



ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT



## 2010 REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS

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CENTRE FOR TAX POLICY AND ADMINISTRATION

## **FOREWORD**

This Report was approved by the Committee on Fiscal Affairs on 22 June 2010 and by the OECD Council for publication on 22 July 2010. The Recommendation adopted by the Council is included as an Addendum to the Report.

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## PREFACE

1. The permanent establishment (PE) concept has a history as long as the history of double taxation conventions. Currently, 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.

2. The principles underlying Article 7, and in particular paragraph 2 of the Article, have a long history. When the OECD first examined what criteria should be used in attributing profits to a permanent establishment, this question had previously been addressed in a large number of tax conventions and in various models developed by the League of Nations. The separate entity and arm's length principles, on which paragraph 2 is based, had already been incorporated in these conventions and models and the OECD considered that it was sufficient to restate these principles with some slight amendments and modifications for the main purpose of clarification.

3. Practical experience has shown, however, that there was considerable variation in the interpretation of these general principles and of other provisions of earlier versions of Article 7. This lack of a common interpretation created problems of double taxation and non-taxation. Over the years, the Committee on Fiscal Affairs spent considerable time and effort trying to ensure a more consistent interpretation and application of the rules of the Article. Minor changes to the wording of the Article and a number of changes to the Commentary were made when the 1977 Model Tax Convention was adopted. A report that addressed that question in the specific case of banks was published in 1984. In 1987, noting that the determination of profits attributable to a permanent establishment could give rise to some uncertainty, the Committee undertook a review of the question which led to the adoption, in 1993, of the report entitled "Attribution of Income to Permanent Establishments"<sup>1</sup> and to subsequent changes to the Commentary.

4. Despite that work, the practices of OECD and non-OECD countries regarding the attribution of profits to permanent establishments and these countries' interpretation of Article 7 continued to vary considerably. The Committee acknowledged the need to provide more certainty to taxpayers: in its report "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations" (the Guidelines), adopted in 1995, it indicated that further work would address the application of the arm's length principle to permanent establishments. That work resulted, in 2008, in a report entitled "Attribution of Profits to Permanent Establishments" (the 2008 Report). The approach developed in the 2008 Report was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus was on formulating the most preferable approach to attributing profits to a permanent establishment under Article 7 given modern-day multinational operations and trade.

5. When it approved the 2008 Report, the Committee considered that the guidance included therein represented a better approach to attributing profits to permanent establishments than had previously been available. It also recognised, however, that there were differences between some of the conclusions of the Report and the interpretation of Article 7 previously given in the Commentary. For that reason, in 2008 the Committee decided to amend the Commentary on Article 7 to incorporate a number of conclusions of the

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<sup>1</sup> Reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention at page R(13)-1.

2008 Report that did not conflict with the previous version of that Commentary, which prescribed specific approaches in some areas and left considerable leeway in others.

6. At the same time, the Committee decided that a new version of Article 7 should be included in the next update to the Model Tax Convention to allow the full incorporation of these principles. The new Article 7 was included in the 2010 update to the OECD Model Tax Convention.

7. The 2008 Report will serve as background guidance to the 2008 revised Commentary's interpretation of the pre-2010 Article 7 for as long as bilateral tax treaties that are based on the text of that version of Article 7 are in force. However, because the 2008 Report included a number of references to the text of the pre-2010 Article 7, and because the Committee revised the text of Article 7 in the 2010 update to the Model Tax Convention, the Committee believed it would be advisable to prepare a modified version of the 2008 Report which would delete obsolete references to the text of the pre-2010 Article 7 and which would align the Report's wording with the wording of the new Article 7, thus making the modified Report available as a future reference for guidance on the interpretation of future treaties based on the new Article 7. The Committee decided to prepare this modified version of the 2008 Report for publication simultaneously with the 2010 update to the Model Tax Convention.

8. This Report does not change the conclusions of the 2008 Report and has been prepared simply to avoid difficulties that might arise in trying to use the 2008 Report for the interpretation of the new Article 7.

9. Several commentators on draft versions of the 2008 Report expressed concerns about whether the Report could be interpreted to affect the legal threshold for determining the existence of a PE under Article 5. Whilst the draft Report stated several times that it was not addressing the Article 5 PE threshold, this final version reiterates that point and stresses that this Report is not intended to affect in any way the currently existing standards under Article 5 for determining the existence of a PE.

10. Finally, this Report has been based upon the principle of applying by analogy the guidance found in the Guidelines for purposes of determining the profits attributable to a PE. To the extent the Guidelines are modified in the future, this Report should be applied by taking into account the guidance in the Guidelines as so modified from time to time.

**2010 REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS**

## PART I: GENERAL CONSIDERATIONS

### A. Introduction

1. The permanent establishment (PE) concept has a history as long as the history of double taxation conventions. At the multilateral level, the wording of the various draft conventions has evolved from the League of Nations drafts of 1927, 1933, 1943 and 1946 through to the Draft Double Taxation Convention on Income and on Capital in 1963 and its successor in 1977, the OECD Model Double Taxation Convention on Income and on Capital. Currently, 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 Tax Convention), which forms the basis of the extensive network of bilateral income tax treaties between OECD member countries and between many OECD member and non-member countries. These principles are, to a certain extent, also incorporated in the Model United Nations Double Taxation Convention between Developed and Developing Nations.

2. Practical experience has shown, however, that there was considerable variation in the interpretation of these general principles and of the provisions of earlier versions of Article 7. This lack of a common interpretation created problems of double taxation and non-taxation. Over the years, the Committee on Fiscal Affairs spent considerable time and effort trying to ensure a more consistent interpretation and application of the rules of the Article. Minor changes to the wording of the Article and a number of changes to the Commentary were made when the 1977 Model Tax Convention was adopted. A report that addressed that question in the specific case of banks was published in 1984. In 1987, noting that the determination of profits attributable to a permanent establishment could give rise to some uncertainty, the Committee undertook a review of the question which led to the adoption, in 1993, of the report entitled “Attribution of Income to Permanent Establishments”<sup>1</sup> and to subsequent changes to the Commentary.

3. Despite that work, the practices of OECD and non-OECD countries regarding the attribution of profits to permanent establishments and these countries’ interpretation of Article 7 continued to vary considerably. The Committee acknowledged the need to provide more certainty to taxpayers: in its report “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations” (the Guidelines), adopted in 1995, it indicated that further work would address the application of the arm’s length principle to permanent establishments. That work resulted, in 2008, in a report entitled “Attribution of Profits to Permanent Establishments” (the 2008 Report).<sup>2</sup> The approach developed in the 2008 Report (*i.e.* the “authorised OECD approach” or “AOA”) was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus was on formulating the most preferable approach to attributing profits to a permanent establishment under Article 7 given modern-day multinational operations and trade. The basis for the development of the AOA was to examine how far the approach of treating a PE as a hypothetical separate and independent enterprise could be taken. The testing and development of the AOA examined how the guidance in the Guidelines could be applied to attribute profits to a PE of a banking, global trading or insurance enterprise in accordance with the arm’s length principle of Article 7. In particular, the examination focussed on the extent to which modifications, if any, would be needed in order to take into account differences between a PE and a legally distinct and separate enterprise. It should be noted that under the authorised OECD approach, 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.

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<sup>1</sup> Reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention at page R(13)-1.

<sup>2</sup> Available at <http://www.oecd.org/dataoecd/20/36/41031455.pdf>.

4. When it approved the 2008 Report, the Committee considered that the guidance included therein represented a better approach to attributing profits to permanent establishments than had previously been available. It also recognised, however, that there were differences between some of the conclusions of the Report and the interpretation of Article 7 previously given in the Commentary. For that reason, in 2008 the Committee decided to amend the Commentary on Article 7 to incorporate a number of conclusions of the 2008 Report that did not conflict with the previous version of that Commentary, which prescribed specific approaches in some areas and left considerable leeway in others.

5. At the same time, the Committee decided that a new version of Article 7 should be included in the 2010 update to the Model Tax Convention to allow the full incorporation of these principles. The Committee also considered that it would be necessary to revise the 2008 Report in order to align its wording with the wording of the new Article 7 and to delete obsolete references to the pre-2010 version of Article 7. This revised Report, which has been prepared for publication in conjunction with the release of the 2010 update to the Model Tax Convention, does not change the conclusions of the 2008 Report and has been prepared simply to avoid difficulties that might arise in trying to use the 2008 Report for the interpretation of the new Article 7.

6. This Report focuses on the interpretation and application of Article 7 as included in the 2010 OECD Model Tax Convention. The question of whether the current interpretation of other relevant Articles of the OECD Model Tax Convention (such as Articles 5, 13 and 23) produces a desirable result is beyond the scope of this Report. In particular, the Report does not address the question of whether a PE exists in respect of any particular business activity, nor is it intended to affect in any way the currently existing standards under Article 5 for determining the existence of a PE. The definition of a PE is described by Article 5 of the OECD Model Tax Convention and readers are referred to its Commentary for further information (including the changes made in the January 2003 and July 2005 updates).

7. The rest of Part I of this Report provides general background and further information about the authorised OECD approach in relation to Article 7. Section B provides a summary of the basic principles of the authorised OECD approach. Section C analyses Article 7, paragraph 1, which provides the central rule concerning the allocation of taxing rights over the business profits of an enterprise<sup>3</sup> between the country in which the PE is situated (the “host country”) and the country of residence of the enterprise (the “home country”). Section D analyses Article 7, paragraph 2, which provides the central rule concerning the attribution of the business profits of an enterprise to a PE and the statement of the arm’s length principle in the context of PEs. The authorised OECD approach is applicable to all types of PEs, but there is a separate Section examining the special considerations applicable to PEs existing under Article 5(5) of the OECD Model Tax Convention (*i.e.* so-called “dependent agent PEs”; see Section D-5).

## **B. Statement of principles used to attribute profits to a PE**

### **B-1. The “functionally separate entity approach”**

8. The authorised OECD approach is that the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise. The phrase “profits of an enterprise” in Article 7(1) should not be interpreted as affecting the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that

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3 For the purposes of this Report, references to the “enterprise” or to the “enterprise as a whole” should be interpreted as describing the juridical entity.

“the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment” (*i.e.* there should be no “force of attraction principle”). Profits may therefore be attributed to a permanent establishment even though the enterprise as a whole has never made profits. Conversely, Article 7 may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

## **B-2. Basic premise of the authorised OECD approach**

9. The authorised OECD approach does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host country of the PE. Accordingly, the profits to be attributed to a PE are the profits that the PE would have earned at arm’s length, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise, determined by applying the Guidelines by analogy. This is in line with one of the fundamental rationales behind the PE concept, which is to allow, within certain limits, the taxation of non-resident enterprises in respect of their activities (having regards to assets used and risks assumed) in the source jurisdiction. In addition, the authorised OECD approach is not designed to prevent the application of any domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of assets or risks. Finally, where their domestic law does not recognise loss transactions in certain circumstances between associated enterprises, countries may consider that the authorised OECD approach would not require the recognition of a loss on an analogous dealing in determining the profits of a PE.

10. The interpretation of Article 7(2) under the authorised OECD approach is that a two-step analysis is required. First, a functional and factual analysis, conducted in accordance with the guidance found in the Guidelines, must be performed in order to hypothesise appropriately the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks, and entering into dealings with each other and transactions with other related and unrelated enterprises. Under the first step, the functional and factual analysis must identify the economically significant activities and responsibilities undertaken by the PE. This analysis should, to the extent relevant, consider the PE’s activities and responsibilities in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the PE. Under the second step, the remuneration of any dealings between the hypothesised enterprises is determined by applying by analogy the Article 9 transfer pricing tools (as articulated in the Guidelines for separate enterprises) by reference to the functions performed, assets used and risk assumed by the hypothesised enterprises. The result of these two steps will be to allow the calculation of the profits (or losses) of the PE from all its activities, including transactions with other unrelated enterprises, transactions with related enterprises (with direct application of the Guidelines) and dealings with other parts of the enterprise (under step 2 of the authorised OECD approach).

11. The hypothesis by which a PE is treated as a functionally separate and independent enterprise is a mere fiction necessary for purposes of determining the business profits of this part of the enterprise under Article 7. The authorised OECD approach should not be viewed as implying that the PE must be treated as a separate enterprise entering into dealings with the rest of the enterprise of which it is a part for purposes of any other provisions of the Convention.

12. These general principles are further discussed under Section D.

### **B-3. Step one: hypothesising the PE as a separate and independent enterprise**

See Section D-2 for a more detailed discussion of step one of the authorised OECD approach.

#### **(i) Functional and factual analysis**

13. The functional and factual analysis under step two of the authorised OECD approach performs the same role in the comparability analysis in a PE context under Article 7 as it does in situations involving associated enterprises under Article 9. Notwithstanding this similarity, the functional and factual analysis has further applications under step one of the authorised OECD approach for purposes of hypothesising the PE as a “separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.” These further applications are necessary because a PE is not in fact legally separate from the rest of the enterprise of which it is a part in the way that an associated enterprise is legally separate from other enterprises within the same MNE group. This factual, legal difference gives rise to issues in a PE context that are not present in an associated enterprises context.

14. As between unrelated enterprises, the determination of which enterprise owns assets and which bears risk is determined by legally binding contracts or other ascertainable legal arrangements. Similar considerations apply to associated enterprises providing those contracts or legal arrangements reflect the underlying reality and meet the criteria in Chapter I of the Guidelines. Similarly, in a separate enterprise context no issues generally arise over determining which enterprise possesses the capital. The factual, legal position in a PE context, on the other hand, is that there is no single part of an enterprise which legally “owns” the assets, assumes the risks, possesses the capital or contracts with separate enterprises. The legal position is thus unhelpful in a PE context, since Article 7(2) requires the PE to be treated as if it were a separate and independent enterprise, performing its own functions, assuming its own risk and owning or using assets on its own. It is therefore necessary under the arm’s length principle of Article 7 to develop a mechanism for attributing risks, economic ownership of assets<sup>4</sup> and capital to the hypothetically separate and independent PE, for associating with the hypothetically separate and independent PE the rights and obligations arising out of transactions between separate enterprises and the enterprise of which the PE is a part and for recognising and determining the nature of the “dealings” (*i.e.* the intra-enterprise equivalents of separate enterprise transactions) between the hypothetically separate PE and other parts of the enterprise of which the PE is a part.

15. As it is not possible to use a legal analysis as the required mechanism, another solution must be sought. After careful consideration, the OECD decided that a functional analysis should be used, as this concept underpins the application of the arm’s length principle under Article 9 and there is already considerable guidance on how to conduct this analysis in the Guidelines. However, in order to address the issues created by the fact that legally the assets, risks, capital, and rights and obligations arising out of transactions with separate enterprises belong to the enterprise as a whole rather than to any one part of the enterprise and that there is no legal transaction between different parts of a single entity, it proved necessary to supplement the functional analysis of Article 9. Accordingly, the authorised OECD approach attributes to the PE those risks for which the significant functions relevant to the assumption and/or management (subsequent to the transfer) of risks are performed by people in the PE and also attributes to

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4 As used in this Report, the “economic” ownership of assets in the Article 7 context means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (*e.g.* the right to the income attributable to the ownership of the asset, such as royalties; the right to depreciate a depreciable asset; and the potential exposure to gains or losses from the appreciation or depreciation of the asset).

the PE economic ownership of assets for which the significant functions relevant to the economic ownership of assets<sup>5</sup> are performed by people in the PE. The authorised OECD approach also sets forth approaches to attribute capital, including “free” capital (*i.e.* funding that does not give rise to a tax deductible return in the nature of interest), to the PE to support the functions it has performed, the risks assumed and assets attributed to it, as well as criteria for the recognition and characterisation of dealings between the PE and other parts of the enterprise to which it belongs.

16. The significant people functions relevant to the assumption of risk and the significant people functions relevant to the economic ownership of assets will vary from business sector to business sector (*e.g.* such functions are unlikely to be the same for an oil extraction company and a bank) and from enterprise to enterprise within sectors (*e.g.* not all oil extraction companies or all banks are the same). It should be stressed that a particular enterprise may have one or more significant people functions relevant to the assumption of risk and to the economic ownership of assets, each of which has to be taken into account in the above analysis. The extent of the overlap between the significant people functions relevant to the assumption of risk and the significant people functions relevant to the economic ownership of assets will also vary from business sector to business sector and from enterprise to enterprise within sectors. For example, in the case of financial assets of financial enterprises, the same significant people functions will generally be relevant both to the assumption of risk and to the economic ownership of those assets. This special category of asset is discussed in Part II (bank loans), Part III (financial products of enterprises engaged in global trading), and Part IV (the assets representing the investment of reserves and surpluses derived from insurance business). Because of the special relationship between risks and financial assets in those specific sectors, the authorised OECD approach uses the “key entrepreneurial risk-taking function” (“KERT function”) terminology in describing the functions relevant to the attribution of both risks and assets, but that terminology is not used for other sectors. Outside the financial enterprise sector, risks may be less intimately linked with assets, so that there may be less overlap between the significant people functions relevant to the assumption of risk and those relevant to the economic ownership of the assets.

