



**DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT
ESTABLISHMENTS (PES): PART II (BANKS)**

This document is a revision of a Discussion Draft that was released for public comment in February 2001 and discussed at the April 2002 consultation with Business.

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PART II: SPECIAL CONSIDERATIONS FOR APPLYING THE WORKING HYPOTHESIS TO PERMANENT ESTABLISHMENTS (PES) OF BANKS

A. Introduction

1. Part I of this report describes how to apply the working hypothesis (WH) to a permanent establishment (PE) for the purposes of testing the application of the WH in general. However, it is also considered necessary to supplement this general advice with more specific and practical guidance in order to assist the testing of the application of the WH in commonly occurring factual situations. This Part of the report (Part II) looks at the banking sector and discusses how the WH might apply to a number of factual situations commonly found in enterprises carrying on a banking business through a PE. The starting point for this analysis is naturally the 1984 OECD Report, "Transfer Pricing and Multinational Enterprises - Three Taxation Issues; The Taxation of Multinational Banking Enterprises" ("1984 Report").

2. However, there have been considerable changes in the global economy since 1984, which have affected the way multinational banks carry on business. There also have been changes in thinking about the application of the arm's length principle, reflected most notably in the revision of the OECD Transfer Pricing Guidelines started in 1995 ("the Guidelines"). This report is therefore intended not only to update the issues and situations described in the 1984 Report but also to deal with particular issues and situations arising from the widespread financial liberalisation and globalisation of financial markets which have been such a feature of the global economy since the late 20th century. For example, while risk has always been of significant concern to banks, technological developments have resulted in the ability and willingness of banks to undertake pro-active risk management as a means of maximising shareholder wealth and of dealing with risk-based capital adequacy requirements.

3. This part of the report considers what might be called traditional banking activities, the borrowing and on-lending of money¹ and provides guidance on how the income from such activities (most often interest or interest equivalents) might be attributed to a PE of a banking enterprise. In this Report, the term "interest" is intended to have a broad meaning in order to encompass a wide range of receipts and payments in the nature of business profits earned by a bank from the borrowing and lending of money. Other financial activities carried on by banks, such as the global trading of financial instruments, are dealt with in Part III of this report - such activities are also commonly carried on by financial institutions other than banks. It should be noted that under the WH, the same principles should be applied to attribute losses as to attribute profits. References to attributing "profits" should therefore be taken as applying equally to attributing losses.

4. Both Parts I and II of the Report were released as a Discussion Draft for public comment in February 2001. Twenty-five responses were received from the business community, banking associations and advisory firms, reflecting a diversity of views and interests. Because of the variety of positions expressed and the complexity of the issues, a consultation was held in Paris in April 2002 with the commentators on the Discussion Draft. The consultation was very valuable as it allowed the identification of common ground in terms of principles, of areas that needed further clarification and of areas where further work was needed.

5. In this context, it should be noted that the aim of the WH is not to achieve equality of outcome between branch and subsidiary in terms of profits but rather to apply to dealings among separate parts of a

1. All references in this Report to banking or to banks should therefore be treated as relating to traditional banking activities or to banks undertaking traditional banking activities unless stated otherwise.

single enterprise the same transfer pricing principles that apply to associated enterprises when determining those profits (see Section A of Part I). It might be expected that business done through branches is actually more profitable because of the possibilities of efficient capital utilisation, risk diversification, economies of scale etc. The legal form chosen, PE or subsidiary, therefore has some economic effects that should be reflected in the determination of taxable profits.

6. This Report has been revised in the light of the above and to try to address the major concerns expressed by the commentators on the Discussion Draft. A more detailed response to some of the business comments can be found in Annex 2.

B. Factual and functional analysis of a traditional banking business

7. This section analyses the most important functions of a traditional banking business (i.e. the borrowing and on-lending of money) both in terms of the functions performed when creating a financial asset (a loan) and the subsequent functions performed over the life of the financial asset. Following the approach in Chapter I of the Guidelines, the analysis of functions performed also takes into account the assets used and risks assumed in performing those functions.

B-1 Functions performed

i) Functions involved in creating a new financial asset - a loan

8. For the negotiation and conclusion of a traditional banking transaction leading to the creation of a financial asset (a loan), the following functions would normally need to be performed by the enterprise as a whole (not necessarily in the order set out below):

a) Sales/Marketing - e.g. cultivating potential clients, creating client relationships and inducing clients to start negotiating offers of business;

b) Sales/Trading - e.g. negotiating the contractual terms with the client, deciding whether or not to advance monies and, if so, on what terms, evaluating the credit, currency and market risks related to the transaction, establishing the creditworthiness of the client and the overall credit exposure of the bank to the client, deciding what levels of credit, currency and market risk to accept, pricing the loan, considering whether collateral or credit enhancement is needed and committing the bank (and its capital) to the loan and its associated risks, etc.;

c) Trading/Treasury - e.g. raising funds and capital, taking deposits, raising funds on the most advantageous terms, making the funds available; and

d) Sales/Support - e.g. checking draft contracts and completing the contract formalities, resolving any outstanding legal issues, checking any collateral offered, signing the contract, recording the financial asset in the books and disbursing the loan proceeds.

ii) Functions involved in managing an existing financial asset - a loan

9. Once a financial asset (a loan) has been created, the following functions would normally need to be performed by the enterprise as a whole over the life of the asset (not necessarily in the order set out below):

a) Loan support - e.g. administering the loan, collecting and paying interest and other amounts when due, monitoring repayments, checking value of any collateral given;

b) Monitoring risks assumed as a result of entering into the loan - e.g. reviewing creditworthiness of the client, monitoring overall credit exposure of the client to the bank, monitoring interest rate and position risk, analysing the profitability of the loan and return on capital employed, reviewing efficiency of use of regulatory capital, etc.;

c) Managing risks initially assumed and subsequently borne as a result of entering into the loan - e.g. deciding whether, and if so, to what extent various risks should continue to be borne by the bank, e.g. by transferring credit risk to a third party by means of credit derivatives or hedging interest rate risk by purchase of securities, reducing overall risk by pooling individual risks and identifying internal set-offs and actively managing the residual risks retained by the bank, e.g. by hedging residual risks or by leaving risk positions open in the hope of benefiting from favourable market movements etc., deciding write-offs for non-performing loans;

d) Treasury - e.g. managing the bank's overall funding position (funding deficits or investing surpluses in the market), including managing the interest rate risk and liquidity risk exposures of the bank, allocating the costs of funds raised by the bank as a whole to branches/business units, matching duration of borrowing with lending, and maximising efficiency of employment of regulatory capital and return on capital employed;

e) Sales/trading - e.g. refinancing the loan, deciding to sell or securitise the loan, marketing to potential buyers, pricing the loan, negotiating contractual terms of sale, completing sales formalities etc., deciding whether to renew or extend the loan and, if so, on what terms.

iii) Key entrepreneurial risk-taking functions involved in creating and subsequently managing a loan

10. There are a number of functions directly related to the creation and subsequent management of a loan. It will be important to identify not just what functions are performed but also their relative importance. The key entrepreneurial risk-taking functions are those which require active decision-making with regard to the taking on and day-to-day management of individual risks and portfolios of risks. It is these key entrepreneurial risk-taking functions that are likely to impact most directly on the profitability of the bank and so, as discussed in Section D-1(i), will normally be rewarded by having the loan (and its associated income and expense) attributed to the location performing those functions.

11. As can be seen from the description in Section B-1(i) above, it is the sales/trading function described in point b) of paragraph 8 that is likely to be the key entrepreneurial risk-taking function in the creation of a financial asset. As can be seen from the description in Section B-1(ii) above, it is the risk management function as described in point c) of paragraph 9 that is likely to be the key entrepreneurial risk-taking function in the ongoing management of an existing financial asset. However, this determination should be made on a case-by-case basis as the key entrepreneurial risk-taking functions and especially their relative importance are likely to vary according to facts and circumstances, e.g. product differences, business strategies etc.

iv) Other functions

12. As with all enterprises a certain infrastructure is necessary to support these functions, often centralised in the head office. Most of these functions, general management, setting of business strategies, development of computer systems, research, personnel functions etc. are not confined to banking

operations. Such functions are sometimes classified either as “back office” or as “middle office” functions, with “back office” functions being seen as generally adding less economic value to the business and so deserving a lower reward. An area of particular significance to a bank is the function relating to the supervision of the management of the bank’s overall capital and risk exposure. Banks normally have committees which set risk limits on a cascading basis - there will be a limit for overall risk for the bank, an overall limit for different types of risk (e.g. credit risk) and limits for particular business lines etc.

B-2 Assets used

13. The Guidelines note at paragraph 1.20 that compensation will usually reflect not just functions performed but also the assets used and risks assumed in performing those functions. So the functional analysis will have to consider what assets are used and what risks are assumed in creating, and subsequently managing, a loan.

14. Banks use physical assets such as branch premises, computer systems etc. and so the functional analysis will have to consider which tangible assets are used by the PE. Section C-1 (ii) of Part I of this Report provides some guidance in this area. The assets may need to be taken into account in making any comparability analysis under the second step of the WH. For example, retail internet and telephone banking services are cheaper than branch based services partly because they do not need a physical retail branch network to distribute their products and so use less of expensive physical assets (such as branch premises).

15. Further, as with any other business, the functional analysis should also examine whether any intangible assets have been used. In the banking area a common intangible is likely to be the marketing intangible represented by the name, reputation, trademark or logo of the bank. Other intangibles would be more akin to manufacturing intangibles, such as proprietary systems for maximising efficient use of regulatory capital and for monitoring various types of risk. Moreover, these intangibles are of particular relevance to financial firms as they reflect the importance of measuring and optimising use of capital and of monitoring and managing financial risks in the financial sector.

B-3 Risks assumed

16. In a banking business, a proper evaluation of “risks assumed” is of prime importance. Banking, like other financial businesses, is based on taking on (assuming) risks from customers, and it is these risks² which are particularly relevant when performing a functional analysis under the WH because they require capital to support them (see Section B-4). In a banking business, the creation of a loan involves the assumption of a number of different types of risk by the bank, of which the following have traditionally been considered the most important for tax purposes;

a) Credit risk - the risk that the customer will be unable to pay the interest or to repay the principal of the loan in accordance with its terms and conditions.

b) Market interest rate risk - the risk that market interest rates will move from the rates used when entering into the loan. Market interest rate risk can arise in a variety of different ways depending on the nature of the interest rate on the lending and on the borrowing. For example, the borrowing could be fixed but the lending floating or even if both the lending and borrowing are floating there could be a mismatch in

² Banks also face a range of risks which are not specific to financial institutions, for example development risk in respect of IT / communications systems and new products.

timing. Interest rate risk can also arise due to the behavioural effects of market movements on the bank's customers. For example, a decline in interest rates may encourage customers to prepay fixed-rate loans.

c) Market foreign exchange risk - the risk that where the loan is made in a currency other than the domestic currency of the bank (or the currency of the borrowing) that the exchange rate will move from the rate used when entering into the loan.

17. It should be noted that there are also other types of risk, such as country risk and legal risk, which may be of importance in particular situations. There may also be so-called "Herstatt" risk arising from unsettled foreign exchange positions, as well as settlement and delivery risk generally, although real-time gross settlement systems may impact on settlement risk. Solvency risk and general business risk will also be relevant. Further, the Basel Committee on Banking Supervision ("Basel Committee") announced recently that it was considering extending its review of risks that require minimum capital requirements to include interest rate risk in the banking book and operational risk. These developments will need to be closely monitored to ensure that all significant risks for tax purposes are adequately taken into account when performing a functional analysis.

18. In a banking business, the risks assumed from entering into transactions with customers may arise from items that do not appear on the balance sheet. Preparation of a balance sheet is generally done in accordance with accounting standards and to satisfy corporate or other regulatory requirements. The WH by way of contrast is not restricted to an analysis of functions, assets and risks based on accounting standards or satisfaction of corporate or other regulatory requirements. Consequently, the functional analysis would need to identify all risks including those related to off-balance sheet items that need to be taken into account in the application of the arm's length principle.

19. Between legally distinct enterprises it is important to distinguish between the initial assumption of risk and the subsequent bearing of that risk. The term "risk assumption" refers to the initial assumption of risk arising from the creation of a financial asset. However, although the act of creating a financial asset leads to the taking on or acceptance of risk (risk assumption), it is not necessary that the enterprise that created the financial asset has to subsequently bear the risk assumed (i.e. remain responsible for losses caused by the realisation of the assumed risk over the life of the financial asset). That risk can be transferred to another enterprise so that the risk originally assumed may no longer be borne by the creator of the financial asset but will be assumed and subsequently borne by the other enterprise (unless they also decide to transfer those risks to another enterprise). This raises the question of whether, and if so, in what circumstances, transfer of risks should be recognised within a single legal entity so that risks initially assumed by one part of the enterprise will be treated as assumed and subsequently borne by another part of the enterprise. The circumstances in which it is possible to recognise such a transfer are discussed in Section D-2 (iii)(e).

20. Of particular significance to banking and other financial activities is that the creation of a financial asset leads to the assumption of different types of risk (credit risk, market risk, operational risk etc.). However, it is possible for the bank not to ultimately bear all the different types of assumed risks. For example, it is possible to bear all the assumed risks apart from the credit risk by retaining ownership of the financial asset but transferring the credit risk by entering into a credit derivative with another enterprise.

21. The risks assumed and subsequently borne need to be managed in order to protect the capital of the bank. Risk management is a function and, just like other functions, the risks assumed and subsequently borne as a result of the performance of that function will play an important part in determining the level of reward for the part of the enterprise performing the function (see Section D-2(iii)e).

B-4 Capital and funding

i) Introduction

22. Capital is relevant to the performance of traditional banking business because in the course of a traditional banking business, banks assume risk, for example by lending money to third parties some of whom may not repay the full amount of the loan. In order to assume material risk, a bank needs “capital”, i.e. the ability to absorb losses due to the realisation of assumed risks. This is because capital, in this context, refers to funds placed at the bank’s disposal by investors who are prepared to accept some higher level of risk in respect of their investment in exchange for an economic return which is expected to be higher than the risk-free rate. For example, a bank’s equity holders (like those of any business) stand to lose their entire investment if the bank becomes insolvent, but also are able to share in the after-tax profits of the bank. Retained profits also form part of capital in this sense because until distributed to equity holders as dividends they remain available to absorb losses.

23. As discussed in sub-section (iii) below, regulators require banks to have minimum amounts of capital (regulatory capital) based on the risks they assume. Because some regulators recognise certain types of subordinated debt as a source of capital for regulatory purposes, many banks have issued such instruments. Subordinated debt holders may likewise lose their investment if the bank is unable to repay its ordinary creditors. However, they are entitled to repayment ahead of equity holders and consequently do not assume the same degree of risk; their reward is therefore typically a higher rate of interest than an ordinary loan creditor would receive, but it is nevertheless usually limited to a percentage of their investment, unlike that of ordinary shareholders. Long-dated debt that is not subordinated may also sometimes be included in “capital” as the investors in this type of loan place funds at the bank’s disposal over a period which allows losses to be temporarily funded from such loans until the bank is able to generate sufficient profits to offset these losses, once again enabling the bank to assume risk.

24. Therefore, the amount and nature of the risks assumed plays an important part in determining the amount of capital, especially regulatory capital, that a bank needs to possess. However some of the forms of capital described above give rise to a return to investors which is not deductible for tax purposes by the bank under the rules of the PE jurisdiction, regardless of how such capital is classified for regulatory purposes or how the return is classified for accounting purposes. Such capital is referred to in this draft as “free” capital and is of obvious significance for tax purposes (see sub-section (v) below).

25. As well as needing capital to assume risks, banks also need to fund the creation of financial assets, such as loans, that generate gross income in the form of interest and interest equivalents. This funding comes from a variety of sources; equity capital, retained earnings, liabilities such as deposits from customers and various forms of debt funding such as interest bearing loans and subordinated debt. Some of those sources of funding consist of items that play a dual role in the bank - both acting as regulatory capital and thereby enabling the bank to assume the risks related to its business and providing a source of funding.

