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)

Swiss Bankers Association

1. The Swiss Bankers Association (SBA) appreciates this opportunity to comment on the proposed OECD Discussion Draft of the Attribution of Profits to Permanent Establishments (PE), as this topic is of significant importance to some of our members. Banks in Switzerland have traditionally tended to carry on their domestic business through branches rather than through subsidiaries and they have to a large extent operated in the same way in other countries. Subsidiaries are set up when required by local law or for other reasons where convenient. It does not appear that, normally, taxation has an important influence on the choice made by a bank to operate internationally through a branch or a subsidiary. Any changes to the tax treatment of branches, and especially in the degree of level playing field between branches and subsidiaries, is therefore of particular interest and concern to us and our members.

2. In view of the significant role bank branches have played and continue to play internationally, we somehow understand OECD's aim to came up with a consensus in interpretation and application of Article 7 of the OECD Model Treaty (Taxation of Business Profits), although SBA is not aware of any clear and urgent need for having a common interpretation.

3. Said so, we nevertheless agree with much of the contents of the Draft Report, and in particular the aim of harmonising the tax treatment of branches and subsidiaries with regard to profit attribution. We have therefore confined our comments to the two areas in which we believe further consideration is required before any proposals can be satisfactorily implemented, namely:

- Conceptual issues on capital allocation and credit rating attribution

- Practical issues on capital allocation.

4. These aspects are dealt with in turn below. We have attempted to keep our comments relatively brief and have therefore not included a separate executive summary.

Conceptual Issues on Capital Allocation and Credit Rating Attribution

5. The Draft Report states (at paragraph 138 of Part I) in relation to the working hypothesis ("WH") that:

> "Under the WH, the PE needs for tax purposes to have attributed to it an arm's length amount of "free capital", irrespective of whether any such capital is actually allocated to the PE. To do otherwise is unacceptable on tax policy grounds - the result is not neutral between residents and non-residents (it favours non-residents), does not follow the arm's length principle and, in jurisdictions with thin capitalisation rules, produces a discrepancy between the tax results of a branch and of a subsidiary carrying on similar operations."

6. We agree that a key objective should be to achieve neutrality between residents and non-residents (and that anomalies in tax rules which interfere with business behaviour should be avoided). However, in our view, the WH as set out in the Draft Report does not achieve this objective of neutrality, for the following reasons:

7. The Draft Report proposes that the "free capital" of an enterprise should he attributed to the various parts of that enterprise, this being necessary "to ensure an arm's length attribution of profits to the PE" (see paragraph 129 of Part I). In the context of banks, the Draft Report concludes that conceptually an arm's length approach should be used (*i.e.* a "thin capitalisation approach" attributing to the PE the capital which it would have if it were an independent enterprise); however, it is proposed that in practice a BIS ratio approach should instead be used as a proxy, except where this would give a markedly different result from that which would apply under the arm's length principle (in which case the latter would need to be used, *e.g.* reverting to a thin capitalisation approach) - see paragraph 86 of Part II. We understand the underlying rationale behind all of this, *i.e.* the extension of the arm's length principle to capital allocation and the use of the BIS ratio approach as a proxy unless clearly inappropriate.

8. However, we further considered whether the Draft Reports proposals on credit rating attribution are consistent with the above. We have to say that, in our view, they are not. Part II of the Draft Report suggests that the hypothesised distinct and separate enterprise should be deemed to have the same credit rating as the bank as a whole. This is clearly the actual position; however, it does not reflect the notional separate entity hypothesis underlying the arm's length principle which is proposed to be applied for capital attribution purposes. If it is proposed that the arms length principle (*i.e.* notional separate entity hypothesis) should be adopted for capital allocation purposes, then we can see no justification for not doing so in exactly the same manner for the purposes of attributing a credit rating. We therefore believe that the WH contains a logical flaw which means that the stated aim of neutrality between residents and non-residents will not be achieved.