17. Whilst it is important under the first step of the authorised OECD approach to identify the significant people functions relevant to the assumption of risk and those relevant to the economic ownership of assets, it is also important under the first step to analyse other functions performed by the PE. This is because the profits (or losses) of the PE will be based upon all its activities, including transactions with other unrelated enterprises, transactions with related enterprises (with direct application of the Guidelines) and dealings with other parts of the enterprise (under step 2 of the authorised OECD approach). Under the second step of the authorised OECD approach the Guidelines are applied by analogy to the PE’s dealings with other parts of the enterprise to ensure that the performance of all of its functions in relation to these dealings is rewarded on an arm’s length basis. The dealings of the hypothesised separate and independent enterprise will be compared to transactions of independent enterprises performing the same or similar functions, using the same or similar assets, assuming the same or similar risks and possessing the same or similar economically relevant characteristics. The transfer pricing methods set out in the Guidelines are applied to determine an arm’s length price for the dealings. It should be noted that there is no presumption that functions other than significant people functions relevant to the assumption of risk and significant people functions relevant to the economic ownership of assets are by nature of low value. This will be determined by the functional and comparability analyses based on the particular facts and circumstances.

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5 Note that the exercise of identifying significant people functions relevant to the assumption of risks and significant people functions relevant to the economic ownership of assets is relevant for purposes of attributing initial assumption of risks and economic ownership of assets to particular parts of an enterprise under step one. However, it does not limit the need under step two of the authorised OECD approach to ensure that all functions performed by the PE are remunerated at arm’s length, nor does it in any way affect the threshold for determining the existence of a PE under Article 5.



**(ii) Attribution of assets**

18. Under the authorised OECD approach it is necessary to hypothesise the PE as if it were a separate and independent enterprise. This exercise entails, *inter alia*, the determination of which assets are “economically owned” and/or used by the PE and in what capacity. The factual position is that no one part of an enterprise owns assets; they belong to the enterprise as a whole. It is therefore necessary under the first step of the authorised OECD approach to find a means of attributing economic ownership. One possible approach would be to allow taxpayers to simply nominate which part of the enterprise economically owns the assets. This approach, though simple and administrable, would potentially provide an incentive for taxpayers to attribute economic ownership of assets in ways that would lead to inappropriate allocations of profit and thus has been rejected as not in accordance with sound tax policy. Instead there is a broad consensus that assets generally are to be attributed to the part of the enterprise which performs the significant people functions relevant to the determination of economic ownership of assets. The functional and factual analysis will examine all the facts and circumstances to determine the extent to which the assets of the enterprise are used in the functions performed by the PE and the conditions under which the assets are used, including the factors to be taken into account to determine which part of the enterprise is regarded as the economic owner of the assets actually owned by the enterprise. The attribution of economic ownership of assets will have consequences for both the attribution of capital and interest-bearing debt and the attribution of profit to the PE.

19. The consequences of attributing economic ownership of assets under the first step for determining profits under the second step may depend upon the type of asset and the type of business in which the asset is used. For example, economically owning a tangible asset used in a manufacturing process does not necessarily, of itself, attribute to the economic owner of the asset the income from selling goods produced by using the asset. Attributing economic ownership of financial assets, on the other hand, attributes the income and expenses associated with holding those assets or lending them out or selling them to third parties.

20. In the case of financial assets of financial enterprises, the creation and management of such assets (and their attendant risks) is itself the significant people function relevant to determining the initial economic ownership of the assets, so the initial attribution of economic ownership of those assets to the part of the enterprise performing that function has primary importance not only for determining characterisation of the “separate and independent enterprise” under step one, but also to the attribution of profits under step two, since the attribution of income-generating assets also effectively determines which part of the enterprise receives the income and expenses associated with those assets. This special category of asset is discussed in Part II (bank loans), Part III (financial products of enterprises engaged in global trading) and Part IV (the assets representing the investment of reserves and surpluses derived from insurance business).

**(iii) Attribution of risks**

21. The functional and factual analysis will initially attribute to the PE any risks inherent in, or created by, the PE’s own significant people functions relevant to the assumption of risks and take into account any subsequent dealings or transactions related to the subsequent transfer of risks or to the transfer of the management of those risks to different parts of the enterprise or to other enterprises. The term “risk assumption” refers to the initial assumption of risk but it is not necessary that the same part of the enterprise subsequently be treated as having retained the risk assumed. Being attributed risks in the Article 7 context means the equivalent of bearing risks for income tax purposes by a separate enterprise, with the attendant benefits and burdens, in particular the potential exposure to gains or losses from the realisation or non-realisation of said risks. This raises the question of whether, and if so, in what circumstances, dealings resulting in the transfers of risks should be recognised within a single entity so that

risks initially assumed by one part of the enterprise will be treated as 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(vi).

22. Depending on the nature of the enterprise's business, some risks will be related to the potential loss in value of assets attributed to the PE while some other risks will be created by activities and not necessarily linked to the simple existence of the assets (*e.g.* liability risks). The significant people functions relevant to the assumption of risks are those which require active decision-making with regard to the acceptance and/or management (subsequent to the transfer) of those risks. The extent of the decision-making will depend on the nature of the risk involved.

23. By way of illustration, take the example of an enterprise which consists of a head office in one jurisdiction and one PE in another jurisdiction. Assume products are manufactured at the head office location and delivered to the PE premises for sale to customers in the PE jurisdiction. Assume the manufacturing functions are performed by employees of the head office and the sales are concluded by employees of the PE. A functional and factual analysis is performed and concludes that in this particular instance this particular PE is acting as a distributor of the head office products. In this example it might be necessary to attribute, among others, excess inventory risk and credit risk.

24. Under the authorised OECD approach, the attribution of these risks within the single enterprise will follow from the identification of the significant people functions relevant to the initial acceptance and subsequent management of those risks:

- The excess inventory risk is likely to be regarded as initially assumed by that part of the enterprise which makes the active decisions related to inventory levels. Depending on the circumstances of the case, this may be either the head office or the PE.
- The credit risk is likely to be regarded as initially assumed by that part of the enterprise which decides to conclude a sale to a particular customer after having reviewed the creditworthiness of this customer. A question may arise however where a review of the creditworthiness of each customer is performed by one part of the enterprise before a sale is concluded by another part of the enterprise. In such a case, the functional and factual analysis would have to examine whether the people in charge of reviewing the customers' creditworthiness are in effect the ones making a decision that leads to the assumption of credit risk, or if they act as a support function for the PE which ultimately makes the decision of whether or not to sell to a particular customer.

25. Note that the fact that general parameters for inventory levels or credit risks might potentially be set by another part of the enterprise would not change the assumption of the risk, as the significant people functions relevant to the assumption of risks are those which involve active decision-making.

26. The attribution and measurement of risk is an important part of the functional and factual analysis since the presence of risk affects both the attribution of capital under step one of the authorised OECD approach and the attribution of profits to the PE under the second step. Under step one of the authorised OECD approach, since capital follows risks, the part of the enterprise that performs the significant people functions relevant to the assumption of risks (or that performs the significant people functions relevant to taking over and managing a risk initially assumed by another part of the enterprise) would be attributed the capital necessary to support these risks. Under the second step of the authorised OECD approach, the selection and application of a transfer pricing method will take into account risks assumed by the PE and by other parts of the enterprise it has dealings with.

27. The attribution of risk is particularly important in the financial sector where it has a substantial impact on the attribution of both capital and income and expenses to the PE, but it can also be important in other businesses. The financial sector, because of the nature of its business, has very sophisticated risk measurement tools. Outside the financial sector it will still be necessary – although often more difficult – to measure risk.

*(iv) Attribution of free capital*

28. The functional and factual analysis will attribute “free” capital (*i.e.* funding that does not give rise to a tax deductible return in the nature of interest) to the PE for tax purposes, to ensure an arm’s length attribution of profits to the PE. The starting point for the attribution of capital is that under the arm’s length principle a PE should have sufficient capital to support the functions it undertakes, the assets it economically owns and the risks it assumes. In the financial sector regulations stipulate minimum levels of regulatory capital to provide a cushion in the event that some of the risks inherent in the business crystallise into financial loss. Capital provides a similar cushion against crystallisation of risk in non-financial sectors.

29. A key distinction between a separate legal enterprise and a PE is that one legal enterprise can enter into a legally binding agreement to guarantee all the risks assumed as a result of the functions performed by another legal enterprise. For such a guarantee to have substance, the “free” capital needed to support the risks assumed would reside in a different legal enterprise from that in which the transactions giving rise to the risks are booked. In contrast one of the key factual conditions of an enterprise trading through a PE is that the “free” capital and risks are not segregated from each other within a single legal enterprise. To attempt to do so for tax purposes (*i.e.* to treat one part of an enterprise as able to guarantee a risk assumed by another part of the enterprise) would contradict the factual situation and would not be consistent with the authorised OECD approach. Capital needed to support risks must be regarded as following the risks. In other words, capital needed to support risks is to be attributed to a PE by reference to the risks attributed to it and not the other way round.

30. The attribution of “free” 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 attribution of profits to the PE under Article 7(2). The Report describes a number of different possible approaches for applying that principle in practice, recognising that the attribution of “free” 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 “free” capital attributable to a PE, not a single figure. There is a common premise to the authorised approaches to attributing “free” capital, that an internal condition of the PE is that the creditworthiness of the PE is generally the same as the enterprise of which it is a part.

31. The authorised OECD approach recognises a range of acceptable approaches for attributing “free” capital that are capable of giving an arm’s length result, each with its own strengths and weaknesses, which become more or less material depending on the facts and circumstances of particular cases. Different methods adopt different starting points for determining the amount of “free” capital attributable to a PE, which either put more emphasis on the actual structure of the enterprise of which the PE is a part or alternatively, on the capital structures of comparable independent enterprises. The key to attributing “free” capital is to recognise:

- The existence of strengths and weaknesses in any approach and when these are likely to be present (discussed in more detail in Section D-2(v)(b)(2)).

- That there is no single arm's length amount of "free capital", but a range of potential capital attributions within which it is possible to find an amount of "free" capital that can meet the basic principle set out above.

(a) *Funding costs*

32. The PE requires a certain amount of funding, made up of "free" capital and interest-bearing debt. The objective is to attribute an arm's length amount of interest to the PE, using one of the authorised approaches to attributing "free" capital in order to support the functions, assets and risks attributed to the PE. These issues are discussed in more detail in Section D-2(v)(b)(3).

(v) *Recognition of dealings*

33. 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 is not in fact legally or economically separate from the rest of the enterprise of which it is a part. It follows that:

- Save in exceptional circumstances, all parts of the enterprise have the same creditworthiness. This means that dealings between a PE and the rest of the enterprise 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 enterprise to guarantee the PE's creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the enterprise.

34. Second, dealings between a PE and the rest of the enterprise of which it is a part have no legal consequences for the enterprise as a whole. This 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. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist and considering the uniqueness of this issue, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealing.

35. 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 independent enterprises acting at arm's length. Only once that threshold is passed can a dealing be reflected in the attribution of profits under Article 7(2). The functional and factual analysis must determine whether a real and identifiable event has occurred and should be taken into account as a dealing of economic significance between the PE and another part of the enterprise.

36. Thus, for example, an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the authorised OECD approach. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that:

- the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner or, if they do so differ, the structure as presented in the taxpayer's

documentation does not practically impede the tax administration from determining an appropriate transfer price; and

- the dealing presented in the taxpayer's documentation does not violate the principles of the authorised OECD approach by, for example, purporting to transfer risks in a way that segregates them from functions.

See paragraphs 1.48-1.54 and 1.64-1.69 of the Guidelines by analogy.

37. It is important to note, however, that the authorised OECD approach is generally not intended to impose more burdensome documentation requirements in connection with intra-enterprise dealings than apply to transactions between associated enterprises. Moreover, as in the case of transfer pricing documentation under the Guidelines, the requirements should not be applied in such a way as to impose on taxpayers costs and burdens disproportionate to the circumstances.

38. Third, where dealings are capable of being recognised, they may lead to a transfer of assets and/or risks between the PE and other parts of the enterprise to which it belongs. As a consequence the characterisation and recognition of dealings will affect the attribution of risks, assets and therefore capital to the PE.

#### **B-4. Step two: determining the profits of the hypothesised separate and independent enterprise based upon a comparability analysis**

See Section D-3 for a more detailed discussion of step two of the authorised OECD approach.

39. 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 using by analogy the guidance on transfer pricing methods contained in the Guidelines.

40. The authorised OECD approach is to undertake a comparison of *dealings* between the PE and the enterprise of which it is a part, with *transactions* between independent enterprises. This comparison is to be made by following, by analogy, the comparability analysis described in the Guidelines. By analogy with the Guidelines, comparability in the PE context means either that none of the differences (if any) between the dealing and the transaction between independent enterprises materially affects the measure used to attribute profit to the PE, or that reasonably accurate adjustments can be made to eliminate the material effects of such differences. Principles similar to the aggregation rules of Chapter III of the Guidelines should also apply to permit the PE's dealings to be aggregated, where appropriate, in determining the PE's attributable profit.

41. Under the authorised OECD approach, for purposes of determining the arm's length remuneration of dealings, the most appropriate method to the circumstances of the case should be selected and applied by analogy to the guidance in the Guidelines.

42. In an arm's length transaction an independent enterprise normally would seek to charge for making a provision in such a way as to generate profit, rather than providing it merely at cost, although there can be circumstances in which a provision made at an arm's length price will not result in a profit (*e.g.* see paragraph 7.33 of the Guidelines in connection with the provision of services).

43. Section D-3(iv) contains a discussion of some commonly occurring dealings which require special mention – dealings involving changes in the use of tangible assets, intangible assets, cost contribution arrangements and internal service dealings.

## **B-5. Summary of the two-step analysis**

44. The attribution of profits to a PE of an enterprise on an arm's length basis will follow from the calculation of the profits (or losses) from all its activities, including transactions with other unrelated enterprises, transactions with related enterprises (with direct application of the Guidelines) and dealings with other parts of the enterprise (under step 2 of the authorised OECD approach). This analysis involves the following two steps:

### *Step One*

A functional and factual analysis, leading to:

- The attribution to the PE as appropriate of the rights and obligations arising out of transactions between the enterprise of which the PE is a part and separate enterprises;
- The identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the PE;
- The identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the PE;
- The identification of other functions of the PE;
- The recognition and determination of the nature of those dealings between the PE and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test; and
- The attribution of capital based on the assets and risks attributed to the PE.

### *Step Two*

The pricing on an arm's length basis of recognised dealings through:

- The determination of comparability between the dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the PE; and
- Selecting and applying by analogy to the guidance in the Guidelines the most appropriate method to the circumstances of the case to arrive at an arm's length compensation for the dealings between the PE and the rest of the enterprise, taking into account the functions performed by and the assets and risks attributed to the PE.

The pricing on an arm's length basis of any transactions with associated enterprises attributed to the PE should follow the guidance in the Guidelines and is not discussed in this Report. The order of the listing of items within each of the steps above is not meant to be prescriptive, as the various items may be interrelated (*e.g.* risk is initially attributed to a PE as it performs the significant people functions relevant to the assumption of that risk but the recognition and characterisation of a subsequent dealing between the PE and another part of the enterprise that manages the risk may lead to a transfer of the risk and supporting capital to the other part of the enterprise).

45. It can be seen that the functional and factual analysis is primarily needed to hypothesise the PE as a functionally separate entity, to identify the significant people functions relevant to determining which part of the enterprise assumes and/or subsequently manages particular risks and economically owns

particular assets, and to attribute to the PE as a hypothetically separate entity an appropriate amount of capital. This step of the analysis is likewise necessary to identify which part of the enterprise should be hypothesised to have undertaken the enterprise's rights and obligations arising from transactions with other enterprises and what dealings should be hypothesised to exist between the PE and other parts of the enterprise. Secondly, it is important to identify the respective functions performed by both the PE and other parts of the enterprise with which it is hypothesised to have dealings in order to price those dealings under the second step of the authorised OECD approach.

