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MEMORANDUM

To: OECD Business Industry and Advisory Committee

From: United States Council for International Business

Re: OECD Discussion Draft on the Attribution of Profits to Permanent Establishment

Date: September 25, 2001

This memorandum contains the comments of the United States Council for International Business (USCIB) on the Discussion Draft on the Attribution of Profits to Permanent Establishment (Discussion Draft), which was released for public comment by the OECD's Committee on Fiscal Affairs on February 8, 2001. The USCIB is the United States affiliate of the International Chamber of Commerce, the Business and Industry Advisory Committee to the OECD, and the International Organization of Employers.

The USCIB's comments were prepared by a Task Force of USCIB member companies chaired by William W. Chip and Stephen Labrum of Deloitte & Touche. The Task Force operated within the USCIB's Taxation Committee's Tax Treaties Subcommittee, which is chaired by Henry J. Birnkrant of Alston & Byrd.

The USCIB commends the Committee on Fiscal Affairs for its work on the Discussion Draft, starting with the excellent historical summary of the rules for attributing profits to a permanent establishment (PE) under Article 7 of the OECD Model Tax Convention on Income and on Capital (Model Treaty) and the comprehensive survey of the different interpretations of these rules by treaty countries.

The USCIB generally supports the Discussion Draft's working hypothesis (WH), which treats a PE as a hypothetically distinct and separate enterprise, and also generally supports using the OECD Transfer Pricing Guidelines as the foundation for attributing profits to a PE. The USCIB also supports the approach, taken in the Discussion Draft, of testing the WH by considering its application to specific business situations and encourages the Committee on Fiscal Affairs to consider testing the WH in other such situations, such as when equipment is consigned by a home office to a PE

Because, legally speaking, PEs are not separate from the persons to which they are attributed, application of the WH to matters that are normally determined by legal contracts and instruments, such as funding costs, allocation of risk, and ownership of intangible property, is bound to be problematic. For those problematic matters, there may be a tendency to fall back to a "relevant business activity" approach, otherwise rejected by the WH, or to look for external indicators of what the legal relationship between the PE and home office "ought" to be. The USCIB believes that such approaches should be a last resort. In general treaty countries should recognize the relationship between the PE and home office that is established by the PE's books and records and by prior written undertakings so long as the arm's length standard and other principles of general application, including "thin capitalization" rules, are respected.

The following comments on specific paragraphs of the Discussion Draft bear the same numbers as the Discussion Draft paragraphs to which they refer.

Part I: General Considerations

A. Introduction

A. 3. The experience of USCIB members accords with the Committee's observation that there is a lack of consensus among OECD members on how to apply Article 7 of the Model Treaty. The lack of consensus can result in double taxation, but this is not the only concern. Uncertainty as to the applicable rules or likely outcome of potential disputes between treaty countries over interpretation of treaty provisions complicates and therefore hinders cross-border trade and investment decisions.

B. Determining the Profits of an Enterprise

B. 31. The USCIB agrees with the Committee that OECD members should agree to a single approach to attributing profits to a PE, and the USCIB generally supports the "functionally separate entity" approach on which the WH is premised. The key issues that arise under that approach are (1) the allocation of profits attributable to risk and to assets, (2) the degree to which "dealings" between the PE and home office are recognized, and (3) the potential for attributing profits to a PE when no profits exist. As explained in greater detail below, USCIB members believe that such issues are best resolved by accepting the PE's own financial accounting, if prepared in accordance with generally accepted principles, and by giving effect to written undertakings between the PE and home office, if consistent with the arm's length standard.

B. 33. The Committee correctly recognizes that uniform application of Article 7 will not always prevent double taxation if domestic sourcing rules are not consistent. The OECD should encourage its members to adopt consistent sourcing rules.

B. 36. While a truly "functionally separate entity" might realize a profit even though the enterprise of which it formed a part might have a loss, a PE is only to be attributed a share of the "business profits of the enterprise." Consequently, taxpayers should be permitted in appropriate circumstances to argue against attribution of profits to a PE on the grounds that the enterprise has no profits to allocate. The argument is especially cogent when the PE generates no revenue of its own and merely provides support service to a global enterprise that cannot cover its operating expense. Moreover, it should not be overlooked that, even under the arm's length standard, the amount of profit attributable to the PE may be adversely impacted by the fact that no profit is generated on the overall transaction. For example, service providers commonly adjust the prices of services rendered to customers in depressed industries and even to individual customers in economic distress.