9. Let us take, as an example, the situation of a UK Branch of a multinational bank. Under current law, it is true that the UK Branch may have attributed a smaller amount of free capital to it (*e.g.* based on fixed assets etc) than would be the case under a BIS ratio type approach, or than the level of capital which would be injected if the operations were carried on through a subsidiary instead. The Draft Report suggests (at paragraph 49 of Part II) that this "is unacceptable on tax policy grounds - the result is not neutral between residents and non-residents (it favours non-residents), does not follow the arm's length principle and produces a discrepancy between the tax results of a branch and of a subsidiary carrying on similar operations." However, this fails to recognise the quid pro quo for this position, namely the considerable benefit to the results of the UK Branch (and hence the UK Revenue) from the fact that the UK Branch is entitled to be funded from its Head Office at the banks overall (low) funding rate. If the activities were instead carried on through a subsidiary, capitalised with the same amount of capital as under a BIS ratio type approach, then the appropriate funding rate on its borrowings from the parent bank would probably be considerably higher than the parent banks funding rate. We suggest that it is inappropriate to take this into account in arriving at a WH designed to achieve neutrality between branches and subsidiaries.

10. In summary therefore, it appears to us that in many instances:

- The result of applying the proposed WH is the attribution of additional income to the overseas Branch (*e.g.* UK in the example above), giving broadly the same result regarding capital as if operations were carried on through a subsidiary;

- Importantly, however, the WH (as it currently stands) does not allow for the same credit spread (interest margin) to be charged by the Head Office to the Branch on its borrowings as would be appropriate in the case of a subsidiary, such that neutrality is *not* achieved;

- The WH may therefore encourage banking groups which currently operate through a branch structure to restructure and carry on their overseas activities through subsidiaries instead, in order to allow an appropriate level of funding to be charged on borrowings from the head office (*i.e.* an arm's length interest rate based on the creditworthiness of the subsidiary). This may be commercially undesirable and, in our view, it is wrong for tax rules to interfere with business decisions in this way;

- The result of such a restructuring may well be that the Revenue authority in the overseas jurisdiction concerned in fact ends up in a worse position than under the current approach, on the grounds that the additional funding costs in the subsidiary may well outweigh the additional revenue earned from being separately capitalised.

11. We do not mind whether

- the existing position is maintained (*i.e.* recognising that branches are conceptually different from subsidiaries, without their own independent capital but benefiting from a lower funding cost due to the higher credit rating), or

- the tax treatment of branches and subsidiaries is aligned by applying the arm's length principle across the board.

12. However, we do not think it is right to have a mixture of the two which, for the reasons given above, we believe is the case under the WH set out in the Draft Report.

13. We note the concerns outlined at paragraphs 36/37 of Part II that the attribution of a different credit rating to a branch could result in loss-making transactions in the branch (*e.g.* if the branch continued to evaluate and enter into transactions on the basis of the entity's overall lower funding rate). However, in our view, the answer to this concern is not to accept only a partial application of the arm's length principle, but rather to ensure that proper transfer pricing arrangements are in place to reflect the fact that the transactions produce a profit for the entity overall. So, for example, let us take the factual scenario set out at paragraphs 36/37 of Part II, *i.e.* where the Head Office borrows at 4.95%, the Branch lends at 5.05% and the arm's length funding rate of the Branch if it was a distinct and separate enterprise, would be 5.1%. It is obviously true that if the Branch, borrows from its Head Office at 5.1% and on-lends at 5.05%, its starting point is a 5 bp loss. However, in our view, transfer pricing principles would then require one to recognise the fact that the Branch has entered into the transaction to benefit the entity as a whole (*i.e.* because the 5 bp loss in the Branch is outweighed by the 15 bp profit in-the Head Office) and hence that in an arm's length situation the Branch would charge the Head Office a fee for entering into such a transaction. In other words, part of the 15 bp would be payable as a fee by the Head Office to the Branch, thus leaving the Branch with an overall profit from the transactions. We would suggest that this type of analysis adequately addresses the concerns expressed in the Draft Report and is preferable to the current proposal of simply not applying the arm's length principle to inter-branch lending (as a result of not attributing a separate credit rating for such purposes).

Practical Issues on Capital Allocation

14. We comment below on some of the practical issues arising from the capital allocation proposals if a BIS ratio type approach is indeed adopted. We consider it most important that:

- The rules should be straightforward to apply in practice and should not require a separate set of accounting records to be maintained (nor time-consuming or costly systems changes);

- The rules should allow for complete symmetry between jurisdictions so as to ensure that the objective of no double taxation (or less than single taxation) is met;

- There should be a large degree of specificity in terms of how the notional capital allocations and any associated tax disallowance/deductions are to be measured.