#### **B-6. Dependent agent PEs**

46. This Report does not examine the issue of whether a PE exists under Article 5(5) of the OECD Model Tax Convention (a so-called "dependent agent PE") but discusses the consequences of finding that a dependent agent PE exists in terms of the profits that should be attributed to the dependent agent PE.

47. Where a dependent agent PE is found to exist under Article 5(5), the question arises as to how to attribute profits to the PE. The answer is to follow the same principles as used for other types of PEs, for to do otherwise would be inconsistent with Article 7 and the arm's length principle. Under the first step of the authorised OECD approach a functional and factual analysis determines the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise. On the one hand the dependent agent enterprise will be rewarded for the service it provides to the non-resident enterprise (taking into account its assets and its risks (if any)). On the other hand, the dependent agent PE will be attributed the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident, together with sufficient capital to support those assets and risks. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those assets, risks and capital.

48. See Section D-5 for a more detailed discussion of the attribution of profits to dependent agent PEs.

#### **C. Interpretation of paragraph 1 of Article 7: determining the profits of an enterprise**

49. Article 7(1) does not allow a host country to tax the profits of an enterprise of the other Contracting State unless the enterprise carries on business in the host country through a PE situated in that country. Where the non-resident enterprise carries on business in the host country through a PE situated in that country, Article 7(1) permits the host country to tax the profits that are "attributable to" a PE in accordance with Article 7(2).

50. By its reference to Article 7(2), Article 7(1) embodies the so-called "functionally separate entity" approach. In other words, the profits to be attributed to the PE are the profits "it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise". This approach does not limit the profit attributed to the PE by reference to the profit of the enterprise as a whole or a particular business activity in which the PE has participated, and properly applied the approach should reduce the incidence of double taxation. Paragraph 1 of Article 7 does not affect the determination of the quantum of the profits that are to be attributed to the PE, other than providing specific confirmation that, the right to tax of the host country does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment, *i.e.* there is no "force of attraction" resulting from the existence of a PE.

## **D. Interpretation of paragraph 2 of Article 7: determining the profits attributable to the permanent establishment**

### **D-1. Introduction – Article 7 and the arm’s length principle**

51. Paragraph 2 of Article 7 provides that the profits to be attributed to a PE are, “the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise”.

52. This language has its origins in the draft convention adopted by the League of Nations in 1933 and is acknowledged as the statement of the arm’s length principle in the context of PEs. The Commentary on Article 7 confirms that the principle reflected in Article 7(2) “corresponds to the arm’s length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises”. The arm’s length principle has thus always been at the heart of Article 7.

53. Accordingly, the authorised OECD approach is to apply the arm’s length principle of Article 9, as articulated in the Guidelines, to the attribution of profit to a PE using the arm’s length principle under Article 7(2).

54. One issue in applying this approach is that for the purposes of Article 7, it is necessary to postulate the PE as a hypothetical enterprise that is separate from the enterprise of which it is a PE, whereas in an Article 9 case the enterprises being examined are actually legally separate.

55. To reflect this issue, the authorised OECD approach is to apply the guidance given in the Guidelines not directly but by analogy. This Report discusses how and to what extent the guidance in the Guidelines can be applied, by analogy, to attribute profits to a PE and how to adapt and supplement that guidance to take into account factual differences between a PE and a legally separate enterprise. In this context, it should be noted that the aim of the authorised OECD approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. There are generally economic differences between using a subsidiary and a PE. Application of the authorised OECD approach will not achieve equality of outcome between subsidiaries and PEs where there are economic differences between them. The legal form chosen, PE or subsidiary, may have some economic effects that should be reflected in the determination of taxable profits. In many cases, businesses operate through permanent establishments rather than separate entities precisely because the PE structure provides for efficient capital utilisation, risk diversification, economies of scale, etc., making the structure more profitable. Thus, a PE will be more commonly used in some sectors (banking, insurance) or for activities carried on temporarily in a State (public works) or by virtue of the level of activity or complexity of operations. By contrast, a subsidiary may combine a more complete set of operations within a country.

56. Sections B-2 through B-5 above set forth the basic elements of the two-step analysis required to attribute profits to PEs under the authorised OECD approach. Section D-2 below discusses in greater detail the attribution of functions, assets, risks and “free” capital to the PE under the first step of the authorised OECD approach. Section D-3 below discusses in greater detail the second step: the application by analogy of the Guidelines to attribute profits to the PE in accordance with its functions performed, assets used and risks assumed by comparison to independent enterprises performing the same or similar functions, using the same or similar assets and assuming the same or similar risks.



## **D-2. First step: determining the activities and conditions of the hypothesised separate and independent enterprise**

This Section provides for a detailed discussion of practical application of the basic principles stated in Section B-3 with respect to step one of the authorised OECD approach.

### Introduction

57. In accordance with Article 7(2), the first step of the authorised OECD approach is to hypothesise the PE as a separate and independent enterprise “engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise”. The approach of the Guidelines in linking the earning of profit to the performance of “functions” is capable of being applied in the PE context by equating “functions” to “activities”.

58. Further, the guidance on comparability at paragraph 1.33 of the Guidelines equates “conditions” with “economically relevant characteristics”. There is also an obvious similarity between the concept of “same or similar” and the concept of “comparability” discussed in Chapter I and Chapter III of the Guidelines. As noted by paragraph 1.36 of the Guidelines, “it is necessary to compare attributes of the *transactions or enterprises* (emphasis added) that would affect conditions in arm’s length transactions.” In the PE context, some of the “conditions” of the PE as a hypothesised separate and independent enterprise will be derived from a functional and factual analysis of the internal attributes of the enterprise itself (“internal conditions”), whilst other “conditions” will be derived from a functional and factual analysis of the external environment in which the functions of the PE are performed (“external conditions”). It is therefore necessary in the first step of the authorised OECD approach to analyse not only the functions of the hypothesised separate and independent enterprise but also the “conditions” under which those functions are performed. Only then will it be possible to undertake the comparability analysis under the second step of the authorised OECD approach. Unless stated otherwise in the text, the term “conditions” refers to both “internal” and “external” conditions.

59. In short, the first step of the authorised OECD approach will apply a functional and factual analysis to the PE (based on the guidance in Chapter I and Chapter III of the Guidelines) in order to:

- Attribute to the PE as appropriate the rights and obligations arising out of transactions between the enterprise of which the PE is a part and separate enterprises (see sub-section (iv) below);
- Determine the functions of the hypothesised separate and independent enterprise and the economically relevant characteristics (both “internal” and “external” conditions) relating to the performance of those functions (see sub-section (i) below);
- Attribute risks among the different parts of the single enterprise, based on the identification of significant people functions relevant to the assumption of risks (see sub-section (ii) below);
- Attribute economic ownership of assets among the different parts of the single enterprise, based on the identification of the significant people functions relevant to the attribution of economic ownership of assets (see sub-section (iii) below);
- Recognise and determine the nature of those dealings between the PE and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test (see sub-section (vi) below); and
- Attribute capital based on the assets and risks attributed to the PE (see sub-section (v) below).

Under the second step the dealings of the hypothesised separate enterprise will be compared to transactions of independent enterprises performing the same or similar functions, using the same or similar

assets, assuming the same or similar risks, and possessing the same or similar economically relevant characteristics.

*(i) Functions: what are the activities of the PE?*

60. Chapter I of the Guidelines provides a detailed discussion of functional analysis and its application. The Guidelines at paragraph 1.42 state that a functional analysis “seeks to identify and to compare the economically significant activities and responsibilities undertaken” by the parties to controlled and uncontrolled transactions. In the PE context, the functional analysis will be initially applied for purposes of hypothesising the PE as a “separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise”. The functional analysis must also determine which of the identified activities and responsibilities of the enterprise are associated with the PE, and to what extent. Additionally, it has to be determined in what capacity functions are performed, *i.e.* as a service performed for another part of the enterprise or as a function of the PE on its own. Where the PE is created through a fixed place of business within the meaning of Article 5(1), the determination of which activities and responsibilities of the enterprise are associated with the PE should be determined from an analysis of the “fixed place” that constitutes the PE and the functions performed at that “fixed place”. Where there is a PE by virtue of Article 5(5) of the OECD Model Tax Convention (a “dependent agent PE”), the functional analysis would have to take into account any functions undertaken by the agent on behalf of the enterprise. This issue is discussed in more detail in Section D-5 below.

61. The guidance in the Guidelines on functional analysis seems capable of being applied fairly directly in the PE context in order to determine the “activities” of the hypothesised separate and independent enterprise. The main difficulties are with determining how to take into account risks assumed and assets used. These are discussed in sub-sections (ii) and (iii) below. What is needed in the first step of the authorised OECD approach is a functional and factual analysis of all the economically relevant characteristics (“conditions”) relating to the PE so as to ensure that the “separate and independent” enterprise is appropriately hypothesised to be engaged in “comparable” activities under “comparable” conditions to the PE. Then under the second step the dealings of the hypothesised “separate and independent” enterprise (the PE), with its bundle of economically relevant characteristics, will be compared to the transactions of independent enterprises with the same or similar economically relevant characteristics. However, the guidance on comparability cannot be applied directly in the PE context and needs to be applied by analogy. This is because the guidance in the Guidelines is based on a comparison of the conditions of controlled and uncontrolled transactions between actual separate enterprises, rather than hypothesised separate enterprises.

62. The functional and factual analysis takes account of the functions performed by the personnel of the enterprise as a whole including the PE – “people functions” – and assesses what significance if any they have in generating the profits of the business. People functions can range from support or ancillary functions to significant functions relevant to the attribution of economic ownership of assets and/or the assumption of risk.

63. The guidance on comparability in Chapter I of the Guidelines identifies a number of factors in addition to a functional analysis which may have to be taken into account when undertaking a comparison of conditions: characteristics of property or services, contractual terms, economic circumstances and business strategies. By analogy, such factors should also be considered when undertaking the functional and factual analysis to determine the “conditions” of the hypothesised separate and independent enterprise and to ensure that they are “same or similar” to those of the PE. So under the authorised OECD approach,

care needs to be taken to ensure that the attribution of profit takes into account the conditions of the enterprise to the extent those conditions are relevant to the performance of the PE's functions.

64. In the distributor example at paragraph 23 above, a full functional and factual analysis of the distribution function would be undertaken under the first step of the authorised OECD approach. This would determine the economically relevant characteristics relevant to the performance of the distribution function by the PE, for example, the identification of a business strategy such as a market penetration scheme. It might be important to identify any peculiar business strategy in order to undertake properly the comparability analysis under the second step of the authorised OECD approach between the dealings between the PE and the rest of the enterprise of which it is part and transactions between independent enterprises. Such a condition might explain why in the example at paragraph 23 above, it might be appropriate to attribute a loss to the distributor PE in the PE country in question (but not to another distributor PE in a second PE country), for example because the enterprise as a new entrant to the market in the first PE country has been carrying out a market penetration scheme.

65. In many cases, all the activities necessary to carry on the business through a fixed place take place within the PE's host country. For example, the PE may act as a distributor and carry on all the associated activities, including market research, in its jurisdiction. However, it is important that the functional analysis include not just activities taking place in the jurisdiction of the PE, but all activities performed on behalf of the PE by other parts of the enterprise and all activities performed by the PE on behalf of other parts of the enterprise.

66. An interesting issue can arise in an e-commerce operation in circumstances where it is accepted that the location of a server of itself constitutes a PE, as functions may be performed at that location without personnel. Nevertheless, the same principles apply and the functional analysis will determine what automated functions are performed by the server-PE and what assets are used and risks assumed in the performance of those functions. Both the discussion draft from the Business Profits Technical Advisory Group entitled "Attribution of Profit to a Permanent Establishment Involved in Electronic Commerce Transactions" released in 2001<sup>6</sup> and the BP TAG's final report entitled "Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?" completed in 2004<sup>7</sup> have concluded that the automated nature of the functions means that the assets or risks attributed to the PE are only likely to be those directly associated with the server hardware. In fact, since a server-PE will not be carrying out any significant people functions relevant to the attribution of economic ownership of assets and/or the assumption of risks in the absence of personnel acting on behalf of the enterprise, no asset or risk could be attributed to it under the authorised OECD approach, supporting the conclusion that little or no profit would be attributed to such a PE.

67. The functional and factual analysis needs to be carried out in a thorough and detailed manner in order to establish the exact nature of the function being performed. This is because the functional analysis in a PE context is important not just for the comparability analysis, but also for attributing assets, risks and free capital to the PE.

**(ii) Risks attributed to the PE**

68. Businesses may be exposed to a range of risks including inventory risk, credit risk, currency risk, interest rate risk, market risks, product liability and warranty risks, regulatory risk, etc. Between associated enterprises risks may be assigned among the parties by contractual arrangements, which will be respected subject to what is said in the Guidelines at paragraphs 1.47-1.54 and 1.65-1.66. In the context of a PE and

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6 See <http://www.oecd.org/dataoecd/46/25/1923312.pdf>, paragraph 140.

7 See <http://www.oecd.org/dataoecd/58/53/35869032.pdf>, paragraph 132.

its head office, as contrasted with a parent company and its subsidiary, it is the enterprise as a whole which legally bears the risk. However, under the authorised OECD approach it is possible to treat the PE as assuming risk, even though legally the enterprise as a whole assumes the risk and there can be no legally binding contractual arrangements allocating that risk to a particular part of the enterprise. The PE should be considered as assuming any risks for which the significant people functions relevant to the assumption of risk are performed by the personnel of the PE at the PE's location. For example, the PE should, generally, be treated as assuming the risks arising from negligence of employees engaged in the function performed by the PE.

69. In the absence of contractual terms between the PE and the rest of the enterprise of which it is a part, determining what assumption of risks should be attributed to the PE will have to be highly fact-specific. Following, by analogy, paragraph 1.52 of the Guidelines, the division of risks and responsibilities within the enterprise will have to be “deduced from their [the parties’] conduct and the economic principles that generally govern relationships between independent enterprises”. This deduction may be aided by examining internal practices of the enterprise (*e.g.* compensation arrangements), by making a comparison with what similar independent enterprises would do and by examining any internal data or documentation purporting to show how that attribution of risk has been made. The extent to which such documentation is determinative is discussed in more detail in Section D-2(vi).

70. In summary, to the extent that risks are found to have been assumed by the enterprise as a result of a significant people function relevant to the assumption of those risks being performed by the PE, the assumption of those risks should be taken into account when attributing profit to the PE performing that function. In particular, the expectation would be that any provisions booked in relation to those risks would be attributed to the PE and as a consequence the PE would bear the fiscal consequences of deducting or adding back allowances to these provisions and the potential exposure to gains or losses from the realisation or non-realisation of said risks. If risks are found not to have been assumed by the enterprise as a result of a significant people function performed by the PE, the assumption of those risks should not be taken into account for the purposes of attributing profits to the PE. It should be noted that even though a risk may be considered initially assumed by a PE by virtue of the PE's performance of a significant people function relevant to the assumption of the risk, a separate question (to be dealt with in Sections D-2(vi) and D-3 below) will arise as to how to take into account any subsequent dealings related to the subsequent transfer of risks (*e.g.* when an asset and the associated risks are transferred from a PE to another part of the enterprise) or to the transfer of the management of those risks to different parts of the enterprise. A PE may “assume” a risk and may subsequently use the services of another part of the enterprise to “manage” that risk, without necessarily transferring the risk to that other part of the enterprise. In that sense, the risk (which is still allocated to the PE) could be separated from the function of managing the risk (which is done at the other part of the enterprise). On the other hand, a risk may be considered transferred to another part of the enterprise if there is documentation evidencing the intention to engage in a “dealing” in the form of a transfer of the risk to that other part, and that other part thereafter performs the significant people function relevant to the management of the risk. However, documentation by itself would not affect such a transfer, since a part of the enterprise which has not initially assumed a risk cannot be deemed to have subsequently taken over the risk unless it is also managing the risk. In this sense, risk cannot be separated from function under the authorised OECD approach.

