should therefore be possible.

10. The use of a “safe harbour” as a simple alternative to reduce compliance costs should be considered. This approach is currently adopted by several countries. Banks should be able to opt for this alternative, which is accepted as being a rough and ready solution, in order to avoid the compliance costs of attempting to allocate branch capital based on the more sophisticated approach suggested in the

Discussion Draft. Such a safe harbour could abandon detailed consideration of Tier 1, Tier 2 or hybrid capital and simply adopt a measure of 4-6% of booked assets as free capital.

11. We have concerns as to the legal consequences of some of the proposals in certain jurisdictions and in particular whether there are real issues as to non discrimination between branches and subsidiaries in an EU context. Arguably, for example, the proposal to attribute the credit rating and a relevant proportion of the total capital to a branch, when these would not naturally be available to a subsidiary without payment of guarantee fees, could be regarded as discriminatory against a subsidiary. There are also arguments that the suggestion for the allocation of capital to bank branches could be regarded as a violation of the Second EU Banking Directive. The OECD should explore this issue before finalising the proposals as it would be counterproductive to implement a proposal which is subsequently found to be contrary to EU law.

Detailed Observations on the Working Hypothesis

Separate enterprise principle

12. Subject to certain concerns set out below, we welcome the theoretical approach set out in the *Discussion Draft* which is that profits should be allocated to permanent establishments based on the arm's length principle and we welcome the rejection of a 'force of allocation' principle. As the *Discussion Draft* notes, the impact of globalisation means that many banks operate increasingly on a global business line basis across branches and head office rather than each branch operating as a self contained unit. The pace of globalisation means that this trend is likely to intensify with time. As a consequence, it is becoming ever more important to establish tools, which are generally acceptable to tax authorities across the world, to divide up the profits of individual business lines between the various branches engaged in the particular business line. The separate enterprise model and the arm's length principle are the natural tools to use. The guidance to the application of these principles as set out in various OECD documents (culminating in the *1995 OECD Guidelines*) is now well embedded in practice and we do not see particular difficulties in extending these principles to the allocation of business line profits between branches. Therefore, on this basis, the use for example of the cost plus or TNMM methodologies which result in a mark-up on costs being allocated to or from a branch should not be rejected on the grounds that it is not appropriate to charge a mark-up on costs between different parts of the same legal entity. A corollary of this is that a permanent establishment could, based on the functions performed in that location, have taxable profits where the bank as a whole or a particular business line as a whole registers a loss.

13. However, in order to apply the WH in practice much clearer guidance is required as to what is meant in practice by internal "dealings". The *Discussion Draft* does acknowledge (II-98/104) that it is possible to transfer assets (and the associated reward) between branches but shies away from acknowledging that this is acceptable where there has been no transfer of "people functions". In other words, if we take the standard phraseology from the *1995 Guidelines*, it seems to place little weight on "risks assumed" compared to "functions performed". This seems contrary to the WH. It also seems to prejudice a branch as opposed to a subsidiary. This approach is even less explicable given the fact that there is a well developed secondary market for loans and it is standard practice for banks to lay off risk on loan portfolios (without any transfer of people functions) by way of credit derivatives. Part of the reason for this seems to be a concern on the part of certain tax authorities that placing any weight on risk will open the door to widespread tax avoidance through artificial tax driven "dealings". However, the result of this is that the *Discussion Draft* as it currently stands has a slightly distorted perspective. It must also carry with it a high risk of double taxation in that there are likely to be frequent situations where one jurisdiction refuses to recognise the "dealing" on the ground that "people" functions have not transferred whilst the recipient jurisdiction accepts the transfer on the grounds that there has been a "dealing" at arm's length between the

two branches. The better approach (and the approach closer to the WH) is to work from the assumption that all arm's length dealings between branches should be accepted unless it can be demonstrated by the tax authorities that they are clearly artificial transactions enacted for purely tax avoidance reasons. The burden of proof should clearly be on the tax authorities to demonstrate that this is the case. At the very least the *Discussion Draft* must give much clearer guidance to when "dealings" should be recognised and what is meant by the phrase "risks assumed" in the context on intra-branch transactions.