15. We deal with each of these in turn below.

16. With regard to the first point, if a banks systems are set up to measure risk weighted assets ("RWAs") on a global portfolio basis (*e.g.* to satisfy regulatory capital requirements on entity-wide basis), then we would note that it may not be at all straightforward to make a geographical allocation of RWAs. The position will be even further complicated if a "split' capital allocation method is to be used for certain lines of business where the functions are carried out in more than one location (*e.g.* where a profit-split transfer pricing method is used). In our view, the Report needs to give clear and specific guidance on the capital allocation principles to be followed in such circumstances. Whatever method is adopted, we think it is important that no requirement should be imposed to maintain a further set of accounting records reflecting an adjusted balance sheet for tax purposes (*i.e.* extending transfer pricing profit-split principles from purely income allocation to a balance sheet allocation of RWAs), given the level of additional administrative burden which would result. We would urge that the rules be made as straightforward as possible and that full consideration be given to the possible systems changes (*e.g.* in IT architecture) that may be required by banks in order to implement a BIS ratio type approach. In particular, we consider that the requirement for any such changes should be kept to an absolute minimum and there must be a significant lead time before any new rules are introduced.

17. Turning to the second point above, it is obviously critical that the capital attribution rules should work symmetrically, *i.e.* that the new regime should allow for a tax deduction in situations where a branch's dotation capital is more than would be required under the BIS ratio approach (as well as a disallowance where it is lower). Clearly banks will not be able to put exactly the right amount of dotation capital in their branches each year (indeed this will be impossible if RWAS are measured retrospectively), nor will they commercially want to have to vary the amounts of branch dotation capital at frequent intervals. Indeed, it may well be that a bank's preferred approach is to keep all physical capital in the head office and then simply suffer tax disallowance at the branch level and a corresponding tax deduction at the head office level. The rules therefore need to be applied in a symmetrical fashion at the level of both the head office and each of the various branches.

18. Finally, dealing with the last point above, the Draft Report is silent on many areas of detail as to how the new capital attribution rules will be applied in practice. We would suggest that if the risk of double taxation is to be reduced to an acceptable level, then there should be very clear guidance as to how the rules should be operated in practice. In our view, some of the aspects which need to be clarified in the Report are as follows:

- Does the new regime attribute income earned from the entity's capital, or simply disallow part of the PE's funding cost?

- If the answer is the latter, what happens if the PE is funding itself locally (*i.e.* externally)? Will the new rules mean that part of the PE's external interest cost is required to be disallowed?

- In what currency will the capital be attributed? Is it the currency of the entity's actual tier 1 and tier 2 capital, or the currencies in which the PE funds itself, or otherwise?

- What interest rates are to be applied in calculating any adjustment (*e.g.* overnight, term or other)?

- On what basis and how frequently are RWAs to be measured? At year end, or using a weighted average basis, or a simple average basis, or otherwise?

- How are internal transactions to be dealt with for RWA purposes?

- In calculating RWAs, what treatment should be applied where offsetting external transactions are dealt by different parts of the enterprise (*i.e.* where the transactions are in fact netted off for RWA measurement purposes)? For example, where Branch A has sold a swap to X and Branches B and C have each bought a swap from X, how is the benefit of the offsetting to be allocated for tax purposes between each of the Branches (it may not need to be for regulatory purposes)?

- How will RWAs be allocated where the results of an activity have been attributed between more than one part of the enterprise for transfer pricing purposes, *e.g.* under a profit split method?

- How will the potential future inclusion of operational risks in Basel 2 be accommodated within the new regime? We think it important that full consideration is given to the impact of this before any new tax regime is introduced.

Conclusion

19. As noted above, we are grateful to have had the opportunity of commenting on these proposals. You will appreciate from our comments above that we believe that some of the areas covered in the Draft Report require further consideration. We and our banks should be very happy to comment in more detail on these aspects if you would find it helpful and, if so, please do not hesitate to contact us.