71. The amount and nature of the risks assumed by the PE also affects the amount of capital that needs to be attributed to the PE. This is because an enterprise assuming material additional risks would need to increase its capital correspondingly in order to maintain the same creditworthiness. This is most clearly seen in the financial sector where regulators may oblige banks to have minimum levels of capital to support the risks to which they are exposed. But the link between risk and capital is also present in non-financial sectors. All business activity involves some element of risk, though some are more risky than others. The activities of an enterprise engaged, for example, in cutting-edge biotechnology research will

assume risks that will generally require a greater level of capital support than an enterprise engaged, say, in property investment with blue chip tenancy agreements. Risks associated with the former activity are more likely to result in a differential between income generated and the costs (funding and non-funding) of carrying out the activity. It is the role of capital to provide a cushion against the crystallisation of risks into actual losses.

**(iii) Assets: drawing up a “tax balance sheet” for the PE under the authorised OECD approach**

**(a) Introduction**

72. In applying Article 7(2), the facts and circumstances must, in the first instance, be examined in order to determine the extent to which the assets (tangible or intangible) of the enterprise are economically owned<sup>8</sup> by and/or used in the functions performed by the PE. The first step of the authorised OECD approach not only identifies assets used by the PE but also determines the conditions under which the assets are used: as joint or sole owner, for example, as licensee or member of a cost contribution agreement. Determining ownership of the assets used by a PE can present problems not found in separate enterprises where legal agreements can be relied upon to determine ownership. In a PE context the assets owned by the enterprise belong, legally, to the enterprise of which the PE is part. It is therefore necessary to introduce the notion of “economic ownership” in order to attribute economic ownership of assets to a PE under the first step of the authorised approach. In determining the characteristics of the PE for taxation purposes, it is the economic (rather than legal) conditions that are most important because they are likely to have a greater effect on the economic relationships between the various parts of the single legal entity. Economic ownership of an asset is determined by a functional and factual analysis and in particular rests upon performance of the significant people functions relevant to ownership of the asset (but see the discussion of tangible assets, below).

73. As indicated in paragraphs 18-20 the consequences of attributing economic ownership of assets under the first step for determining profits under the second step may depend upon the type of asset and the type of business in which the asset is used. For example, economically owning a tangible asset used in a manufacturing process does not necessarily, of itself, attribute to the economic owner of the asset the income from selling goods produced by using the asset. Attributing economic ownership of financial assets, on the other hand, attributes the income and expenses associated with holding those assets or lending them out or selling them to third parties.

74. The consequences of attributing assets to the PE under the first step of the authorised OECD approach for determining profits under the second step depends upon the circumstances, in particular on the nature of the business and the asset, and whether or not the significant people functions relevant to determination of economic ownership of assets are the same as the significant people functions relevant to the assumption of risk in the business.

**(b) Tangible assets**

75. When the OECD member countries discussed how to attribute tangible assets<sup>9</sup> within the single enterprise, different views were expressed. At one end of the spectrum, a view was expressed in favour of applying to tangible assets the general principles as set out in Section B-3(i), *i.e.* attributing tangible assets based on a determination of the significant people functions relevant to the economic ownership of said assets, by means of a functional and factual analysis of the case. At the other end of the spectrum, the view

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8 See footnote 3 for a definition of “economic” ownership of assets in the Article 7 context.

9 For this purpose, “physical” or “tangible” assets are understood to include “immovable property” as that term is used in Article 6.

was expressed that place of use should be the sole criterion for attributing tangible assets to a PE, especially in those cases where a fixed place of business PE (Article 5(1)) existed precisely due to the presence in the host country of those tangible assets. Having discussed the practical implications of each of these two options, the OECD member countries concluded that in practice in most cases they should both arrive at the same or at not significantly different results, that is:

- Where a PE is treated as the economic owner of a tangible asset, it will typically be entitled to deductions for depreciation (in the case of depreciable assets) and interest (in the case where the asset is wholly or partly debt-financed).
- Where a PE is treated as the lessee of a tangible asset, it will typically be entitled to deductions in the nature of rent.

Over the useful life of the asset, the deductions allowable in the two cases may not differ significantly in practice although of course, the two cases may result in quite different profit allocations in any given year or span of years. As a consequence, there was a broad consensus among the OECD member countries for applying use as the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view. This is regarded as a pragmatic solution for attributing economic ownership of tangible assets under the authorised OECD approach.

(c) *Intangibles*

(1) Introduction

76. One of the most important commercial developments in recent decades has been the growth in the significance to an enterprise or an MNE group of its intangible property. The pace of technological change has meant that, more than ever before, the ability of an enterprise or MNE group to generate profits is linked to the specialised knowledge and processes at its disposal, while the revolution in communications has led to an ever-increasing emphasis on advertising and the value of brands and the creation of new ways of conducting business such as e-commerce in which reliance on physical capital may in certain cases be less significant.

77. These developments represent a major challenge for tax administrations and taxpayers who need to place a value on a company's intangible property or estimate the revenue it generates. Intangible property in various forms, including the company's name itself, can represent the main part of the substantial differences between the net asset value of many quoted companies and the market value of their shares. Therefore, it is vitally important that, in determining the profits attributable to a PE under the authorised OECD approach, due consideration is given to the treatment of intangible property. This is a complex area not least because unlike the situation involving other assets (considerations relating to cost contribution arrangements aside), it is common for intangible property to be used simultaneously by more than one part of the enterprise. Significant issues may arise where there is some change of use in relation to intangible property and these are considered in step two below (see Section D-3(iv)(b)).

(2) Guidance on applying the authorised OECD approach to intangible property

78. It would be overly prescriptive to allow only one approach for dealing with the variety of ways in which intangible property can be exploited.

79. For transactions between associated enterprises, Chapter VI of the Guidelines provides guidance on the treatment of intangible property, which usefully distinguishes between marketing intangibles and other commercial intangibles (referred to as "trade" intangibles) and could be applied by analogy in the PE

context. In particular, the concept of functional and factual analysis would be applied in order to determine which, if any, part of the enterprise could be identified as having performed the function of creating the intangible.

80. Clearly the determination of the economic ownership of intangible property created by an enterprise should be based on principled grounds so as to rule out the possibility of the enterprise's simply nominating one part of the enterprise as the owner (by booking the intangible assets there) irrespective of whether, for example, that part had the expertise and/or capacity to assume and manage the risks associated with the intangible property. The discussion below explores the extent to which it may be possible to attribute economic ownership of the intangible property to one part of the enterprise, by reference to the significant people functions relevant to the attribution of economic ownership.

81. The rest of this section provides guidance on two main issues: first, the determination of which part(s) of the enterprise is the economic owner of the intangible property; and second, the impact of intangible property on the profits to be attributed to the PE. Issues concerning the recognition and pricing of any dealings between the part of the enterprise that is the owner of the intangible and another part(s) of the enterprise that uses the intangible are discussed below (see Sections D-2(vi) and D-3(iv)(b)).

(3) Which part(s) of the enterprise is the economic owner of the intangible property

82. The discussion in this section focuses first on trade intangibles, then moves on to consider whether it is possible to apply the same approach to marketing intangibles. The following two situations are discussed:

- Where the intangible property is newly developed by the enterprise,
- Where the intangible property has been acquired from another enterprise.

**(A) The attribution of trade intangibles to a single part of the enterprise**

(i) Internally developed trade intangibles

83. Under the first step of the authorised OECD approach it will be necessary to use a functional and factual analysis to determine what intangible property the PE uses and under what conditions, *i.e.* does it “own” the intangible either solely or jointly with another part of the enterprise. It may be that one part of the enterprise is a research centre for the enterprise and therefore has performed most or all of the functions by which a trade intangible, *e.g.* a complex software operation, has been created. However, that does not necessarily mean that one of the internal “conditions” of the research centre PE is that it is treated as the economic owner or joint economic owner of the intangible.

84. Between separate enterprises, one company may commission another to develop a particular piece of software in return for remuneration. The legal terms of the contract will determine their relationship, and in particular may define what risk, if any, is borne by the developer and what ownership rights the developer and the commissioning company will acquire in the finished software. The performance of the development function(s) does not of itself determine the legal ownership. Rather, the key issue is which enterprise acts as the entrepreneur in deciding both to initially assume and subsequently bear the risk associated with the development of the intangible property.

85. The significant people functions relevant to the determination of the economic ownership of internally created intangibles are those which require active decision-making with regard to the taking on and management of individual risk and portfolios of risks associated with the development of intangible property.

86. As will be seen in Parts II-III in financial enterprises, depending upon what business organisation model they use, the active decision-making and management may often be devolved throughout the enterprise. An issue arises as to whether this is likely to be the same with regard to the development of intangible property or whether it is more likely that the significant people functions relevant to determination of economic ownership of intangible assets are performed at a high strategic level by senior management or by a combination of centralised and devolved decision-making functions.

87. Whether the degree of centralisation of the decision-making process for the development of intangible assets is high will depend on the circumstances of the particular business, and so be dependent on the facts. However, it should be noted that there is no hard evidence that the decision-making process for the development of intangible property is generally so centralised, especially as the focus for determining the significant people functions relevant to the determination of economic ownership is on the active decision-making and management rather than on simply saying yes or no to a proposal. This suggests that, just as for financial assets, economic ownership may often be determined by functions performed below the strategic level of senior management. This is the level at which the active management of a programme toward the development of an intangible would occur, where the ability to actively manage the risks inherent in such a programme lies. Further such a determination must be made on a case-by-case basis as the significant people functions relevant to determining economic ownership of intangible assets and especially their relative importance are likely to vary according to facts and circumstances.

88. The functional and factual analysis should therefore describe and evaluate the dynamics of the particular enterprise's research and development programme, and in particular the nature of the critical decision-making process and the level at which those decisions are taken. Although not a definitive or prescriptive list, functions which may be relevant include designing the testing specifications and processes within which the research is conducted, reviewing and evaluating the data produced by the tests, setting the stage posts at which decisions are taken and actually taking the decisions on whether to commit further resources to the project or abandon it, etc. It is also suggested that the performance of such a rigorous functional analysis should protect against manipulation so that there should be no problem in accepting the case where genuinely all the decision-making process for the development of intangible property is centralised in one part of the enterprise such as the head office.

89. With the development of intangible property the main risk is that the development is unsuccessful or is not successfully implemented for some other reason, thereby creating a financial loss (the researchers' salaries and other costs not covered by income received from the successful development of the intangible). Depending on the type of intangible property there may also be other developmental risks, *e.g.* adverse side-effects caused in a trial of a new active ingredient for a drug. Under the authorised OECD approach the "developer" of the assets would have to bear such losses and would have sufficient free capital attributed to it to support the risk assumed.

90. The failure to develop an intangible asset on the other hand may affect not just the owner of the asset, but also the intended users of the intangible property. Financial assets are not generally used by other parts of the financial enterprise to the extent that intangible property is used by other parts of the enterprise. This raises a question as to whether use and intended use of an intangible should be a factor in determining economic ownership. The answer would seem to be that intended use *per se* does not determine the capacity in which the user subsequently uses the asset once developed, *i.e.* as sole or joint economic owner or licensee. Therefore it is not so much the intention to use the intangible *per se* that should be a factor in determining economic ownership of an intangible, but the extent to which the intended user performed the significant people functions relevant to the determination of economic ownership of the intangible asset, *e.g.* by taking (or taking part in) the initial decision to develop the intangible or undertaking the active management of the R&D programme. It may well turn out that the user of the developed intangible is, in



fact, the party or one of the parties that has performed the significant people functions relevant to determination of economic ownership, precisely because the user stood to gain from it.

91. Again consistent with the position taken in Parts II-IV for created financial assets, an assertion that one part of the enterprise has the capital necessary to support the risks of development would not be a relevant factor. As already noted, capital follows risks and not the other way round so the part of the enterprise found to be the economic “owner” of the intangible property would be attributed the free capital necessary to support the associated risks. In short, the key factor is whether the PE undertakes the active decision-making with regard to the taking on and active management of the risks related to the creation of the new intangible.

#### (ii) Acquired trade intangibles

92. Although trade intangibles are commonly developed internally they are also acquired from other enterprises, either outright or through a licensing agreement. The question arises as to how to attribute the economic ownership of such assets within the single enterprise, once such assets are acquired by the enterprise. Again under the authorised OECD approach, the approach is to identify the significant people functions relevant to determining economic ownership.

93. In some circumstances, this may be determined in exactly the same way as for internally created intangibles. For example, where an enterprise both acquires and develops similar trade intangibles the functional and factual analysis might show that ownership of both the acquired and internally created intangibles lies with the same part of the enterprise because the part(s) of the enterprise which performs the significant people functions relevant to determination of economic ownership of internally developed intangibles also performs the same function in respect of acquired intangibles. This may not be that unusual given that two decisions are involved in making an acquisition of intangibles. The first is to determine whether that particular intangible is valuable to the enterprise’s business. The second is that it makes more sense to buy the intangible than to develop it in-house. Such decisions may well be made by the same people who would decide whether it is better to develop the intangible internally.

94. Just as with internally developed intangible property, the key question in determining economic ownership of acquired intangibles is where within the enterprise the significant people functions related to active decision-making relating to the taking on and management of risks are undertaken. With regard to acquired intangibles, these functions might include the evaluation of the acquired intangible, the performance of any required follow-on development activity, and the evaluation of and management of risks associated with deploying the intangible asset.

95. A further consideration that the discussion may need to take account of is the fact that trade intangibles may be acquired at various stages of development. It could be that the acquired intangible is fully developed as assumed in the preceding paragraph. Or it might be that there is still some way to go before the intangible is fully developed. This may affect the identity of the significant people function relevant to the determination of economic ownership.

#### (iii) Marketing intangibles

96. Similar issues arise in respect of marketing intangibles, in particular the name and logo of the company or the brand. Does the name of a well-known company belong equally to all parts of the enterprise, such that each PE can be said to share in the name by analogy with the fact that it is said to share in the capital of the enterprise? Is it one of the internal conditions of the enterprise like creditworthiness? And if this is so what are the consequences?

97. The principles of the authorised OECD approach can also be applied to questions regarding the attribution of income with respect to marketing intangibles. The fundamental principles as regards marketing intangibles are the same as for trade intangibles. The significant people functions relevant to the determination of economic ownership are likely to be those associated with the initial assumption and subsequent management of risks of the marketing intangibles. These may include, for example, functions related to the creation of and control over branding strategies, trademark and trade name protection, and maintenance of established marketing intangibles. Because marketing intangibles may have been developed in the past and maintained by means of expenditures and activities over an extended period, it may sometimes be difficult to determine conclusively the owner of marketing intangibles. This analytical difficulty is not limited to PEs, but similarly applies to the analysis of marketing intangibles between associated enterprises under Article 9.

**(iv) *Attributing rights and obligations to the PE***

98. As indicated in Section B, the profits (or losses) of the PE will be based on all its activities, including transactions with other unrelated enterprises, transactions with related enterprises, and dealings with other parts of the enterprise to which it belongs. Accordingly, as part of the functional and factual analysis carried out in step one, it will be necessary to attribute to the PE those rights and obligations of the enterprise of which it is a part which arise out of that enterprise's transactions with separate enterprises as are properly attributable to the PE. In effect, this involves identifying those of the enterprise's transactions with separate enterprises which should be hypothesised to have been entered into by the PE. This should become clear as a result of analysing the PE's functions in light of its assets used and risks assumed. The PE's profits (or losses) attributable to its participation in these transactions can be computed directly in the case of transactions with unrelated enterprises, or through direct application of the Guidelines under Article 9 in the case of transactions with related enterprises, in either case taking into account the effect of the PE's dealings with other parts of the same enterprise under step two of the authorised OECD approach.

**(v) *Capital: drawing up a "tax balance sheet" for the PE under the authorised OECD approach***

**(a) *Attributing creditworthiness to the PE***

99. It is an observable condition that PEs generally enjoy the same creditworthiness as the enterprise of which they are a part. Accordingly, under the authorised OECD approach, the "separate and independent enterprise" hypothesis requires that an appropriate portion of the enterprise's "free" capital be attributed to its PEs for tax purposes and that the PE be attributed the creditworthiness of the enterprise as a whole. It is worth re-emphasising that an attribution of "free" capital in excess of the amounts recorded in or allotted to the PE by the home country may have to be made for tax purposes, even though there may be no need to formally allot "free" capital to the PE for any other purpose.

100. Generally, under the authorised OECD approach, the same creditworthiness is attributed to a PE as is enjoyed by the enterprise as a whole; an exception being where for regulatory reasons the capital attributed to the PE of one jurisdiction is not available to meet liabilities incurred elsewhere in the enterprise. In addition, it was also determined that there is no scope for the rest of the enterprise guaranteeing the PE's creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the enterprise.

