



Business and Industry Advisory Committee to the OECD

Comité Consultatif Economique et Industriel Auprès de l'OCDE

Paris, 3 October, 2001

Dear Jeffrey,

The OECD Discussion Draft has been received by the BIAC membership with great interest, and BIAC commends the OECD on the scope and depth of the Discussion Draft in its analysis of the pertinent issues and questions involved in the taxation of Permanent Establishments; both as a general proposition (Part I: Development of a Working Hypothesis) as well as its application to the banking industry in which the PE approach is prevalent (Part II: Banks). We understand that additional drafts are being written to address the application of the PE concept in other areas (Part III: Global Trading; Part IV: Insurance). We look forward to the opportunity to provide input on these additional chapters.

As you are aware, the development of meaningful comments related to the PE issue requires a thorough examination by companies using the PE form. In the banking sector this applies not only within the traditional, but also in the business of the global trading of financial instruments. Additionally, today many banking institutions are engaging in both investment banking and the private banking business, which significantly contributes to their earnings. We recommend that this reality be recognised in the current and future parts of the Discussion Draft.

Outside of banking, many businesses would like to be able to adopt branch strategies, but at present are deterred by the uncertainties on the rules on attributing profits. There is also an outstanding need to deal with agency PEs.

Request for Consultative Process

Accordingly, PE issues are of great significance to both tax administrations and business. As the OECD moves ahead in developing the Discussion Draft into Guidelines and new language for Article 7 in the Model Treaty, we believe that an interactive dialogue between the OECD and the private sector is essential to the further development of work on taxation of permanent establishments being addressed in the project.

To complement the current process of submitting written comments on the Discussion Draft, BIAC suggests that a regular consultative process to address the key issues raised in the paper be established. Indeed this point is specifically raised in the Discussion Draft in paragraph 5, and BIAC stands ready to cooperate with the OECD in this regard.

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On this point, we recommend that consideration be given to developing a process similar to that of the technical advisory groups (TAGs) -- an established program of consultation between government and private sector experts, that would provide for a regular consultative process and information exchange to complement further development of the paper until it is complete. This consultation process also could be established on an informal basis.

The Views of Business: Key Issues

BIAC members strongly support the papers already submitted to the OECD on the Discussion Draft from the banking sector including from The Banking Federation of the European Union (EBF), The British Bankers' Associations (BBA), The Institute of International Bankers (IIB), The Swiss Bankers Association (SBA), and The Australian Bankers Association (ABA), and thus these submissions generally reflect the fundamental views of the BIAC membership.

In addition to these submissions, BIAC is pleased to submit additional comments from the United States Council for International Business (USCIB), which are attached.

With this in mind, there are a number of general points related to the Discussion Draft that BIAC members wish to highlight:

- BIAC urges the OECD and its members to refrain from adopting any new positions impacting a business carried on locally through a PE, before an international consensus has been reached on the appropriate tax treatment for a PE. In addition, careful consideration must be given to the lead time associated with such measures, particularly to allow taxpayers the opportunity to comply with them. The overriding objective of these principles is the avoidance of double taxation, based on a manageable, auditable, and consistent set of rules.
- BIAC continues to urge the continued applicability of the fundamental principles of the OECD Transfer Pricing Guidelines, espousing the arms length principle to transactions involving a PE and its head office, or between two PEs.
- BIAC supports the efforts of the OECD to create a level playing field and to ensure reasonable certainty and consistency with regard to the application of methods for attribution of profits to a PE for tax purposes. In this context, BIAC welcomes, as set forth in part one of the discussion draft, the decision to treat a PE as a "functionally separate entity" to refute the "force of attraction principle," and to recognise transactions between branches and head offices under the heading of "dealings." Tax administrations should not attempt to allocate profits or losses under any approach that is patently inconsistent with the arm's length standard. The Discussion Draft supports this approach, and BIAC commends the OECD for its clarity on this point.
- Subject to principles of general application, such as in "thin capitalisation," the existence and terms of "dealings" should be used based on branch books and prior written undertakings of the branch and not by analogy to what uncontrolled parties might have done or other "external" indicia. This is consistent with the Transfer Pricing Guidelines, which provide at paragraph 1.36 that tax examinations should be based on actual transactions and not on how the tax examiner thinks it should have been structured.