14. Whilst in general the WH is recognised (subject to the comments above) as a sensible approach to the allocation of income between branches, we have certain reservations in respect of the application of the approach to Head Office costs. The standard current approach to Head Office functions is to allocate out the costs to the various branches on an 'indirect key' approach. Whilst almost inevitably, there are disputes between the tax authorities of the host jurisdiction as to the operation of the allocation factors or keys, the absolute level of costs incurred by Head Office (and hence the knock-on effect on the amounts allocated around) is in our experience rarely challenged. One reason for this is that the costs have as a matter of fact been incurred by the legal entity in question and, subject to the respective tax treaties and the OECD Commentaries on the Model Tax Convention, it is generally accepted that in principle it is appropriate to allocate out those costs. We have a concern, which has been echoed by many of our clients, that the approach adopted by the *Discussion Draft* will encourage tax authorities in the branch host jurisdictions to challenge the allocations on the basis that the absolute level of costs borne by Head Office is too high and that as a result the charges out to the branches are, on a strict application of the separate enterprise principle, higher than a third party would have borne. Such approach would give rise to a high risk of double taxation particularly in exemption system countries and would be a highly undesirable outcome if it was put into practice. It would be desirable if the *Discussion Draft* explicitly stated that the WH should not be used to deny a deduction for expenses incurred by the legal entity simply on the basis of the absolute overall amount of those expenses. The *Discussion Draft* suggests, without going into great detail, that cost contribution arrangements ("CCAs") along the lines of those set out in Chapter VIII of the *OECD Guidelines* might be appropriate for these type of costs. Adopting the CCA concept to the branch situation might have certain advantages but this needs to be elaborated further. Again we would have a concern that forcing banks to put in place formal CCAs in respect of their Head Office expenses would place an undue compliance burden upon those banks without necessarily reducing the risk of double taxation.

15. Another outcome of the WH is the suggestion that the OECD Commentaries to the Model Tax Convention should be revised to allow a charge for the bank's name or other intangibles intra-entity. In theory we have no objection to this. However, applying this in practice is likely to prove to be fraught with difficulty. The WH suggests that intangibles will be attributed to permanent establishments based on use. However, it is likely that several permanent establishments could be deemed to use an intangible such as a bank's name or logo. It is by no means clear that 'use' is the most appropriate test for intangibles. For example, a brand name might more reasonably be regarded as 'owned' by Head Office unless significant costs of creating and maintaining the brand had been borne at branch level. Additionally, any calculation to arrive at what the charge (if any) for the use of the intangible should be is likely to be complex with a high risk of challenge in many of the jurisdictions which are the recipients of the charge. Given the high compliance costs and difficulties associated with such a charge, we would recommend that intra-branch charges for intangibles should be available as an option for the banks which are prepared to invest in implementing such arrangements but that they should not be seen as mandatory.

16. The *Discussion Draft* proposes that branches should retain the credit rating of a bank as a whole. This pragmatic approach is endorsed by most of our clients. However, as explained further below, one result of this may be that the application of the WH in practice will over-reward branches in comparison to subsidiaries. The proposal to allow charges for intangibles intra-entity without a physical cash charge being made could also be seen to favour branches. In the EU context any difference in treatment between

branches and subsidiaries runs the risk of being regarded as discriminatory and therefore contrary to EU law.

17. Another concern which has been raised by our clients is that the WH might be used as the justification for certain tax authorities to apply withholding taxes to intra-branch “dealings” for example on interest or royalties. This is clearly not appropriate since, as a matter of legal fact, these are purely means of internal accounting within the legal entity itself rather than legal binding transactions between two parties. In our view the final document should stress that the WH is only in point as a way of allocating profits to permanent establishments and does not in itself allow tax authorities to deem transactions to which withholding taxes can be applied.

Capital attribution

18. The WH preferred approach to attributing capital to a banking branch is, in essence, to attribute a proportion of the entire regulatory capital of the enterprise as a whole by reference to the value of branch assets in relation to total assets. Assets for these purposes would be attributed based on a functional analysis of where the assets are used. This is interpreted as the place where the sales/trading function leading to their creation was performed. Subsequent “dealings” may lead to the assets being attributed to other parts of the enterprise. Assets would be valued in accordance with the risk-weighting principles contained in the 1988 Basel Accord.