101. It has been suggested that in hypothesising the same creditworthiness throughout the enterprise and not recognising intra-enterprise guarantee payments the authorised OECD approach fails to recognise the fact that the creditworthiness of an enterprise is greater than the sum of its parts; *i.e.* that the very act of hypothesising the PE as a separate entity has the effect of degrading the creditworthiness of all parts of the enterprise below that of the enterprise as a whole. Whilst not denying this effect 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 authorised OECD approach is based on the factual situation of the enterprise, which is that the capital, risks, etc. are fungible, so it would be inconsistent to grant all the benefits of synergy to the head office.

102. Secondly, 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 factors should be treated as belonging to one part of the enterprise.

103. The authorised OECD approach does not recognise dealings in respect of guarantee fees between the PE and its head office or between the PE and another PE. Guarantee payments between associated enterprises are recognised in certain circumstances.<sup>10</sup> This has led some commentators to conclude that the authorised OECD approach discriminates between subsidiaries and PEs by applying transfer pricing principles in different ways. However, it is not the authorised OECD approach that discriminates between the two legal forms. Rather the legal forms have different economic consequences: a PE, except in the circumstances referred to in Parts II-IV,<sup>11</sup> generally has the same creditworthiness as the enterprise of which it is a part. The same is not necessarily true of a subsidiary and its parent company.

104. Moreover, a key distinction between a separate legal enterprise and a PE is that an enterprise can enter into a legally binding agreement to guarantee the debts of a second enterprise, and third party lenders may take that guarantee into account when assessing the creditworthiness of the second enterprise. For such a guarantee to have substance, the capital needed to support the risks assumed would necessarily reside in a separate enterprise from that in which the risk of default occurs. In contrast, one of the key factual conditions of a PE is that capital and risks are not segregated from each other within a single legal enterprise. And if capital is not segregated then there is no basis for guarantee fees. Discrimination arises when taxpayers in the same or similar circumstances are treated differently. For the reasons given above, PEs in their dealings with other parts of the same enterprise in the context of guarantee fees may not be in similar circumstances to a subsidiary.

(b) *Capital attribution and funding the operations of the PE*

(1) Introduction – the importance of “free” capital

105. Enterprises require capital to fund day-to-day business activities, the cost of creating or acquiring assets (tangible and intangible), and as explained in the previous section to assume the risks associated with an ongoing business (e.g. credit or market risk). Broadly, capital comes from three sources: (1) contributions of equity by shareholders; (2) retained profits (including sometimes reserves, though practices among member countries may vary); and (3) borrowings. Sources (1) and (2) are referred to collectively in this Report as equity capital and source (3) is debt capital. Under tax law, deductions are generally not given for payments made to equity holders, whereas deductions are generally available (subject to thin capitalisation rules, etc.) for payments of interest or interest equivalents to the holders of debt capital. There may be differences between accounting, regulatory and tax definitions of debt and equity. For example, in the financial sector, certain types of subordinated debt may be treated as debt for accounting purposes, equity for regulatory purposes, and either debt or equity for tax purposes, and the tax classification may vary with the jurisdiction. Accordingly within this Report the term “free” capital is

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10 See the Guidelines at paragraph 7.13.

11 *I.e.* 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 (see e.g. paragraph 30 of Part II and paragraph 231 of Part III).

defined as an investment which does not give rise to an investment return in the nature of interest that is deductible for tax purposes under the rules of the host country of the PE.

106. Because interest expense is generally deductible for tax purposes, it will be necessary to ensure an appropriate attribution of the enterprise's "free" capital to a PE in order to ensure an arm's length attribution of profits to the PE. The impact on non-financial PEs may be significant, since the ratio of "free" capital to interest-bearing debt is generally much higher outside the financial sector. Historically, the attribution of "free" capital has been made difficult by a lack of consensus on a number of key issues related to the capital attribution and funding of a PE. This section describes how the authorised OECD approach applies to attribute "free" capital and funding costs to a PE.

## (2) Principles of the authorised OECD approach

107. Under the authorised OECD approach, 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. Under the authorised OECD approach, the economic ownership of assets is attributed to a PE based on where the significant people functions relevant to the determination of economic ownership are performed, and risks are attributed to a PE based on where the significant people functions relevant to the assumption and/or management (subsequent to the transfer) of the risks are performed. Once the functional and factual analysis has attributed the appropriate assets and risks of the enterprise to the PE, the next stage in attributing an arm's length amount of profits to the PE is to determine how much of the enterprise's "free" capital is needed to cover those assets and to support the risks assumed. This process involves 2 stages. The first is to measure the risks and value the assets attributed to the PE. The second is to determine the "free" capital needed to support the risks and assets attributed to the PE.

### (A) Stage 1 – measuring the risk and valuing the assets attributed to the PE

108. As noted above, in attributing profits to a PE the authorised OECD approach uses a functional and factual analysis to attribute assets and risks to the PE and it also works on the premise that capital and risk cannot be segregated. It follows that under the authorised OECD approach it is necessary to attribute "free" capital to the PE in accordance with the risks and assets so attributed. Certain financial enterprises are obliged by regulators to measure risks and attribute capital (whether or not "free" capital; see Part II Sections B-4(iii) and (iv) for more detail). Enterprises that are not banks or non-bank financial institutions ("non-financial institutions") are less likely to measure risks and value assets for business purposes on a day-to-day basis and will not be subject to regulatory requirements requiring them to do so.

109. Where enterprises which are non-financial institutions do not measure risks, one possible approach would be to attribute capital to a PE by reference only to the assets attributed to the PE. This is because, for non-financial enterprises, more so than for financial enterprises where the role of capital is to support risk, the capital would primarily be serving a funding purpose and it is the assets that are being funded. There are a number of possible valuation options. One option would be to use the book value of the asset as shown in the accounts for the relevant period. Another option would be to use the market value of assets, either as a matter of course or in cases where there is a significant difference between book and market value.

110. Another option would be to use the original purchase price or cost of the asset. This approach would appear to offer a number of advantages. Firstly, the borrowed amounts would bear a close relation to the historical value of assets funded by the borrowings. Secondly, the approach facilitates a consistent measurement of assets across jurisdictions (in particular where different accounting rules exist to determine the book value of assets) and thirdly it would be simpler to comply with than an approach requiring the periodical determination of the market value of assets. However, the cost approach can produce

inappropriate results where, for example, different parts of the enterprise have assets of similar value, but very different costs (because one part of the enterprise bought the asset at a different time when the cost was different). There is no prescribed method for valuing assets but any method used must be used consistently from year to year. Ideally, similar asset classes would be valued in a consistent manner across different parts of the enterprise, whilst recognising that there are practical difficulties in doing so given different domestic laws and/or accounting rules.

111. However, further consideration shows that for non-financial enterprises risks are not necessarily directly correlated to particular assets. It may be the activity putting the assets to use that creates the risk rather than the assets themselves. An approach that just used assets to attribute capital would therefore seem unlikely to lead to an arm's length result in situations where significant risks are assumed by the PE, for example where the PE takes on all the risks of developing a marketing intangible but is unsuccessful so no intangible asset is ever produced. Such developmental or entrepreneurial risks were effectively not taken into account when attributing capital to financial enterprises except to the extent that they were recognised by the regulator, on the basis that anything not recognised by the regulator was, in the context of financial enterprises, relatively insignificant compared to the other types of risk assumed by financial institutions. However such risks may be more significant in some non-financial businesses, and where this is the case it would be appropriate to recognise that more "free" capital would need to be attributed to support this entrepreneurial risk.

112. Significant risk in the context of a non-financial business means risks which would be regarded as requiring capital by the market in which the PE operates. For example, whilst the risk of, say, a fast food vendor's being sued in a particular location for contributions to obesity in the population is a theoretical risk, if independent fast food vendors in that location would not provide capital to support that risk, then it is not a "significant risk" for the purposes of attributing capital. In other jurisdictions the risk might be more than theoretical and independent fast food vendors might reserve against such litigation risks. In such jurisdictions this would be a significant risk for the purposes of attributing capital. Equally, some business activities are subject to more volatile economic cycles than others, and additional capital may be needed to support the business against the cyclical downturns. Again, outside the financial sector, there is little regulatory constraint on capital adequacy for different business sectors. The amount of capital being determined rather by market perceptions of what is appropriate for given sectors, business strategies, etc., and by the shareholders' and loan creditors' appetite for risk.

113. Quantifying the amount of additional capital in such circumstances will be difficult given the lack of a regulatory environment. However, one might expect that businesses are likely to try to evaluate significant risks at least to some extent and it might be possible to use an enterprise's own measurement tools, where they exist, as a starting point. Even if it is accepted that significant risks may not be capable of being measured exactly, where the PE assumes significant risks, an attempt should be made to take account of these risks. Where on the other hand the risk is not significant it may not be necessary to try to measure such risk and simply valuing the assets is enough.

114. The rest of this section discusses how to apply the authorised OECD approach to non-financial PEs in the context of capital allocation and funding issues. Three main issues arise and are discussed below. The first is how to determine the funding costs of the PE, especially how to allocate "free" capital to a PE. The second is whether a movement of funds within an enterprise could be treated as a dealing giving rise to interest. The third is how to determine the amount of interest expense that should be attributable to a PE and how to make any necessary adjustments to the interest expense recorded in the books of the PE.

**(B) Stage 2 — determining the “free” capital needed to fund the assets and support the risks attributed to the PE**

115. Tax considerations aside, and in the absence of regulatory requirements, there is ordinarily no need for any “free” capital to be formally allotted to a PE. Consequently, the PE's funding needs could legally be entirely debt-funded. Nevertheless, while the PE may not need to have “free” capital allotted to it, under the authorised OECD approach the PE is treated as having an appropriate amount of “free” capital in order to support the functions it performs and the assets and risks attributed to it. Moreover, if the same operations were carried on through a subsidiary in the host country, the subsidiary may be required by thin capitalisation rules to have some equity or “free” capital.

116. Under the authorised OECD approach, the PE needs for tax purposes to have attributed to it an arm's length amount of “free” capital, irrespective of whether any such capital is formally allotted to the PE. To do otherwise would be unacceptable on tax policy grounds. The result would not follow the arm's length principle, would not reflect the profits earned in the PE and would provide considerable scope for tax avoidance. Accordingly, a management decision in the home office to allot a certain amount of capital to the PE, or to record capital on the books, is not determinative of the risks assumed by the PE and the amount of “free” capital that is attributed under the functional and factual analysis.

117. The next issue is how to attribute an appropriate amount of “free” capital and interest-bearing debt to the various parts of the enterprise. The attribution would be made in accordance with where the assets and the associated risks have been attributed and should take into account, as far as practicable, the specific functions, assets and risks of the PE relative to the functions, assets and risks of the enterprise as a whole. This recognises that some business activities involve greater risks and require more “free” capital than other activities; hence the business activities undertaken through a PE may require proportionately more or less “free” capital than the enterprise as a whole.

118. A number of approaches to determining funding costs are considered below, but a few points of general application are made first. First, where an authorised approach to attributing “free” capital appears to produce results in a particular case that are not consistent with the arm's length principle, another authorised approach which does so may be substituted for it. For the purpose of the authorised OECD approach, the debt-equity characterisation rules used for tax purposes in the PE's host country would be applied to the enterprise's capital for the purpose of determining which items would be treated as “free” capital for tax purposes under the domestic laws of the host country.

119. 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 authorised OECD approach. This issue is of wider significance and is not confined to PEs.

120. A final point to bear in mind is that there are some important differences between a regulated banking enterprise and a non-financial enterprise which give rise to additional difficulties in resolving funding issues within non-financial enterprises. A combination of the regulatory environment and market forces will generally ensure banking enterprises have a narrower range of debt to “free” capital ratios than non-financial enterprises, a category of business which by definition covers a wider range of activities than banking.

**(1) The capital allocation approach**

121. The capital allocation approach seeks to allocate an enterprise's actual “free” capital to a PE in accordance with the attribution of assets owned and risks assumed. Under this approach, “free” capital is

allocated on the basis of the proportion of assets and risks attributed to the PE by the functional analysis. So if the PE has 10% of the enterprise's assets and/or risks it will have attributed to it 10% of the enterprise's "free" capital.

122. Where enterprises have capital structures that are consistent with those observed in comparable independent enterprises, then allocating "free" capital of any such enterprise to its PE can produce an arm's length result. Similarly where the enterprise of which the PE is a part is resident in a different jurisdiction from the group parent company, the thin capitalisation rules of the enterprise's country of residence may ensure that the enterprise is adequately capitalised and the "free" capital of the enterprise may again provide an appropriate starting point for allocating "free" capital to the PE.

123. Since the capital allocation approach seeks to attribute the actual "free" capital of the enterprise the effect is that it distributes the benefits of synergy to the constituent parts of the enterprise in a way that, in theory, minimises the likelihood of double taxation. In practice, however, differences in the definition of "capital" between home and host countries may result in the attribution of more or less than the total amount of capital of the enterprise.

124. A problem with the capital allocation approach is that there will be instances where the PE conducts a very different type of business from the enterprise as a whole (*e.g.* the PE is a distributor and the enterprise as a whole is also a manufacturer) or the market conditions in the host country of the PE are very different from those applying to the rest of the enterprise (for example the enterprise has a dominant market position in its home territory but is in a very competitive market in the host country). In general, the focus of the authorised OECD approach on attributing "free" capital by reference to the functional and factual analysis should mean that such differences are adequately taken into account. However, in cases where the differences, for example 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 the differences in the way the PE operates or the conditions under which it operates.

125. Another potential problem with the capital allocation approach is that where the enterprise of which the PE is a part is itself thinly capitalised, a simple allocation of the actual "free" capital of the enterprise is unlikely to produce an arm's length result without adjustment. This issue is discussed later in this section.

126. In situations where the capital allocation approach may be applied straightforwardly (*i.e.* where the enterprise is adequately capitalised) there are still a number of issues to be resolved. It has been suggested, for example, that whilst in principle the total "free" capital should be allocated, there are circumstances in which this should not be the case. For example, a company might have designated capital to acquire a business (a "war chest") or might have a temporary cash surplus from selling a business. How these situations would be treated would be determined on a case-by-case basis. If the company has a general intention to acquire a business in a jurisdiction, but no commitment, so that the capital still could be used for other purposes, that capital should be allocated along with other capital. In those cases, the company frequently will have cash or other short term investments that need to be actively managed to maximise the investment return. Where this is the case the authorised OECD approach would be to attribute economic ownership of those financial assets to the part of the enterprise performing the significant people functions relevant to managing the surplus cash or other short term investments. If, however, the company has a commitment to purchase a particular business (such as a legally binding purchase contract), then the capital may be segregated. Segregation might also be appropriate if the enterprise has earmarked the proceeds for timely distribution to shareholders or otherwise committed itself to using the funds in a particular manner within a reasonable period of time.

127. The discussion in this sub-section attempts to provide an agreed framework for the OECD member countries that favour a capital allocation approach. The framework does not cover all the issues, including what deductions to allow when computing capital, over what period to compute the capital ratios (perhaps using some kind of weighted or moving average) or how to deal with foreign exchange gains and losses issues. There may also be problems for the host country in obtaining the information necessary to apply the approach. It should also be stressed that in the case of non-financial institutions, because of the absence of a regulatory framework which requires measurement of risk, there are practical difficulties in producing a meaningfully narrow range of acceptable outcomes, even after determining the creditworthiness.

## (2) Economic capital allocation approach

128. In the banking context 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 authorised OECD approach as it is explicitly 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 could in theory be useful in non-financial sectors; in seeking to measure, for example, the economic risk inherent in developing patented technology. However, such measures do not appear to be very well developed even in banking institutions that have very sophisticated risk measurement systems. It is likely to be rare therefore for non-financial institutions to have risk measurement systems in place. Nevertheless such measures might provide a useful starting point where the PE has significant developmental risks. Moreover, developments in the area might mean that economic measures of capital usage may become more accurate and an increasingly acceptable proxy to arrive at a result within the arm’s length range.

## (3) Thin capitalisation approach

129. Another approach would be to require that the PE has the same amount of “free” capital as would an independent enterprise carrying on the same or similar activities under the same or similar conditions in the host country of the PE by undertaking a comparability analysis of such independent enterprises. The functional and factual analysis would identify the assets and risks to be attributed to the PE and this would determine the amount of funding *per se* (*i.e.* without distinguishing between debt and “free” capital) that would be required by the PE. The next stage would be to determine the allocation of the funding into interest-bearing debt and “free” capital.