In addition to the above general points, BIAC members wish to highlight a number of specific issues. In the view of BIAC members, these are serious issues and obstacles, which need to be addressed by the OECD as the Discussion Draft is being revised.

- *Attribution of Assets According to Use*

Enterprises may consign assets to a related or unrelated foreign corporation to be used in producing goods. If the consignee uses the assets to produce goods for its own account, transfer pricing guidelines may require that it pay for the use, and realise profit attributable to the asset. However, no rent is due and no profit is realised if the consignee produces goods for the account of the consignor. The WH contemplates that a PE may be treated as the owner or lessee of an asset of the enterprise, but should be expanded to acknowledge that a PE may be a consignee, with the same tax consequences as a corporate consignee.

The place-of-use test is especially problematic when applied to intangibles. In general, the owner should be the party that bore the costs and risks of development. Exceptions may apply in the area of certain marketing intangibles. A cost-contribution arrangement should not be deemed to exist absent written undertakings or book entries from which the arrangement may be inferred. If a PE is using an intangible only to produce goods for the owner, the intangible should be treated like any other consigned asset, i.e. the PE should not be attributed profit rising from the intangible and no royalty should be paid.

A much wider recognition of traditional accounting and booking than is proposed in the Discussion Draft should be addressed, including the issue of recognition vs non-recognition of traditional financial accounting and booking of assets at the starting point of the attribution of profits to a PE, both in general, and specifically in the case of banks.

Issues include: taking into account head office costs, intangible assets, mobility of booking assets, and non-tax reasons; regulatory reasons; examination of the integration and portfolio approach; split functionalities that entail different owners of assets; and consideration of additional compliance burdens and the manageability of the assets.

- *Credit Ratings and the Functionalities of an Integrated Treasury and Funding Function Should be Further Addressed*

Issues that should be examined include: credit rating and internal funding trade-offs (recognition of dealings, treasury functionalities, source of credit rating) and free capital vs other soft factors with regard to credit ratings including: profitability, strategy, settlement and back office reliability, infrastructure -- both internal and external, etc.

- *Capitalisation Models: Thin Capitalisation vs Quasi Thin Capitalisation vs BIS Capital Model*

Without much discussion, thin capitalisation and quasi thin capitalisation are abandoned in the report in apparent favour of the BIS capital model. Further discussions are required on this issue, especially given the completely different objective of BIS regulatory capital (creditor's safety, safety of financial systems, etc.) as well as the existence of future developments (Basel II, market risk, operational risks, relying on international models and portfolio approach, home country regulator's flexibility leading to asymmetric treatment).

- *Attribution of Capital and Free Capital.*

From the banking perspective this is the most critical issue, which includes addressing the role of BIS Capital requirements as a regulatory framework with a different objective; risk weighted assets; on and off balance sheet items; definitions of capital (Tier 1 and 2), different consolidation methods (“solo” consolidation subsidiaries); and the issue of home vs host country treatment with possibility of asymmetries and double taxation consequences.

BIAC members note that BIS capital requirements are somewhat dated and are also recognised to be rather crude, and in fact are undergoing substantial revision. Roughly 100 comments were filed with the BIS regarding their various consultative papers. It is envisaged that the new rules should become applicable sometime around 2004. One interesting point is that the BIS gives some flexibility to home regulators. From a tax perspective it should be carefully considered whether and how to rely on a somewhat already outdated and crude approach.

BIAC appreciates the opportunity to submit these comments to the OECD. We are happy to respond to any questions you may have concerning this letter or the attached USCIB comments.

Sincerely,

A handwritten signature in black ink, appearing to read 'Richard Hammer', enclosed within a large, loopy, handwritten oval.

Richard Hammer
Chairman, BIAC