C. Determining the Profits Attributable to the Permanent Establishment

C-1 Determining the activities and conditions of the hypothesized distinct and separate enterprise

C. 47. The WH, which USCIB generally endorses, requires determination of the functions performed, assets used, and risks assumed by the PE. Some USCIB members are concerned that attempting to apply the Guidelines to this determination by "analogy" to uncontrolled transactions between legally independent enterprises has a significant potential for controversy since the arm's length standard accommodates a range of potential results. These members believe that the best way to avoid such controversy is for tax authorities to give effect to the allocations of functions, assets, and risks reflected in the PE's financial accounting and advance written undertakings with the home office, so long as such accounting and agreements are reasonable and consistent with the arm's length standard. There should be little risk of tax manipulation when intracompany undertakings are consistent with the arm's length standard and are in place before potentially attributable profit or loss has accrued.

C. 49. USCIB members noted that a functional analysis alone will not determine whether the PE should be viewed as operating "by analogy" as a full-fledged distributor that assumes all the risks of distribution or as a "stripped" distributor with very little risk. Respecting written arrangements between the PE and the home office on the allocation of risk may be the most effective way to determine which of the two types of distributors should be viewed as comparables.

C. 50. Performing a functional analysis of a hypothesized distinct and separate entity is much easier said than done. USCIB members are concerned that such an exercise will be very difficult to do and strongly recommend more tests of the WH's application to other functional activities. For instance, how are simple items such as intercompany payment terms addressed in the absence of actual transactions?

C. 51. Some USCIB members are concerned that the attribution of activities to a PE other than those performed by the PE itself is a "slippery slope." These members believe that determining whether activities performed in the home country are performed "on behalf of" the PE is a very subjective exercise and that only those activities directly performed by the PE should be attributable to the PE.

C. 55. In applying the Guidelines by analogy, the WH adopts a "place of use" test for determining assets associated with the PE. Since, under the Guidelines, the amount of assets used can impact the amount of arm's length profit that should be assigned to the PE, the place of use becomes critically important. Some USCIB members are concerned that determining assets of the PE solely based on geographic location of the assets is inappropriate. Instead, they suggest that assets such as inventory held by a contract assembler ought to be treated in appropriate cases as merely consigned to a PE by the home office, in which cases the risk of obsolescence and costs of financing ought to be treated as retained by the home office. Such treatment would be appropriate where the PE maintains separate branch books that do not reflect the inventory or when the home office and the PE have entered into a written undertaking that the home office bears all the risk of loss associated with the inventory.

C. 56. "Deeming" the PE to assume risks inherent in functions conducted by the PE is a highly subjective standard for assigning profits attributable to risk assumption. The USCIB recommends that the WH recognize written undertakings between the PE and the home office that clearly state how the to the enterprise allocates risk.

C. 57 Some USCIB members are concerned by the inference that tax authorities are to determine the attribution of risk by "examining any internal data or documentation purporting to show how the attribution of risk has been made." In the case of agreements that purport to be legally binding, the existence of contradictory documentation is only relevant to whether the agreements should be respected for tax purposes. However, a PE and its home office cannot have legally binding agreements since they are a single legal personality. The function of agreements between a home office and a PE is not to bind the parties but to permit the taxpayer for management reporting and other internal business purposes to allocate assets, functions, funding costs, and risks in the same manner as independent parties. Where such undertakings are in place, they ought to be respected and not "second guessed" on the basis of other internal data or documentation that might be inconsistent. "Second guessing" will lead to document-intensive tax audits as tax authorities try to piece together from internal correspondence how the parties intended to share risks, which in turn may lead to unreliable and conflicting results. With respect to a purely internal transaction, how does one determine whether the author of a piece of internal correspondence had the appropriate authority to establish the relationship between the parties or whether the other party accepted the relationship the author was trying to establish? In a large multinational company, correspondence is often routinely drafted by employees who may not have the authority or the appropriate knowledge to make the statements or representations contained in that correspondence.

