Attributing profits to a PE: a US perspective

Determining the profits attributable to a PE is poorly explicated in practice. The OECD has drafted a proposal to clarify matters. By Philip R West, Andersen Office of Federal Tax Services, Washington, DC, and Robert Janukowicz and W Anne Jie, Andersen, New York

A basic purpose of an income tax treaty is the allocation of taxing rights between the signatories so as to minimize the potential for double taxation. For example, with respect to dividends, interest and other similar types of portfolio income, the international norm reflected in many income tax treaties is that the jurisdiction from which the payment originates (the source jurisdiction) should, in general, give up its right to tax the income in favour of the jurisdiction in which the payee resides (the residence jurisdiction). With respect to active business income, the international treaty norm is the opposite, ie the source country retains the right to tax business profits arising within its borders and the residence country is obliged to relieve any double taxation that might arise from its taxation of those profits.

This international norm of source taxation for business profits raises a question, however: when do business profits in fact arise within a source state? To resolve this issue, virtually all income tax treaties employ two concepts. First, as a measuring rod to determine the minimum required level of activity a business must have in a state before its business profits can be deemed to have arisen there for tax purposes, treaties use the concept of permanent establishment (PE). Where a treaty PE provision applies, if a person resident in one state (the residence state) does not maintain a PE in the other state (the source state), none of its business profits may be taxed by the source state. The second relevant concept seeks to determine, where a PE is found to exist, the amount of business profits that may be taxed by the source state. The concept is that of profit attribution, so that a resident of one state that maintains a PE in the other state (the source state), is taxable by the source state on the business profits attributable to the PE.

Although the meaning of the term PE has been explicated in both treaty text and treaty interpretation, there is a comparative dearth of authority on how to determine the profits attributable to the PE. As a result, there is a marked lack of consensus among treaty signatories on how such determination should be made. Yet without such consensus, a key objective of hundreds of tax treaties – the avoidance of double taxation – is being significantly impaired.

To achieve greater international consensus on the point, the OECD charged one of its subsidiary bodies with drafting a proposed interpretation and application of the attribution concept. In February 2001, that subsidiary body, the Steering Group on the OECD Transfer Pricing Guidelines of Working Party 6 on the Taxation of Multinational Enterprises (the Steering Group), produced as its proposal the OECD Discussion Draft on the Attribution of Profits to Permanent Establishments (the Draft). As might be expected from a group whose mission is related to transfer pricing, the Draft has a transfer pricing orientation.

This article briefly discusses the Draft and highlights several issues that it raises. The article is not intended to be a comprehensive commentary on the Draft but rather is intended to introduce the issues to those who may not be familiar with it. The Draft contains some significant departures from existing practice in the US and, if implemented in place of the current US tax regime, would appear to have a material impact on the taxation of PEs in the US. The OECD encouraged comments on the Draft and requested that those comments be submitted by July 1 2001.

THE DRAFT’S WORKING HYPOTHESIS

The international tax principles for attributing profits to a PE are provided in article 7 of the OECD Model Tax Convention on Income and on Capital (OECD Model) and in the analogous provisions of bilateral tax treaties.
As indicated above, however, there is no international consensus on the application of article 7. To help achieve such consensus, the Steering Group developed, and incorporated in the Draft, a working hypothesis as to the preferred approach for attributing profits to a PE. The working hypothesis, as reflected in the Draft, is that "the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length as if it were a separate enterprise performing the same functions under the same or similar conditions, determined by applying the arm’s-length principle."

The objective of the Draft is to describe the working hypothesis in detail, provide an explanation of the reasoning behind the adoption of the working hypothesis, and present the results of testing the application of the working hypothesis to PEs in general (Part I) and to PEs of banking enterprises (Part II). Part II focuses specifically on PEs of banking enterprises because a banking enterprise frequently operates through PEs to employ the global capital of the institution in the most effective way. The Draft is intended as a discussion piece, not a conclusive resolution of the issue.

Article 9 of the OECD Model and corresponding provisions of bilateral tax treaties generally require that separate but related enterprises determine their income under arm’s-length principles. A significant body of prescriptive law and interpretive guidance has developed regarding the application of article 9 and its analogues under domestic law, including the 1995 OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (the Guidelines). The Draft starts from the eminently reasonable position that arm’s-length profit attribution to a PE may be understood and interpreted with reference to the Guidelines.