26. In conclusion, it is suggested that for banks and other financial institutions, a functional analysis should be undertaken taking into account assets used and risks assumed in the same manner as a functional analysis would be undertaken for non-financial institutions. However, given that capital is essential in order to enable banks to assume the risks arising from their traditional banking business, the functional and factual analysis would need to pay particular attention to an examination of the issues related to capital adequacy and attribution of capital. Finally, and as a separate matter, the analysis would also consider the funding arrangements of the bank’s financial assets.

ii) *Creditworthiness*

27. A bank's creditworthiness is an important factor to be taken into account in any transfer pricing analysis as it affects both the bank's ability to borrow, the rate at which it can do so and the gross margin that can be earned. Generally, and in the absence of deposit insurance, the creditworthiness of a bank is inversely related to the interest rate it pays to its investors (its depositors and holders of its debt instruments). The higher the creditworthiness of the bank the lower the interest rate it pays to its investors. This is because investors demand a risk premium for investing their money in order to reflect the risk of not getting back the full amount of the investment and the investment return when due. The risk premium represents the additional return (in the form of a higher interest rate) that the investor expects to receive as compensation for investing in a riskier bank (e.g. one with a AA credit rating) rather than investing on the same terms in a safer bank (e.g. one with a AAA credit rating).

28. Creditworthiness is the perception by an independent party, e.g. a credit rating agency, of the likelihood that a company will meet its commitments in respect of any borrowings it has made and investments it has received. A number of factors are taken into account, the amount of regulatory and "free" capital of the bank obviously being an important factor. Other relevant factors include a solid reputation, good management, risk profile, regulatory status, ability to raise fresh equity and a history of consistently high profitability. Certain types of "niche" business are restricted to banking entities with the highest creditworthiness (e.g. some borrowers will only transact with AAA rated counterparties).

29. Importantly, any evaluation of creditworthiness is usually undertaken by reference to the bank as a whole or to specific financial instruments and not to individual branches. As for capital, this reflects the fact that generally the whole of the bank's assets and capital are potentially available to meet any claims on the bank regardless of where the asset leading to the claim is located. There may be exceptions to the general rule, for example where assets located in a specific jurisdiction are not available to meet claims outside the jurisdiction or have been earmarked to support a particular financial instrument in order to give that instrument the desired rating by a credit rating agency.

iii) *Capital adequacy requirements*

30. Importantly, to protect customers, and to maintain the integrity of the financial system, banks are regulated by Governments and are required to have minimum amounts of "regulatory" capital (regulatory minimum capital) based on the risks they assume in conducting business. This is an area in which there have been significant developments since the 1984 Report was issued.

31. The Basel Committee on Banking Supervision is the body that sets internationally accepted standards for capital adequacy, see the July 1988 publication, "International Convergence of Capital Measurement and Capital Standards"(the 1988 Basel Accord). The 1988 Basel Accord sets minimum levels of capital to cover credit risk for internationally active banks while permitting national authorities to adopt arrangements that set higher capital levels. There have been a number of amendments to the 1988 Basel Accord with by far the most significant being the January 1996 "Amendment to the Capital Accord to Incorporate Market Risks" (the 1996 Market Risk Amendment). In this report, unless otherwise stated, a reference to the 1988 Basel Accord means the original document together with all subsequent amendments.

32. Regulatory capital is classified into different Tiers of capital, based broadly on the permanency of the capital invested. The most permanent capital is Tier 1 capital and consists of items such as paid-up ordinary shares, non-repayable share premiums, reserves and retained earnings, non-cumulative and non-redeemable preference shares. Tier 2 capital includes items such as subordinated debt instruments and long-dated debt. One other matter of interest is that, in calculating Tier 1 capital, a deduction is normally

made for capital invested in affiliated banks in order to discourage the banking system as a whole from creating cross-holdings of capital rather than drawing capital from outside sources. However, there are certain circumstances in which some regulators will allow the capital in such subsidiaries to be counted for regulatory purposes as belonging to the parent bank. This matter is considered in more detail in paragraphs 100 and 101 in the context of attributing “free” capital to the PE.

33. Capital adequacy requirements are calculated by dividing the bank’s capital base by the total risk-weighted assets of the bank (including risks arising from “off-balance sheet” items) to produce a capital ratio (the Cook ratio). The assets are weighted to take into account both credit and market risk. The minimum requirement set by the Basel Committee is that total capital must be equal to at least 8% of the total risk-weighted assets of the bank. Out of the total capital, Tier 1 capital must be at least equal to 4% of the total risk-weighted assets of the bank.

34. In general, for financial accounting purposes Tier 1 capital does not result in any interest cost, whilst Tier 2 capital does. Consequently, in computing the bank’s profit for accounting purposes it is usually only the return on Tier 2 capital that will be deducted. The treatment for tax purposes may not follow the accounting treatment. Although the return on Tier 1 capital does not result generally in any tax deduction (it is “free” capital for tax, as well as accounting, purposes), there may be some instruments that qualify as Tier 1 capital and also are treated as debt for tax purposes in some jurisdictions. Such instruments are being issued with increasing frequency. Further, in a number of jurisdictions, some Tier 2 capital such as subordinated debt may be treated as “free” capital for tax purposes.

35. The corollary of the above situation is that in order to create a financial asset the bank must have sufficient regulatory capital available (including “free” capital) to meet the minimum capital requirements of the regulatory authorities. Broadly, if the bank does not have enough regulatory capital available it will be unable to enter into a loan without adversely affecting its creditworthiness or breaching bank regulations. To avoid an adverse impact on its creditworthiness and to avoid regulatory intervention, the bank could reduce the risk of holding the asset, for example by disposing of it to a securitisation vehicle and investing the proceeds in less risky assets.

iv) Other regulatory requirements

36. As well as setting minimum capital adequacy requirements, regulatory regimes may also prescribe other restrictions. For example, they may require that regulatory capital be invested in certain assets considered to be “safe”, such as government bonds, or that banks maintain mandatory reserves in the form of deposits at the central bank. Banks would prefer to employ their capital in their own loan assets which potentially yield higher returns and so there is an “opportunity cost” caused by regulation. Further, this opportunity cost varies according to the particular regulatory regime; some jurisdictions are stricter than others in terms of setting minimum amounts of regulatory capital, reserve requirements and investment restrictions etc. Accordingly, regulatory capital is a scarce resource for a bank and so must be “used” as efficiently as possible in order to ensure that the bank can create and retain the most profitable financial assets on its books.

37. The business drive to optimise use of capital within the regulatory constraints may cause financial assets to be booked in the most advantageous location for regulatory purposes (“regulatory competition”). Such competition can arise, for example, through differences in regulatory minimum reserve requirements between jurisdictions. Consequently, the jurisdiction in which a financial asset is booked need not be the same jurisdiction in which any of the functions necessary to create the asset were performed or need not be the same jurisdiction in which the functions needed to maintain the asset are currently performed. Banks may also undertake regulatory arbitrage and take advantage of different capital

requirements of the banking or trading book, perhaps by using credit derivatives. Regulatory capital requirements may also make it too expensive to hold some types of assets on the bank's balance sheet, leading to the development of securitisation techniques.

38. Regulatory competition and arbitrage create a problem for both taxpayers and tax administrations, as the results of such competition or arbitrage may mean that an asset is not necessarily booked in the jurisdiction in which most of the profits related to that asset are in fact earned. In such cases, the financial accounts of the bank may require considerable adjustment in order to accurately reflect where profits have been earned for tax purposes.

v) *Significance of "free" capital*

39. Banks attempt to earn gross profits from lending transactions by ensuring that they receive more interest from lending funds than they pay in interest costs to obtain the funds. One way a gross profit margin can be achieved is by the bank borrowing the funds at a lower interest rate than the rate it charges the customer for a loan. There are a number of ways it can do this, for example by borrowing short-term funds and lending those funds on longer terms in order to take advantage of the interest rate yield curve (short-term funds are usually cheaper than long-term funds) or by having a higher creditworthiness than the customer (see sub-section (ii) above).

40. If all the funds lent to the customer are borrowed, the bank's expected gross profit margin will be an interest rate differential that reflects the functions performed by the bank taking into account any assets used and risks assumed (for example the yield curve or credit risk referred to in the previous paragraph). The expected gross profit margin can be improved if not all of the funds lent to the customer are borrowed. This requires the bank to use some of its own financial resources that do not require the payment of interest, for example funds from retained earnings and funds from issuing shares, which are usually treated as "free" capital for tax purposes.

41. The amount of "free" capital will have a large impact on the potential profit a bank can make and the amount of tax it will pay. The matter has therefore been of considerable interest to tax authorities because unlike payments to equity holders, payments to holders of debt capital are generally tax deductible. This provides an incentive to maximise the amount of tax deductible debt funding. The particular significance in the PE context is discussed in Section D - 1 (iii)(a).

C. Banks operating through subsidiaries

42. It is not believed that there are any particular theoretical problems with applying the Guidelines to transactions between associated enterprises carrying on traditional banking activities. The functional and factual analysis of a banking enterprise provided in Section B is applicable both to banking activities conducted between associated enterprises and to banking activities within a single legal enterprise. Further, the guidance in Section D on how the Guidelines can be applied, by analogy, to attribute profit to a bank PE also provides useful guidance on how to apply the Guidelines to banking activities more generally. This analysis and guidance should enable taxpayers and tax administrations to apply appropriately the guidance in the Guidelines to transactions between associated enterprises carrying on traditional banking activities.

D. Applying the WH to banks operating through a PE.

43. Part I of this report describes how to apply the WH to a PE for the purposes of testing the application of the WH in general. This Part discusses how to apply the WH to a PE of a bank for the

purposes of testing the application of the WH to banks. The approach taken is first of all to describe the basic principles before describing in Section D-1 how the WH would apply generally to banks. Particular attention is paid to how the transfer pricing concepts of functional and comparability analyses, which are necessary to perform both steps of the WH, can be applied by analogy to a bank PE. Section D- 2 discusses in detail how this general guidance would apply to specific situations commonly found in the banking sector.

Basic principles used to attribute profits to a bank PE

44. For banks no less than for other businesses, the key aim is to attribute profits to a PE in accordance with Article 7(2) of the OECD Model Tax Convention. In other words, it is necessary to determine “the profits which [the PE] might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions”. The following issues are of particular significance when applying the WH to bank PEs.

Attribution of assets and risks

45. Assets and risks will be attributed to the PE in accordance with a factual and functional analysis of the bank concerned that seeks to identify the key entrepreneurial risk-taking functions. The key entrepreneurial risk-taking functions associated with traditional banking business of the kind covered in this part of the report will generally be:

- the creation of assets, typically loans; and
- the subsequent management of the risks associated with those assets.

This determination should be made on a case-by-case basis as the key entrepreneurial risk-taking functions and especially their relative importance will depend on the particular facts and circumstances.

Attribution of capital

46. The factual starting point for the attribution of capital is that a bank’s capital is primarily required to support the risks assumed by the bank through its making of loans (and to support the risks associated with off-balance sheet items such as undrawn commitments to make loans). This capital must be regarded as following those risks. In other words, capital is to be attributed to a PE by reference to the risks arising from its activities, and not the other way round.

47. This attribution of capital should be carried out in accordance with the arm’s length principle, to ensure that a fair and appropriate amount of profits is allocated to the PE. The purpose of the attribution is to inform the allocation of profits to the PE under Article 7(2). Under the arm’s length principle, a bank PE, just like any other PE, should have sufficient capital to support the functions it undertakes, the assets it uses and the risks it assumes. The Report describes a number of different possible approaches for applying that principle in practice, recognising that the attribution of capital to a PE is not an exact science, and that any particular facts and circumstances are likely to give rise to a range of arm’s length results for the capital attributable to a PE, not a single figure.

48. The different possible approaches for attributing capital to the PE of a bank all have their strengths and weaknesses in terms of how closely they approximate to the arm’s length principle, the relative importance of which will depend on the circumstances. The key to attributing capital is to recognise:

- ❑ the existence of the strengths and weaknesses in any approach, and when these are likely to be present;
- ❑ that the key test of the suitability of an approach in any particular case is whether it gives a result that falls within the arm's length range. It may well be appropriate to test this by applying one of the other approaches, to see whether this produces an outcome within a similar range.

Attribution of profits

49. The attribution of profits to a PE of a bank on an arm's length basis will follow from:

- ❑ the attribution of assets and risks between it and the rest of the enterprise of which it is a part based on a functional and factual analysis, taking account of dealings that can appropriately be recognised (see below);
- ❑ the attribution of capital based on the allocation of assets and risks;
- ❑ the pricing on an arm's length basis of dealings that can appropriately be recognised; and
- ❑ the recognition of transactions between the PE and independent third parties (subject to any displacement of third party borrowings as a result of the attribution of capital to the PE's assets and risks).

50. The guidance in the Guidelines can be applied by analogy in order to attribute profit to the PE on an arm's length basis, taking into account the principle outlined in the previous paragraph.

Recognition of dealings

51. There are a number of aspects to the recognition (or not) of dealings between a PE and the rest of the enterprise of which it is a part. First, a PE is not the same as a subsidiary, and it is not in fact legally or economically separate from the rest of the enterprise of which it is a part. (This is of course a quite deliberate outcome, resulting from the decision to operate through a PE rather than a subsidiary.) It follows that:

- ❑ save in exceptional circumstances, all parts of a bank have the same creditworthiness. This is the reality as seen by depositors and other creditors of the bank. It means that dealings between a PE and the rest of the bank of which it is a part should be priced on the basis that both share the same creditworthiness; and
- ❑ there is no scope for the rest of the bank guaranteeing the PE's creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the bank.

52. Second, dealings between a PE and the rest of the enterprise of which it is a part normally have no legal consequences for the enterprise as a whole. This increases the scope for tax-motivated transfers between the two and also acts to reduce the usefulness of any documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist. It therefore implies a need for greater scrutiny of dealings between a PE and the rest of the enterprise of which it is a part than of transactions between two associated enterprises and places the onus on the taxpayer to be able to demonstrate clearly that it would be appropriate to recognise the dealing.

53. This greater scrutiny means a threshold needs to be passed before a dealing is accepted as equivalent to a transaction that would have taken place between independents at arm's length, and is

therefore reflected in the attribution of profits under Article 7(2). Furthermore, there are circumstances in which dealings in relation to the transfers of assets and risks would not be recognised because the transfers were not made under the normal commercial conditions that would apply between independent enterprises (see 1.38 of the Guidelines which discusses the circumstances in which transactions between associated enterprises would be similarly not recognised or would be restructured in accordance with economic and commercial reality). By way of further illustration, this threshold would preclude the recognition of a dealing between a PE and the rest of the enterprise of which it is a part which purportedly led to the transfer of an asset from the PE to another part of the enterprise unless that part of the enterprise also performed the key entrepreneurial risk-taking functions in respect of the asset and the profit and risk potential of the asset was also transferred.

54. Third, where dealings are capable of being recognised, they should be priced on an arm's length basis, assuming the PE and the rest of the enterprise of which it is a part to be independent of one another. This should be done by analogy, with the Guidelines, following a factual and functional analysis.

55. Traditional banking, which is the subject of this part of the report, involves borrowing money from depositors for on-lending to third parties. Interest costs are consequently an intrinsic part of a bank's business, and its trading profits can only properly be determined by deducting such costs. It follows that lending and borrowing by a PE to and from the rest of the enterprise of which it is a part should generally be recognised where it meets the requirements for recognition as a dealing. Such borrowing may, however, be displaced by the attribution of capital to the PE's assets and risks, as indeed may third party borrowing.