19. A constant theme in the *Discussion Draft* which underlies the choice of method for allocating capital is that it must conform with the arm’s length principle. In this regard we have two overriding concerns. The first is whether the WH adequately achieves a result which is in accordance with the arm’s length principle. The second concern is whether this approach over-emphasises a theoretical principle at the expense of important practical issues such as the avoidance of excessive compliance burdens and the likelihood of acceptance and implementation of the solution in individual countries.

20. We believe there are serious grounds for doubting whether the preferred approach accords with the arm’s length principle. The *Discussion Draft* itself seems partially to acknowledge this (e.g. II-85). This can best be illustrated by reference to the issue of credit rating. The *Discussion Draft* observes a direct link between the enterprise’s credit rating and the level of its capital (II-11). The draft further observes that a banking branch enjoys the same credit rating as the enterprise as a whole (II-38). Under the arm’s length principle, the branch must be hypothesised as a distinct and separate enterprise “engaged in the same or similar activities under the same or similar conditions” as the PE. This means that the branch must be hypothesised as a separate enterprise with the same credit rating as the banking enterprise as a whole. Even if it is a correct assumption to make that a branch enjoys the same credit rating as the bank as a whole (for example, if a bank has offices in London and Moscow, it is very unlikely that any external counterparties or the bank itself would perceive the risk profiles as being identical, particularly if the branches were subject to different exchange controls), it is highly questionable whether this can be achieved by a proportionate attribution of the enterprise’s capital. The fallacy in the *Discussion Draft* approach is to assume that the PE, *hypothesised as an independent enterprise*, with a proportionate level of capital, would enjoy a similar credit rating. This is because, as the *Discussion Draft* itself acknowledges, in the case of a banking branch, “potentially the whole of the bank’s assets and capital are available to meet any claims on the bank regardless of where the asset leading to the claim is located” (II-16). This is simply not the case with a hypothesised independent enterprise and cannot be replicated by capital being “harmoniously” or otherwise attributed as suggested in the *Discussion Draft*. In other words, a fundamental feature of an international banking enterprise is that the “sum is more than the parts”. In fact, the *Discussion Draft* implicitly acknowledges the difficulty of hypothesising a banking branch as a separate enterprise for purposes of attributing capital, in the context of the alternative “thin capitalisation

approach” where it states that “small independent banks may not be comparable to a PE that is part of a large banking enterprise” (II-67).

21. Although it may be argued that the above-mentioned problem could be rectified through the making of additional adjustments we suggest this would not render the preferred approach any more acceptable. Such adjustments might consist of, for example, upward adjustments to the interest rate charged to third parties (to reflect the assumption that the hypothesised independent entity does not, simply through pro rata attribution of capital, have the same credit rating as the branch) or to remunerate the head office by way of guarantee fee (to reflect the assumption that, for a combination of reasons, the hypothesised separate entity *does* have the same credit rating as the branch). From a technical perspective it may be questioned whether the ability to make such adjustments strengthens the arm’s length nature of the capital attribution: after all, in theory, given appropriate adjustments, the same results could be achieved, even in the absence of any capital attribution. From a practical perspective it may also be questioned whether this solution is desirable - for both taxpayers and tax administrations - given the potential for disagreement over the level of the adjustments to be made.

22. It may also be questioned whether an approach which implies rejecting the capital structure adopted by the taxpayer would accord with the principles of the OECD Transfer Pricing Guidelines (as adapted for the purposes of the *Discussion Draft*), to the effect that the tax administration “should not disregard the actual *dealings* or substitute other *dealings* for them” (II-104) (it seems clear that the exceptions to this principle referred to in the Guidelines at para. 1.37 would not normally be applicable). The attribution of actual capital on the basis of relative asset values also bears significant similarities to global formulary apportionment. Both approaches suffer from the fact they do not reflect a transactional approach. This means (as the *Discussion Draft* itself points out) that “in practice, it may be very difficult to achieve [an arm’s length] result” (I-179).

23. If the WH approach to attributing capital cannot be adequately justified in terms of producing an arm’s length result it should either be rejected for that reason or judged, in relation to other alternatives, by reference to other criteria. For the reasons already indicated we believe a more realistic approach would be to accept that the arm’s length principle is an inadequate tool to attribute capital and approach the issue in terms of other criteria. We would emphasise that, as already pointed out, this does not mean that the arm’s length approach is not appropriate in other respects or regards attribution of profits between the various parts of a banking.