The manner in which the Draft proceeds, and some issues raised by it, form the basis for the remainder of this article. A brief description of the relevant US law is presented in Box 1 (page 32) to set the context for a discussion of certain potential ramifications that the Draft’s approach would have if adopted in the US.

**BOX 1: CURRENT US TAX TREATMENT OF BRANCHES OF FOREIGN CORPORATIONS**

US law imposes the following taxes on non-US corporations operating in the US:

- tax on net income effectively connected with the conduct of a non-US corporation’s trade or business within the US (effectively connected income or ECI) (Internal Revenue Code section 882(a)(1)). ECI can originate from sources within or outside the US and is taxed at the same rates that apply to US domestic corporations (top rate is 35%). This tax is collected through the filing of a return and the normal voluntary compliance process;
- tax at 30% or applicable reduced treaty rate on the gross amount of any fixed or determinable annual or periodical income, such as interest or dividend, but only to the extent such amount is non-ECI from sources within the US (Internal Revenue Code section 881(a)). This tax is collected through withholding; and
- if a non-US corporation operates in the US in branch format, in addition to the above, the US branch will be subject to two additional taxes:
  a. a branch profits tax (BPT) at 30% or applicable reduced treaty rate on deemed repatriated earnings of the US branch;
  b. a branch level interest tax (BLIT) at 30% or applicable reduced treaty rate on certain payments of interest made or deemed made by the US branch.

A non-US corporation is not subject to tax on its income which is not effectively connected with its conduct of a US trade or business and which is received from sources outside the US.

Income from US sources is effectively connected if either an "asset use" test or a "business activities" test is met. Under the asset use test, income is ECI if generated by an asset used in a US trade or business. An asset is used in a US trade or business if it is held for the principal purpose of promoting the present conduct of a trade or business in the US, or it is acquired and held in the ordinary course of the US trade or business, or it is held in any other direct relationship between the holding of the asset and that trade or business. Under the business activities test, income is effectively connected if the income arises from the active conduct of a trade or business in the US.

US law also provides a special rule for the active conduct of banking, financing or similar activities (Treasury Regulation section 1.864-4(c)(5)). Under this rule, interest income and gain or loss from a security is income effectively connected with the active conduct of a banking, financing or similar business of a non-US corporation in the US if the security is "attributable" to the US branch, and certain other requirements are met (Treasury Regulation section 1.864-4(c)(5)). A security is considered attributable to a US branch if the branch actively and materially participates in soliciting, negotiating or performing other activities required to
APPLICATION OF WORKING HYPOTHESIS TO BANKS

The Draft applies the working hypothesis to a traditional banking business (borrowing and lending money) as follows:

Step 1: determine the activities and conditions of the hypothetical distinct and separate entity.

i. Determine functions of the PE through a factual and functional analysis:
   a. determine the assets used in performing the functions – a split function business requires the recognition of deemed dealings between PEs;
   b. determine the risks assumed in performing the functions (the Draft suggests the sales/trading function leads to the greatest initial assumption of risk).

ii. Attribute a credit rating to the PE:
   a. under the Draft, a PE enjoys the same credit rating as the enterprise as a whole – failure to do so would produce "an unrealistic, perhaps perverse attribution of profits".

iii. Attribute "free" capital to the PE:
   a. attribute a risk weighting to the assets of the PE using the 1988 Basel Accord. (The Basel Committee on Banking Supervision introduced the International Convergence of Capital Measurement and Capital Standards (the Accord) in July 1988. These standards are outdated and due to developments in the global financial markets, in June 1999 the Committee released a proposal to replace the 1988 Accord with a more risk-sensitive framework. The Committee expects the final version of the new Accord to be published around the end of

The mere booking of an asset or the performance of other administrative duties will not give rise to ECI (Treasury Regulation section 1.864-4(c)(5)(iii)(b)). Further, under this test, income from a transaction is either all ECI or all non-ECI. There is no split or allocation if non-US branches participate (the so-called "all or nothing" concept).

Generally, once the ECI determination is made, future income from the transaction continues to be classified as ECI until the asset is sold, disposed of to another corporation or matures. Interbranch transfers of effectively connected assets are ignored. For example, when loans originally classified as effectively connected assets are transferred from a US branch to the head office, the loans will continue to be effectively connected (the so-called "once effectively connected, always effectively connected" concept).