130. There are a number of factors relevant to the determination of an arm’s length amount of debt and “free” capital for PEs. These include:

- The capital structure of the enterprise as a whole
- The range of actual capital structures of independent host country enterprises carrying on the same or similar activities as the PE under the same or similar conditions (including the condition discussed in Section D-2(v) that generally the PE has the same creditworthiness as the enterprise as a whole).

131. Issues arise in seeking to apply a thin capitalisation approach to non-financial enterprises. For non-financial enterprises it will probably be necessary to focus on capital structure, such as debt-to-equity ratios, rather than on “free” capital in isolation. This would require a determination first of all the arm’s length amount of funding that should be attributed to the PE to support its functions, assets and risks. Then



comparable debt-to-equity ratios in the host country could be used to determine which part of the arm's length funding should be made up of "free" capital.

132. One concern with such an approach is what appears to be the wide range of debt-to-equity ratios observable at arm's length and whether, given the diverse range, it is possible to apply a thin capitalisation approach outside the financial sector. However, the debt-to-equity ratio of a particular enterprise within the wide range is unlikely to be the result of random chance, but is rather likely to be the outcome of a number of factors. A critical issue is whether it is possible to take into account all the factors that underlie such different debt-to-equity ratios. Further consideration perhaps needs to be given as to why certain enterprises are highly geared and some are not. Differences in shareholders' appetite for risk have already been identified as one contributing factor, but in the context of an adequately capitalised enterprise the authorised OECD approach significantly decreases the importance of that variable by making the creditworthiness/capital structure of the enterprise one of the internal conditions of the PE.

133. Other key variables, the "external" conditions – location of the borrowing PE, quality and nature of assets, cash flows, business sector, business strategies, capital acquisitions and disposals, market conditions in the host jurisdiction, etc. — could be identified and an effort made to quantify the effect of those variables on gearing, where possible by examination of the accounts of comparable independents or by researching the criteria used by independent bankers when lending to particular categories of borrowers. A functional and factual analysis of the assets, risks and activities of the PE would reveal the extent to which the key variables were present in its business, and it could be possible to attribute to the PE an appropriate amount of "free" capital for a business with these features.

134. The thin capitalisation approach has the advantage of avoiding some of the issues that arise in determining the amount of "free" capital to be attributed in situations where the enterprise as a whole is entirely debt-funded. However, a weakness of a thin capitalisation approach is that the aggregate amount of "free" capital it attributes to individual PEs may be greater than the amount of free capital in the enterprise as a whole.

#### (4) Safe harbour approach - quasi thin capitalisation /regulatory minimum capital approach

135. Another possibility discussed in Part II for banks would be to require the PE to have at least the same amount of "free" capital required for regulatory purposes as would an independent banking enterprise operating in the host country (quasi thin capitalisation/regulatory minimum capital approach). This approach is not an authorised OECD approach as it ignores important internal conditions of the authorised OECD approach, *e.g.* that the PE generally has the same creditworthiness as the enterprise as a whole. However, it may be acceptable as a safe harbour as long as it does not result in the attribution of more profits to the PE than would be attributed by an authorised OECD approach.

136. In practice there are likely to be significant problems in finding sufficiently objective benchmarks outside the regulated financial sector to apply the quasi thin capitalisation/regulatory minimum capital approach. More generally, there may be limited scope for having fixed ratios based on sector benchmarks for particular industries outside the financial sector, but only as part of a safe harbour regime.

137. However, the main disadvantage of the quasi thin capitalisation/regulatory minimum capital approach is that it is unlikely to provide a solution for all taxpayers in all sectors, it relies on sector benchmarks which may not meet comparability standards, and the more refined and wide-ranging the approach becomes the more it resembles the thin capitalisation approach (and therefore loses the advantages of administrative simplicity).

138. The quasi thin capitalisation/regulatory minimum capital and the thin capitalisation approaches may be used in conjunction with safe harbours. The Guidelines contain much discussion of the pros and cons of safe harbours in general before concluding in paragraph 4.123 that “the use of safe harbours is not recommended.” However, as noted in 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”.

(5) Other methods

139. In the context of the insurance sector, other potential approaches to attributing capital have been analysed. The results of this analysis are included in Part IV.

(6) Attribution of capital to the PE of a thinly capitalised enterprise

140. Outside the regulated financial sector a difficulty arises that there is often no requirement for individual enterprises within the Group to have an arm’s length amount of “free” capital. The enterprise of which the PE is a part may for example be almost entirely debt-funded (so-called \$2 companies, with \$2 equity and \$1m debt) so that even attributing all such an entity’s “free” capital to the PE is likely to leave the PE thinly capitalised. Accordingly a separate discussion of the problems connected with thinly capitalised enterprises now follows the main discussion of capital attribution approaches.

141. In circumstances where the capital structure of the enterprise to which the PE is a part does not provide an arm’s length result it is necessary to look outside the enterprise itself for suitable data. There are two possible solutions to arrive at a result consistent with Article 7:

- A thin capitalisation approach
- An approach which adjusts the “free” capital of the enterprise to an arm’s length amount before allocating that capital to the PE.

142. The thin capitalisation approach looks at the capital structures of comparable independent enterprises in comparable circumstances, etc. The objective under this approach is to determine an arm’s length amount of “free” capital. Consistent with the conclusion for PEs of non-thinly capitalised enterprises, the creditworthiness implied by that amount of “free” capital would be assumed to belong to the enterprise as a whole, with the consequence that internal dealings in respect of guarantee fees and creditworthiness differentials affecting intra-enterprise interest rates would not be recognised.

143. A second approach would be to first adjust the “free” capital of the enterprise of which the PE is a part to an arm’s length amount. The PE would subsequently be attributed an arm’s length amount of the adjusted “free” capital under Article 7 through a capital allocation approach.

144. In determining whether a particular capital attribution approach gives an arm’s length result for a PE of a thinly capitalised enterprise it may be necessary to consider why the enterprise as a whole is thinly capitalised.

145. In applying a thin capitalisation approach, if any commercial reasons for the enterprise being thinly capitalised had nothing to do with the business operations of the PE, then the attribution to the PE of more than the enterprise’s “free” capital may well be consistent with the arm’s length principle. If such commercial reasons *did* relate to the business operations of the PE, then this must be accounted for in seeking to benchmark the PE’s capitalisation against whatever uncontrolled comparables are selected. This would be either by selecting comparables that are similarly affected by such factors, by adjusting the

comparables to account for any differences in such factors, or if the available comparables data cannot reliably be used because of such factors, using a different authorised OECD approach that would be more consistent with the arm's length principle.

## (7) Conclusion on attributing capital to the PE

146. The attribution of “free” capital among the parts of an enterprise is a pivotal step in the process of attributing profits to the PE. The general principle is that the PE should have sufficient “free” capital to support the functions, assets and risks attributed to the PE. For this reason, the method by which capital is attributed is an important step in avoiding or minimising double taxation or less than single taxation.

147. The consultation process has shown that there is an international consensus amongst governments and business on the principle that a PE should have sufficient “free” capital to support the functions, assets and risks it assumes. However, the consultation process has also shown that it is not possible to develop a single internationally accepted approach for attributing the necessary “free” capital. As can be seen from the discussions above, there is no single approach which is capable of dealing with all circumstances.

148. Rather the focus of the Report is on articulating the principles under which such an attribution should be made and on providing guidance on applying those principles in practice in a flexible and pragmatic manner. As such, whilst any of the authorised approaches described in this section are capable of producing an arm's length result, there may be particular situations where the approach does not produce an arm's length result and so flexibility may be required but in a manner that should reduce the incidence of double taxation.

149. Where the two Contracting States have interpreted paragraph 2 of Article 7 differently and it is not possible to conclude that either interpretation is not in accordance with paragraph 2 of Article 7, it is important to ensure that any double taxation that would otherwise result from that difference will be eliminated. As explained in the Commentary on Article 7, paragraph 3 of Article 7, where applicable, will ensure that this result is achieved. The fact that it will sometimes be necessary to resolve disputes through MAP is not a weakness of the authorised OECD approach. Rather it reflects the fact that the attribution of “free” capital to a PE can be a very difficult and complex issue. The authorised OECD approach describes the strengths and weaknesses of different approaches and therefore provides a framework for resolving difficult cases.

## (3) Determining the funding costs of the PE

### (A) Introduction

150. The authorised OECD approach acknowledges that the PE requires a certain amount of funding (made up of both “free” capital and interest-bearing debt). Once that amount has been determined, one of the authorised capital attribution approaches as described in the preceding section is used to determine the amount of the funding that is made up of “free” capital. The balance of the funding requirement is therefore the amount by reference to which the interest deduction is calculated and is the focus of this section. For simplicity's sake the discussion is couched in terms of “debt” and “interest” but the comments below are applicable to any financial instrument and any funding costs, whether strictly classified as interest for tax purposes or not. Much of the discussion in this section strictly belongs in the second step of the authorised OECD approach but is included here for convenience.

151. Just as there is more than one authorised approach to attributing “free” capital to a PE so too there is more than one authorised approach to attributing interest-bearing debt and to determining the rate of interest to be applied to that debt. Under the authorised OECD approach the attribution can include, in

appropriate circumstances, the recognition of internal “interest” dealings. The various approaches are discussed in the first sub-section below. This recognition creates the potential for tax avoidance as discussed in the second sub-section below. The third subsection discusses the extent to which it is appropriate to recognise a mark-up on any internal “interest” dealings.

**(B) Authorised approaches to attributing funding costs to PEs**

152. A key feature of the authorised OECD approach as it applies to funding costs is that it moves the focus away from the recognition of dealings as such to a wider consideration of determining an allowable interest deduction for the PE. The objective of the authorised OECD approach is to establish, using one of the authorised approaches described below, an arm’s length amount of interest in the PE, commensurate with the functions, assets and risks attributed. Whilst movements of funds between parts of the enterprise do not necessarily give rise to dealings, there would be circumstances where they could be recognised as internal interest dealings within non-financial enterprises, for the purposes of rewarding a treasury function (“treasury dealing”). Treasury functions are described in Part II of this Report, Section D-2(ii)(b).

153. Where such an approach is used, the question of whether any movement of funds would be recognised as a “treasury dealing” would depend on a functional and factual analysis of the “dealing” and the conditions under which it was performed. In particular, it would be necessary in order to recognise a dealing as a “treasury dealing” to identify one part of the enterprise as undertaking in substance the significant people functions relevant to determining economic ownership of the cash or financial asset in order to be treated as the “owner” of the cash or financial asset and therefore entitled to an arm’s length return from the cash or asset under an internal “treasury dealing”. In the absence of such significant people functions, it would not be possible to recognise any internal “treasury dealings” at arm’s length prices.

154. There are in principle two other approaches for attributing the external interest expense of the enterprise to its PE: (1) a tracing approach, and (2) a fungibility approach. A number of countries currently use some variation of these approaches. Under a “pure” tracing approach, any internal movements of funds provided to a PE are traced back to the original provision of funds by third parties. The interest rate on the funds provided to the PE are determined to be the same as the actual rate incurred by the enterprise to the third party provider of funds. A tracing approach could, in certain circumstances, be evidenced by internal dealings that allocate the actual interest expense of the enterprise to the PE. Under a “pure” fungibility approach, money borrowed by a PE of an enterprise is regarded as contributing to the whole enterprise’s funding needs, and not simply to that particular PE’s funding needs. This approach ignores the actual movements of funds within the enterprise and any payments of inter-branch or head office/branch interest. Each PE is allocated a portion of the whole enterprise’s actual interest expense paid to third parties on some pre-determined basis. Hence, there would be no need under a fungibility approach for any recognition of internal interest dealings.

155. Both a tracing approach and a fungibility approach, at least in their pure form, have problems.

156. Just as for capital attribution, it does not seem possible to develop a single approach for determining the amount of attributable interest expense that could be applicable in all circumstances. Some countries favour a fungibility approach, whilst others want to retain tracing of funds for non-financial institutions. Others want a more flexible approach, perhaps by using tracing for “big-ticket” items and a fungibility approach for the rest of the assets. Other countries want to determine the amount of interest by reference to the amount of interest of comparable independent enterprises in comparable circumstances. Other countries may want to use appropriately recognised “treasury dealings” to reward a treasury function. The important point to stress is that the goal of all the approaches described above is the same, *i.e.* that the amount of interest expense claimed by the PE does not exceed an arm’s length amount and that any treasury functions are appropriately rewarded. Accordingly, all these approaches should be treated as

authorised under the authorised OECD approach. Where the two Contracting States have interpreted paragraph 2 of Article 7 differently and it is not possible to conclude that either interpretation is not in accordance with paragraph 2 of Article 7, it is important to ensure that any double taxation that would otherwise result from that difference will be eliminated. As explained in the Commentary on Article 7, paragraph 3 of Article 7, where applicable, will ensure that this result is achieved.

157. As regards the scope for avoidance, in particular the scope for giving an interest expense to the PE in cases where the enterprise as a whole is solely or predominantly equity-funded, it should be noted that the recognition of “treasury dealings” only rewards the performance of any significant people functions relevant to determining the economic ownership of the cash and financial assets of the enterprise. If there are no significant people functions then only the actual external interest expense of the enterprise will be allocated amongst the various parts of the enterprise. For example, in the absence of any external debt it is unlikely that there will be significant people functions relevant to determining the economic ownership of assets performed by one part of the enterprise such that one part of the enterprise would be treated as the economic owner of all the cash and financial assets of the enterprise.

158. Under the authorised OECD approach, therefore, the concern for avoidance for non-financial enterprises disappears because internal interest dealings are recognised only for the purpose of rewarding treasury functions and therefore do not affect the attribution of free capital and, by way of consequence, the quantum of debt attributed to the PE determined under the basic principles set out in Section D-2(v)(b)(1) – (2) above.

(4) Determining the arm’s length price of treasury dealings

159. Finally, it remains to consider how to reward the “treasury dealings”. The answer will be to do so under the arm’s length principle and by reference to a comparability analysis applying by analogy the methods of the Guidelines. For example, where the “treasury dealing” relates to external debt, one method of arriving at an arm’s length price might be to add a margin to the external debt by reference to comparable margins earned by independent enterprises performing comparable functions. One feature of the authorised OECD approach is that it generally attributes the creditworthiness of the enterprise to its constituent PEs. It follows from this that no margin should be added in respect of credit differentials between one part of the enterprise and another. The addition of a margin would therefore only be appropriate where there is clear evidence that one part of the enterprise is providing a real treasury function to the other parts of the same enterprise. Where the “treasury” PE is doing little more than acting as a conduit (borrowing funds and immediately on-lending) the functional analysis is unlikely to show that the “treasury” PE has been performing the significant people functions relevant to determining the economic ownership of assets and so should be treated as the economic owner of those funds and entitled to the associated return. Instead, it may be appropriate to reward the “treasury” PE not as the owner but instead as a service provider, for example with a reimbursement of any administrative costs incurred or on a cost plus basis, depending on what precisely was involved (*i.e.* the costs do not include interest cost).

160. Where the PE of a non-financial enterprise is performing a fully fledged treasury function, the functional analysis may well determine that the treasury centre is the economic owner of the internal financial assets as it has been performing the significant people functions relevant to determining economic ownership of those assets and so is entitled to the return on those assets. The pricing of that return can be determined in accordance with the discussion of treasury centres in Part II (Section D-2(ii)(b)). As noted in Part II, the addition of a margin to an internal interest dealing is only one of a number of possible methods to reward the performance of a treasury function. Where these other methods are used, the treasury function would be rewarded separately through an arm’s length remuneration.

161. There are other financial dealings which may occur in non-financial enterprises, for example hedging transactions, but such purported transfers of risk would need to meet the threshold hurdle, *i.e.* they would not be recognised unless, for example, the part of the enterprise to which the risk was transferred had the expertise to manage the risk and so was performing the significant people functions in respect of those risks.

(5) The authorised OECD approach for adjusting interest expense

162. Where the amount of “free” capital allotted by the enterprise is less than the arm’s length amount as determined by one of the authorised approaches, an appropriate adjustment would need to be made to reduce the amount of interest expense claimed by the PE in order to reflect the amount of the enterprise’s “free” capital that is actually needed to support the activities of the PE. The adjustment will be made following the rules of the PE’s host country, subject to Article 7.

163. It should be noted that the host country PE 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 host country 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 countries 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 country does not make an upwards adjustment in excess of the arm’s length amount.

