

**Comments of the
Association of German Banks
on the OECD Discussion Draft (Centre for Tax and Administration [CTPA])
on the Transfer Pricing Aspects of Business Restructurings**

The Association of German Banks would like to thank the OECD Centre on Tax Policy and Administration (CTPA) for the opportunity to comment on the OECD Discussion Draft on the Transfer Pricing Aspects of Business Restructurings for a group of associated companies.

The German banks greatly welcome the CTPA's efforts to address the difficult problem of the tax treatment of business restructurings in a group of associated companies.

There is currently insufficient OECD guidance under both the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the "TP Guidelines") and the OECD Model Double Taxation Convention on Income and on Capital (the "Model Convention").

The CTPA proposes that business restructurings be defined as the cross-border redeployment by a multinational enterprise of functions, assets and/or risks with implications for profit and loss potentials in the countries concerned (paragraph 2). These typically comprise the

- conversion of full-fledged distributors ("pure distributor") into limited-risk distributors or commissionaires for a related party that may operate as a principal;
- conversion of full-fledged manufacturers ("pure manufacturer") into contract-manufacturers or toll-manufacturers ("farmed-out producer") for a related party that may operate as a principal;
- rationalisation and/or specialisation of operations (manufacturing sites and/or processes, research and development activities, sales, services);
- transfers of intangible property rights to a central entity (e. g. a so-called "IP company") within the group (paragraph 3).

In this context, risk allocation, risk control (in the sense of the capacity to make decisions to assume risk), transfer of risks and its consequences are of fundamental importance for assessing the adequacy of business restructurings and agreements in this respect (paragraph 29ff.).

From the perspective of the Association of German Banks, this applies particularly to the banking industry.

The German banks are of the opinion that, in view of the ongoing process of globalisation of economic activities in general and of the financial markets in particular and the ever closer ties between multinational enterprises and banks going hand in hand with it, a broad international consensus on questions concerning the tax treatment of business restructurings is needed. The task at hand is eliminating the existing uncertainty among international enterprises and averting the growing danger of double taxation due to a unilateral, unconcerted approach by some countries and/or tax authorities.

The German banks warmly welcome it that the CTPA is now addressing an important aspect, namely the application of transfer pricing rules during and/or after business restructurings between associated enterprises, and presenting its findings for discussion.

In the following, we look only at specific aspects from the perspective of the banking industry.

Regarding general aspects in connection with the tax treatment of business restructurings between associated enterprises belonging to a group, we refer to the comments made by the business sector, particularly to these by the Business and Industry Advisory Committee (BIAC). BIAC's criticism is generally endorsed by the Association of German Banks.

From the perspective of the German banks, the main points of criticism by the business sector that should be emphasized are

- the OECD itself goes beyond the accepted principles of transfer pricing in the Discussion Draft;
- the OECD interferes to a dangerous extent in the freedom/power of control of the group; in particular
 - it does not focus on the benefits of restructuring from a group perspective but from the perspective of one associated enterprise belonging to the group;
 - linking risk allocation and risk control in the way called for by the OECD goes too far because it does not do justice to the risk management of present-day groups of enterprises where the strategic control is exercised across regions or worldwide through divisions and business units directed by headquarters or management companies;
- it ultimately remains unclear in which cases shifting of profit potential as a consequence of a change in the distribution of risks between the associated companies is to be compensatable, particularly as the assumption of risks itself need not involve any compensatable profit potential;

- it is questionable in respect to intangible assets whether pricing of the day-to-day business after the restructuring could not also take place within the framework of the restructuring itself if a sale/ purchase and licence-back is assumed;
- the observations on the transfer of an “ongoing concern” or business restructuring are limited to the case equivalent to the sale of an enterprise but do not contribute anything to the controversial issue of whether the transfer package approach has a field of application beyond this case;
- the reflections on transfer pricing after the restructuring, especially concerning the comparison of the profit before and after the restructuring, on the application of unilateral transfer pricing methods (cost-plus; market price-minus and transactional net margin method (TNMM)), on the remuneration of agents, commissionaires and toll-manufacturers (“farmed-out producer”), service agents and on the pricing of purchasing services fail to convince in every case;
- the above points, especially in cases of non-recognition of the freedom/power of control of the group, harbour the danger of serious double taxation.

Special aspects from the perspective of the banking industry

Transfer pricing issues are particularly important for the banking industry because banks, as financial intermediaries, trade in financial instruments worldwide around the clock today.