Interest expense deduction for US branches of a non-US corporation

Interest expense is the most significant deduction for US branches of banks operating in the US. A US branch of a non-US corporation is not allowed simply to deduct the interest expense shown on its US books. Instead, the US branch must compute its allowable interest deduction using a three-step formula set forth in Treasury Regulation section 1.882-5 that recognizes the fungibility of money, as follows:

- Step 1 – determine the asset base by taking the average asset balance on the US books, adding average effectively connected assets booked at other locations and subtracting non-effectively connected assets and interbranch loans on the US books (for these purposes, the term "average" means average of values of assets computed at semi-annual or more frequent basis) (Treasury Regulation section 1.882-5(b)(3));
- Step 2 – establish the level of funding required for the assets determined in step 1 between tax-deductible debt funding and non-deductible equity funding using either: (a) the bank’s actual worldwide debt/equity ratio, or (b) the fixed ratio of 93% debt and 7% equity;
- Step 3 – establish the borrowing rate to apply to the debt funding, determined in step 2, by electing one of the two methods: (a) the adjusted US booked liabilities (AUSBL) method, or (b) the separate currency pool (SCP) method. The interest deduction computed under the AUSBL method is largely determined with reference to the US branch’s borrowing costs, while the interest deduction under the SCP method is determined with reference to the non-US corporation’s global borrowing costs on the currencies in which the US booked assets are denominated.

In all of the steps above, interbranch borrowing or lending is ignored. However, in the recent case of National Westminster Bank v US (44 Fed. Cl. 120 (Ct. Cl. 1999), Appeal denied, 232 F.3d 906 (Fed. Cir. 2000)), the Claims Court of the United States ruled in favour of the taxpayer, finding, in essence, that the US-UK Income Tax Treaty allows for the recognition of interbranch dealings as if the US PE were a separate entity. However, the general US tax principle of disregarding interbranch dealings is still operative, in the absence of a contrary construction of an applicable treaty.

APPLICATION OF WORKING HYPOTHESIS TO BANKS

The Draft applies the working hypothesis to a traditional banking business (borrowing and lending money) as follows:

Step 1: determine the activities and conditions of the hypothetical distinct and separate entity.
allocate sufficient capital to the PE to support its risk-weighted assets in the same proportion as the ratio of the risk-weighted assets of the US PE to the total risk-weighted assets of the bank as a whole (BIS ratio approach – the ratio of capital base to the total risk-weighted assets that is used by the Bank for International Settlements to measure the capital sufficiency of a bank). In the risk weighting process, both on-balance sheet and off-balance sheet positions are considered.

iv. Adjust the interest expense claimed by a PE if actual free capital allocated to the PE is less than the arm’s-length amount needed to support the lending activities of the PE.

Step 2: determine the profits of the hypothesized distinct and separate enterprise based on a comparability analysis.

i. Recognize interbranch dealings where there has been any economically significant transfer of functions, risks and profits potentials between PEs.

ii. Apply transfer pricing methods to attribute profits (ie comparable uncontrolled price, resale price, cost plus, etc).

From a US tax perspective, each point in Step 1 raises issues. These are discussed next.

BOX 2: BACKGROUND

The OECD, Its Committee On Fiscal Affairs And The Drafting Of The Profit Attribution Paper

The Organization for Economic Cooperation and Development (OECD) is a forum for national governments to discuss and develop economic, tax and social policy. The OECD promotes international standards in these areas, and collects and publishes comparative data on a broad range of subjects.

OECD member countries carry out their work through committees, which address matters as diverse as trade, public management and development assistance. The committee dealing with tax matters is the Committee on Fiscal Affairs (CFA). The CFA is responsible for such landmark achievements as the OECD Model Income Tax Treaty and the OECD Transfer Pricing Guidelines, each of which was the result of initial work done by a different subsidiary body of the CFA. The Transfer Pricing Guidelines were the result of initial work done by the Steering Group on the OECD Transfer Pricing Guidelines of Working Party 6 on the Taxation of Multinational Enterprises (the Steering Group). Since the approach to the taxation of permanent establishments (PEs) taken by the OECD Model Treaty is a ‘separate entity’ approach, using transfer pricing concepts like the arm’s-length standard, the Steering Group was selected to do the initial work on the attribution of profits to permanent establishments.