164. Where interest-bearing debt attributed to the PE (including recognised “treasury dealings” in respect of internal movements of funds) covers some part of the arm’s length amount of “free” capital properly attributable to the PE, any interest on the amount so covered would not be deductible in arriving at the PE’s taxable profits. In some cases, the PE’s accounts may specifically identify the interest liability in relation to the amount of “free” capital that has been covered by interest-bearing debt. In these cases, it may be a fairly simple matter to determine the amount of non-deductible interest. In other cases, the PE’s accounts may not readily identify any specific interest liability in relation to the amount of “free” capital that has been covered by interest-bearing debt. This raises the question of how to determine the amount of non-deductible interest.

165. A variety of methods are possible. One method for determining the amount of non-deductible interest might simply be to apportion the actual interest expense claimed by the PE (after any adjustment to reflect arm’s length amounts) by using a ratio based on the average debt level that the PE had during the year, and the average debt level that the PE would have had during the year after adjustment to reflect the additional “free” capital that should have been attributed to the PE. Another method might be to use a weighted average of rates actually charged on the interest-bearing debt attributed to the PE. It is also desirable to allow the use of other methods where the results produced are more acceptable to the taxpayer and to the tax administration of the host jurisdiction.

166. Another issue that can arise is where the PE has allotted capital in excess of the arm’s length range of “free” capital. This might be because the host jurisdiction has a domestic tax law requirement on allotted capital. In that case the host jurisdiction is taxing more than is permitted under Article 7. Any such domestic tax law requirement that provided for an amount of “free” capital in excess of the arm’s length range would be restricted by Article 7 to an amount that was within the limit set by the arm’s length range. Alternatively, an enterprise 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 enterprise wishes to maximise interest deductions in its home jurisdiction subject to higher taxation. In such situations the authorised OECD approach would enable the home country to adjust the amount of “free” capital attributed to the PE to an amount within the limits set by the arm’s length range.

167. 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 separate and independent enterprise would have “free” capital as discussed earlier in the 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 an amount of “free” capital in the PE that is below the limits set by the arm’s length range of “free” capital.

168. 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 “treasury dealing”. However, this solution is not possible where the PE’s borrowings are wholly with third parties. One way of making the adjustment for “free” capital would be 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.

(6) Conclusion on capital attribution and funding costs

169. The first step of the authorised OECD approach determines the activities and conditions of the hypothesised separate and independent enterprise. A functional and factual analysis attributes functions, assets and risks to the PE, and sufficient “free” capital is attributed to support those functions, assets and risks. The attribution of “free” capital and funding to PEs of non-financial enterprises presents certain difficulties not encountered in the financial sector, however the approach is practical and effective.

170. As with the attribution of “free” capital to the PEs of financial enterprises, the testing in the general situation has demonstrated the need for flexibility over such issues as the attribution of “free” capital and the determination of funding costs. To some extent, this flexibility also reflects the real practical difficulties of translating the authorised OECD approach into precise guidance in this area. On the other hand, the attribution of “free” capital is now governed by a clear principle the observance of which will help minimise instances of double taxation. In other words, the authorised OECD approach is rooted in a detailed functional and factual analysis which first attributes functions, assets and risks to the PE, and then attributes a sufficient amount of “free” capital to support the assets used and the risks assumed.

171. Given the importance of the attribution of assets and risks to the determination of both the profits of the PE and an appropriate funding structure, it will be necessary to require PEs to document how they have attributed assets, measured risks (or why they do not consider it necessary to measure risks) and attributed “free” capital and interest expense. Documentation requirements are discussed in more detail below in Section D-4.

(vi) ***Recognition of “dealings”***

(a) *Introduction*

172. Under the first step of the authorised OECD approach a functional and factual analysis of the PE is undertaken in the process of constructing the hypothetical “separate and independent enterprise, engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise”. Functions, assets, risks and “free” capital are attributed to the PE together with the income and expenses arising from transactions with other enterprises (both associated and independent). The arm’s length price of transactions with associated enterprises can be determined by applying directly the Guidelines. However, the language of Article 7(2) goes on to require that the profits

to be attributed to the PE must also be based on the hypothetical separate and independent enterprise, acting as such also in its dealings with other parts of the enterprise. Thus, in fully hypothesising the PE, it is necessary to identify and determine the nature of its internal “dealings” with the rest of the enterprise of which it is a part. In order to complete the attribution of profits to the PE under the second step of the authorised OECD approach, Section D-3 provides guidance on how to price those internal dealings by applying the arm’s length principle.

173. Where the PE has dealings with other parts of the enterprise, those dealings (provided they pass the threshold test discussed below) will affect the attribution of profits to the extent that the dealings are relevant to the functions performed by the PE and the other parts of the enterprise, taking into account assets used and risks assumed. For example, the PE may begin to use assets (tangible or intangible) belonging to the enterprise that were developed by the head office or purchased for the business of the head office or vice versa. The PE may use services rendered by the head office or vice versa. The PE may use cash earned by the head office or vice versa. The PE may manufacture goods and transfer them to another part of the enterprise, or it may sell goods manufactured by another part to the enterprise to third parties. Under the authorised OECD approach, internal dealings should have the same effect on the attribution of profits between the PE and other parts of the enterprise as would be the case for a comparable provision of services or goods (either by sale, licence or lease) between independent enterprises. However, the authorised OECD approach is based on the premise that the internal dealings are postulated *solely* for the purposes of attributing the appropriate amount of profit to the PE.

174. The question arises as to how to adapt the guidance of the Guidelines on transfer pricing methods to the PE context for purposes of hypothesising the “dealings” between the PE and the rest of the enterprise. In an Article 9 situation, there are “controlled transactions” between associated enterprises, and the transfer pricing methods apply by comparing those transactions with comparable uncontrolled transactions between independent enterprises. In the PE situation there are “dealings” rather than actual “controlled transactions” that govern the economic and financial relationships between the PE and another part of the enterprise.

(b) *Recognition of dealings*

175. 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. Second, dealings between a PE and the rest of the enterprise of which it is a part have no legal consequences for the enterprise as a whole. This implies a need for a 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. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist, and considering the uniqueness of this issue, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealing.

176. 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 should therefore be reflected in the attribution of profits under Article 7(2). In the associated enterprise situation it will usually be self-evident that a transaction has occurred, *e.g.* the transaction will have legal consequences other than for tax. Even transactions between associated enterprises may not be recognised where they do not take place under the normal commercial conditions that would apply between independent enterprises (see paragraphs 1.65-1.66 of the Guidelines which discuss the circumstances in which transactions between associated enterprises would not be recognised or would be restructured in accordance with economic and commercial reality). A dealing within a single legal entity is not something which is self-evident but is a construct, the existence of which is inferred solely for the purposes of



determining an arm's length attribution of profit. Consequently, intra-entity dealings are perhaps more susceptible to being disregarded or restructured than transactions between associated enterprises.

177. The starting point for the evaluation of a potential "dealing" will normally be the accounting records and internal documentation of the PE showing the purported existence of such a "dealing". Under the authorised OECD approach, that "dealing" as documented by the enterprise will be recognised for the purposes of attributing profit, provided 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.). A functional and factual analysis should be used to determine whether such an event has occurred and should be taken into account as an internal dealing of economic significance. And ultimately it is the functional and factual analysis which determines whether the dealing has taken place, not the accounting records or other documentation provided by the enterprise.

178. This will require the determination of whether there has been any economically significant transfer of risks, responsibilities and benefits as a result of the "dealing". In transactions between independent enterprises, the determination of the transfer of risks, responsibilities and benefits would normally require an analysis of the contractual terms of the transaction. This analysis would follow the guidance on contractual terms found in paragraphs 1.52-1.54 of the Guidelines.

179. A dealing takes place within a single legal entity and so there are no "contractual terms" to analyse. However, the authorised OECD approach treats "dealings" as analogous to transactions between associated enterprises and so the guidance in paragraphs 1.52-1.54 of the Guidelines can be applied in the PE context by analogy. In particular, as noted in paragraph 1.52, "The terms of a transaction may also be found in correspondence/communications between parties other than a written contract." So, by analogy, the "contractual terms" are the accounting records, together with any contemporaneous internal documentation, purporting to transfer risks, responsibilities and benefits from one part of the enterprise to another part. Further, paragraph 1.48 of the Guidelines notes 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 1.49 goes on to note that "an 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."

180. An analysis of the contractual terms of the transaction is part of the functional and factual analysis and can be used to examine whether the actual conduct of the parties conforms to the terms of the contract and is consistent with the economic principles that govern relationships between independent enterprises. Such an examination is considered necessary even where there are contractual terms between legally separate, albeit associated, enterprises. Paragraph 1.53 of the Guidelines, as modified to substituted references to "dealings" for references to "contractual terms", states that it will be necessary to, "examine whether the conduct of the parties conforms to the terms of the *dealing* or whether the parties' conduct indicates that the *terms of the dealing* have not been followed or are a sham". The paragraph goes on to note that in such cases, "further analysis is required to determine the true terms of the transaction." Such an analysis will be even more important in the PE context where any terms between the various parts of the enterprise are not contractually binding.

181. Thus, for example, an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the authorised OECD

approach. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that:

- the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner or, if they do so differ, the structure as presented in the taxpayer's documentation does not practically impede the tax administration from determining an appropriate transfer price; and
- the dealing presented in the taxpayer's documentation does not violate the principles of the authorised OECD approach by, for example, purporting to transfer risks in a way that segregates them from functions.

See paragraphs 1.48-1.54 and 1.64-1.69 of the Guidelines by analogy.

182. Once the above threshold has been passed and a dealing recognised as existing, the authorised OECD approach applies, by analogy, the guidance at paragraphs 1.48-1.54 and 1.64-1.69 of the Guidelines. The guidance is applied not to transactions but to the dealings between the PE and the other parts of the enterprise. So the examination of a dealing should be based on the dealing actually undertaken by the PE and the other part of the enterprise as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapter II of the Guidelines. Except in the two circumstances outlined at paragraph 1.65, tax administrations should apply the guidance in paragraph 1.64 when attributing profit to a PE and so “should not disregard the actual dealings or substitute other dealings for them.”

### **D-3. Second step: determining the profits of the hypothesised separate and independent enterprise based upon a comparability analysis**

This Section provides for a detailed discussion of practical application of the basic principles stated in Section B-4 with respect to step two of the authorised OECD approach.

#### **(i) Introduction**

183. The authorised OECD approach is to undertake a comparison of *dealings* between the PE and the enterprise of which it is a part, with *transactions* between independent enterprises. This comparison is to be made by following, by analogy, the comparability analysis described in the Guidelines. By analogy with the Guidelines, comparability in the PE context means either that none of the differences (if any) between the dealing and the transaction between independent enterprises materially affects the measure used to attribute profit to the PE, or that reasonably accurate adjustments can be made to eliminate the material effects of such differences. Principles similar to the aggregation rules of Chapter III of the Guidelines should also apply, to permit the PE's dealings to be aggregated, where appropriate, in determining the PE's attributable profit.

184. Under the authorised OECD approach, for purposes of determining the arm's length remuneration of dealings, the most appropriate method to the circumstances of the case should be selected and applied by analogy to the guidance in the Guidelines. Sub-section (ii) below discusses in more detail applying transfer pricing methods to attribute profits. Sub-section (iii) discusses the comparability analysis. Sub-section (iv) then discusses a number of commonly occurring dealings which require special mention – dealings involving changes in the use of tangible assets, intangible assets, cost contribution arrangements

and internal service dealings. Sub-section (v) discusses the issue of expenditure incurred before and after the period of the PE's existence.

**(ii) Applying transfer pricing methods to attribute profit**

185. Consider a PE that distributes a product manufactured by its head office. Assume for this purpose that the PE should be deemed to have purchased the product from the head office for on-sale to third parties. It is understood that the third party sales price is at arm's length and so the transfer pricing examination would be focused on the dealings with the head office. To determine the PE's attributable profit from these dealings, the transfer pricing methods would be applied in light of the PE's business activities and functions as a distributor. If, for example, the head office also sells the product to third party distributors operating in circumstances comparable to those of the PE, the CUP method might be used to determine the price at which the PE would have obtained the products had it been a "separate and independent enterprise" within the meaning of paragraph 2 of Article 7. The amount of gross profit attributed to the PE would be determined as the difference between revenues from third party customer sales attributed to the PE and the price notionally charged by the head office, adjusted, if necessary, to the arm's length price by reference to comparable transactions between third party distributors and manufacturers.

186. Where a CUP is unavailable, assuming the functional and factual analysis of the PE reveals that it operates as a distributor of the head office's products, the arm's length price of the products that are deemed purchased by the PE from the head office might be determined by subtracting from the third party customer sales price of the products an appropriate gross margin (the "resale price margin") representing the amount out of which an independent reseller operating at arm's length in comparable circumstances would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. The same approach would be used in applying the other methods described in the Guidelines. So if, for example, the functional and factual analysis shows that the PE does not operate as a mere distributor of the head office products, but that it performs significant people functions relevant to determining the economic ownership of a valuable marketing intangible associated with the product (*e.g.* because it has developed that intangible), while no significant intangible is used and no significant value is added by the head office which manufactures and supplies the products to the PE, then it may be appropriate to apply a cost plus method to determine the notional price of the transfer of goods from the head office.

187. An issue arises where there is a dealing between the PE and another part of the same enterprise and there are costs related to that dealing that have been incurred by the other part of that enterprise for the benefit of the PE. To the extent that the costs that have been incurred by the other part of the enterprise have been reflected in the arm's length price for that dealing, these costs should not be allocated to the PE. Moreover, care is needed with regard to the internal accounting for the costs attributed to different dealings, *e.g.* to ensure that costs covered in a dealing are not also claimed again under another dealing. For example, product testing costs relating to an arm's length CUP for a product "sold" to the PE may not also be claimed a second time as part of "services" charged to the PE under a cost plus method. The issue is akin to the issue addressed by paragraph 7.26 of the Guidelines and the guidance in that paragraph will be relevant by analogy for the situation where there is a dealing between the PE and another part of the same enterprise.

188. When attributing profit to the PE, it may also be necessary to take into account expenses incurred by the enterprise for the purposes of the PE, where such expenses represent functions (performed by other parts of the enterprise) for which compensation would be charged at arm's length. Whether expenses incurred outside the PE need to be taken into account would be revealed by a functional and factual analysis of the relevant parts of the enterprise. Subject to the preceding paragraph, the method by which

this is achieved may vary. Some countries prefer to take such compensation for functions performed by other parts of the enterprise into account by adjusting the gross profit margin to reflect the performance of those functions. The actual amount of expenses incurred by other parts of the enterprise in performing those functions should not be deducted to arrive at the PE's arm's length net profit. Other countries prefer a two-step analysis. First, the gross margin for the PE based on comparables would be determined, without taking into account compensation for the functions performed by other parts of the enterprise. Second, transfer pricing methods are applied to provide an appropriate compensation for the functions performed by other parts of the enterprise. Both methods should produce the same result as far as Article 7 is concerned (although there may be further implications under other treaty articles, which are not discussed in this Report).

**(iii) Comparability analysis**

189. The authorised OECD approach provides for a comparability analysis, based on the guidance in the Guidelines, to be applied by analogy.

190. The Guidelines identify five factors determining comparability between controlled and uncontrolled transactions: characteristics of property or services, functional analysis, contractual terms, economic circumstances, and business strategies. The authorised OECD approach seeks to apply the same factors to ensure comparability between dealings and uncontrolled transactions. It is considered that all the factors, with the exception of contractual terms, can be applied directly to evaluate dealings as they are essentially based on fact. The concept of contractual terms is rooted in relationships between legally separate, albeit associated, enterprises and so needs to be applied by analogy to dealings within a single legal entity (see discussion in Section D-2(vi) as to how to apply, by analogy, the guidance on contractual terms at paragraphs 1.52-1.54 of the Guidelines). Once the "contractual terms" of the internal dealings have been determined, a comparison can be made with the contractual terms of potentially comparable transactions between independent enterprises.

191. The comparability analysis might determine that there has been a provision of goods, services or assets, etc. between one part of the enterprise and another that is comparable to a provision of goods, services or assets, etc. between independent enterprises. Accordingly, the part of the enterprise making such a "provision" should receive the return which an independent enterprise would have received for making a comparable "provision" in a transaction at arm's length. In an arm's length transaction an independent enterprise normally would seek to charge for making a provision in such a way as to generate profit, rather than providing it merely at cost, although there can be circumstances in which a provision made at an arm's length price will not result in a profit (*e.g.* see paragraph 7.33 of the Guidelines in connection with the provision of services).