24. The criteria which we would consider of greatest importance in evaluating capital attribution methods have been mentioned earlier: avoiding double (or less than single) taxation, simplicity, and acceptability. We question whether the WH described in the *Discussion Draft* adequately satisfies these criteria. Particular areas of concern include the method of allocating assets, risk-weighting of assets, and the fact that under the BIS ratio method, there is an allocation of the bank enterprise’s entire capital. These issues are discussed further below.

Allocation of assets

25. As already indicated, the preferred approach adopted by the *Discussion Draft* is that assets should be allocated on the basis of where the assets are “used”. In the case of the initial creation of a financial asset, “use” for these purposes is equated with the sales/trading function (II-51). Where this function is split between different parts of the enterprise (and “the significant” sales/trading function cannot be attributed to a single location) the WH proposes that the asset would be jointly owned. An alternative which is addressed by the *Discussion Draft* is to attribute assets to branches on the basis of where the assets are booked. This latter approach is the approach favoured by our clients.

26. Our clients have emphasised to us that practicality is vital to any agreed methodology for allocating capital to branches. In this respect the suggested approach in the *Discussion Draft* of performing a functional analysis on an asset by asset basis in order to attribute assets to branches (or even to split assets between branches where there are split functions) in order to arrive at a figure for tax purposes for which branch capital can be calculated is regarded by most clients as impractical and undesirable. The compliance burden from such an exercise will be extremely high and, even if such an exercise is completed, it will not remove the risk of double taxation as there will still be considerable scope for disagreement between tax authorities as to where assets should be attributed. Our clients take the view that the calculation should use records currently prepared by the bank as its basis. Therefore, the detailed functional analysis suggested in the *Discussion Draft* should not be adopted but rather the calculation should be performed using the assets shown in the accounts of the branch. We endorse this view. The exception to this should be if the tax authorities can demonstrate that there has been tax motivated booking of assets to distort the calculation. However, the emphasis must be on the tax authorities to demonstrate that this is the case.

27. We would also suggest that an approach based on the location of the sales/trading function arguably undervalues the significance of other functions (in terms of risk), in particular the credit committee function. In practice the split of risk between the various functions varies considerably between the different types of products. A rule attributing ownership to a single function would therefore be at best arbitrary. However, attribution on the basis of the booking location should not in practice result in artificially high or low profits being attributed to a particular location since, as the WH itself proposes, to the extent functions are performed in relation to the asset by other parts of the enterprise, part of the profit would in effect be used to reward these functions (II-121). Rejection of this approach on grounds of potential tax avoidance does not therefore seem adequately grounded.

28. Furthermore, use of the sales/trading function creates the possibility (acknowledged by the *Discussion Draft*) of joint ownership with its attendant complications (*e.g.* as regards income and expense attribution, apportioning relative asset values) and a mismatch between ownership for tax and regulatory purposes. Using the booking location does not suffer from these disadvantages.

29. In addition, as we have already indicated in relation to internal “dealings”, in attributing ownership to the sales/trading function the *Discussion Draft* appears to ignore the possibility of attribution on the basis of risk, *i.e.* the assumption of the profit and risk potential of an asset. While attribution of risk within a single legal entity is clearly a troublesome issue, the *Discussion Draft* does acknowledge its possibility (*e.g.*, II-149). Thus, while it does not seem unreasonable to reject the booking location for ownership attribution purposes (either at the time of creation or subsequently) where neither “people functions” nor risk is present, it would seem unreasonable to reject this where one (or both) of these factors is present. Although not entirely clear, the *Discussion Draft* appears to reject the booking location unless both these factors are present (II-101).

30. Finally, the *Discussion Draft* appears to overlook the possibility that in general a banking enterprise will book assets in a particular location for regulatory reasons and not for tax avoidance reasons. Adoption of the booking location to attribute ownership does not, of course, prevent individual countries applying their domestic laws (*e.g.* substance over form, general anti-avoidance, etc.) to combat cases of clear abuse.