C. 59. Even when the allocation of risks based on the performance of functions is otherwise reasonable, taxpayers should be able to bring about a different allocation of risks through documentation that (a) is consistent with how independent parties might have allocated the risk, (b) is in place before the risk is assumed, and (c) provides for appropriate compensation to the risk bearer. Although the allocation of risk between a PE and its home office is inherently problematic given that they are not legally separate, a reasonable allocation can ordinarily be arrived at without a nonrebuttable rule that forces an allocation of risk based on where functions are performed.

C-2 Determining the Profits of the Hypothesized Distinct and Separate Enterprise Based On a Comparability Analysis

C. 69. The USCIB supports looking to accounting records as an initial indication of dealings. Separately established "branch books" should be a key indicator of the intended relationship of the parties.

C. 71. While the USCIB supports looking to contemporaneous documentation to determine the terms of a "dealing" between a PE and the home office, some standard needs to be applied to determine when internal documentation should rise to the level of setting the terms of a "dealing." For instance, when the parties are a parent and subsidiary, mere internal correspondence does not usually set the terms of a contractual relationship. A similar approach should be adopted for a dealing. Mere correspondence that would not rise to the level of an agreement between two separate legal entities should not be relied on to establish the terms of a dealing.

C. 73. It is not clear what standard would apply to determine when the conduct of the parties could be used to disregard the existence of a dealing even if such dealing were reflected in the accounting records.

C. 74. The importance of not disregarding actual "dealings" or substituting other dealings for them cannot be overly stressed.

C. 83. As previously noted, in lieu of relying solely on analogy to establish contractual terms between a home office and a PE, the WH should permit written understandings to be entered into by the home office and the PE that would set forth the terms for the dealings. Advance written understandings are a more reliable way to establish the terms of the dealings than internal correspondence that may not have been entered into with the appropriate authority or mutuality normally required for a written agreement between two legal entities.

C. 85. Consistent with the strict requirements in the Guidelines for a "bona-fide" cost contribution arrangement, the WH should only assume a cost contribution arrangement where clear evidence of intent to create a cost contribution arrangement is demonstrated by a contemporaneous written undertaking or an allocation of cost to the "branch books."

C. 91. Some USCIB members thought that a distinction should be made between a capital asset acquired by a PE for purposes of the PE's business and a capital asset acquired by the home office and provided to the PE to use for performing services for the home office. In the former case, the capital asset is being used in the PE's business and in such a case all of the profit from the use of that capital asset should be attributable to the PE. In the latter case, the capital asset arguably is being used in the business of the home office and not the PE.

C. 94-97. Absent a clear designation on "branch books" or a written undertaking evidencing a dealing, it may be difficult to distinguish the intent of the parties as to whether a capital asset should be treated as bought, leased, or rented by the PE from the home office. The treatment on the "branch books" or in contemporaneous written undertakings should therefore control the characterization of the relationship unless shown to be a sham. Some USCIB members noted that in addition to the three alternative uses of assets by a PE that are considered in the Discussion Draft, there are at least two others that are common in business transactions--a contribution for no charge and a rent-free consignment to manufacture products for the home office.

C. 103. The transfer of a capital asset by a home office to a PE should not automatically be deemed to give rise to gain or loss. As noted above the transfer could have been in the form of a contribution for no charge or a rent-free consignment.. In either case, it would seem inappropriate to trigger gain at the home office level at the time of the transfer.

C. 105. Once again, some USCIB members thought that a distinction should be made between the use of an asset to facilitate the business of the home office versus the use of an asset to facilitate the business of a PE. Where a PE uses an asset solely for purposes of performing services for, or supplying, the home office, it may not be appropriate to impute a lease or license.

C. 112. We strongly support the view that for purposes of attributing profits to intangibles, attributing intangible property to a PE solely by the location of the place of use, and then applying the cost allocation model contained in the commentary of the Model Treaty, is flawed. The economic owner of the intangibles should be the party that bore the costs and risks associated with the development of the intangibles. The determination of the economic ownership should be based upon a review of the facts of each particular case. The cost allocation model should only be adopted where the intent was clear to have the PE participate in the risks and costs of developing the intangibles.