Differences between the Draft and the current US tax regime

The key questions and potential points of difference between the Draft and the current US tax regime can be summarized as follows:

- Will the existing three-step formula of Treasury Regulation section 1.882-5 for determining deductible interest in the US be replaced? Does the Draft provide the Treasury and the IRS an opportunity to begin to move away from the three-step formula where the US rules are clearly different from those of other major financial centres and in light of the NatWest decision?
- Could the Draft, in certain cases, supersede the longstanding US concept of "once effectively connected, always effectively connected" when evaluating interbranch asset transfers by recognizing transfers or dealings between branches?
- Will the existing "all or nothing" concept of determining effective connection associated with traditional loan activities be replaced by a split-function/jointly-owned asset concept, an approach perhaps more precise in theory, but requiring further analysis and significantly more complexities?
- How and when would the equity determination needed to measure reinvested profits for purposes of the branch profits tax be effected in light of the Draft’s determination of capital?
- The Draft acknowledges but does not conclude on the impact of loan securitizations that serve to remove or reduce assets from Basel risk weighting for financial statement and regulatory purposes, but not necessarily for US tax purposes.
- The emphasis on employing arm’s-length principles would put a premium on comprehensive and continuing transfer pricing methodology, analysis and documentation. Indeed, the Draft’s analysis of the traditional and relatively straightforward borrowing/lending function discussed in Part II would impose a significantly higher burden of supporting capital allocations, interest expense, interbranch dealing transactions and the like, than current law. When added to the significant and potentially
costly transfer pricing requirements associated with the eventual finalization of the global dealing regulations, a US PE’s cost and burden of compliance will probably be significantly increased.

- The Draft mentions, but is not specific, regarding imputed charges from a PE to the home office (e.g., home office general and administrative charges, guaranty fees, royalties for the use of intangible assets, etc). At least some, such as the home office allocation, are valid tax deductions. All could have a significant impact on a PE’s taxable income base and should be considered in greater detail in the final report. Would any such imputed charges in the nature of fixed or determinable annual or periodic payments be subject to US withholding taxes at source as if actually remitted?

At the Institute of International Bankers Annual Seminar on June 19 2001, officials from the Internal Revenue Service and the US Treasury Department offered the following comments:

i. the Draft is intended to cap the amount of profits attributable to a PE and does not override the domestic law of OECD member countries;

ii. the US does not require a change in the existing Treasury Regulation section 1.882-5 interest deduction determination, except to incorporate the Natwest holding, that certain treaties override the current regulations; effectively, a taxpayer can choose the method more favourable to it;

iii. the Draft has no self-executing effect on domestic law; and

iv. the imputation of a deemed payment (e.g., royalties) would not result in a US withholding tax obligation.

These comments would suggest that the Draft may not have as significant an impact on current US law as otherwise be the case, but these comments may not reflect the final position of the Treasury Department.

Determining functions of the PE

As financial markets become more global and technology becomes more advanced, banks are increasingly moving towards splitting functions in various geographical locations. For example, one part of the enterprise may create a new financial asset, but another part of the enterprise may manage it. In that case, and others, questions arise as to how to split the functions for purposes of allocating risk to the PE and, ultimately, attributing profits to the PE.

For example, if a bank has a PE in the US and uses it as the funding and administrative base to expand its business into Latin America, the bank could use its Latin America network to originate a loan but fund and book the loan from the US PE. Similarly, the US PE could be instructed to advance dollar funding to a multinational’s US subsidiary pursuant to a global funding facility negotiated between the ultimate parent and the bank’s home office. Under current US law, assuming the US branch personnel have not actively and materially participated in the acquisition of the loan, the loan is treated as not effectively connected with the bank’s US PE. In effect, profits are not attributed to the US PE even though certain functions, potentially including credit risk management, are. Also, under US law, part of the expenses incurred by the US PE should be removed so that the PE would not deduct expenses related to non-taxable income in the US.

Under the Draft, however, economic analysis of the functions involved in both the creation and management of an asset is required. Therefore, a booking location retains only the profit and loss attributable to its administrative booking functions. Additional analyses and profit attribution would be required if some or all of such other functions were performed by the PE.

The Draft does not articulate particular problems related to split functions if the creation and management of an asset are performed in more than one location. And the Draft does not specifically request comments on this issue, but its relatively brief treatment of the issue prevented it from exploring in detail the impact of various functions on risk allocation and the impact of human capital on proper measurement of the financial health of a PE.