Risk-weighting of assets and the use of the Basel Accord

31. Consistently with the perceived interrelationship between capital requirements and risk at the level of the enterprise as a whole, the WH (in all variants considered) proposes risk-weighting branch

assets to determine the amount of branch level capital. However, given the doubts raised above as regards the appropriateness of the arm's length principle - in which risk plays a key part - to determine branch capital attribution, it may also be questioned whether risk-weighting in fact achieves a more balanced result. In addressing this question it is important also to recognise the potential practical implications for taxpayers of risk-weighting, in particular in relation to the records required to be kept for regulatory purposes and the frequency with which these records would need to be updated.

32. The adoption of regulatory risk-weighting is of particular concern insofar as it means that off-balance sheet items will also be taken into account. This means either that capital may be allocated to such items (without necessarily being applied to finance an investment in particular assets), or that adjustments will be needed to remove such items. In the former case, this would result in a spurious allocation of capital for tax purposes, and in the latter case would be an unwelcome addition to the administrative burden.

33. We would further question what happens when there is a netting for regulatory purposes so that assets concerned are in effect attributed a nil risk-weighting? Similarly, what happens where the risk-weighting has been reduced because of collateral held elsewhere within the enterprise? Not only is this likely to give rise to complicated adjustments to the regulatory records but in a worst case would render the regulatory records unusable. In this respect, the anticipated changes being considered to the current Basel Accord, which would take account of portfolio risk profiles and effectively break the direct link between specific assets and risk, should be taken into account. Moreover, in some cases, banks may already be using internal models in order to determine capital requirements in respect of credit and operational risk (instead of the "standardised" approach under the Basel Accord) and in such cases the branch would be required for tax purposes to maintain separate, additional records to record risk weighted assets. A tax solution which relied on records which are not sufficiently correlated with those required to be maintained for regulatory purposes would appear at the very least of questionable merit. In this respect the WH would seem to require more research and testing.

34. It appears also to be the intention that risk-weighting would be applied to intangible assets (II-10). However, it is difficult to see how this would be achieved in a workable fashion in practice since there is no clear accounting framework for valuing internally generated intangible assets and, even where such assets are externally generated, the regulatory treatment is for them to be deducted from the regulatory capital base rather than include them in risk weighted assets.

35. If it is decided, after taking into account the comments on the *Discussion Draft*, that the use of Basel measurements is to be pursued, it is vital that regulatory experts with detailed knowledge of how the existing Basel Accord is applied in practice (and how the proposed revisions to Basel are likely to work) are involved in working on the detail of the proposals. The detailed knowledge that they can bring to bear in respect of the regulatory requirements (in particular as regards the records that banks maintain in order to meet those requirements) will be invaluable. Applying such knowledge will be essential in order to arrive at an approach which can be implemented in practice without excessive compliance costs.

Attribution of total capital under the BIS ratio approach

36. The approach to capital attribution advocated under the WH would have the effect of allocating the bank's entire capital between the various parts, including "surplus" capital which is often centrally managed and in practice is not always used to support branch operations. Such capital may be maintained for a variety of reasons, *e.g.* because the head office regulator sets capital requirements over and above the minimum required under the Basel accord, to maintain the overall credit rating of the bank, in anticipation of future actions (such as a particular acquisition or general growth of operations), to take advantage of

market conditions for raising capital, to maintain a safety margin over the regulator's minimum to reflect market volatility, etc. An unqualified allocation of such capital to branches for tax purposes would not appear to reflect economic reality and in effect over-reward branches for their function thus producing distortions including possible double taxation. The particular outcome would be influenced to some extent by the question whether the home country applied an exemption or credit method of relieving double taxation. Although these results could partly be mitigated by additional adjustments in the same way as suggested above in relation to credit rating (e.g. through higher interest rates and/or guarantee fees) the already mentioned potential drawbacks of such solutions would remain.

37. Insofar as actual capital is allocated the *Discussion Draft* addresses the question whether this should be done on a solo or consolidated basis, and expresses a preference for a solo basis. Since many banks tend to focus the management of their capital on a consolidated basis (the emphasis can vary from country to country) this may well lead to distortions as well as generating additional compliance burdens. Moreover, it is not clear how deductions from Tier 1 and Tier 2 capital required under the Basel accord should be treated in the attribution of capital, e.g. intangibles, investments in banks and investment firms, investments in subsidiaries: some deductions are made at Tier 1 level and some at Tier 1 plus Tier 2 level.