C. 113, 116. These paragraphs imply that a PE using intangibles should be treated as either having bought, licensed, or jointly developed the intangibles. A party dealing at arm's length, however, might be provided intangibles for no charge where the party is a supplier or contract assembler for the owner of the intangibles. A distinction should be made between a PE using intangibles solely to supply or assemble product for the owner of the intangibles and a PE using intangibles to assemble product for itself.

C. 114, 115. The fact that a PE exists and is in the business of exploiting similar intangibles should not be a significant factor in determining whether the PE was, at least in part, a developer of the intangibles. The PE should only be viewed as a developer of the intangibles if there was a written undertaking expressly providing for a cost sharing arrangement or it is clear from the facts that the PE actively participated in the development of the intangibles, such as by bearing development costs on the "branch books."

C. 118. Some USCIB members believe that when ownership of an intangible asset has been transferred to a PE, it should not be treated as having been "sold" by the home office to the PE unless the PE actually transferred cash for the intangible asset or there was a written undertaking evidencing a sale. Arguably, absent evidence to the contrary, an intangible asset should be viewed as having been transferred to the PE not as a sale but as a equity contribution. Domestic law of the contracting states should decide whether a taxable event has occurred from the mere contribution of an asset to a PE.

C. 120. The Guidelines have fairly stringent documentation requirements in order to evidence a bona-fide cost sharing arrangement. If the Guidelines are being applied by analogy, then a cost-sharing arrangement should not be inferred from the fact that the PE currently uses the technology that is being developed by the enterprise as a whole.

C. 122-127 Internal services should be compensated on an arm's length basis rather than merely an allocation of costs. (Of course in some circumstances the Guidelines would deem a cost-based price to be arm's length.) Profit attributable to a PE should include arm's length compensation for any services performed by the PE for the enterprise. Conversely, the head office should also be compensated on an arm's length basis for any services it provides to the PE. Only services that are of a direct benefit to the PE should be allocated to the PE.

C. 137. Absent a compelling, specific reason, the treatment of interest expense for a PE should be the same for banks as for non-banks. Some of the USCIB's non-bank members believe that the Discussion Draft does not spell out such a case. Whenever the activity of the PE is evidenced by separate "branch books," the amount of intercompany debt and interest expense should be respected as long as the PE is not too thinly capitalized and interest is charged at an arm's length rate.

C. 145. Risk weighting of assets should not be necessary for non-financial institutions. Allocation of capital based on the value of assets assigned to the PE relative to the value of assets for the whole enterprise should be avoided. As previously noted, "branch books" should be followed where they are consistent with the activities of the enterprise.

C. 151. While allocating the capital structure of the enterprise as a whole to the PE may have appeal from a "fairness" perspective as between member countries, this approach departs from the separate-entity approach that is the basis of the WH. A thin capitalization approach is preferable, and debt reflected on "branch books" should be respected unless it runs afoul of thin capitalization guidelines. While it is reasonable to consider the debt/equity ratio of comparable companies as an indicator of appropriate levels of debt, such approach should not be used in a way that would mandate the required debt/equity ratio of a branch based on the midpoint debt/equity of the comparable companies. Companies may have legitimate reasons for a different capital structure.

C. 155-161. Some USCIB members strongly disagree with the proposed distinction between financial institutions and non-financial institutions concerning the recognition of internal "interest." They believe that non-financial institutions should be able to establish "branch books" that reflect internal debt and interest payments and that such capital structures should be respected as long as they satisfy thin capitalization rules and the arm's length standard.

C. 165. The use of a consistent credit rating for the PE and the enterprise as a whole is desirable. While the pure application of the separate entity approach may suggest different rates should be used, an enterprise will strive to minimize its borrowing costs and will often do so by using its overall borrowing capacity to fund individual needs.

C. 166-167 If documentation standards are established for "dealings," adequate time should be provided for communication and implementation of the new standards.

D. Interpretation of Paragraph 3 of Article 7

D. 168-174. The language of Article 7(3) should be interpreted consistently with the arm's length principles set forth in the Guidelines as merely intended to ensure that relevant expenses are tax deductible.

E. Interpretation of Paragraph 4 of Article 7

E. 176-180. The language of Article 7(4) should be deleted from the Model Treaty to more closely mirror the arm's length standard.