The Association of German Banks would like to encourage the CTPA to take further steps, i. e. to also draft and present for discussion papers dealing with another kinds of questions in connection with business restructurings, particularly

- the tax treatment of business restructurings in connection with Article 5 of the OECD Model Convention (“Permanent Establishment”; PE) and Article 7 (“Business Profits”) of the OECD Model Convention,

plus the aspects which the CTPA has already addressed itself, such as

- the determination of the existence of, and subsequent attribution of profits to, PE through a representative;
- the recognition or non-recognition of transactions.

Tax treatment of business restructurings in connection with Articles 5 and 7 of the OECD Model Convention

The Discussion Draft focuses only on the transaction(s) between associated companies in connection with Article 9 of the OECD Model Convention (paragraph 17). It does not deal with the tax questions concerning business restructurings in connection with Articles 5 and 7 of the OECD Model Convention.

- Multinational banks as an inner-group of PEs

Banks usually have the organisational structure of an inner-group of PEs. This is due above all to prudential regulation, which greatly influences

- the pursuit of a business activity which is not geared to producing or distributing goods but mainly to managing customer deposits, lending, trading in securities on behalf of customers and providing financial services;
- the determination for tax purposes of the pro-rata equity capital, ("free capital" (dotation capital) which is attributable to a PE and
- the calculation of their earnings.

With the regulatory circumstances of multinational banks in mind, it must already be asked in general to what extent multinational banks, as an inner-group of PEs, may be indirectly affected by the Discussion Draft on the Transfer Pricing Aspects of Business Restructurings. We would like to ask for appropriate clarification in the paper.

- Implications of the reallocation of risks and income following from business restructurings of associated companies based on the arm's length principle and further impact on the OECD Report on the Attribution of Profits to PEs

The analysis in the Discussion Draft is based on the outgoing OECD TP Guidelines. The arm's length principle should not be applied differently to the transfer of assets, functions and risks and thus be interpreted uniformly, i. e. both before and after the restructuring.

The questions that should already be asked are

- whether, besides the remuneration (in line with the arm's length principle) for transferred assets, these assets additionally bear risks/chances that affect the profit/loss in the countries concerned of the associated companies

- whether a transfer of profit or loss potential between third parties would lead to a compensation payment at all.

It is questionable whether in cases of business restructurings of multinational enterprises there is actually any scope at all for assuming a reallocation of income when applying the arm's length principle.

Arguments against this are: The arm's length principle does not generally require (additional) remuneration for the transfer of potential but only for the transfer of assets as such (see also paragraph 64 along these lines). Furthermore, even if they are aimed at creating synergy potential, business restructurings do not necessarily raise the profits of the multinational group. Business restructurings are carried out not only to increase profits but also to make companies globally competitive. Besides, it is possible that the expected synergies will not materialise and have the opposite effect.

In this context, a further question is what the tax consequences of business restructurings of an inner-group of PEs, especially of banks, would be if business restructurings of associated companies are accompanied by a reallocation of income caused by an attribution of profit/loss potential through application of the arm's length principle. In other words, what implications would the remarks in the Discussion Draft have for the interpretation of Articles 5 and 7 of the OECD Model Convention in the relationship between parent firm and foreign PE.

As is known, on 7 and 8 September 2008 the OECD Committee on Fiscal Affairs released a partially revised version of the OECD Model Convention and particularly of the OECD Model Double Taxation Commentary, which refers in particular to the OECD Report on the Attribution of Profits to Permanent Establishments of 17 July 2008. According to it, the profit of a PE should be calculated in two steps applying the arms length principle enshrined in Article 7 para. 2 of the OECD Model Tax Convention, i. e.

- As step one, PE and other parts of the enterprise are treated as distinct and separate enterprises. The functions performed, the use of assets and the assumption of risks are subjected to a functional and factual analysis conducted in accordance with the OECD TP Guidelines. The purpose of the functional and factual analysis is to consider the activities performed by the PE and the risks borne by it in the context of the activities performed and risks borne by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the PE.

- As step two, the results of the functional and factual analysis should allow determination of the remuneration for the transactions between the PE and the other parts of the enterprise under the arm's length principle; in this respect, attention is drawn to the importance of proper accounting and a simultaneous documentation.