Furthermore, it is not entirely clear when a deemed transfer or dealing between locations has occurred and, if so, whether taxable gain or loss recognized is by the disposing PE without corresponding financial statement or regulatory recognition. Thus, deemed transfers and split functions could create additional administrative complexities (particularly since they are generally not recognized for financial accounting or regulatory purposes) and raise particularly difficult issues in the context of financial assets such as loans and securities (as opposed to tangible assets).

In what might be viewed as a significant departure from current US practice, the Draft suggests that the functional analysis should examine whether any intangible assets have been used by the PE, including marketing intangibles, such as the name, trademark, logo or reputation of the bank. The Draft suggests that it may be appropriate to impute (and presumably deduct) a deemed royalty payment from the PE to the home
Attributing a credit rating to a PE

The credit rating is a crucial factor in determining how much income a bank earns from the spread between the lending rate and the borrowing rate. The stronger the credit rating assigned to the PE, the lower the borrowing rate and the higher its income subject to tax. The Draft looks at a variety of theories for attributing a credit rating to a PE. All of these theories reach the same conclusion: that a PE, as a hypothetical distinct and separate enterprise, should have the same credit rating as the bank as a whole.

The current US tax treatment of this issue varies. On one hand, when the SCP method is used in computing the Treasury Regulation section 1.882-5 interest deduction under Step 3 of that regulation, the bank’s global cost of borrowing in a particular currency is used rather than the US PE’s cost of borrowing that particular currency (Treasury Regulation section 1.882-5(e)(2)). On the other hand, when the AUSBL method is used, the bank’s US PE’s actual cost of borrowing from third parties is used except in the case where there is an excess of calculated US-connected liabilities over US booked liabilities.

Banks as a whole (and not individual PEs) are assigned credit ratings. However, the Draft, if adopted in the US so as to apply the bank’s global cost of raising capital to the PE, would fail to recognize that a US PE as a hypothetical distinct and separate entity would, in reality, incur different (and, in most cases, higher) borrowing costs for external borrowings. That is, a multinational bank and its individual branches generally can obtain financing (and engage in other financial transactions) at rates that are more attractive (perhaps significantly more attractive in certain cases) than those which would apply to its branches if they were distinct and separate entities with equity capital as determined under a risk-weighted allocation method.

This is mainly due to two factors. First, the branch is smaller, and has less credit capacity, which typically leads to higher borrowing costs. Second, US branches frequently engage in riskier business than other branches or the head office, also leading to a less favourable separate entity credit rating and in turn higher borrowing costs. One alternative would be to recognize the need to impute a deductible guarantee fee from the home office. Another alternative would be to employ the bank’s worldwide credit rating as a rebuttable presumption, but permit the election of the PE’s actual borrowing cost to be used. This would have the effect of more closely aligning the approach with the professed guiding principles of the working hypothesis: the arm’s-length standard.

Attributing ”free” capital to a PE

A traditional bank makes a net profit from lending activities if the gross margin or spread from lending exceeds the cost of making and maintaining the loan. If the bank were to obtain all of its funding from borrowing (eg customer deposits), then the bank would profit from the interest rate differential only. If, in addition, however, the bank were to use other capital resources, such as retained earnings and capital share issuance, which do not require interest payments (so-called “free” capital), its profit margin would improve. Therefore, the amount of free capital is a significant factor in determining a bank’s potential profitability. Because banks cannot assume increases in risk without a corresponding increase in capital, capital is closely related to risk assumption for a bank. Therefore, the manner in which a bank’s free capital is actually allocated determines its actual profitability, and the allocation of free capital for tax purposes affects, in part through its impact on risk, the attribution of taxable profits to the PE.

The working hypothesis proposes two steps for determining the free capital attributed a PE:

i. determine risk-weighted assets of the PE using the 1988 Basel Accord for risk weighting; and
ii. determine how much of the capital is needed to cover the particular PE’s functions performed, risks assumed, etc, under the arm’s-length principle.