D-1 First step: determining the activities and conditions of the hypothesised distinct and separate enterprise

56. It is necessary under the first step of the WH to hypothesise the PE as a distinct and separate enterprise "engaged in the same or similar activities under the same or similar conditions." As explained in Part I of this Report (see Section C-1) this will be determined by a thorough functional and factual analysis to identify the economically significant activities and responsibilities undertaken by the enterprise as a whole, before going on to identify which of those economically significant activities and responsibilities are undertaken by the PE, and to what extent. The accounts or books of the PE will be a useful starting point in this analysis but will not be determinative. For example, while taxpayers may book assets in a particular jurisdiction, the results of such booking practices should not be respected where they are inconsistent with the functional and factual analysis. Section B provides a brief general functional and factual analysis of traditional banking activities, i.e. the borrowing and lending of money which should assist in carrying out the functional and factual analysis of a banking enterprise.

57. Having identified the functions performed and other relevant factors of the enterprise in relation to traditional banking operations, the next step under the WH is to determine which of those functions are performed by the PE and what assets are used and what risks are assumed as a result of performing those functions. For a bank, capital adequacy (especially "free" capital) and creditworthiness are likely to be particularly important as both affect the profitability of the bank, for example by affecting the compensation a bank would have to pay to independent parties for providing funds to the bank. This section only discusses areas where it is considered further guidance is needed on how to apply the general guidance in Part I of this Report to a bank PE.

i) *Attributing functions, assets and risks to the PE*

58. Looking at the description of the functions normally necessary to create a new financial asset for the bank, or subsequently to manage that asset, at paragraphs 8 and 9 above, it can be seen that all of the functions are performed by personnel: “people functions”. So the functional analysis should be able to determine which of those functions are performed by the PE by looking at whether the people performing those functions are located in the PE. However, it may also be necessary to determine whether some of the functions described at paragraph 12 above, although performed outside the PE, should nevertheless be taken into account when attributing profit to the PE as being related to, at least in part, the functions and characteristics of the PE. This will be determined by applying the general guidance on services in Part I of this Report, for example by recognising an arm’s length remuneration for “back-office” functions performed by Head Office that represent the rendering of a service to the PE. The application of this general guidance to the banking context is discussed in Section D-2 (iii)(g) below.

59. In addition to the input from the relevant personnel, the performance of such “people functions” also requires the possession of capital in order initially to assume and subsequently to bear the risks associated with the performance of the functions. As discussed in Part III, pure capital and risk-taking arrangements, i.e. that relate simply to possessing the capital necessary initially to assume and subsequently to bear risks, can exist between legally distinct enterprises. For example, one legal entity can enter into a legally binding agreement to guarantee all the risks assumed as a result of the functions performed by another legal entity. In such a case, the capital needed to support the risks assumed resides in a different legal entity from that in which the transactions giving rise to the risks are booked.

60. However, one of the key factual conditions of a banking enterprise trading through PEs is that capital and risks are not segregated from each other within the single legal entity. To attempt to do so for tax purposes would contradict the factual situation and so would not be consistent with the WH. Rather, as can be seen from later sub-sections, the WH uses a functional analysis to attribute assets and risks and then attributes capital to support the risks so attributed. Accordingly, it is not possible for one part of the enterprise to be treated as possessing the capital needed to support a certain amount of risks assumed where those risks are properly attributed to another part of the enterprise.

61. Tax issues arise particularly where the functions involved in the creation and management of financial assets are performed in more than one location, a “split function business”. In such cases, the functional analysis would have to examine in detail the true nature of the functions performed, especially in order to determine the true risk-taker where the key entrepreneurial risk-taking functions are split between different locations. For example, the functional analysis at the time the financial asset was created might show that one of the locations had in fact not really acted as the risk-taker but rather had performed an origination function similar to that found in loan syndication agreements between independents. The location that had actually evaluated the risks related to the transaction and had made the active decision to accept those risks would therefore be treated as the “economic owner” and so would be allocated the financial asset, whilst the location which performed the origination function would be rewarded with an arm’s length remuneration.

62. As well as analysing each of the functions performed by the PE in detail, it is also necessary to consider what assets are used and what risks are assumed in performing those functions. In terms of assets used, the most important intangibles used in a banking business have already been identified in Section B-2 above. It is not considered there are any problems particular to banking which require guidance beyond that applicable to non-financial institutions, although following the consultation process this guidance is currently under review. In terms of risks assumed, it is the performance of the sales/trading functions that generally leads to the initial assumption of the greatest risks (credit risk, operational risk and market risk). It is then the responsibility of the risk management function to ensure that the assumed risks are

successfully borne. Consequently, it is the undertaking of the key entrepreneurial risk-taking functions that creates the possibility of significant profit or loss for the bank and the need for minimum regulatory, including “free”, capital.

63. Having appropriately determined the functions performed, the assets used and the risks assumed by the PE, the next question is how to reward those functions. The preferred method under the WH is to attribute the financial assets based on where the key entrepreneurial risk-taking functions described in Section B-1 (iii) were performed (which of necessity implies the capacity to perform those functions) i.e. where the assets are “economically owned”. This will give the location performing those functions (the “economic owner”) the income from the financial assets, e.g. the interest income from a loan. This interest income can be viewed as representing an arm’s length reward for performing the various functions necessary to create and manage the loan (taking into account assets used and risk assumed) and part of the interest income represents a reward for the capital required to support the risks relating to that loan. Of course, the “economic owner” of the assets will also have attributed to it necessary expenses both in terms of rewards for functions being performed (by other parts of the enterprise, associated enterprises or third parties,) and the interest expense related to funding the assets, including any adjustment as a consequence of the “free capital” attributed to the PE.

64. The assets and risks recorded in the accounts and books of the PE form a practical starting point for determining whether the economic ownership of assets has been assigned to the location where the key entrepreneurial risk-taking functions were performed. The accounts and books should be respected for tax purposes, provided they reflect an allocation of assets and risks that is consistent with the functional and factual analysis. There may, however, be cases where the accounts and records are inconsistent with the functional and factual analysis, for example because material amounts of assets and risks may be booked in a location where none, or very few, of the functions related to their creation or subsequent management were performed. Respecting the booking location in such cases would not lead to an arm’s length attribution of profit.

65. This is why the theoretical basis of the WH is that the assets and risks of the bank are initially attributed by reference to a functional analysis. Following the aggregation principle of the Guidelines (see paragraph 1.42) this analysis may be performed at the level of portfolios of similar assets and risks, rather than for each individual asset and risk.

66. Where the functional analysis has determined that the PE alone has performed the key entrepreneurial risk-taking functions, the PE will be attributed the newly created financial assets and risks. Where the functional analysis shows that key entrepreneurial risk-taking functions related to the creation of the asset are performed partly in one jurisdiction and partly in another, this raises the issue of which part of the enterprise should be considered the economic “owner” of the financial asset and so have attributed to it the benefits and risks of ownership of the asset, in the form of the associated interest income and expense (as adjusted to take account of capital). This determination is to be based on the functional and factual analysis.

67. In traditional banking activities, unlike in global trading, it would generally be possible from the functional analysis to determine that the key entrepreneurial risk-taking functions (likely to be the sales/trading function) leading to the creation of the asset were performed in only one location and that the other locations performed less significant functions. In such cases, the location performing the key entrepreneurial risk-taking functions would have the asset attributed to it and so be treated as the “owner” of the financial asset and the associated interest income and expense (as adjusted to take account of “free” capital). There would be dealings to take into account between the location treated as the “owner” of the asset and the locations performing the other functions. These would be rewarded in accordance with the arm’s length principle, for example by means of a sales commission or service fee.

68. Exceptionally, the functional analysis may show that the key entrepreneurial risk-taking functions leading to the creation of the asset have been performed in more than one location so that the asset can be considered as owned jointly. The relative value of those functions performed in the different parts of the enterprise will be used to attribute the financial asset and consequently the “free” capital necessary to support that asset. For example, if it were determined that 60% of the value of the key entrepreneurial risk-taking functions were performed in the PE and 40% in head office, the financial asset would similarly be attributed 60% to the PE and 40% to head office.

69. The guidance in the Guidelines will be applied, by analogy, in order to determine the relative value of the key entrepreneurial risk-taking functions performed in the different parts of the enterprise. Again, following the aggregation principle of paragraph 1.42 of the Guidelines, the analysis may be made at the portfolio or book level of similar assets and risks, rather than for each individual financial asset or risk.

70. Events subsequent to the creation of the assets and risks may also affect where the assets and risks are ultimately attributed. Subsequent transfers may lead to the assets and risks being attributed to another part of the enterprise, provided those transfers are recognised for tax purposes following the guidance given in Section D-2 (iii)(f) below. Further, that attribution would also have to take into account any subsequent events leading to the assets and risks becoming jointly owned. For example, where key entrepreneurial risk-taking functions, such as risk management, are transferred, the assets and risks might be treated as jointly owned by the parts of the enterprise that created them and the parts of the enterprise that subsequently manage them (see Section D-2 (iii)(e) below), but only if part of the risk remains with the initial risk-taker.

ii) Attributing a creditworthiness to the PE

71. As discussed earlier, the ability to borrow at one rate of interest and to lend at another, higher, rate is fundamental to the business of a banking enterprise. The creditworthiness of the banking enterprise is a crucial factor in the ability to raise funds at a rate that enables the enterprise to make a “turn” and therefore potentially a profit on its activities. This is because the creditworthiness of an enterprise is a significant factor in determining the lender’s perception of credit risk involved in making a loan to that enterprise, a perception that translates into the interest rate charged.

72. The importance of creditworthiness can be illustrated by means of an example (please note the figures in the following example are illustrative only). Assume that a AAA rated bank can borrow for 3 years at a rate of 4.95%; an enterprise rated AAA can borrow for 3 years at a rate of 5.05%; and a AA rated bank can borrow for 3 years at a rate of 5.1%. In the normal course of business, a branch of the AAA rated bank (because it relies on the credit rating of the whole bank) could borrow at 4.95% and lend for exactly the same 3-year term to a AAA enterprise at 5.05%, making a profit of 0.10%.

73. Conversely, assume the branch is a legally distinct and separate banking enterprise, with a credit rating less than that of the parent bank, say a rating of AA. Now it can only “borrow” at 5.1%. Its AAA customer will not pay more than 5.05% for a 3-year loan, which would leave the branch with a loss of 0.05% if it borrowed the funds to on-lend for the same 3-year term (NB. The AA rated bank could lend at an expected profit to the AAA rated enterprise but only by taking advantage of the yield curve and borrowing the funds for a shorter period, say 6 months, than the 3 year term of the lending (see paragraph 39 above). This would leave the lender exposed to yield curve risk, i.e. the risk that short-term interest rates would have risen at the end of the 6 month period, thereby making it prohibitively expensive to re-finance the loan.)

74. In fact, bank branches generally enjoy the same creditworthiness as the enterprise as a whole, which enables them to borrow and on-lend at a profit on the same terms. To postulate that Article 7 requires that the branch should not enjoy that creditworthiness, but should be treated as having a lower creditworthiness than the enterprise as a whole, would produce an unrealistic attribution of profit.

75. It has been suggested that dealings similar to guarantees should be hypothesised between the PE and Head Office. This is on the basis that when the capital of the bank is allocated amongst its parts, there would be insufficient capital for each part of the enterprise to have the same creditworthiness as the bank (the whole is greater than the sum of its parts). Accordingly, a guarantee would be needed to give the PE the same creditworthiness as the bank.

76. However, this proposal is not acceptable. First, it is an observable condition that a PE is treated in general as having the same creditworthiness as the bank. It should also be remembered that a PE must be hypothesised as a distinct and separate enterprise carrying on the same and similar activities under the same or similar conditions. One of the important “conditions” is the creditworthiness of the enterprise itself. Furthermore it is not clear why one part of the enterprise, such as the Head Office, would have the higher creditworthiness necessary to enable it to guarantee the transactions undertaken by the PE. The WH is based on the factual situation of the bank, which is that capital, risks etc. are generally fungible so it would be inconsistent to grant all the benefits of synergy, internal risk set-offs etc. to the Head Office.

77. Second, as noted in Section B-4(ii), there are factors other than capital such as reputation, profitability, management quality, risk diversification that also affect creditworthiness. Again it is hard to understand why all these other factors would be concentrated in one part of the enterprise.

78. In short, the hypothesised distinct and separate enterprise should have the same creditworthiness as the bank as a whole, except in the exceptional circumstances referred to in paragraph 29 above. In such cases it will be necessary to determine the creditworthiness of the PE, for example by reference to independent enterprises in the PE jurisdiction that are comparable in terms of assets, risks, management etc. or by reference to objective benchmarks such as credit evaluations from independent parties that evaluate the PE based on its facts and circumstances and without reference to the enterprise of which it is a part.

iii) Attributing capital to the PE

79. Under the WH, the PE is treated as having an appropriate amount of capital in order to support the functions it performs, the assets it uses and the risks it assumes. As discussed in Section B-4, in order to assume risk, a bank needs “capital”, i.e the ability to absorb losses due to the realisation of assumed risks. Regulators require banks to have minimum amounts of capital based on the risks they assume. However, some of the forms of that capital give rise to a return to investors that is not tax deductible under the rules of the PE jurisdiction (“free” capital). This section looks in detail at (a) attributing “free” capital and at (b) attributing capital other than “free” capital.

a) Attributing “free” capital to the PE

80. Section B-4 (v) discussed the general significance of “free” capital for a bank. The subject is even more significant for the taxation of a bank PE because in order to arrive at an arm’s length attribution of taxable profit to the PE, it will be necessary to ensure that the PE is treated as having an appropriate amount of “free” capital in order to support the functions it performs, the assets it uses and the risks it assumes. As noted in paragraph 24, “free capital” refers to capital the return on which does not give rise to a tax deduction under the rules of the PE jurisdiction, regardless of whether such capital is classified for

regulatory purposes as Tier 1 or Tier 2 capital. This section considers how to determine the arm's length amount of "free" capital that should be attributed to the PE, following the debt/equity characterisation rules of the PE jurisdiction.

81. The regulatory system for banks is based on world-wide regulation of the consolidated banking group by the home country. This regulation aims, amongst other things, to ensure that the consolidated banking group as a whole maintains an adequate amount of capital to cover the business it takes on and the risks it assumes from its world-wide operations by requiring that adequate capital be maintained at every tier within a banking group. For these purposes, the whole capital of each bank in the consolidated banking group is taken into account, regardless of where it is located, because its whole capital is potentially available to meet losses in respect of any asset of that bank. Provided the home country bank regulators follow the Basel Committee standards, the bank regulators in the PE jurisdictions will ordinarily not attempt to determine capital adequacy levels for the bank or, importantly, insist on separate minimum capital requirements for the PE.

82. Consequently, for regulatory purposes in both home and host jurisdictions, there is no need for any "free" capital to be formally allotted or endowed to the PE and so its operations (unlike those of the bank itself) could be wholly debt funded. However, if the same banking operations were carried on through a subsidiary in the host jurisdiction, the regulatory authorities would insist on minimum capital requirements, including Tier 1 capital, which is largely "free" capital. If the tax authorities followed the regulatory approach, which is indifferent as to whether any capital is attributed to PEs, the PE would be much more lightly taxed than the subsidiary because of the absence of "free" capital. The following example may help to illustrate this point.

Example (please note the figures are for illustration only)

Midas Bank (a resident of Country B) conducts banking operations in Country A (local currency \$) and lends \$100 to a third party customer at 10.2%. Midas Bank can borrow \$100 in market of Country A at 10%.

Situation 1: Midas Bank operates through a PE in Country A

Country B's regulators follow the Basle Committee Standards and ensure that Midas Bank fulfils the minimum capital adequacy requirements. Accordingly, the regulators in Country A do not insist on the PE of Midas Bank in Country A maintaining any separate minimum regulatory capital. The Midas Bank PE has no "free" capital allotted to it and so its operations are wholly debt funded producing the following gross profit margin for accounting purposes:

	Interest received	=	100 * 10.2%	=	10.2
	Less Interest paid	=	100 * 10.0%	=	10.0
Gross profit margin					0.2

Situation 2: Midas Bank operates through a subsidiary in Country A, Midas Ltd

Midas Ltd is regulated by Country A's regulators who also follow the Basel Committee Standards and ensure that Midas Ltd fulfils minimum capital adequacy requirements based on its global activities. Accordingly, the regulators in Country A insist that the Midas Ltd maintains a minimum capital ratio of 8% of which 4% must be Tier 1 Capital (it is assumed that this is all "free" capital under the tax rules of A).