Article 7 para. 3 of the OECD Model Convention deals with the question of the extent to which operating expenses are attributable to a PE. When applying the arm's length principle to banks, it is taken into account that the financial resources of a PE provided by the parent firm are subject to a internal "interest rate", plus a pro-rata external financial expense, provided the pro-rata debt capital exceeds the pro-rata equity capital (so-called "free capital"; dotation capital) attributable to the PE depending on its assets, functions and risks.

In order to solve the well-known problems in implementing these attribution principles, the OECD is of the opinion that the country of the parent firm should recognise the attribution method applied by the PE country for debt interest deduction purposes provided, among other things, that the attribution of pro-rata equity capital by the country of the PE is based on an accepted method which has produced a result in individual cases in line with the arm's length principle.

We believe that the country of the parent firm should not be allowed to call into question or thwart acceptance of a result (in line with the arm's length principle) obtained by the country of the PE on the basis of the Discussion Draft on the Transfer Pricing Aspects of Business Restructurings between associated companies due to assumed conversions during the period.

Outsourcing of auxiliary, additional, administrative and distribution/sales services

With the regulatory circumstances of multinational banks in mind, the transactions with or between associated foreign subsidiaries are probably generally restricted to outsourcing auxiliary, additional, administrative and distribution/sales services which are of no regulatory relevance. The outsourcing reflects a rationalisation and/or specialisation of services (see paragraph 3).

In this context, it is must be assumed that, besides remuneration (in line with the arm's length principle) for the function-related transfer of assets to the associated company providing (auxiliary) services, there is no scope for additional remuneration for a profit and loss potential based on a new attribution of economically non-relevant risks. Instead, in such cases remuneration of the associated company for the services rendered after the restructuring under a cost-plus approach appears appropriate because this is an arm's length approach.

The Association of German Banks is of the opinion that compensation as a result of business restructuring is generally out of the question particularly for multistage agent services that are also sometimes encountered in the banking sector (so-called structured distribution).

It is doubtful whether the situation would be any different if, along the lines of paragraph 68 of the Discussion Draft, the distributing persons acting in their own name and at their own risk were given the right to conclude a less risky distribution agreement or to reject this, the offered agreement were not sufficiently profitable and the foreign associated company were willing from an arm's length perspective to bear the risk of the operating agent continuing to act in another form. This is because, firstly, the agent need not necessarily be left a profit which is sufficient in his subjective opinion. How high the profit is, depends instead on the market situation and the market power of the parties. Secondly, as assumed, the willingness of the associated company in conformity with the arm's length principle to continue to bear the risk would not make the transaction unreasonable and thus compensatable. This must at any rate apply if the associated company exercises the "risk control" as referred to in paragraph 30 over the agency activity. It should also be noted that the agent thus bears his own business risk and this risk, including the risk of losing a client, must be distinguished from the (distribution) risk of the bank.

With respect to financial services, the Association of German Banks expressly endorses the remarks in paragraph 30 of the Discussion Draft and in the example in paragraph 32 (fund manager), according to which it is not sufficient for the purpose of passing on risks if one party (investor) who bears the risk entrusts another party (fund manager) with day-to-day risk monitoring and risk management. In such a case, the investor "controls" his own risks by way of the basic decision to hire (or terminate the contract with) a particular fund manager, the decision on the scope of the authority he gives to the fund manager and the objectives he assigns to the latter, and the decision on the size of the investment that he asks the fund manager to manage.

Besides the issue of the transfer of risks in connection with the mediation of financial services, the German banks would like to ask, over and above the remarks in the Discussion Draft, to what extent the activities of the agent are to (still) qualify as a business activity for own account or (already) qualify as an activity of a dependent agent within the meaning of Article 5 para. 5 of the OECD Model Convention. Assuming that the latter is correct, a dependent agent PE must then be deemed to exist and, consequently, the subsequent profit attribution would have to be made in accordance with the attribution of assets, risks and dotation capital to the dependent agent PE.

The Association of German Banks hopes that the CTPA – as it has already indicated itself – will find appropriate answers to aspects that have still to be examined in connection with the determination of dependent agent PEs and the subsequent profit attribution to these.

It would be disastrous if the extended definition of a PE specified in the OECD Report on the Attribution of Profits to Permanent Establishments and the broad recognition of PE profits which should be generated by the activity of associated companies as dependent agents with the power to conclude contracts were to ultimately lead to the non-regulated coexistence of taxation of PEs and taxation of associated companies in a group. Legal uncertainty and the danger of double taxation, which should be specifically avoided, would increase considerably.