38. As already indicated, one of the most important considerations in dealing with capital attribution should be its chances of general acceptance and uniform implementation by countries around the world. In this respect it should be recognised that not all countries are members of the OECD, and those which are do not universally subscribe without qualification to OECD recommendations. The possibility of conflicts with other bodies of rules should also be recognised and calculated into any final proposals on this issue. In this respect it should be noted that there are arguments that the proposed mandatory allocation for tax purposes to EU branches may contravene EU law (in particular the Second EU Banking Directive (89/646/EEC)) where the bank itself is resident in an EU member state. It would seem wise to investigate the legal position in greater depth to avoid a solution which proved contrary to EU law and therefore inapplicable in many situations. A factor which will weigh heavily in determining how willing countries are generally to embrace a solution to this problem is the extent to which it diverges from existing law and practice. This will affect not only the superficial attraction of any proposed solution but will also have a practical bearing on the time it is likely to take to revise domestic rules (our estimates in some cases range from 3 to 10 years in some cases) as well as the uniformity and effectiveness of the subsequent implementation of the solution. In this respect we would refer to the attached *Annex* prepared by the KPMG Bank Tax Group. This is intended to give a general indication of the current position in a number of selected countries. It is clear from this survey that there is a significant divergence between the current position and that advocated in the *Discussion Draft*. In our view the extent of this divergence is so great as to prompt serious consideration of alternatives.

39. As a final comment on the use of the BIS ratio in relation to the entire capital of the bank enterprise we raise the question what happens where the capital attributed in accordance with the WH is less than the actual allotted capital. While the *Discussion Draft* focuses on downwards adjustments of interest expense where the amount of capital actually allotted to the branch is less than the amount computed in accordance with the WH (II-90), it does not deal with the corollary of this whereby upwards adjustments should be permitted where the amount of capital actually allotted to the branch is more than the amount computed in accordance with the WH. It is assumed that such adjustments would in fact be permitted under the WH. The further question then arises as to what interest rate to use. In this respect, the Canadian approach (see attached country survey) is instructive in view of the fact that an upwards deduction would be permitted based on the Bank of Canada rate (this presumably being based on the desire for easily verifiable amounts and avoiding the need to use judgement). However, further work may be needed to identify the most appropriate solution here.

Alternative approaches

40. It follows from the above, that a modified form of the WH may, depending on the outcome of further research, in particular as regards the regulatory records and requirements, be workable. A number of modifications would appear to be essential in this regard. In the first place, attribution of capital should be based on booked assets. The requirement for detailed functional analysis to determine where assets belong should be abandoned. Clearly, tax authorities should be able to reallocate assets to branches which have been booked elsewhere solely for tax purposes. However, the assumption should be that the calculation should be based on the assets recorded in the branch accounts. In the second place, off-balance sheet items should be ignored for the purposes of this calculation. Finally, adjustments should be made so as not to attribute “inappropriate” worldwide capital to the branches.

41. On the basis of the selected country survey (see *Annex*), it may be surmised that countries do not as a general rule apply risk-weighting. In this regard, the Canadian experience is again instructive in that, under recently introduced legislation, asset valuation is required no less frequently than every 31 days and, further, risk-weighting appears to have been rejected for these purposes (although it has been retained on an annual basis for certain purposes). The survey also indicates a tendency to favour a simple “fixed percentage of branch assets” approach. The combination of these two features has evident advantages in terms of simplicity and local acceptance. While it still requires branch level asset analysis the absence of risk-weighting and the fact that this analysis is limited to the branch level (*i.e.*, each branch is not required to carry out this exercise for the assets of the bank as a whole) has clear advantages in terms of compliance. The potential for double taxation under this approach is, however, acknowledged. This may arise where, for example, the approach results in more capital being attributed than the enterprise’s total capital. This risk is also referred to in the *Discussion Draft* in relation to the thin-capitalisation approach. Double taxation may also arise where, for example, different countries take a different view as to the appropriate percentage to apply. While this is an evident risk, this is where consensus at OECD level should help in mitigating its effects. Double taxation may also arise where different countries were to take differing views as to the assets which are attributable to a particular branch. The potential for disagreement on this aspect would, however, seem to be minimised by allocating by reference to the booking location, as advocated in greater detail above.