Calculation of interest paid:

It is necessary to calculate the amount of the “free” capital that is needed to support the lending. Let us assume that the loan of \$100 is given a risk weighting under the regulatory rules of 50%.

“Free” capital (Tier 1) is set by regulators at 4% of risk-weighted assets. So for the loan of \$100 with risk weighting of 50%, the amount of “free” capital must be 4% of 50 = 2. So the bank will only have to borrow \$98 the remaining \$2 must be “free” capital and is interest free. This produces the following gross profit margin for accounting purposes:

	Interest received	=	100 * 10.2%	=	10.2
	Less Interest paid	=	98 * 10.0%	=	<u>9.8</u>
Gross profit margin					0.4

So the gross profit margin of the subsidiary, Midas Ltd, is double that of the Midas Branch for the same banking transaction simply because of regulatory differences permitting it to operate without “free” capital.

83. It is suggested that the above result should not be followed for tax purposes. It is unacceptable on tax policy grounds. The result does not follow the arm’s length principle, does not actually reflect the profits earned in the PE, and it provides considerable scope for tax avoidance.

84. As noted in paragraph 82 above, the regulatory focus on the consolidated banking group means that there may be no need to allocate any “free” capital to the PE for regulatory purposes. This should not however affect the attribution of “free” capital for tax purposes. Consequently, an arm’s length attribution of “free” capital to the PE may have to be made to ensure an arm’s length attribution of taxable profit to the PE, even though no “free” capital has actually been allocated to the PE for regulatory or other purposes.

Step 1 - Measuring the risks attributed to the PE

85. As noted in Section D-1 (i), the WH uses a functional and factual analysis to attribute assets and risks to the PE and the same section also notes that capital and risk are not segregated within a single legal entity. It follows that under the WH it is necessary to attribute “free” capital to the PE in accordance with the risks attributed to that PE, and that it is therefore necessary to measure those risks. Moreover, the WH is consistent with the arm’s length principle, as independent enterprises would need to have more capital in order to support “riskier” financial assets. This is also consistent with Part III, where the capital of a global trading business is often used primarily to enable those businesses to assume risks rather than to fund the creation of assets. Further, as discussed in paragraph 18, the WH takes into account risks arising from off-balance sheet items notwithstanding that such items may not give rise to an immediate need for funding because the principle is to attribute “free” capital in respect of all risks. Accordingly, attributing “free” capital based on the quantum of risks (including risks arising from off-balance sheet items) reflects the role of “free” capital for financial businesses and by following the same principle for all types of financial businesses has the additional advantage of helping to ensure a level playing field amongst different types of financial institution.

86. The question remains as to how to apply the principle stated above in practice. Measuring risks is difficult and flexibility is required. A regulatory based approach to measuring the risks attributable to a PE could be used under any of the methods used to attribute “free” capital to a PE discussed under Step 2 below, i.e. under the capital allocation, quasi-thin capitalisation or thin capitalisation approach. For example, one regulatory based approach to measure risks would be to risk-weight the assets by reference to the internationally accepted regulatory benchmarks of the Basel Committee, currently found in the 1988 Basel Accord and its subsequent modifications. There are differences in the possible regulatory based

approaches depending on whether or not standardised measures are used for particular types of risk and to the extent to which it is possible to take into account the bank's own models for evaluating risks rather than adopting the standardised BIS measures.

87. The 1988 Basel Accord has the potential to be used to measure risks attributed to a PE as it seeks as a first step to weight the bank's assets for credit risk. Further, since the adoption in January 1996 of the amendment to incorporate market risks in the trading book, the Basel Accord can now be used to weight the bank's assets for market risk. Such an approach has the advantage of providing an internationally consistent framework within which to measure risks. This may make it easier for host and home country to agree on the appropriate risk weightings and thereby reduce the risk of double taxation, although some countries may apply a more prudent interpretation of the Accord than others, or may impose additional requirements.

88. However, one disadvantage is that the current regulatory benchmarks for weighting assets for credit risk under the 1988 Basel Accord are somewhat crude. For example, credit risks are divided for weighting purposes into only 5 categories; 0, 10, 20, 50 and 100%. The way the categories are currently drawn up also leads to some odd results - the same degree of credit risk is effectively given to a loan to a AAA counterparty as to an individual buying a car. In that sense the current regulatory benchmarks would only be a proxy for an arm's length approach to measuring risks, although some of the apparent problems may be reduced because the individual scorings are averaged over a large number of assets. Indeed, given the large number of assets usually involved in a traditional banking business, a certain degree of approximation is inevitable. Further, other types of risk such as interest rate risk in the banking book and operational risk are not included in the risk weighting.

89. Encouragingly, the regulatory authorities are aware of some of the rough edges in the current approach and the Basel Committee released in June 1999 a proposal to improve matters by retaining the existing Accord as the "standardised (credit risk) approach" but modifying it to improve its accuracy. Greater emphasis will be placed on a proper assessment of the risks involved in traditional banking operations in addition to credit and market risk, for example by developing a standardised capital charge for interest rate risk in the banking book and for other risks, principally operational risk (including legal risks and risks resulting from inadequate or failed internal processes). The current proposal of the international regulatory community to retain the "standardised (credit risk) approach" but to modify it to improve its reliability is therefore most welcome and holds out the prospect of a more accurate, as well as internationally acceptable, method for measuring risk in accordance with the arm's length principle.

90. However, there are regulatory developments that raise tax issues worth further consideration. One regulatory development that has already occurred concerns the use of the bank's internal models for measuring market risk. The January 1996 Market Risk Amendment provides for two ways of measuring market risk. The first is a "standardised (market risk) approach" that determines minimum capital charges for "general" and for "specific" market risk. The second is based on following the bank's internal "value at risk" models, provided the models are deemed suitable by the regulatory authority and the bank's risk management systems are satisfactory. Unlike the "standardised (market risk) approach", the internal models take into account the correlative effects of positions within or across risk categories.

91. The June 1999 proposal to modify the 1988 Basel Accord also opens up the possibility of allowing approaches other than the "standardised (credit risk) approach" to measure credit risk. In particular, it may be possible in the future to use banks' internal credit risk models to measure credit risk on a portfolio basis, based on either external or internal assessments of creditworthiness. Such models might be used as the basis for measuring the credit and market risks attributed to a PE, provided they are approved by the regulatory authorities, applied consistently and sufficient details of the model, especially the assumptions underlying the model, are made available to the relevant tax authorities so that they can be

satisfied that the result is in accordance with the arm's length principle. Possibilities also arise to use banks' own models for determining operational and other risks. However, care would need to be exercised in relation to using banks' own models, particularly for operational risk. Such models may not be based on observable conditions since operational risk may arise from unforeseeable events that are not measurable by data.

92. In conclusion and subject to the next paragraph, the "standardised" approaches of risk weighting assets under the current version of the modified 1988 Basel Accord seem to be a reasonable proxy for measuring risks under the arm's length principle and have the advantage of providing an internationally accepted and reasonably consistent way of measuring risk. Regulatory developments to maintain and improve the reliability of the standardised (credit risk) approach have the potential to provide an even more accurate method of measuring credit risk and so provide a more reliable proxy for the arm's length principle. Regulatory developments that are not based on the "standardised" approaches, such as using the bank's own risk measurement models to measure the risks requiring regulatory capital, have the potential to provide more accurate measures of credit and market risk and so more accurately reflect the arm's length principle. Such methods have the potential disadvantage that, unlike the standardised approach, they may not yet be readily accepted by all countries as valid for tax purposes and may be difficult to audit satisfactorily.

93. However, given the need for flexibility, it is suggested that a variety of regulatory based approaches to measure risks may be acceptable to both host and home jurisdictions, such as use of banks' own risk measurement models, provided that they are consistent with the arm's length principle, are approved by the regulators, are applied consistently and sufficient details, for example the assumptions underlying the bank's internal model, are made available to both tax authorities to satisfy themselves that the above conditions have been met. Issues arise because the risk models of banks are generally developed and applied on a consolidated basis. When necessary, these models and other systems would need to facilitate the determination of risk weighting at the PE level.

94. Moreover, it should be borne in mind that the WH is to measure risks in accordance with the arm's length principle, rather than to follow regulatory approaches for measuring risks or risk weighting financial assets. Regulatory developments will need to be carefully monitored to ensure that any changes do not affect the reliability of any regulatory approach as a proxy for measuring the risks attributable to a bank PE under the arm's length principle.

Step 2 - Determining the "free" capital needed to support the risks attributed to the PE

95. Having measured the risks attributed to the PE, the next step is to determine how much "free" capital is needed to support those risks under the arm's length principle. There are a number of different possible approaches for working out the "free" capital attributable to the PE of a bank. These include:

- capital allocation approaches, where a bank's actual "free" capital is allocated in accordance with the attribution of financial assets and risks, thus leading to an attribution of capital to a PE;
- quasi-thin capitalisation approaches, which would require a PE to have at least the same amount of "free" capital attributed to it as would be required for regulatory purposes for an independent banking enterprise operating in the host country; and
- thin capitalisation approaches, under which a PE would have attributed to it the same amount of "free" capital as would an independent banking enterprise carrying on the same or similar activities under the same or similar conditions in the host jurisdiction of the PE.

1. Capital allocation approaches

96. One possible approach would be to *allocate* the bank's actual "free" capital (i.e. the "free" capital used to assume the risks from the bank's operations) in accordance with the attribution of financial assets and risks by first attributing assets and risks and then risk-weighting the assets following the Basel standardised regulatory rules. Under this approach, capital is allocated on the basis of the proportion that the risk-weighted assets of the PE bear to the total risk-weighted assets of the entity as a whole (the BIS ratio approach). So if the PE has 10% of the bank's risk-weighted assets, it will have attributed to it 10% of the bank's "free" capital. Other versions of the capital allocation approach do not risk-weight the assets according to a standardised regulatory approach but may, for example, use banks' own models for determining risks. However similar principles apply in that if the PE has 10% of the bank's total assets and risks, it will have attributed to it 10% of the bank's "free" capital.

97. It will be necessary to properly allocate the total "free" capital of the bank, and not just the regulatory minimum, if capital allocation approaches are to be used as a proxy for the application of the arm's length principle. This is on the basis that all the assets and all the associated risks of the bank have been attributed to the various parts of the bank, including the head office, under the functional analysis. Given a functionally based attribution of assets and, especially, risks, there is no reason to allocate part of the "free" capital of the bank to head office on the basis that the head office would be expected to absorb any extraordinary and unforeseeable losses arising from the realisation of risks.

98. A number of issues arise when applying this approach. It has been suggested that whilst in principle the total "free" capital should be allocated, temporary surpluses, for example from the sale of a business, should be excluded. This determination would have to be made on a case-by-case basis and raises a number of difficult practical issues. For example, should a surplus be excluded even if the proceeds from the sale of a business are actually invested in the bank's ordinary loan business? Would it be necessary to segregate the surplus in some way (e.g. in an investment fund that does not invest in loan assets)? Similarly, would a war-chest being built up to buy another business have to be segregated and the bank required to demonstrate that the funds set aside have in fact later been used to buy another business?

99. There might also be instances where the PE conducts a very different type of business to the bank as a whole (e.g. a private banking part of a retail bank) or the market conditions in the PE are very different from those applying to the rest of the bank (e.g. where the home jurisdiction is in a protected market such that all banks can operate there with very high levels of capital but where the host jurisdiction is very competitive so that banks operate much closer to the regulatory minimum). In general, the focus of the WH on attributing "free" capital by reference to risks should mean that those differences are adequately reflected in the allocation of "free" capital. For example, it would be expected that the difference in types of business between private and retail banking would be reflected in the measurement of risks and so would be appropriately reflected in the capital allocation. However, in cases where the differences, e.g. in market conditions are not appropriately reflected in the measurement of risk, the results of the capital allocation approach might be outside the arm's length range unless reasonably accurate adjustments could be made to account for differences in the way it operates and the conditions under which it operates.

100. Another point that needs consideration when determining the "free" capital to be allocated is the basis of the capital adequacy report that the regulatory authorities require from a bank for the purpose of ensuring compliance with minimum capital requirements. Most commonly, banking groups are required to submit a report on a "consolidated" basis, encompassing the banking entity itself and all relevant affiliates. However, a report on a "solo" basis, applying to the banking entity only, may be required. Moreover, if certain conditions are met, the regulatory authorities may allow the banking entity to modify its "solo" return in order to include capital invested in "solo-consolidated" subsidiaries in its computation of regulatory capital (a "solo-consolidated" basis).

101. General tax principles are based on respecting the separate legal entities within a MNE group. Those principles therefore suggest the WH should be applied so as to attribute to a PE only the regulatory capital of the banking entity of which the PE is a part (a “solo” basis). This basis would exclude from allocation any capital held in the subsidiaries of the banking entity. However, applying the WH to a “solo” banking entity may lead to problems where the “solo” banking entity is thinly capitalised, for example because significant amounts of its capital are held in subsidiaries and these investments are not adequately reflected on its balance sheet. In such cases an approach other than capital allocation may be needed in order to arrive at an arm’s length result.

102. The discussion in this section attempts to provide an agreed framework for OECD member countries that favour a capital allocation approach. The framework does not cover all the issues, including what deductions to allow when computing the amount of capital, over what period to compute the capital ratios (perhaps using some kind of weighted or moving average), or how to deal with FX issues where the assets and the capital attributed to cover them are denominated in different currencies. It also should be noted that there may be problems for the host country in obtaining the information necessary to apply the approach and for it to be applied consistently in all the countries where the bank operates.

2. Economic capital allocation approach

103. Another approach to allocating “free” capital has been suggested based not on regulatory measures of capital but by reference to economic capital. This approach has the potential to conform to the WH as it is based on measuring risks. The rationale for this approach is that regulators only look at the types of risk that cause concern for regulators and are not concerned with other types of risk that may well have a greater impact on bank profitability. Such an approach would have to rely on the bank’s own measures of risk and economic capital and such measures do not appear sufficiently well developed to be relied on at the moment. However, development in this area might mean that economic measures of capital usage could become an acceptable proxy to arrive at a result within the arm’s length range.

3. Alternative approaches to capital attribution - quasi-thin capitalisation

104. Another possibility would be to require the PE to have at least the same minimum amount of “free” capital required for regulatory purposes (regulatory minimum “free” capital) as would an independent banking enterprise operating in the host country jurisdiction (*a quasi-thin capitalisation approach*). The regulatory minimum “free” capital would be determined in accordance with the regulatory standards and tax characterisation rules of the host jurisdiction. There are a variety of possible quasi-thin capitalisation approaches, depending on whether the assets are risk-weighted, whether or not risks arising from off-balance sheet items are included etc.

105. The focus of the “quasi-thin capitalisation” approach is on providing an administratively simple way of ensuring that the PE cannot have less “free” capital than the regulatory minimum “free” capital for an independent banking enterprise operating in the same jurisdiction. However, problems may arise where the PE would be attributed less “free” capital under the rules used by the home jurisdiction than the regulatory minimum of the host country. In such cases, double taxation may arise because the home country would restrict the profits of the PE qualifying for double taxation relief, to reflect the lower amount of “free” capital necessary under their view of the application of the arm’s length principle.

106. Concerns about double taxation are less where the approach is applied as a safe harbour (for example, the PE would be required to have “free capital” at least equal to a fixed percentage of the assets of the PE) and the taxpayer is given the opportunity to demonstrate that the PE actually requires less “free” capital than the safe harbour percentage. Such a demonstration would have to be based on the principles set out in this section. For example, if the taxpayer wanted to argue that it should have “free” capital less than

a safe harbour figure based on a ratio of “free” capital to assets that did not take into account risks, it would also be required to measure the risks attributed to the PE (including risks arising from off-balance sheet items).