F. Interpretation of Paragraph 5 of Article 7

F. 181-183. There is no need for Article 7(5) in the Model Treaty.

Part II: Considerations For Applying The Working Hypothesis To PEs of Banks

B. Factual and Functional Analysis of a Traditional Banking Business

B. 8-11. The discussion of assets, notably including marketing or trade intangibles, presents a number of substantial challenges on which additional guidance would be helpful. For financial assets, the guidance attributes assets to where they are used without regard for which part of the enterprise acquired them, absent a specific internal dealing to the contrary. For intangibles, the guidance takes the alternative view, and seems to attribute them to where the development costs were incurred. Under the existing income attribution rules, the costs will generally have been shared by the beneficiaries of the asset – i.e., an implicit cost contribution arrangement. Banks that agree with the observation (in paragraph 112 of Part I) that it is "overly prescriptive" to allow only a cost-contribution arrangement will find it difficult to achieve the transition to the notional royalty approach, as this will presumably entail valuation and buy-in requirements. We therefore recommend that the Discussion Draft offer guidance on transition procedures on which there is reasonable agreement among the OECD members.

B. 12-27. The discussion of risks is helpful, as it identifies many of the risks that might be faced by a bank. However, the discussion presumes that banking risks arise principally from the holding of financial assets, as this is the framework on which the Basle Accords are based. The Basle framework emphasizes the risks important to regulatory interests (protection of a bank's creditors), which are fundamentally different from the interests of an equity investor (earnings from all sources). Thus, important financial risks may also arise from the performance of financial services that are not asset-intensive or from events that threaten the value of intangibles. These risks are economically significant but not the primary concern of regulators. The allocation of regulatory capital based on risk-weighted assets may produce a very different result from the allocation of economic capital based on the value of all income-producing "assets," which may include goodwill and going concern value. The proposed revisions to the Basle framework attribute capital to operational risk and thereby address many of the concerns cited here. Accordingly, it is recommended that tax principles recognize operational risk and provide workable and flexible implementation rules during the transition period in which the new Basle framework is to be implemented.

D. Applying the WH to Banks Operating Through a PE

D. 33. The issue of a "split function business" presents many complications and, perhaps more importantly, room for disagreement between tax authorities. If contemporaneous functions are split, then the question becomes one of measuring and weighting the functions. If the split functions are performed sequentially, guidance is needed as to whether the transaction or business can be viewed in the aggregate or whether, and under what circumstances, an internal dealing should be recognized. On this point there is a seeming inconsistency between the position taken in paragraph C.93 of Part I and paragraph D.52 of Part II.

The Committee's report on "The Taxation of Global Trading of Financial Instruments" provided a useful framework for categorizing transactions that may also be helpful in this context. The integrated trading, centralized product management, and separate enterprise models provide a basis for characterization that may be used to determine whether transactions (or dealings by extension) should be priced by reference to comparable, uncontrolled transactions or whether profits should be split in recognition of non-routine contributions.

D. 35-45. The view that a common credit rating is an internal condition of the enterprise is a practical solution, and is therefore supported by the USCIB.

D. 54-64. The use of the Basel Accords for risk weighting of assets is described as a "promising possibility." Their merit clearly derives from their extensive use by banks and the credibility that results from the scrutiny received of industry and regulators. That said, concern has been expressed by some USCIB members that "standardized" rules and principles change over time, which may give rise to the need to recognize dealings in the future to rebalance the attribution of assets and therefore capital to reflect the new methods. It would seem reasonable to offer protection against the possibility of tax costs or benefits resulting from changes in financial theory. Furthermore, some USCIB members have concerns about the practicality of a "standardized" approach. The Discussion Draft proposes principles that may require a bank to maintain a completely separate, but linked, risk-weighted asset system for tax purposes, since the booking location may not be the economic home indicated by the functional analysis. The effort and expense required to comply with this requirement may be burdensome. The separate systems may be subject to error as they will not receive the level of scrutiny given to the system used for regulatory purposes. In practice, this suggests a need for some degree of latitude in implementation.

D. 65-89. The lengthy discussion of the three capital-attribution models (or more, if the cleansed BIS model and its permutations are counted) is interesting but also challenging to tax practitioners. Two major concerns are whether the discussion leads to the right model and whether a theoretically acceptable result may nevertheless be impractical.