42. An important issue to which passing reference is made in the *Discussion Draft* is the use of safe harbours. It can be seen from the attached country survey that safe harbours are by no means unknown in this area. A safe harbour approach could go a long way to resolving many of the problems alluded to in this response, in particular as regards the compliance aspects. It may also help reduce the risk of double taxation under the approach discussed in the previous paragraph. However, it may also merit consideration in relation to other methods, including the thin capitalisation and quasi-thin capitalisation approaches referred to in the *Discussion Draft*. A safe harbour approach would have the additional merit of giving taxpayers the flexibility to apply more sophisticated methods such as that of the WH (adapted as necessary to take account of the reservations expressed above) if these would produce a more appropriate result.

43. A simple safe harbour would eliminate the complexities of calculating surplus capital, Tier 1, Tier 2, Hybrid Capital etc, but could be based on a reasonable percentage of assets of the branch (say 4-6%) to be regarded as the free capital of the branch. Although this would be a rough and ready solution it would provide the vast majority of banks with a cost effective solution which could more easily secure international consensus and avoid double taxation. Arguably it could also be regarded as more in line with the arm’s length principle by treating the branch (albeit on a simplistic basis) as a separate enterprise rather than allocating a proportion of the bank’s overall capital.

Annex

**Selected country analysis of branch capital attribution
(not including countries with no clear branch capital attribution requirement)**

Country	Basic approach	Risk-weighting ?	Factor	Safe harbour?	Formal rules?
Australia ¹	(a) % branch assets (b) Arm's length ²	(a) Yes (b) No ³	(a) Fixed ratio (4%) (b) N/A	Yes (a)	Yes
Austria	% branch assets	Yes ⁴	Fixed ratio (8%) ⁵	No	No
Canada	% branch assets	No ⁶	Fixed ratio (5%) ⁷	No	Yes
France	% branch assets	Yes	(a) Fixed ratio (8%) ⁸ (b) Cook ratio	No	No
Germany	(a) % branch assets ⁹ (b) Arm's length ¹⁰	No	Degrressive ratio	Yes(a) ¹¹	Yes ¹²
Ireland	% branch assets	No	Host country regulatory ratio (8%)	No	No
Japan	% total capital ¹³	No	Head Office regulatory rules	No	No
Netherlands	% branch assets	Yes	Home country regulatory ratio	No	No
United Kingdom	Actual branch capital ¹⁴	No	N/A	No	No
United States	% branch assets	No	(a) Fixed ratio (7%) (b) Actual worldwide liabilities/ worldwide assets	Yes (a)	Yes

Notes:

1. This analysis is based on government announcements concerning the proposed thin capitalisation regime which is to apply from the start of a taxpayer's first tax year beginning after 30 June 2001.
2. A minimum capital amount based on specific factual assumptions.
3. In determining a minimum capital amount, risk-weighting of assets may be relevant but is not decisive.
4. In relation to Austrian branches of German banks a degressive ratio is applied according to the (non-risk-weighted) branch assets.
5. In relation to Austrian branches of German banks and banks from other countries with which agreement is reached a different ratio may be applied.
6. Branch assets must be computed on a periodic basis throughout the year, where each period cannot exceed 31 days. No risk-weighting is required for these purposes. However, annual computation of risk-weighted branch assets is required for purposes of computing the minimum tax on capital.
7. In fact capital is attributed indirectly by limiting the amount of deductible debt to 95% of branch assets. To the extent that third party and documented head office loans are less than this amount interest may be deducted on a residual amount based on Bank of Canada rates. The ratio adopted is intended to reflect an assumed home country regulatory minimum.
8. Both approaches may be applied in practice. A less common approach is to use the actual ratio of the entire capital to balance sheet. However, the position is likely to change in the near future.
9. Applied in general to EU or certain treaty country inbound banks. For other inbound banks and in general for outbound German banks a quasi-thin capitalisation approach is applied (i.e. based on the host country regulatory minimum capital).
10. In the case of outbound German banks this takes the form of a quasi-thin capitalisation (see note 9).
11. Only in the case of inbound banks. For outbound banks, only the arm's length rule applies (see note 10).
12. This analysis reflects the rules for inbound banks (which are being phased out). In practice banks with their head office in Germany do apply other methods.
13. Minimum requirement under Japanese thin capitalisation rules. Otherwise actual branch capital applies.
14. Or, if higher, amount of deemed capital based on value of branch fixed assets.