107. There are other situations where there may be problems with this approach. The effect of attributing only the regulatory minimum for each of the jurisdictions where the bank has PEs is that any “free” capital in excess of that amount is effectively allocated to the head office. However, the effect of such an approach is that the host jurisdiction is exercising less than its potential taxing rights under Article 7 and so there are unlikely to be problems of double taxation. Problems of less than single taxation would arise if the home jurisdiction were to relieve double taxation by reference to the full arm’s length amount of profit even though the host jurisdiction has taxed less than that amount, as frequently occurs in the case of certain exemption systems.

4. Alternative approaches to capital attribution - thin capitalisation

108. Another approach would be to require that the PE has the same amount of “free” capital as would independent banking enterprises carrying on the same or similar activities under the same or similar conditions in the jurisdiction of the PE by undertaking a comparability analysis of such independent banking enterprises (*a thin capitalisation approach*).

109. The key to undertaking the comparability analysis is that the comparable is not just any independent banking enterprise but an independent banking enterprise carrying on the same or similar activities under the same or similar conditions as the PE. Care must be taken when making the comparison with independent enterprises. The branch when hypothesised as a separate enterprise would be smaller than the bank as a whole and so might be compared with similarly smaller independent banking enterprises. However, small independent banks are unlikely to be comparable to a PE that is part of a large banking enterprise. They are likely to carry on different types of business, to have different risk profiles and to have different types of customers than the PE to which they are being compared. In short, small independent banks may not be a reliable benchmark to use for attributing capital to such a PE.

110. There are a number of factors that need to be taken into account to ensure that appropriate comparables can be found of which the following are likely to be the most important :

- the capital structure of the enterprise as a whole;
- the minimum amount of “free” capital that the host country regulator would require for an independent host country bank carrying on the same or similar activities under the same or similar conditions;
- the range of actual capital structures of independent host country banks carrying on the same or similar activities under the same or similar conditions (to reflect the fact that independent host country banks generally operate with levels of “free” capital above the regulatory minimum);

As indicated in paragraphs 1.15 and 1.17 of the Guidelines, if there are material differences between the economically relevant characteristics of the PE and the host country banks, reasonably accurate adjustments should be made to account for those differences so that the comparability standard is fulfilled.

111. Like the quasi-thin capitalisation approach, the thin capitalisation approach has the advantage of avoiding some of the issues that arise in determining the amount of capital to be allocated, for example due to solo-consolidation. However, under a thin capitalisation approach, it is perfectly possible for either more or less capital than the enterprise as a whole possesses to be attributed amongst its various parts. In

practice, banks often carry on riskier business outside their home jurisdiction and so the PE, when hypothesised as a legally distinct and separate enterprise, is likely to require more capital than independent banking enterprises operating in the same jurisdiction in order to cover the riskier activities it undertakes. Double, rather than less than single, taxation is more likely to occur under a thin capitalisation approach, unless the riskier nature of the activities of the PE is appropriately recognised by the home jurisdiction.

5. Safe harbours

112. Both the quasi-thin capitalisation and the thin capitalisation approaches may be used in conjunction with a safe harbour. The Guidelines contain much discussion of the pros and cons of safe harbours in general before concluding in paragraph 4.123 that, “[I]n view of the above considerations, special statutory derogations for categories of taxpayers in the determination of transfer pricing are not generally considered advisable, and consequently the use of safe harbours is not recommended.” However, as noted at paragraph 4.96, the discussion in the Guidelines, “does not extend to tax provisions designed to prevent “excessive” debt in a foreign subsidiary (“thin capitalisation” rules), which will be the subject of subsequent work.” That work is currently in progress and will examine, amongst other things, the risks of double or less than single taxation arising from the use of safe harbours to deal with thin capitalisation issues.

b) Attributing capital other than “free” capital to a PE

113. For commercial or tax reasons, banks are likely to include in their regulatory capital not just “free” capital but also other types of semi-permanent interest bearing capital such as subordinated debt. Investors require a higher return on such debt to reflect the restrictions on such debt as compared to conventional debt. Under the arm’s length principle, it will be necessary to take such capital into account in order that the PE can deduct the right amount of interest expense. For example, if Tier 2 subordinated debt is raised by one part of the enterprise, it would not be correct for this part of the enterprise to bear all the interest expense in respect of debt that was raised for the benefit of the bank as a whole.

114. There are broadly two different ways of taking such capital into account depending on the general approach taken to attribute capital and to determine interest expense. The first would be to treat regulatory capital other than “free” capital in the same way as “free” capital. Under a capital allocation approach, one way would be to use the BIS ratio of the whole bank to attribute both Tier 1 and Tier 2 regulatory capital to a PE (the “pure” BIS ratio approach described in Annex 1). So when applying the quasi-thin capitalisation approach, the PE would be required to have at least the same regulatory minimum capital (not just regulatory minimum “free” capital) as an independent enterprise operating in the host country jurisdiction. Similarly, under a thin capitalisation approach, the PE would be treated as having the same amount of capital (not just “free” capital) as would independent banking enterprises carrying on the same or similar activities under the same or similar conditions in the jurisdiction of the PE.

115. The second would be only to attribute “free” capital under the preferred attribution approach (capital allocation, quasi-thin capitalisation and thin capitalisation). So under a capital allocation approach, the BIS ratio of the whole bank would be used to attribute only the “free” capital in Tier 1 to a PE (the “cleansed” BIS ratio approach described in Annex 1). However, the capital other than “free” capital would be taken into account when determining the interest expense of the PE and/or when rewarding the performance of the treasury function. Although such matters are dealt with in general under the second step of the WH (see Section D-2(iii)(b)), it is convenient to deal with them here. There are different ways to address this issue, depending on the method chosen for rewarding the treasury function and for computing the interest rate on internal “interest” dealings.

116. Under some methods there will be no need to make an adjustment because the higher interest rate on the subordinated debt will already have been reflected appropriately in the calculation of the rate on any internal “interest” dealings. Funds raised by the bank are from a variety of sources and have varying interest rates. Some funds are free or give rise to very low interest rates, whilst others give rise to high interest rates, such as subordinated debt qualifying as Tier 2 capital. So if, for example, any internal “interest” dealings are charged at an appropriately “blended” rate to reflect the proportions of funding at different interest rates and maturities, there should be no need to make further adjustments to arrive at an arm’s length interest expense for the PE.

117. Under other methods, an adjustment would need to be made because the method used to price the internal dealings would not appropriately reflect the higher interest rate debt. For example, internal dealings could be priced by reference to market wholesale interbank interest rates but this rate may not be an appropriate comparable without an adjustment to reflect the actual funding mix of the bank of which the PE is a part.

118. It should be stressed that the goal of all the approaches described above is the same, i.e. that the amount of interest expense (defined according to the classification rules of the host jurisdiction) claimed by the PE does not exceed the arm’s length amount. Consequently, the overall result of applying any of the above approaches should be similar.

c) Conclusion on attributing capital to the PE

119. The attribution of capital among parts of an enterprise involved in a banking business is a pivotal step in the process of attributing profit to a bank PE. It determines the quantum of capital that the bank PE should be considered to have under the WH and the appropriate treatment of Tier 1 and Tier 2 capital under the tax rules of the PE’s jurisdiction. This reflects the accepted view that a bank PE, just like any other type of PE, should have sufficient capital to support the functions it undertakes, the assets it uses and the risks it assumes. For this reason, the method by which capital is attributed is an important step in avoiding or minimising double taxation.

120. The consultation process has shown that there is an international consensus amongst governments and business on the principle that a bank PE, just like any other type of PE, should have sufficient capital to support the functions it undertakes, the assets it uses and the risks it assumes. However, the consultation process has also shown that it will not be possible to develop a single internationally accepted approach for making that attribution of capital, including “free” capital. Further, a review of the domestic law of OECD Member countries, shows that there are different views on the preferred approach to capital attribution, and so it will not be possible to develop an internationally accepted hierarchy of approaches.

121. Rather, the focus of the OECD work is on articulating the principles under which such an attribution should be made and on providing guidance on applying those principles in practice and in a flexible and pragmatic manner. This work would be informative for the development of countries’ domestic legislation and would be of particular benefit in resolving any disputes under Article 25 of the OECD Model Tax Convention. As such, any of the approaches described in this section are capable of producing an arm’s length result in general, although there may be particular situations where the approach does not produce an arm’s length result and so flexibility may be required and other approaches used.

122. It is also worth stressing that, just as for other transfer pricing matters, the application of the arm’s length principle to attribute capital is likely to come up with a range of results rather than a single number. Moreover as noted in paragraph 1.69 of the Guidelines, it may in difficult cases be helpful to use more than one transfer pricing method. Attributing capital to a bank PE is a good example of a difficult

case and so it may sometimes be informative to use more than one capital attribution approach as a “sanity check” on the overall result.

123. Finally, it should be remembered that the focus of Article 7 is on appropriately determining the taxing rights of the host jurisdiction on non-resident enterprises. Each OECD Member country is likely to adopt only one of the agreed approaches to attributing capital and may require taxpayers to follow that approach in their jurisdiction when computing the profits of a PE under the arm’s length principle. Double taxation may potentially arise where the approach required by the home country in order to compute the profits of a PE eligible for double taxation relief is different from the approach used in the host jurisdiction. The Mutual Agreement Procedure of Article 25 is available to resolve disputes between the host and home jurisdiction including situations where countries use different approaches under their domestic law.

iv) Adjusting the interest expense claimed by a PE for attributed capital

124. Once the arm’s length amount of capital attributable to a PE has been determined, a comparison needs to be made with the actual capital allotted to the PE by the bank. Where the amount of capital allotted by the bank is less than the arm’s length amount, an appropriate adjustment may need to be made to the amount of interest expense claimed by the PE in order to reflect the amount of the bank’s capital that is actually needed to support the lending activities of the PE. The adjustment will be made following the rules of the PE’s jurisdiction, subject to Article 7.

125. It should be noted that the PE jurisdiction may be taxing less than an arm’s length amount if no adjustment is made to increase the allotted amount of “free” capital. The focus of Article 7 is on determining the appropriate taxing rights of the PE jurisdiction in that it cannot tax in excess of the arm’s length amount of profit. No adjustment is mandated under Article 7 in this case. However, host jurisdictions may wish to exercise their full taxing rights by adjusting upwards the amount of “free” capital. Article 7 permits this adjustment provided that the host jurisdiction does not make an upwards adjustment in excess of the arm’s length amount. Some possible means of making this adjustment are discussed in Section C-2(iv)(d) of Part I and are equally applicable to banks. Section D-1(iii)(b) on attributing capital other than “free” capital may be relevant. Moreover, regard should be had to the discussion in Section D-2(iii)(b) on internal “interest” dealings, as many of the ways of making the adjustment for capital involve adjusting the interest rate charged on internal dealings.

126. An issue also arises in the reverse of the above situation, i.e. where the PE has allotted capital in excess of the arm’s length range of “free” capital. This might arise, for example, because of a domestic tax law requirement on allotted capital. In this case the host jurisdiction is taxing more than is permitted under Article 7. Accordingly, any domestic tax law requirement that provided for an amount of “free” capital in excess of the arm’s length range of capital would be restricted by Article 7 to an amount within the arm’s length range. Alternatively, the bank may allot an excessive amount of “free” capital to a PE, for example where the PE is subject to a low rate of taxation and the bank wishes to maximise interest deductions in its home jurisdiction or in PEs subject to a higher rate of taxation. In such situations, the PE should be taxed in accordance with the WH and therefore should be regarded for tax purposes as having no more than an amount of “free” capital within the arm’s length range.

127. Another issue arises in the extreme situation where the PE has no assets that require funding but has undertaken activities giving rise to off-balance sheet items. Although this is an extreme example it is discussed further as it is illustrative of one of the key principles discussed in the draft. Under the WH, there would be a need to take into account the capital that would be needed by the PE in order to enable it to assume the risks arising from off-balance sheet items. Usually, the adjustment to profits to reflect the role of capital is given effect by reducing the interest expense. However, in this extreme situation the PE has no

interest expense, as off-balance sheet items do not require funding at the time of entering into the transaction.

128. The correct approach is to consider an independent enterprise in a similar situation. That enterprise would also require capital in order to assume risks arising from off-balance sheet items and that capital would probably be invested in income producing assets. Therefore, by analogy, the PE could also be attributed an income based on the likely investment of its capital. One way of doing this would be to impute a “loan” from the PE to the treasury location within the enterprise, which would have the effect of giving interest income to the PE.

129. Another issue relates to the situation where all the operations of the PE are funded by borrowings from third parties. Is it still necessary to disallow part of the interest expense by reference to an amount of “free” capital? The answer is that it would be consistent with Article 7 to make such an adjustment, given that the PE when hypothesised as a distinct and separate enterprise would have “free” capital as discussed earlier in this Report. However, as noted earlier in this section, Article 7 does not mandate such an adjustment when the host country imposes tax on an amount of business profits that reflects the recognition of “free” capital in the PE in an amount that is below the arm’s length range of “free” capital.

130. Some practical issues arise as to how to make any such adjustment. Where the PE borrows funds from the treasury centre a “free” capital adjustment can potentially be made in respect of the internal “interest” dealing. However, this solution is not possible where the PE’s borrowings are wholly with third parties. One way of effectively making the adjustment for “free” capital would be again to impute a “loan” from the PE to the treasury location of the enterprise which would have the effect of decreasing the interest deduction of the PE by reference to the amount of “free” capital.

D-2 Second step: determining the profits of the hypothesised distinct and separate enterprise based on a comparability analysis

131. As noted in Part I of this Report, the functional and factual analysis of the first step of the WH will have appropriately hypothesised the PE and the rest of the bank as associated enterprises, each undertaking functions, using assets and assuming risks. Financial assets will also have been attributed to the PE as the “economic owner” of those assets as a means of rewarding the key entrepreneurial risk-taking functions leading to the creation (sales/trading) and subsequent management (risk management) of those assets. Further, as noted above, other important characteristics (e.g. “free” capital and creditworthiness) will also have been appropriately hypothesised to the PE and the rest of the bank.

132. The second step of the WH goes on to apply, by analogy, the guidance in the Guidelines to any economic relationships (dealings) between the hypothesised distinct and separate enterprise and the rest of the bank. For example, although financial assets may have been attributed to the PE in country A by virtue of the fact that the PE undertook the key entrepreneurial risk-taking functions leading to the creation of the financial assets, it may be that other parts of the enterprise performed other functions related to those assets. These functions would need to be rewarded in order to ensure that the PE in country A is attributed an arm’s length profit. Under the WH, the preferred approach would be to record all the income from the financial assets in the books of the PE in Country A as the “economic owner” of the portfolio and to attribute to it expenses in respect of the dealings representing an arm’s length reward for the functions performed by other parts of the enterprise. In particular, the concept of comparability analysis will be used in order to attribute profit in respect of those dealings by making a comparison with transactions undertaken between independent enterprises.

133. General guidance on making such comparisons has been provided in Section C-2 (iv) of Part I of this report. This section discusses how to apply that guidance to a bank PE involved in the borrowing and lending of money.

i) Recognition of dealings

134. As noted in Part I of this Report, the guidance at paragraphs 1.28-1.29 and paragraphs 1.36-1.41 of the Guidelines can be applied, by analogy, to determine whether a dealing has taken place and whether the dealing as structured by the taxpayer can be disregarded or re-characterised. It will be necessary first of all to determine whether any dealing exists in relation to the PE before deciding whether the dealing, as found, should be used as the basis for the analysis used to determine an arm's length attribution of profit. In terms of the threshold question, Part I of this Report goes on to note that a dealing should not be found between different parts of the enterprise unless it relates to "a real and identifiable event (e.g. the physical transfer of stock in trade, the provision of services, use of an intangible asset, a change in which part of the enterprise is using a capital asset, the transfer of a financial asset, etc.)" that has transpired between them. The paragraph concluded that, "A functional analysis should be used to determine whether such an event should be taken into account as an inter-branch dealing of economic significance."