The Draft does not propose any alternatives to the Basel Accord. However, the Steering Group identifies the three possible approaches for the second step.

i. the thin capitalization approach requires a PE to have the same minimum amount of capital that the regulatory authority of the host country would require of an independent bank carrying on the same or similar activities in the host country;
ii. the quasi thin capitalization approach requires a PE to have at least the minimum amount of capital that the regulatory authority of the host country would require of an independent bank carrying on the same or similar activities in the host country; and
iii. *the BIS ratio approach* requires a bank to attribute part of its regulatory capital to the PE on the basis of the proportion that the risk weighted assets of the PE bears to the total risk weighted assets of the entity as a whole. The "pure" BIS ratio approach would use the BIS ratio to attribute both Tier 1 and Tier 2 regulatory capital to a PE (Tier 1 capital refers to capital that does not result in any interest cost, including paid-up ordinary shares, non-repayable share premiums, reserves and retained earnings, non-cumulative and non-redeemable preference shares. Tier 2 capital refers to capital that results in interest cost, such as subordinated debt and long-term debt). The "cleansed" BIS ratio approach would require adjustment so that the PE would not be attributed a proportion of any Tier 1 or Tier 2 capital that would be characterized as debt under the tax law of the host country.

The Draft seeks comments on the three approaches, but expresses a preference for the "cleansed" BIS ratio approach.

If implemented, the Draft’s proposals on capital attribution would probably increase the tax burden of many US bank PEs. As described above, in general, for purposes of financial accounting, regulatory accounting, and management accounting, the greater the proportion of funding coming from equity or free capital as opposed to interest bearing debt, the greater the profits. And in assessing the US tax position of the US PE, the greater the proportion of funding deemed to come from equity as opposed to debt, the lower the interest deductions, the higher the US tax base and, therefore, the higher the US tax.

If the BIS ratio approach is adopted for US tax purposes, banks with sophisticated US operations are likely to have higher risk-weighted assets than under current rules, resulting in higher allocations of free capital and lower allocations of interest-bearing capital, resulting in fewer interest deductions and a higher tax base. In part, this results from the fact that the Basel risk-weighted capital standards used in the BIS ratio approach do not distinguish between funded (on-balance sheet) and unfunded (off-balance sheet) exposures (e.g., an actual loan versus a letter of credit). By proposing to adopt the Basel Accord, the Draft proposes to include both on-balance sheet and off-balance sheet positions in attributing a bank’s capital to its PE. This blending approach may not be appropriate, however, since the allocation of capital among booked assets and off-balance sheet exposures for bank regulatory purposes differs from the actual deployment of funds that represent such regulatory capital in the assets of the bank. In practice, capital required to support off-balance sheet exposures of one business in one location are commonly invested in on-balance sheet assets of different businesses in different locations.

Common examples of US PEs include the operation of swap books (with significant off-balance sheet positions) and letters of credit for export financing activities. This will result in more free capital being attributed to the US PEs with a corresponding increase in the US tax base.

US PEs may also be adversely affected by this proposal, because many banks maintain in their home offices a greater portion of lower risk-weighted assets such as cash, cash equivalents and government securities than in their US branches. Because low risk weighting translates into a lower attribution of regulatory capital (under the BIS ratio) and a higher amount of allocable interest expense to the home office, this would result in increasing the taxation of a foreign bank’s US PE. Further, if the home office tax base and burden is reduced while the US and other non-residence PEs’ tax burdens are increased, the potential for double taxation increases due to the potential inability to claim a full credit for the increased US tax burden in the home office (where the tax base has decreased).

The OECD has commented favourably on the standardization and administrative benefits of using a revised Basel approach intended to replace the existing, somewhat crude 1988 Basel benchmarks. The revision, however, may well actually achieve neither of these benefits, as the revised Basel standards will permit the use of a bank’s internal risk models for risk-weighting and, thus, create more, rather than less, divergence among individual banks, defeating the intent for standardization. Further, the revised Basel approach weighs portfolio risk without regard to individual branch positions (in contrast to the current asset-by-asset risk weighting), a potentially problematic feature affecting the ability to accurately risk weight portfolios held in different PEs. Perhaps most fundamentally, the objective of achieving standardization using Basel risk weighting may not be significantly achieved, as not all countries apply Basel standards uniformly.