The Discussion Draft presents the Basel/BIS ratio approach as its preferred method, even though it is noted that some of the OECD members favored other methods. Some concern has been expressed about the BIS method on the grounds that "excess" capital is attributed to PEs. We acknowledge that banks tend to be capitalized above the regulatory minimum, and that there is no a priori theoretical basis for assigning this excess to either the head office or to specific PEs. Since the effect of assigning capital to PEs is to limit their capacity to bear and deduct interest, such restrictions are not seen as consistent with the arm's length principle when they lack a mechanism to consider the facts and circumstances underlying a bank's capital. There is a need to balance flexibility with a pragmatic solution that will be acceptable to tax administrations and to the financial sector. To achieve this balance, the USCIB would like to see the OECD members agree to designate one of the models (probably the Basle/BIS ratio approach) as that most likely to produce an arm's length result. This designation would result in the use of this method in the majority of cases, subject to some flexibility to use of another method if it can be demonstrated that the other method would better reflect the application of the arm's length principle.

Even if it were theoretically sound, the preferred approach might be impractical. Banks have invested heavily over the years in systems capable of applying the risk-weighting methods required by BIS and local standards, but these systems are based on legal booking as a means of identifying the presence of assets subject to risk weighting. The methods proposed in the Discussion Draft require a different approach in many cases, tying assets and risks to the location of related functions rather than booking location. Given the high likelihood of split functions, or shifting functions, this may prove even more challenging than the existing system. The tax function within a bank may find it very difficult to secure the level of support and investment necessary to comply, particularly since many countries have quarterly tax payment requirements, which would indicate a need for quarterly analysis. Questions have also been raised as to whether period-end or average balances would be needed.

These doubts about the theoretical correctness and practicality of the BIS ratio approach suggest that flexibility should be retained, allowing individual banks to determine the method that gives the best indication of arm's length results, taking into account the structure and capability of their risk-analysis systems.

D. 90-94. The discussion of tier 2 capital and subordinated debt presents some difficult issues. It seems practical to attribute tier 2 capital to PEs on the grounds that there is no reason to assign it solely to the head office. However, the proposal in paragraph 92 to achieve this by using a blended rate for internal interest dealings is problematic because it would produce a result that is the opposite of what is intended. Loading the higher subordinated debt rates into the interest expense will pass a greater proportion of the capital cost to the PEs with lower capital (i.e., higher debt funding). The solution to this problem, in the opinion of many USCIB members, is to allocate both Tier 1 and Tier 2 capital, essentially following the "pure" definition.

D. 98-102. The difficulty of attributing financial assets to a particular location is noted in the Discussion Draft, which takes the position that functions, rather than mere booking, determine the attribution for tax purposes. We request clarification in particular of the standards imposed to recognize a dealing that would transfer an asset to another PE. Paragraphs 101 and 102 present the requirements that the related functions and/or profit potential also be moved. Some sort of related function test may be appropriate, and the required functions might be limited to the risk-management functions mentioned in B.6 as the functions involved in managing an existing asset. The transfer of the risk or profit potential is clearly a reasonable standard, as the PE should expect to report any profit or loss resulting from assets transferred to it.

D. 103-104. The issue of transferring financial assets becomes more complicated when financial assets are disaggregated, with various risks transferred to a number of PEs. This may happen through secondary internal transactions or hedging transactions. While tax authorities may be concerned that such transactions are motivated by tax considerations, there are often very real and sound commercial reasons for such arrangements, such as transferring the responsibility for particular risks to the part of the enterprise best qualified to manage the risks. Accordingly, respecting such arrangements is fully consistent with the arm's length standard.

D. 125-135. The discussion of interest expense arising from internal dealings between PEs requires the use of arm's length rates, supported by external transaction data and a comparability analysis. While this is a reasonable starting point, there are difficulties that may be expected in practice. USCIB members noted at least three: FX issues, onlending borrowed funds to a home office, and rate stabilization by a treasury center.