135. It is considered relatively straightforward in principle to apply the above guidance to dealings related to the provision of services within a bank. This is discussed in more detail in Section D-2 (iii)(g) below.

136. However, there are more problems when trying to apply that guidance to dealings in relation to financial assets, given the nature of a traditional banking business. A bank's stock in trade is its financial assets - its loans. However, such assets are not physical in the sense that they exist only as contractual arrangements and as entries in the accounting records of the bank. Unlike a physical asset, it can be difficult to determine where in a bank the financial assets are located and, once located, whether they have been transferred to another part of the enterprise or whether another part of the enterprise has begun to use them. These difficulties are compounded by the impact of regulation which can mean that assets are "booked" in a location where none of the functions related to the creation or ongoing management of that asset have been, or will be, carried out.

137. As discussed under the first step, in the context of a PE it is not possible to rely on contractual agreements as can be done between legally distinct enterprises and so instead, the WH relies ultimately on the functional and factual analysis to determine where financial assets and risks are "economically owned", rather than on where they are booked. Financial assets and risks are not "economically owned" where they are booked if the key entrepreneurial risk-taking functions related to their creation have not been performed there. Logically, the same principles must also apply in relation to any dealings purporting to transfer "ownership" of financial assets to another part of the enterprise. Similarly, an accounting entry removing the assets and risks from the books of one PE and transferring them to the books of another part of the enterprise would not be recognised as a transfer of "economic ownership" unless the transfer was accompanied by a transfer of key entrepreneurial risk-taking functions and the transfer of the assumption of the profit and risk potential of the asset. This issue is dealt with in more detail in Section D-2(ii)(f). Furthermore, there are circumstances in which the transfers of assets and risks would not be recognised because the transfers were not made under the normal commercial conditions that would apply between independent enterprises (see 1.38 of the Guidelines which discusses the circumstances in which transactions between associated enterprises would be similarly not recognised or would be restructured in accordance with economic and commercial reality).

138. Where another part of the enterprise performs significant functions, such as risk management, related to the assets originally “owned” by the PE, these dealings need to be taken into account when attributing profit. The question is whether the performance of the significant functions is sufficient to mean that the “ownership” of the financial assets is transferred, or whether the functions can be rewarded by an arm’s length dealing such as a service fee. This evaluation has to be made on a case-by-case basis after a careful analysis of the exact nature of the functions performed and a comparability analysis as to how the function is rewarded between independent enterprises. These issues are dealt with in more detail later (see Section D-2 (iii)(e) for risk management and transfers of risks and Section D-2 (iv) where the transfer of the asset results from the performance of an agency or conduit function).

139. As noted in Section C-2 (ii) of Part I of this Report, where an examination of the conduct of the parties shows that the terms of the dealing were not followed so that there was no real transfer of related functions or of the risk or profit potential of the asset, the transfer of the asset would be viewed as a sham and so would be ignored for tax purposes. Similarly, transferring where an existing asset and risks is booked, without transferring any of the functions and profit and risk potential of the asset would not result in a change of economic “ownership” of that asset or indeed the recognition of any dealings in respect of that asset, although the booking location would receive an arm’s length reward for the performance of any administrative functions related to the booking, such as loan administration.

140. The situation is more complex because the functions and risks associated with financial assets can sometimes be disaggregated so that functions are performed and risks managed by more than one part of the enterprise. For example, some, but not all of the functions related to the management of the risks of a portfolio of financial assets could be transferred to another part of the enterprise. In that case there may be dealings to be potentially taken into account or the portfolio might exceptionally be treated as being “owned” jointly by more than one part of the enterprise. This is discussed in further detail in Section D-1(i) for sales/trading functions, and in Section (iii) below for (e) risk management of an existing financial asset and (f) transfers of financial assets.

141. Issues arise as to how far dealings should be recognised on the same basis as transactions between associated enterprises. For example is the fact that dealings are contemporaneously documented sufficient to ensure their recognition for tax purposes? Is there a need for additional safeguards in the form of requiring conduct to be consistent with the documented dealing and/or an economic substance test related to having the necessary human and financial resources to evaluate and undertake the dealing? Whilst as noted in Part I documentation will be a very important aspect to evaluating the existence of a dealing, the simple reliance on documentation does not go as far as what is contemplated in the Guidelines, especially for dealings related to the attribution of risk. As noted in paragraph 1.25, “[T]he functions carried out (taking into account the assets used and risks assumed) will determine to some extent the allocation of risks between the parties and therefore the conditions each party would expect in arm’s length dealings.”

142. Paragraph 1.26 goes on to note that, “in line with the discussion below in relation to contractual terms, it may be considered whether a purported allocation of risk is consistent with the economic substance of the transaction. In this regard, the parties’ conduct should generally be taken as the best evidence concerning the true allocation of risk. Paragraph 1.27 goes on to note that, “[A]n additional factor to consider in examining the economic substance of a purported risk allocation is the consequence of such an allocation in arm’s length transactions. In arm’s length dealings it generally makes sense for parties to be allocated a greater share of risks over which they have relatively more control.”

143. When this guidance is taken together with the guidance in paragraph 1.28 on contractual terms it can be seen that even for transactions between associated enterprises relying on documentation is not enough, especially in relation to the allocation of risk. Given the lack of legally binding contracts between

different parts of the same enterprise, it seems sensible for the WH to rely ultimately on a factual and functional analysis to determine the economic reality behind any dealing related to the allocation of risk. The dealing as documented by the taxpayer would be a useful starting point for this analysis but would not be determinative where it was found to be inconsistent with the functional and factual analysis and therefore the economic reality of the dealing. This issue is discussed in more detail in Section D-2(iii)(e) and (f) dealing with risk management (including transfer of risk) and transfers of financial assets.

144. Once the above threshold has been passed and a dealing recognised as existing, the WH applies, by analogy, the guidance at 1.36-1.41 of the Guidelines. This means that, except in the 2 circumstances outlined at paragraph 1.37, tax administrations “ should not disregard the actual *dealings* or substitute other *dealings* for them.” Practical issues related to the valuation of internal dealings may arise, especially where market data is not available, although such difficulties may also occur in respect of the valuation of transactions between associated enterprises.

ii) *Applying transfer pricing methods to attribute profit*

145. Having established that a dealing has taken place and that the dealing as structured by the taxpayer would not need to be disregarded or re-characterised the next issue is to determine whether the profit attributed to that dealing by the bank is at arm’s length. To make this determination, the guidance in the Guidelines on comparability is applied by analogy, in the bank PE context. This is done by making a comparison of the reward earned from *dealings* within the bank with comparable *transactions* between independent enterprises, having regard to the 5 factors for determining comparability set out in Chapter I of the Guidelines.

146. Further, the WH provides that all the methods in the Guidelines can be applied in the PE context in order to determine the profit to be attributed in respect of the dealing by reference to comparable uncontrolled transactions. In the first instance, the traditional transaction methods should be examined to see if comparables from uncontrolled transactions are available. In this context, the guidance at 2.7, 2.14 and 2.34 should be borne in mind where differences are found between the dealing and the uncontrolled transaction under respectively the CUP, resale price and cost plus methods. As noted, at paragraph 2.7, “[T]he uncontrolled transaction may be comparable, “if one of two conditions is met: 1. none of the differences (if any) between the transactions (*in the PE context between the uncontrolled transaction and the dealing*) being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or 2. reasonably accurate adjustments can be made to eliminate the material effects of such differences.”

147. A traditional banking business involves the borrowing and lending of money. Money is a global commodity and so there are likely to be few problems with applying the first of the comparability factors: the characteristics of property or services, where traditional financial assets such as loans or bonds are used. Nevertheless, as stated in paragraph 1.19 of the Guidelines, “(d)ifferences in the specific characteristics of property or services often account, at least in part, for differences in their value in the open market.” Characteristics that may be important to consider in relation to financial assets include the following: the principal involved, the term of the financial asset, the applicable interest (discount) rate, the currency in which the financial asset is denominated, the respective rights of the parties in the event of default, etc. If there are no other differences in the other factors it should be relatively straightforward to find comparables and apply traditional transaction methods using market data. However, it may be difficult to find comparables for more exotic financial instruments and for instruments used for dealings that involve internal hedging arrangements.

148. The second factor, functional analysis, raises more issues. Even where there may be few product differences, there may be considerable differences in the nature of the functions performed, especially risks assumed in relation to the dealings. Such dealings may be structured in a different way from the way transactions between independents are structured. For example, the performance of related functions may be split between different parts of the enterprise, whilst such functions would always be performed together by independents, so making it difficult to evaluate the dealings in isolation and apply reliably any of the traditional transaction methods. Such problems occur with increasing frequency in transactions between associated enterprises, and Chapter III of the Guidelines approves other methods (transactional profit methods) to be applied in situations where the traditional transaction methods of Chapter II cannot be applied reliably. The section below on split functions examines the application of transactional profit methods to a bank PE in more detail.

149. With regard to the third comparability factor, contractual terms, no particular conceptual difficulties are envisaged in the banking area, although there may be practical difficulties due to the lack of contemporaneous documentation or other evidence of the intention of the parties etc. The general guidance in Part I of this report should be followed in order to determine the division of responsibilities, risks and benefits between the parties to the dealing.

150. In some countries, internal dealings are often not well documented and this gives rise to the issue of how to determine the terms of any dealing. However, associated enterprises also do not always document transactions and this issue is covered by the guidance in paragraph 1.28 of the Guidelines. That guidance can be applied, by analogy, by equating “terms of the dealing” with “contractual relationships.” Consequently, “Where no written terms exist, the *terms of the* relationships of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.”

151. This determination should be made very thoroughly because of the paramount importance of determining the true division of risks when attributing profits from banking dealings to a PE. This is because of the close relationship between expected profits and risks assumed in a banking business. This issue is discussed in further detail in relation to 2 types of common bank dealings; agency or conduit dealings and transfers of risks and financial assets.

152. One issue will be of particular importance when applying the general guidance on the fourth comparability factor (economic circumstances) to attribute profit to a bank PE. That is the impact of regulation, especially different regulatory regimes as discussed in Section B above. Following the guidance at paragraph 1.30 of the Guidelines, different bank regulatory regimes should be considered as potentially affecting market comparability. For example, it may not be correct to treat market data from a less regulated market as comparable to dealings in a more regulated market, without making reasonably accurate adjustments for those regulatory differences.

153. It is not considered that there are any particular difficulties in applying the general guidance on the final comparability factor (business strategies) to attribute profit to a bank PE. Any relevant business strategies should be taken into account and should have been determined by the functional and factual analysis under the first step of the WH.

154. The discussion above is based on the comparison of individual dealings with individual uncontrolled transactions. In practice, a banking business usually consists of a large number of similar financial assets and dealings. Accordingly, it may be particularly appropriate to apply the guidance on aggregating transactions at 1.42 of the Guidelines in the banking context. For example, a comparability analysis could be made between suitably aggregated dealings and suitably aggregated uncontrolled transactions such as a portfolio of closely linked and similar loan assets.

155. Having discussed in general terms how to apply the second step of the WH to attribute profit to a bank PE, the next sub-section looks at some specific, and commonly occurring, situations in more detail.

iii) Traditional banking business

156. Where, following the functional and factual analysis, it is found that the PE is engaged in a traditional banking business, i.e. acting as a borrower and a lender of money, a number of potential tax issues arise in respect of how to reward the performance of those functions and any related dealings between the PE and the rest of the enterprise. This sub-section discusses those functions and dealings in detail (with the exception of agency or conduit functions and dealings which are discussed in Section D-2(iv) below).

157. The first step of the WH will have determined which parts of the enterprise have undertaken the functions listed at paragraph 8 above that are necessary to create the financial asset. If all the functions necessary to create the loan were performed by the PE, there should be little difficulty in determining an arm's length reward for the performance of those functions. Any transactions related to the performance of the functions will have been conducted directly by the PE and so should be at arm's length prices, either by definition, because they are conducted with independent enterprises, or by application of the usual transfer pricing rules if conducted with associated enterprises.

158. It would still be necessary to consider making an adjustment to the amount of interest paid to third parties to reflect the amount of the bank's "free" capital that is needed to support the lending activities of the PE, following the guidance given in Section D-1 (iv) above. A further adjustment may be needed to reflect the amount of capital other than "free" capital. It should also be noted that there may also be some attribution issues in relation to other functions not related to the creation of the asset, such as the subsequent management of that asset and the provision of general support and an appropriate infrastructure e.g. centralised Head Office functions. These are discussed in later sections.

159. However, more commonly, the first step of the WH will have shown that some of the functions leading to the creation of the new financial asset were performed by other parts of the enterprise (split functions). Those functions represent dealings between the PE and the other parts of the enterprise that will have to be taken into account under the second step of the WH in order for the PE to receive an arm's length attribution of profit. The following sub-sections analyse these dealings in detail.

a) Sales and support

160. The application of the arm's length principle to the performance of sales and support functions related to a global trading business was discussed in some detail in Sections C-2 (i) and (iii) of Part III of this Report. It is considered that this guidance applies equally to the sales and support functions of a banking business listed in paragraph 8 above, although there may be many fewer situations where the sales or support functions are as integrated either with other functions or between different locations. This means that it should be possible generally to use the traditional transaction methods of Chapter II of the Guidelines to attribute profit in respect of dealings related to these functions and market data from brokers and back-office service companies may be available. Further, no special difficulties are seen in applying the general guidance of the WH to equate, for the purposes of comparability analysis, "dealings within an enterprise" with "transactions between associated enterprises".

b) Treasury functions and internal movement of funds/ "interest" dealings

161. Treasury dealings are such an important part of any banking operation, it is considered important to briefly discuss how to apply the WH to the performance of treasury functions and to the evaluation of internal movement of funds and “interest” dealings between different parts of the same enterprise.

162. There is a wide range of possible functions carried out by the treasury of a bank and by parts of the enterprise that raise funds for use by another part of the same enterprise. These range, at one extreme, from complex functions organised on profit centre lines akin to full function banking to, at the other extreme, agent or conduit functions. Analysis of the treasury functions raises a number of areas for consideration, in particular, whether the dealings between a PE and treasury are priced at arm's length and whether they are undertaken in a similar manner to those of independent entities acting in their own interest. Often, the bank will have its own internal funds transfer pricing system, which governs the basis on which funds are transferred between different business units and treasury. It will be particularly important that such an internal mechanism allocates/divides interest margins between various business units and treasury within the bank in accordance with the arm's length principle. This section is intended to provide general guidance on how to do this.

163. It will be essential to carry out, under the first step of the WH, a full functional and factual analysis. This should concentrate on identifying the exact functions performed (especially the risks assumed) in relation to any treasury or “interest” dealings, and which part of the enterprise performs them.

164. Internal funds transfer pricing systems operated by treasury can be used to transfer interest rate risk and liquidity risk from branches/business units to treasury to facilitate efficient management of such risks, provided such transfers are recognised (see Section D-2(iii)(e)). They may also allocate the funds raised by the bank as a whole to individual PEs. Such systems may differentiate between product lines or market segments (e.g. setting different target profits and compensations), can facilitate the setting of target earnings for the entity, and serve as a basis for determining customer prices. Accordingly, internal funds transfer prices that are also used for tax purposes should be closely analysed to ensure their consistency with the arm's length principle.

165. The second step of the WH will apply the transfer pricing methods in the Guidelines to make a comparison between the dealings and uncontrolled transactions so as to ensure the dealings are at arm's length prices and so can be used to attribute an arm's length profit to the PE. When making this analysis, the comparison should be based on the dealings as structured by the taxpayer, e.g. in terms of amount, currency, duration, other terms and conditions and any associated hedging transactions, except in the 2 circumstances outlined in paragraph 1.37 of the Guidelines. The five comparability factors discussed in Section D-2 (ii) above will need to be borne in mind, for example any differences in market conditions due to regulation.