**Adjusting interest expense claimed by a PE**

The working hypothesis proposes to determine the amount of free capital attributable to a PE regardless of whether such amount of capital is actually needed to support the PE’s lending activities. If the free capital actually allocated by a bank to a PE is less than an arm’s-length amount, the interest expense deduction claimed by the PE should be reduced to reflect the amount of free capital needed to support the lending activities.
The Draft uses an example involving Tier 2 subordinated debt. If a PE of a bank issues higher-cost Tier 2 subordinated debt for the benefit of the bank as a whole without being compensated for the treasury functions performed, it would not be correct to allow the PE to deduct all the interest expense related to the subordinated debt. Therefore, it is necessary to adjust the interest expense deduction to properly reflect any internal interest dealings between the PE and the rest of the bank. The Draft suggests three alternative approaches to addressing this adjustment issue: a blended rate approach, the cleansed BIS ratio approach and the pure BIS ratio approach.

The blended rate approach assumes that the bank’s internal borrowing rate is appropriately blended to take into account any and all internal interest dealings. Therefore, no adjustment is necessary under this approach. The approach appears to give banks significant latitude regarding types of debt, the interest on which could be blended into the rate.

Under the pure BIS ratio approach, the BIS ratio for the whole bank is used to determine the amount of Tier 1 and Tier 2 capital actually needed to support the PE. The interest expense deduction claimed by the PE is adjusted by applying the market interest rate to the allocated amount of Tier 2 capital. The approach requires no independent transfer pricing study. However, it may give the bank opportunities to move funds to lower its tax burden in the PE host country. As such, the IRS may not prefer this approach. In addition, certain guidelines would need to be established regarding what constitutes a market interest rate and what adjustment, if any, is needed to make such a rate more reflective of a bank’s business.

Under the cleansed BIS ratio approach, interbranch interest dealings are recognized in determining the arm’s-length amount of Tier 1 and Tier 2 capital attributed to the PE. As a result, there would be no difference between the capital actually allocated and the capital determined under an arm’s-length standard.

This third approach is the most consistent with the working hypothesis that a PE should be treated as a functionally separate entity. However, the US Treasury and IRS may be hesitant to adopt this approach. Under current US law, in the absence of a Natwest application, interbranch dealings generally are not recognized for the purposes of computing an interest expense deduction. This position is reflected in the computation of US assets, the actual worldwide debt/equity ratio and US booked liabilities. Although the proposed global dealing regulations do suggest that interbranch dealings may be recognized for similar purposes in the US, the US Treasury and IRS may be reluctant to fully support the cleansed BIS ratio approach until the issue is more settled.

CONCLUSION

The Draft advances the notion that a PE should be treated as a distinct and separate enterprise for purposes of attributing profits to it under article 7 of the OECD Model. It represents a major contribution and contains substantive and thoughtful analysis. Although the work of the OECD is not binding on its member countries, and the Draft is work in progress, it can be useful for (a) the negotiation of bilateral income tax treaties, (b) as a first step towards developing workable solutions, and (c) during competent authority deliberations when the resident and host countries have home tax rules that are not harmonious.

However, to avoid double taxation or less than single taxation, questions remain regarding whether the alternatives considered in the Draft would attribute profits fairly and equitably to host countries and the home country. In addition, although the Draft highlights the importance of simplicity and administrability, the potential effects of the approaches considered appear to be quite complex and burdensome. The Draft would impose a significantly higher level of complexity, analysis and administration to comply than under current US practice. In the relatively straightforward function of borrowing and lending, it would require the performance of in-depth functional analysis. Presumably, these burdens would further increase when the approaches are applied to the more complex and sophisticated functions performed by international banks.

The use of the Basel Accord computations and adjustments, though perhaps workable in theory, will likewise increase significantly the complexity of the rules and the burden on taxpayers and tax administrators, and may not provide the desired consistency since they are not applied uniformly country-by-country, and will probably be applied on a portfolio, rather than asset-by-asset basis in the future. Finally, although the Draft asks the taxpayer community to provide practical comments and input, the Draft itself would have benefited from more actual examples (branch versus subsidiary being the only significant example offered).

The OECD has taken an important first step in reaching consensus on the very complex issue of taxing PEs, and, in particular, those of global banks. There is clearly a lack of consistency and consensus among OECD member countries and the OECD should be commended for initiating the process, releasing its initial findings in draft format and openly soliciting comments. It is hoped that these comments can help form the basis for a
continued refinement of the approach, and that a regime will result that is reasonably administrable, and otherwise satisfies both the revenue authorities and the relevant taxpayer community.

Nestor House, Playhouse Yard, Blackfriars, London EC4V 5EX
Contact: Oliver Watkins +44 (0) 20 7779 8385