The Discussion Draft is silent on the foreign exchange issues that arise from interest dealings between two PEs with different functional currencies. For example, consider a dealing that is the equivalent of a loan from a PE in Japan to one in the US. A yen-denominated rate will be lower than a dollar-denominated rate under current conditions, and it would be quite reasonable for the loan to be denominated in either currency. From the perspective of the Japanese entity, a yen loan would produce results consistent with the rest of its income statement, but the US PE would expect to incur an FX loss, offsetting the nominal interest expense savings that result from paying a yen rate. Conversely, a dollar loan would produce higher income for the Japan PE, likewise offset by the expectation of an FX loss. If one does not consider the FX implications, the results will not be sound in aggregate. On the other hand, it is administratively challenging to define a reasonable means of addressing the FX issue, particularly for long-dated instruments that would require periodic accrual or mark-to-market treatment. It might be a useful expedient to consider an imbalance under which both parties record what the interest income or expense would have been, had it been denominated in their own functional currency. Another alternative would be to recognize the FX result as an interest-equivalent item.

Another interest issue that requires consideration occurs when a bank attracts deposits through a PE and then remits them to the head office. If the deposit represents favorable financing, then the benefit must be allocated between the PE and the head office. Arguments in favor of the PE keeping most of the benefit tend to be the strongest, as the PE could also lend the funds at market rates through the inter-bank wholesale market. However, arguments may also be made for remitting the profit based on the lack of expertise or resources at the PE to deploy the funds in earning assets, as well as the potential goodwill and other intangibles that may have induced the customer to make the deposit.

It is quite common for treasury operations to stabilize the cost of funds experienced by a bank's operating units over defined periods (usually a month or even a year), to facilitate the decision-making process of management. This may result in internal rates having an implicit one-month or one-year term, whereas the bank's external expense rates may be overnight rates at one end of the spectrum, or long term debt at the other. As a result, the treasury center may experience gains or losses.

Each of these issues presents challenges that may arise in the normal course of banking activity. It is questionable whether a prescriptive methodology could be expected to work well in all cases. Accordingly, the methodology ultimately proposed should be sufficiently flexible to allow banks to make a sensible policy choice based on their assessment of specific situations.

D. 137. Allowing profit-split methods when important functions are split between locations is potentially very helpful. The parallels between banking with split functions and global trading are potentially significant.

D. 139. The statement that interest income and expense will be attributed to the "owner," as indicated by functional analysis, gives rise to a number of questions about the tax treatment of such attribution. While issues such as withholding taxes may be outside the scope of the Discussion Draft, banks need to fully understand the potential implications, including indirect tax consequences, such as the potential creation of services subject to VAT.

D. 140-144. The example cited in Paragraph 140, which splits an asset 60%/40% between two locations, based on functions performed, would be a real challenge to banks trying to manage their balance sheets and income statements in a prudent manner. It is unlikely that a bank would want to duplicate its credit-risk management function, for example. If one location or another manages the credit risk, then a tension develops over who is the economic owner. Similarly, if one of the two locations is assigned interest income not in its own functional currency, then the range of FX issues discussed above becomes relevant. In practice, the 60/40 example would produce a result that is so punitive administratively that banks would face a significant incentive to structure their business differently merely to avoid this tax result. This observation supports the endorsement in Paragraph 144 of the residual profit split method, as this would avoid the difficult requirement to "book" transactions for tax purposes in locations where they are not recognized for all other banking purposes.

D. 150-153. The issue whether a transfer of existing assets is deemed to be a sale at fair market value seems destined to elevate the level of controversy between banks and tax authorities. Depending on whether a tax authority gains or loses revenue (and one clearly will in most cases), it may assert that the transaction was tax-motivated and challenge it. Unproductive efforts may be necessary within banks to avoid taxation that may result from accidental transfers. Defining the threshold of activity that triggers such a deemed transaction will be crucial. These concerns argue for liberal use of the residual profit split to avoid what may be a significant tax penalty for inadvertent dealings.

D. 154-158. The issue of services has been discussed above. While consistency with the arm's length standard is advisable, the approach proposed in the Discussion Draft raises potentially troublesome issues for banks. Notably, it is quite conceivable that a PE may perform substantial shareholder/stewardship functions, particularly with respect to certain business lines. The current proposal has the effect of stranding such costs in the PE, whereas this may not have much bearing on who is the beneficiary of such services. (At a minimum, a default option moving such costs to the head office might be reasonable.)