166. Given the wide range of treasury operations, it is likely that a variety of methods will need to be employed. CUPs may be available, especially for the more routine operations. At the other extreme, where there is considerable integration of treasury functions, it may be that it is not possible to apply reliably traditional transaction methods. Transactional profit methods will need to be applied. It might also be that the treasury function is organised in such a way as to approximate to a CCA between associated enterprises, such that the guidance in Chapter VIII of the Guidelines needs to be followed.

167. There are also three other matters that flow from a treasury dealing that need to be considered. The first relates to the conclusion already discussed that each part of the banking enterprise shares in the creditworthiness of the bank as a whole and the implications of this conclusion for carrying out a comparability analysis. The second relates to the question whether there is any credit risk to take account of in respect of any internal “interest” dealing as there is no risk of default by one part of an enterprise in relation to any other part of the same legal entity. The answer to these questions (except in the exceptional

circumstances described in paragraph 29 where there is a credit differential between the PE and the rest of the enterprise) is to use transactions where there is no credit differential as comparables or to adjust otherwise comparable transactions to remove any effect of the credit differential.

168. The third relates to losses, especially foreign exchange (FX) gains and losses on financial assets. Under the WH, the function that results in the assumption or subsequent bearing of the FX risks in respect of those assets would be rewarded with the profit for assuming or subsequently bearing the FX risks and so would also be attributed any losses arising from the realisation of those risks.

169. In practice, banks will use a variety of methods to set the prices of internal “interest” dealings and reward the treasury function. One method might be to price the internal “interest” dealing using a comparable market inter-bank rate to reward the function of borrowing and lending money, and separately reward any additional treasury functions by a service fee or by adding a margin to this rate. This internal “interest” rate is likely to be computed on a fully debt-funded basis. As noted in Section D-1(v), above, an adjustment will have to be made to reflect the “free” capital attributed to the PE and, as noted in Section D-1(iii)(b), an adjustment may also have to be made to reflect any higher interest rate items, such as subordinated debt, that are not appropriately reflected in the interest rate comparable. It is also possible that some internal “interest” dealings will be directly traced and priced accordingly, for example in respect of agency or conduit transactions (see Section D-2(iv)). It should be stressed that the method used is irrelevant as long as an arm’s length reward is given to the treasury function, and internal “interest” dealings are priced within an arm’s length range that appropriately reflects the hypothesised capital structure of the PE, including any “free” capital.

c) Internal guarantees

170. As noted in Section D-1(ii), an issue arises as to whether dealings similar to guarantees should be hypothesised between the PE and Head Office. As discussed in Section D-1(ii), dealings similar to guarantee fees will not be imputed under the WH.

d) Sales/trading functions

171. In traditional banking activities, unlike in global trading, it would generally be possible from the functional analysis to determine that the key entrepreneurial risk-taking functions leading to the creation of the asset were performed in only one location. In such cases, the reward for performing the key entrepreneurial risk-taking functions would be to have the financial asset attributed to the sales/trading location as the economic “owner” of the financial asset and the associated interest income and expense. Section D-1(i) analysed the situation where the key entrepreneurial risk-taking functions leading to the creation of the asset were carried on in more than one location and discussed how to determine which part of the enterprise was the “economic owner” of the financial assets and risks.

172. This leaves the issue of how to reward the performance of some parts of the sales/trading function carried out by parts of the enterprise that are not determined to be the “economic owner” of the financial assets and risks. The performance of such sales/trading functions will be characterised as dealings between the different parts of the enterprise and comparisons will be sought with transactions between independents. All the methods approved in the Guidelines are available to make this determination, starting with the traditional transaction methods described in Chapter II. No particular theoretical difficulties are envisaged in making this determination. This is because the nature of such sales/trading functions is likely to be routine given that the key entrepreneurial risk-taking part of the sales/trading function has been performed elsewhere, i.e. in the location treated as the economic owner of the financial assets and risks.

e) Risk management functions and transfers of risk

173. As noted in Section B-3, it is important to distinguish between initial risk assumption and subsequent risk bearing. Under the WH, risks are initially assumed by reference to where the related functions are performed. The sales/trading function is generally the key entrepreneurial risk-taking function that leads to the initial assumption of all the risks related to the newly-created financial assets. Those risks will subsequently be borne by the location that carried out the sales/trading function unless there is a dealing that could lead to another location assuming and bearing those risks. Following the WH, any such transfer of risk would have to be accompanied by a transfer of the risk management function. Where another part of the enterprise carries out the risk management function related to those assets, there would be a potential dealing to take into account.

174. The critical question is whether this dealing should simply reward the performance of the risk management function, or whether the dealing should also involve the recognition of a transfer of the risks being managed, i.e. that the risk management location has now assumed those risks. This section looks in more detail at risk monitoring and risk management functions.

175. Risk monitoring has relevance to the broad range of risk types and includes all risk information systems and reporting. Internal control systems will monitor the utilisation of facilities against stipulated risk limits and report on excesses. For example, credit risk may be monitored in terms of the amount at risk and the quality of risk (the likelihood of default) and loan portfolio risk concentrations. Credit risk monitoring is critical as the default of a small number of significant customers could generate large losses for the bank. Where the risk monitoring function is relatively unsophisticated, it should be possible to use traditional transactional methods to attribute profit in respect of dealings related to this function. On the other hand, where the risk monitoring function is so integrated with other functions (e.g. the risk management function) that it is not practicable to evaluate it on a separate basis, the use of other methods may be necessary.

176. Given the nature of this function, it is unlikely that risk monitoring would give rise to the assumption of the risks being monitored. Consequently, any dealing to reward the performance of the risk monitoring function, for example a service fee, would be based on rewarding the function and would not include a dealing transferring the risks being monitored.

177. The management of risk within a traditional banking business (i.e. the borrowing and lending of money), has undergone considerable change since the 1984 Report was issued. Traditionally, this only involved the management of the credit risk associated with the banking book (traditional loan activities). More recently, the management of market risks (interest and currency risks) associated with loans made to customers has also become an important function undertaken within banks (often managed by treasury) and in more sophisticated banks, some market risks may be transferred to a trading book. It is recognised that there are differences in the risks, and in the way those risks are managed, between a traditional banking business and a global trading business. Nevertheless, it is considered that the guidance in the Part III of this Report on rewarding risk management functions may be helpful in the context of evaluating the performance of risk management functions in a traditional banking business.

178. The method of rewarding the performance of the risk management function will depend on the exact nature of the function performed and the risks managed and whether the performance of the risk management function leads to the assumption and subsequent bearing of all or some of the risks that are being managed. As noted in Section C-1 (ii) of Part III of this Report on trading and risk management, profit methods may have to be used where it is not possible to apply reliably traditional transaction methods to reward the performance of risk management functions. This may occur where independent enterprises performing similar risk management functions would demand a share of the profit or where the

risk management function is so integrated with the other functions that it is not possible to make an evaluation in isolation. This can be either a share of the gross or the net profits.

179. As noted above, it will be important to determine whether the performance of the risk management function should also lead to the recognition of a dealing that actually transfers the risks being managed so that they are assumed and borne by the risk management location. That will be determined on a case-by-case basis following the factual and functional analysis. First of all, it is worth noting under the general principles described in Section D-2 (i) that it is not possible to recognise a transfer of risk to a location unless that location performs the function of managing those risks and has the capacity to evaluate, monitor and manage those risks.

180. The functional analysis should also look at the different levels of risk management within the bank. Under the WH, it would be the active day-to-day risk management that would lead to the assumption of risks. More strategic risk management, for example the “middle-office” functions described in Section B-1(iv) would not ordinarily lead to the assumption of risk by the location performing the strategic risk management function. Between legally distinct enterprises there would be an additional test in that the enterprise to which the risks were transferred would also have to have sufficient capital to absorb any losses from the realisation of the assumed risks. However, in the PE situation where capital is not segregated within the enterprise, capital is allocated based on functions and risks and so the capital would follow the risks and not vice versa.

181. It should also be noted that there can be a transfer of only some of the risks associated with a financial asset, e.g. the sales/trading location could retain the credit risk but transfer the market risk to a trading book. However, in the context of a traditional banking business, the relative importance of credit risk is such that it is the management of credit risk which is likely to be the key entrepreneurial risk-taking function in respect of ongoing management of the asset, and therefore a transfer of the asset should not generally be recognised if the management of the credit risk is not transferred.

182. The factual and functional analysis should also be undertaken from the perspective of both the transferor and the transferee. For example, the functional and factual analysis may show that the sales/trading location has managed the currency risks related to a portfolio of assets for some considerable time, developed a risk management strategy, put in place monitoring systems etc., so that even if another location eventually takes on some limited currency risk management functions related to this portfolio, it would not be appropriate to recognise a transfer of those risks.

183. Where there is a transfer of some of the risks associated with a financial asset, for example the credit risk is retained in the Head Office but market risk is transferred to the PE, this has an impact on capital attribution (see Section D-1 (iii) above). Capital will no longer be attributed solely to Head Office as some of the capital is needed to support the market risks being assumed and subsequently borne by the PE.

f) Transfers of existing financial assets

184. The discussion in the report so far has considered the situation where the financial asset has remained in the location where it was created, based on where the sales/trading functions leading to its creation were carried out and, in the previous Section, the situation where risks are transferred.

185. The question to be discussed in this section is what to do where the books and records of the taxpayer show that an asset has been subsequently transferred to another part of the enterprise. Under the WH, it must be decided whether such a transfer should be recognised at all. As discussed in Part I of this report, the WH relies on a functional analysis to determine whether there has been “a real and identifiable

event” which would give rise to a dealing to be taken into account for the purpose of attributing profit. In the context of a financial asset, a book transfer of the financial asset must be accompanied by a real and identifiable event, such as a change in the functions related to the financial asset. Transferring where an existing financial asset is booked, without transferring any of the functions and the assumption of the profit and risk potential of the financial asset, would not result in any dealing in respect of that asset. In practice, most of the significant ongoing functions related to an existing asset are risk management functions. Consequently, the guidance in the previous section can be applied.

186. If the particular asset transfer is recognised as a dealing under the recognition test above, the next stage is to attribute profit in respect of that dealing. Generally, the transfer of the financial asset will be found under the comparability analysis to equate to a deemed disposal and acquisition at market value. The part of the enterprise “acquiring” the financial asset will have attributed to it from the date of acquisition the subsequent interest income and expenses associated with the ownership of the financial asset. The financial asset will also be attributed to the “acquirer” for the purposes of attributing the bank’s capital (see Section D-1 (iii) above). The other functions necessary to maintain the financial asset will be rewarded as already discussed in the locations where they are now performed.

187. Some countries consider that the WH, as expressed in this and the previous section, does not provide sufficient protection against tax motivated transfers of assets and risks. However, it should be noted that the WH only determines the attribution of business profits in respect of a financial asset and its associated risks. In order to meet the concerns expressed above, the onus should be on the taxpayer to demonstrate clearly that any dealing should be recognised as leading to a transfer of assets and risks. Nevertheless, countries may wish to ensure the WH would not override any domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of financial assets or risks. In addition, where their domestic law does not recognise loss transactions in certain circumstances between associated enterprises, countries may consider that the WH would not require the recognition of an analogous dealing in order to determine the profits of a PE.

g) Head office services

188. A considerable head office support infrastructure is considered necessary in order to carry out a banking business. These cover a wide range of activities from strategic management to centralised payroll and accounting functions. The existence of these support functions needs to be considered when attributing profit to the various parts of the enterprise. The WH is to apply the guidance in the Guidelines, especially Chapters VII and VIII, to determine whether, and if so, to what extent, the support functions should be rewarded. Part I of this Report discusses how this guidance can be applied, by analogy, to a PE and reflects the testing of the WH in the banking area.

189. One area where there is a difference between the WH and the existing position arises from the fact that under the WH, the arm’s length principle is applied to determine the reward for performing that service. Application of that principle will take account not only of the price applied to the service but following the guidance in Chapter VII, whether, at arm’s length, both parties would have contracted for the provision of the service. As noted in Part I of this Report, the tests at paragraph 7.6 of the Guidelines will prove helpful in resolving such issues. Moreover, application of the arm’s length principle may indicate a price for the service rendered that is above or below the costs incurred by the head office in providing it (see paragraph 7.33 of the Guidelines).

190. Most of the services provided by the head office of a bank are little different from those provided by the parent, or centralised service provider, of a MNE group. Similar techniques can be used as for associated enterprises. If CUPs are unavailable, cost plus methods may be particularly useful.

191. Where there is found to be a “CCA” type arrangement, the guidance in Chapter VIII on applying the arm’s length principle to services that are the subject of the CCA activity should be followed by analogy. No particular issues of principle are considered to arise in a banking business.

192. Finally, it is worth recalling paragraph 7.37 of the Guidelines which is reproduced below:

“While as a matter of principle tax administrations and taxpayers should try to establish the proper arm's length pricing, it should not be overlooked that there may be practical reasons why a tax administration in its discretion exceptionally might be willing to forgo computing and taxing an arm's length price from the performance of services in some cases, as distinct from allowing a taxpayer in appropriate circumstances to merely allocate the costs of providing those services. For instance, a cost-benefit analysis might indicate the additional tax revenue that would be collected does not justify the costs and administrative burdens of determining what an appropriate arm's length price might be in some cases. In such cases, charging all relevant costs rather than an arm's length price may provide a satisfactory result for MNEs and tax administrations. This concession is unlikely to be made by tax administrations where the provision of a service is a principal activity of the associated enterprise, where the profit element is relatively significant, or where direct charging is possible as a basis from which to determine the arm's length price.”

iv) Agency or conduit functions

193. This section deals with the situation described in the 1984 Report (paragraphs 73-75) where “one branch of a bank will use another branch simply as an instrument for raising funds on a foreign capital market for its own purposes It may in fact be doing little more than providing services as a conduit for the funds.” It does not deal with internal “interest” dealings between a branch and treasury which are discussed in Section D-2(iii)(b). Further, it is assumed in this section that a PE has already been found to exist within the meaning of Article 5. The question of whether the performance of agency or conduit functions can, by themselves, lead to the creation of a PE under Article 5 is beyond the scope of this Report.

194. The significance of the PE having been found to act as an agent or conduit lies in the profit to be attributed in respect of such a function. This function would be “remunerated not by interest but by an appropriate fee. This consideration could take the form of a “turn” - a small fraction of the funds raised or a small fraction of the profit made - if this is how independent enterprises would have arranged the transaction.” Paragraph 74 of the 1984 Report discussed the evidence that might be required before the tax authority would accept the nature of the transaction as one of acting as agent or conduit. The main concern was to ensure that “ the domestic entity had not sacrificed to the other parts of the enterprise a profit which it could have made in the normal course by lending the money to an independent client itself.”

195. The tax issues, and concerns of the tax authorities, have not changed significantly since the 1984 Report. Moreover, the WH should provide a useful tool for making the determination as to whether a particular dealing, the transfer of funds from one branch to another should be treated as comparable to a lending function, rather than to an agency or conduit function, with the resulting difference in attribution of profit. In particular, the concept of functional analysis, especially taking into account risks assumed, should enable this determination to be made on a principled and consistent basis.

196. The determination will be made by reference to the functions actually performed by the parties to the dealing and the circumstances surrounding the performance of those functions. For example, there can be no presumption in a dealing involving a PE and Head Office that the PE is acting as an agent or conduit for Head Office. Rather the guidance on functional analysis involved in creating a new financial asset

(paragraph 8 above) should determine which functions necessary to create the asset have been carried out by which part of the enterprise. In particular, the detailed analysis of the key entrepreneurial risk-taking function will be vital, as this will determine which part of the enterprise has acted as the principal in respect of this transaction, e.g. which part of the enterprise made the decision to raise funds, the decision to enter the market at a particular time and the decision as to what terms should be sought etc.

197. As well as the making of the decision to raise funds, the other critical difference between “agency or conduit” functions and lending functions lies in the assumption of risk. If a bank borrows funds to on-lend there are a number of risks it assumes. For example, the risk that it might not be able to find a customer for those funds (perhaps due to the rapid onset of recession), or on terms which would allow it to make a profit (perhaps due to unexpected market interest rate movements). It is the assumption of all the risks involved in borrowing or lending transactions which, in economic terms, justifies the full lending return. An agency or conduit function is characterised by the elimination of most, or all, of the risks relating to the performance of that function. In the example given in this paragraph, risk would be eliminated by the principal being obliged to take the funds at the rate raised by the agent or conduit (plus the remuneration for the services of the agent or conduit).

198. Following the guidance in Part I of this Report, all the facts and circumstances (including any relevant documentation) surrounding the purported agent or conduit dealing will have to be examined in order to “deduce the economic relationships” between the parties and, in particular, the division of risks. Once the true terms of the dealing have been so determined, it can be seen whether those terms are indeed consistent with the performance of an agency or conduit function.

199. In conclusion, it is considered that the determination of the true nature of an “agency or conduit” dealing does not present any insurmountable problems, provided a full examination of all the relevant economic circumstances is made. The guidance in Chapter I of the Guidelines should be of considerable assistance in this matter.

200. Once the true nature of the dealing has been determined, the question remains of how to attribute profit to the participants in that dealing. Here the concept of comparability analysis will be important - the dealing will have profit attributed to it by reference to transactions between independents that are “comparable” within the meaning of Chapter I of the Guidelines. The most important comparability factors are likely to be the functional analysis (exact type of agency or conduit function and what, if any, risks are assumed (e.g. does the agent or conduit bear any risk, such as market risk, even for a short time)) and the characteristics of the transaction (see paragraph 1.19 of the Guidelines and paragraph 147 of this Report), especially the size of the funds raised and the currency involved.

201. However, the other factors mentioned in Chapter I should also not be overlooked, even if only to dismiss them as not relevant. For example, if the conduit dealing involves US dollars, the guidance on economic circumstances (see paragraph 1.30) is likely to be less important, as comparables are likely to be in a similar market and market conditions, given the deep, liquid and global nature of the financial market for US dollars. The position might be different for a dealing in an illiquid currency or one where a few participants dominate the market for raising funds in that currency.

202. The availability of comparable data is likely to determine the method chosen for attributing profit. Agency or conduit transactions occur between independents in financial markets and so market data should often be available. Such market data are likely to be in the form of potential comparable uncontrolled prices (CUPs), often expressed as a “turn” on the funds borrowed. The amount of the turn would be determined from market transactions that meet the comparability standard of Chapters I and II of the Guidelines (see above for factors to be taken into account).

203. In other cases CUPs may be found in the form of fees or commissions, although such data can be often, for the purposes of comparison, converted into an interest rate “turn”. Comparable data should not be ignored simply because it is expressed in a different form. However, where it is not possible to locate comparable uncontrolled transactions, the other methods approved in the Guidelines will need to be applied in order to resolve the issue.

ANNEX 1 - BIS RATIO APPROACHES

1. The “pure” BIS ratio approach uses the BIS ratio of the whole bank to attribute both Tier 1 and Tier 2 regulatory capital to a PE. This method means that the PE necessarily has proportionately the same composition of regulatory capital as the whole bank - the ratio obtained by comparing the risk-weighted assets of the PE to the total risk-weighted assets of the entity as a whole is applied to attribute both Tier 1 and Tier 2 regulatory capital. Under this approach, the capital attribution would include both instruments that are debt and instruments that are equity for tax purposes.

2. For example, suppose the capital of the bank was made up of 60% Tier 1 capital (40% ordinary share capital and 20% retained profits) and 40% Tier 2 capital (30% subordinated term debt and 10% subordinated perpetual debt). Under the “pure” BIS ratio approach, if the risk-weighted assets of the PE were 10% of the risk-weighted assets of the enterprise as a whole, the PE would be attributed 10% of the capital of the bank. That is it would be attributed with 10% of all the items making up the Tier 1 and Tier 2 capital of the bank (i.e. 4% of the ordinary share capital, 2% of the retained profits, 3% of the subordinated term debt and 1% of the subordinated perpetual debt).

3. The debt/equity characterisation rules of the PE’s jurisdiction would then be applied to the attributed Tier 1 and Tier 2 capital to determine which items would qualify for an interest deduction and which would be treated as “free” capital for tax purposes under the domestic laws of the host jurisdiction. For example, the “interest” on the 1% of the bank’s subordinated perpetual debt attributed to the PE might not be allowed as a deduction in the jurisdiction of the PE because subordinated perpetual debt is treated as equity for tax purposes in that jurisdiction and so any “interest” on such instruments would be disallowed. It is noted that debt/equity characterisation rules for financial instruments may vary from country to country and that such variation may result in double, or less than single, taxation. While less variation in such rules between jurisdictions may be desirable, it is not appropriate to address this issue in the WH. This issue is of wider significance and is not confined to PEs.

4. A number of Steering Group member countries already apply a BIS ratio approach that uses BIS ratios to attribute only the “free” capital in Tier 1 to a PE (the “cleansed” BIS ratio approach).

5. Using the same example as in paragraph 2 above, the first step under the "cleansed" BIS ratio approach, is to apply the debt/equity characterisation rules used for tax purpose in the PE's jurisdiction to the Tier 1 and Tier 2 capital items of the enterprise as a whole. This would determine ("cleanse") which items would be treated as "free" capital for tax purposes under the domestic laws of the host jurisdiction. For example, the subordinated term debt and the subordinated perpetual debt might be characterised as debt instruments for tax purposes in the host jurisdiction and so would not be treated as “free” capital that needed to be attributed to the PE. If the risk-weighted assets of the PE were 10% of the risk-weighted assets of the enterprise as a whole, the next step is to attribute to the PE 10% of the "free" capital items of the bank (i.e. 4% of the ordinary share capital and 2% of the retained profits). It is worth stressing that under this approach, there would be no attribution to the PE of a proportionate share of any Tier 1 or Tier 2 capital items characterised as debt under the debt/equity characterisation rules used for tax purposes in the PE's jurisdiction.

ANNEX 2 – DETAILED RESPONSE TO SOME OF THE BUSINESS COMMENTS ON PART II (BANKS)

Introduction

1. The active participation of business representatives who attended the two-day consultation in April 2002 was welcomed and made that event interactive and constructive. As was stressed by the Chair in his closing remarks, dialogue with business is an essential element in the search for a consensus amongst governments on the interpretation and practical application of tax rules that take account of modern-day multinational operations and trade.

2. The consultation has made it possible to reach a consensus with business on some fundamental principles – although, perhaps inevitably, there is less agreement with business over how these principles should be implemented in practice. Importantly, it has also enabled the OECD Member Countries to achieve a greater consensus amongst each other. Immediately after the consultation Working Party No.6, through the Steering Group on the OECD Transfer Pricing Guidelines, commenced work on the process of taking forward the project including responding to the public comments received and positions expressed.

3. As the focus of interest has proved to be on the banking sector, it was decided to concentrate on revising Part II (Special Considerations for Applying the WH to PEs of Banks) and on issuing a new document (Part III), which covers the related topic of the Global Trading of Financial Instruments. We are now in a position to release a revised version of Part II and the new Part III and invite business to send comments to the OECD Secretariat (john.neighbour@oecd.org) by 31 May 2003.

4. These documents include the response of the OECD Member countries to business comments and contain a number of revisions and clarifications on various issues. However, some of those issues warrant more discussion, especially where the draft takes a different position to that advocated by the majority of the business commentators.

5. This short note is therefore intended to provide further background and explanation on those issues in so far as they relate to traditional banking, which is the subject of Part II. Comments related to the general principles (for example on identifying the economic owner of an intangible, funding/capital attribution and internal “interest” dealings for non-financial institutions) are still under review pending the revision of Part I of the Discussion Draft.

Attributing functions, assets and risks to the PE - following the booking location of financial assets

6. Business commentators have expressed considerable theoretical and practical doubts about the approach of the WH, which seeks to attribute assets and risks in accordance with a functional and factual analysis, rather than following the booking location (except in cases of abuse). Under the WH, the accounts and books of the PE form the practical starting point for the analysis and should be respected for tax purposes, provided they are consistent with the functional and factual analysis.

7. There are two main theoretical objections raised by business commentators. The first is that only assets need to be attributed under the arm's length principle and so it is not necessary to attribute risks. The advocates of this view also point to the practical advantage that it is also much simpler only to consider assets. However, OECD Member countries believe that a consideration of risks as well as assets is mandated under the arm's length principle as can be seen from the basic statement of principles of the Guidelines first quoted at paragraph 1.20, which states that, "[I]n dealings between two independent enterprises, compensation usually will reflect the functions that each enterprise performs (taking into account assets used and risks assumed)." Moreover, the WH appears consistent with the arm's length principle, as independent enterprises would need to allocate more capital to "riskier" financial assets. Therefore, it does not appear possible to ignore risks even though it might be simpler to do so in practice.

8. The second theoretical objection is that it is not correct to seek to attribute financial assets (and risks) based on a functional and factual analysis. Rather, the booking location should be followed except in cases of abuse. Again, OECD Member countries believe that following the basic statement of principles of paragraph 1.20 of the Guidelines, the arm's length principle requires that the proper reward be given for the performance of functions (taking into account assets used and risks assumed). Attributing financial assets, such as loans, based on where the key entrepreneurial risk-taking functions were performed will give the locations performing those functions an arm's length reward in the form of the income associated with that asset.

9. The PE context also needs to be considered when examining the nature of the functions performed in the booking location. Banks operating through branches do not segregate their capital and risks. However, following the booking location without any link to functionality would mean that in effect banks were allowed to explicitly segregate capital and risks to the various parts of the enterprise. This would effectively mean they could decide where to earn their profits not by their decisions on where they carry out activities but by mere bookkeeping entries independent of real activities. Such a result is likely to be unacceptable to governments since it would permit wholly artificial manipulation and an unfair allocation of taxing rights between countries.

10. Business representatives recognised during the April consultation that tax authorities would find it impossible always simply to follow the booking location (for example where the booking location is a "shell" without personnel) and may want to take steps to protect their tax base. One suggestion put forward by business commentators is to follow the booking location except in cases of "abuse". However, this leads to the problem of defining "abuse", e.g. would a motive to avoid tax be a prerequisite before overturning the booking location. In short, the OECD Member countries believe that the correct way to attribute assets to a PE is by reference to the functions performed. This has the advantage of being firmly based on the arm's length principle. Further, attributing assets by reference to the key entrepreneurial risk-taking functions also has the dual benefit of rewarding those key functions and ensuring that capital is attributed according to where the risks are assumed and managed.

11. In terms of the perceived compliance burden on business it is worth noting that like transfer pricing generally, tax administrations are unlikely to incur the administrative cost of initiating a transfer pricing analysis unless adjustments to the attribution of profits are likely to be material. Similarly, the application of the arm's length principle to such a difficult area is likely to lead to quite a wide range of results, although no adjustment is required where the result is within the arm's length range.

Attributing capital to the PE

Role of capital

12. The WH is based on the premise that capital is required to support the risks assumed by the PE as a result of the functions it performs. Accordingly, a first step in attributing capital is to measure the risks properly attributed to the PE, including risks related to off-balance sheet items. Many commentators from the banking community expressed concern about this approach. In their view capital should only be attributed for funding purposes, i.e. to determine the amount of deductible interest. In their view, off-balance sheet items and the associated risks do not require funding (although capital would be needed to fund any losses resulting from the realisation of the risks related to off-balance sheet items) and so should not be used to attribute capital. However, this overlooks the fact that under the arm's length principle, capital is required to support the risks assumed, including risks related to off-balance sheet items.

Alternative capital attribution approaches

13. A number of business commentators suggested alternative capital attribution approaches based on the approach used to attribute assets for non-financial institutions in Part I of the Discussion Draft. A number of possible variations were suggested depending on how the assets are to be measured, i.e. by reference to market value, book value, historic cost or some combination of the different valuation methods.

14. The main difference between the approaches suggested by business and the capital attribution approaches permitted under the WH relates to risks. The alternative approaches are based on attributing capital by reference just to assets, i. e. without risk-weighting the assets or otherwise attempting to evaluate risks. However, whilst such an approach has the advantage of simplicity (although asset valuation may give rise to complex issues), this is achieved at the expense of compliance with the arm's length principle given the crucial importance of risk for all financial businesses. It is hoped that the greater flexibility encouraged by the revised Part II Discussion Draft in terms of the way risk is measured should overcome some of the perceived difficulties with applying an approach of attributing capital based both on assets and risks.

Other alternatives: the "service fee" approach

15. Business commentators have also expressed concerns about the compliance burden of adopting the various approaches to attributing assets, risks and capital, especially in terms of the need to make adjustments to balance sheet items. They have suggested that the same profit attribution could be arrived at without actually requiring the re-booking of assets and risks and the consequent need to formally re-allocate capital between the different parts of the enterprise. The solution proposed is only to adjust the income statements by means of arm's length service fees, for example between the booking location and the key entrepreneurial risk-taking location, which is likely to be the sales/trading location for a bank loan.

16. However, the OECD Member countries are not convinced by the service fee approach. In particular, it would seem to be very difficult to arrive at an arm's length result using this method. For example, the service fee for performing the sales/trading function would need to recognise the assets used and especially the risks assumed and the consequent need for capital both to permit the assumption of those risks and to fund the creation of those assets. In contrast, booking the asset following the key entrepreneurial risk-taking functions in accordance with the functional and factual analysis means that any dealings with other parts of the enterprise are likely to be less complex and so it should be easier to apply the arm's length principle to arrive at an arm's length result.

17. In short, OECD Member countries in general reject the service fee approach, which would be difficult to apply in practice in order to arrive at an arm's length result and would be very difficult for tax examiners to audit properly.

Recognition of dealings

18. Many business commentators argued for the possibility that dealings should be recognised on the same basis as transactions between associated enterprises. Some of the comments stressed that the fact that dealings were contemporaneously documented should be sufficient to ensure their recognition for tax purposes, whilst others suggested the need for additional safeguards in the form of requiring conduct to be consistent with the documented dealing and/or an economic substance test related to having the necessary human and financial resources to evaluate and undertake the dealing. Whilst as noted in Part I, documentation will be a very important aspect to evaluating the existence of a dealing, the simple reliance on documentation does not go as far as what is contemplated in the Guidelines, especially for dealings related to the allocation of risk. As noted in paragraph 1.25, “[T]he functions carried out (taking into account the assets used and risks assumed) will determine to some extent the allocation of risks between the parties and therefore the conditions each party would expect in arm’s length dealings.”

19. Further, dealings between a PE and the rest of the enterprise of which it is a part normally have no legal consequences for the enterprise as a whole. This increases the scope for tax-motivated transfers between the two and also acts to reduce the usefulness of any documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist. It therefore implies a need for greater scrutiny of dealings between a PE and the rest of the enterprise of which it is a part than of transactions between two associated enterprises and places the onus on the taxpayer to be able to demonstrate clearly that it would be appropriate to recognise the dealing.

Internal guarantee fees

20. Many business commentators have also suggested that dealings similar to guarantee fees should be hypothesised between the PE and Head Office in order to arrive at an arm’s length result where the total capital of the bank has been allocated to the PEs. Otherwise, the taxable profits of branches will be higher than that of subsidiaries and so banking business conducted in subsidiary, rather than branch, form will be favoured. This analysis is not accepted by the OECD Member countries (see Section D-1 (ii)). In short, save in exceptional circumstances, all parts of a bank have the same creditworthiness. This is the reality as seen by depositors and other creditors of the bank. It means that dealings between a PE and the rest of the bank of which it is a part should be priced on the basis that both share the same creditworthiness.