192. The comparability analysis may also result in other outcomes than those described in the previous paragraphs. Member countries are of the opinion that these other outcomes should be equally susceptible to analysis, by analogy, with the guidance contained in the Guidelines.

193. To summarise, where internal dealings are recognised, the factual and comparability analysis will attribute a price or profit in respect of the dealings by reference to comparable transactions between independent enterprises. The guidance in the Guidelines on undertaking such analyses will be applied, by analogy, in light of the particular factual circumstances of a PE and as a result of testing the authorised OECD approach. Four particular circumstances are considered in this regard: a change in the use of a tangible asset, use of intangible assets, cost contribution arrangements and the provision of internal services.

(iv) *Application of second step of authorised OECD approach to commonly occurring dealings*

(a) *Change in the use of a tangible asset*

194. The issue of determining which part of the enterprise should be considered the economic owner of a tangible asset that is legally owned by the enterprise as a whole does not arise only at the time of acquisition by the enterprise. It can also become an issue when an asset is transferred from one part of the enterprise for use in another part of the enterprise. For example, the situation may arise in which the use of a tangible asset by one part of an enterprise, *e.g.* the head office, is changed to use by another part of the enterprise, *e.g.* the PE. For instance, if both the head office and the PE engage in a manufacturing function, and the head office no longer has need for a particular machine, that machine might be moved from the head office to the PE for use in the manufacturing business of the PE. As already noted, there is broad consensus among the OECD member countries to apply use in attributing economic ownership of tangible assets absent circumstances in a particular case that warrant a different view. It follows that a change in place of use of a tangible asset is a factor that may trigger a change in the economic ownership of that asset. The removal of the machine from the head office to the PE is a real and identifiable event and so would constitute an internal dealing.

195. Where the economic ownership of the tangible asset would be attributed to the PE using the asset (*i.e.* where the particular circumstances do not warrant a different view), the question then becomes how to account for the transfer of the asset to the PE from the head office when computing the amount of profit that should be attributed to the PE. Where a dealing has taken place within a single legal enterprise, however, there are no “contractual terms” in this regard. As noted in Section D-2(vi), the guidance in paragraphs 1.52-1.54 of the Guidelines can be applied by analogy: “contractual terms” must be discerned from the accounting records and other observable conduct, together with any contemporaneous internal documentation, purporting to transfer risks, responsibilities and benefits from one part of the enterprise to another part (see paragraph 36).

196. In the factual situation where the PE is regarded as becoming the economic owner of the tangible asset from that time forward, the fair market value of the asset at the time of transfer would generally provide the basis for computing an allowance for depreciation in the host country, subject to that country’s domestic law.

197. The factual situation may alternatively reflect that the PE and other parts of the enterprise have structured their dealings in a comparable manner to economic co-participants in a cost contribution arrangement-type (CCA-type) activity that contemplates serial use of a tangible asset by different parts of the enterprise. Following, by analogy, the guidance given in Chapter VIII of the Guidelines there might not be a need in such cases to recognise any appreciation (or depreciation) at the time of the change in the use of the tangible asset, if the asset were transferred between “participants” in a manner consistent with the contemplated serial use of the asset under the CCA-type activity.

198. In other cases, there may still be a need to recognise any appreciation or depreciation in the value of a tangible asset following a change of use, even where an asset is used pursuant to a CCA-type activity. For example, the asset may no longer be used in the activity which is the subject of the CCA, one part of the enterprise involved in the change of use may have ceased to be a participant in the CCA-type activity or another part of the enterprise may have started to use the asset and become a new participant in the CCA-type activity.

199. Where the economic ownership of a tangible asset would not be attributed to the part of the enterprise using the asset (*i.e.* in those cases where the particular circumstances warrant this view), the functional and factual analysis may reflect that the transfer of that asset from one part of the enterprise to

another is analogous to a lease or a licence between independent enterprises. In such a case, no profit or loss at the time of the transfer of the tangible asset would have to be recognised. Instead, profits would be attributed to the PE based on deducting an amount equivalent to the arm's length charge under a comparable lease or license between independent enterprises.

(b) *Intangible property*

(1) Impact of intangible property on the profits to be attributed to the PE

200. If it is determined under the functional and factual analysis that the PE has performed, at least in part, the function of creating an intangible or bears extraordinary marketing expenditure in relation to the intangible, the PE would be entitled to a comparable return to that of an independent enterprise performing a similar function. Where the functional and factual analysis attributes sole or joint ownership of the intangible asset to the PE, the guidance in Chapter VI on special considerations for intangible property should be followed, by analogy, when making the attribution of profit to the PE performing that function, or the guidance in Chapter VII in respect of any services provided in connection with the development of the intangible property.

201. The conditions under which the PE performs that function also need to be taken into account and, in particular, whether the PE is the “sole or joint owner” of the intangible. If the conditions were comparable to those of a contract researcher within the meaning of paragraph 7.41 of the Guidelines, the contract researcher PE would be attributed a profit consistent with that earned by independent enterprises performing a similar function as contract researchers and not as “owners”. Another possibility might be that both the PE and other parts of the enterprise have jointly contributed to the development of the intangible property, for their joint purposes, in which case profit would be attributed between the contributing parties, based on what would happen between independent parties participating in a comparable CCA-type activity. The guidance given in Chapter VIII of the Guidelines would be followed, by analogy. The rest of this section looks in more detail at some of the key issues in determining the impact of intangible property on the profits of the PE.

202. The return on intangible property is part of the overall return to the enterprise from its transactions with third parties and the issue is not to determine that return but rather to attribute the return within the enterprise in accordance with the arm's length principle. For example, the existence of a proprietary trading model may have enabled traders at a financial institution to generate more profits. The profit from the transaction with third parties that has been properly attributed to the PE as a result of functions performed by the PE (including use of intangible assets) may therefore already include an element relating to the return on the intangible property used by the PE. Therefore in such cases there would normally be no need to impute any additional return to intangible property, but rather the issue to be determined will be whether the PE has recognised appropriate expenses associated with the creation, development or maintenance of the intangible that it has used.

203. The focus of Article 7 is on attributing profits to the PE and in the context of rewarding intangible property, the focus is on ensuring that the intangible owner is attributed an arm's length return. There are a number of ways of ensuring that the return to intangible property is appropriately attributed within the enterprise, only one of which attributes the return in a manner similar to a royalty transaction between independent enterprises in similar circumstances. It must be noted, however, that in the context of the authorised OECD approach, the use of the word “royalty” is not meant to convey either an actual payment or a formal license agreement between two parts of the same enterprise but is intended to refer to the arm's length compensation that one would have had to pay (and deduct from income) for the use of the intangible if the provider of the intangible were a separate and independent enterprise. The recognition of the notional royalty is relevant only to the attribution of profits to the PE under Article 7 and should not be

understood to carry wider implications as regards withholding taxes, which are outside the scope of this Report. Between independent enterprises other ways of rewarding the owner of the intangible include incorporating the reward in the price of goods sold by the intangible owner, or by sharing part of the overall profit with the intangible owner, for example through a residual profit split method. If such arrangements were replicated in a PE situation, then the “royalty” issues discussed above would not be in point.

204. Additionally, it is also possible to attribute the return from intangible property without any internal “royalty” by means of a profit method. For example, if the intangible property is closely associated with an integrated global trading business which is remunerated via a profit split method, it would be possible to attribute the return to the intangible property within the profit split calculation either explicitly by including it as a factor in its own right or implicitly by virtue of its impact on other factors. In this case there is therefore no need to calculate royalty income *per se*, or to infer the existence of a cost contribution arrangement. In short, the objective of the analysis is to ensure the appropriate attribution of the return on intangible property, rather than on whether an internal “royalty” should be recognised.

205. Finally, where the PE is determined as the economic owner of intangible property, capital, including “free” capital, is attributed to support any significant risks associated with the development of the intangible property. As discussed in the section dealing with the attribution of “free” capital, it can be difficult to measure precisely the risk associated with the creation of intangible property, however the exercise should be performed where those risks are significant. Where the PE is determined not to be the economic owner of the intangible, but, say, a contract R&D service provider, it will still require funding to meet researchers’ salaries and related administrative expenses, but given that the significant risks lie with the economic owner, it will be attributed little “free” capital, the funding being more in the way of stage payments from the economic owner of the intangible.

## (2) Internal dealings relating to use of an intangible

206. Even more difficult questions can arise when an intangible property that is “solely owned”, say, in the head office, is provided to one or more of its PEs for use in the latter’s business. For example, a PE may begin to make use of a trade intangible developed in the past by activities in the head office and exploited in the past by the head office. This situation commonly arises because of business changes, for example, the PE moving into a new business area. Under the authorised OECD approach, a functional and factual analysis of the situation might show that the PE should be treated as engaging in a dealing with the head office in respect of that intangible property. Profit would be attributed in respect of this dealing by reference to comparable transactions between independent enterprises (*e.g.* a royalty) and would depend on a functional and factual analysis of the dealing, the type of interest obtained or notional rights acquired (exclusive or non-exclusive), etc. Guidance on these issues is given in Chapters VI and VIII of the Guidelines. It is worth reiterating that, as noted in the previous section, an internal “royalty” is only one of a number of possible ways of rewarding intangible property.

207. As stated above, unlike the situation involving tangible assets, it is common for intangible property to be used simultaneously by more than one part of the enterprise. Making an intangible asset available to a PE does not imply that other parts of the enterprise have ceased to be able to exploit that same asset or may not be able to do so in the future. Such a change in use could result in the PE’s being treated as having obtained not the intangible asset itself or an exclusive notional right to use the intangible, but rather a beneficial interest in that asset or a non-exclusive right to use the intangible. Thus, under the authorised OECD approach, the PE would be treated as having acquired an interest in the intangible or a notional right to use the intangible at the time of the change of function.

208. The value of the interest acquired (joint ownership, outright ownership or a beneficial interest) would be determined by reference to comparable transactions between independent enterprises. The PE might be treated as having acquired the intangible or an interest in the intangible at fair market value and so is entitled to depreciate/amortise the interest in the acquired asset using that value, subject to host country depreciation/amortisation rules.

209. Another possible outcome of the analysis of the dealing involved in making an intangible available to a PE could result in the PE's being treated as having obtained a notional right to use the intangible property analogous to a licensing agreement. Depending on the factual circumstances and the comparability analysis, the PE might be entitled to deduct an amount equivalent to the arm's length charge (notional royalty) for a license arrangement that would have been agreed upon between independent enterprises had they entered into a comparable transaction.

210. Similar principles to those discussed above apply to dealings recognised in respect of intangibles acquired by an enterprise through licensing from a third party. An enterprise's right to use an intangible under a license may constitute an asset whose economic ownership can be attributed to a part of the enterprise and can be the subject of a dealing with another part of the enterprise. Economic ownership of this asset is attributable to that part of the enterprise performing the significant people functions relevant to determination of economic ownership of the right to use the licensed asset. Where the economic owner makes the licensed intangible available for use by another part of the enterprise so that a dealing between these parts is recognised, the functional and factual analysis will determine the character of that dealing, e.g. as an outright transfer or a licensing of those rights to use, for purposes of attributing profit from that use.

(c) *Cost contribution arrangements*

211. It should be noted that the analysis in the preceding paragraph deals only with the direct consequences of the transfer of the intangible asset itself or a beneficial interest in an existing intangible asset. In circumstances where an intangible developed by one part of the enterprise is to be further developed by the enterprise as a whole, it might be that such further development would be conducted in a cost contribution arrangement-type (CCA-type) activity in which the PE is a participant. In such circumstances the PE would be treated for tax purposes as if it had acquired an interest in the pre-existing intangible property (a buy-in) and any subsequent dealings related to the further development of the intangible property would be determined by following, by analogy, the guidance given in Chapter VIII of the Guidelines. If, by following, by analogy, the guidance of Chapter VIII, the PE were found to have acquired only the notional right to use the pre-existing intangible that is subject to the CCA-type activity and did not obtain a beneficial interest in the intangible property itself, a notional royalty may be attributed based, by analogy, on the guidance in Chapter VI.

212. Where the PE and the other part of the enterprise dealing with the PE have structured their dealings in a comparable manner to economic co-participants in an activity corresponding to a CCA, the PE and the rest of the enterprise would be found to be economic co-participants in such an activity, and the dealings would be treated in a manner similar to transactions between associated enterprises in a CCA.

213. The guidance in Chapter VIII on determining whether a CCA between associated enterprises satisfies the arm's length principle can be applied, by analogy, in the PE context. A CCA is, like any other transaction between associated enterprises, an arrangement containing rights and obligations designed to achieve a given economic goal for its members. Notwithstanding the fact that the PE is not a separate legal entity from the rest of the enterprise, the same economic goals can nonetheless be replicated as between a PE and the rest of the enterprise as a notional construct to assist in the attribution of profits to a PE. Given the absence of contracts between parts of the same enterprise, however, countries will wish the enterprise



presenting certain activities as being the object of a notional CCA to meet a significant threshold in order to provide reliable evidence in support of its position. Therefore, countries may place the onus on the taxpayer to prepare and produce, where required, the type of documentation that would have been created to document an actual CCA structured in accordance with the guidance of Chapter VIII of the Guidelines. Beyond the documentation of the notional CCA meant to reveal the intentions of the participants, a functional and factual analysis will be required that will determine the conduct of the participants and, thus, establish the true nature of the economic relationships between different parts of the enterprise.

214. For example, where a PE is claimed to be a participant in a CCA-type activity within a single legal enterprise, there should be sufficient evidence available to enable the tax authority in the PE's host country to evaluate whether the PE's contribution to the CCA-type activity is, as stated at paragraph 8.8 of the Guidelines, "consistent with what an independent enterprise would have agreed to contribute under comparable circumstances given the benefits it reasonably expects to receive from the arrangement". Documentary evidence will be critical in making this evaluation, provided it reflects the real situation and any documented intentions are put into effect and followed during the life of the CCA-type activity.

215. Consistent with the earlier guidance on the recognition of dealings, an enterprise and its PE would not ordinarily be found to be acting in a manner consistent with a CCA where this was not the intent of the enterprise, as supported by relevant documentation. Likewise, given the extent of the documentation required to support the existence of a notional CCA, an enterprise could not claim after the fact the existence of the CCA where no contemporaneous documentation is available to support such a claim. In other words, the degree of sophistication of the notional construct that is required by an economic CCA between parts of a single legal enterprise precludes claims that are not backed by convincing contemporaneous documentation.

(d) *Internal services*

216. A considerable head office support infrastructure is often necessary in order to carry out a business conducted through PEs. These can 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.

217. It is important to consider that under the Guidelines, associated enterprises are now always required to comply with the arm's length principle.

218. Under the authorised OECD approach, 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 also, following the guidance in Chapter VII, whether, at arm's length, both parties would have contracted for the provision of the service. 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).

219. The authorised OECD approach is to attribute profits to a PE in respect of services performed by the PE for other parts of the enterprise (and vice versa) by following, by analogy, the guidance given in the Guidelines, especially in Chapters VII and VIII, in order to determine whether, and if so, to what extent, the support functions should be rewarded. In some cases, the PE and the other parts of the enterprise can be considered as acting in a comparable manner to economic co-participants in a CCA-type activity involving the provision of those services. The internal dealings within the enterprise would be treated for tax purposes in a like manner as a provision of comparable services between independent parties in a comparable CCA-type activity, following, by analogy, the guidance given in Chapter VIII of the

Guidelines. Most of the services provided by the head office of an enterprise 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.

220. 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.

(v) ***Treatment of expenses incurred before and after the period of the PE's existence***

221. One subject that has been identified as giving rise to special issues in computing the profits of PEs relates to items of expense (or in some cases, income) realised before the existence of the PE or upon or after the termination of its existence. For example, an enterprise may incur expenses in connection with the establishment of a PE (*e.g.* "start-up" expenses) but before the PE has come into existence (*i.e.* before the enterprise has begun carrying on business through the PE). The question thus arises whether and if so to what extent those expenses should be taken into account in calculating the taxable profits of the PE. As a general principle, income should be allowed to be offset by the expenses associated with generating it, but the principles of computing taxable income on the basis of an annual accounting period and of denying certain deductions for expenses incurred before an income-generating activity is undertaken may operate to counterbalance that general principle.

222. Similarly, when the existence of a PE is terminated, it is possible that the enterprise may subsequently realise income that arose in whole or in part from the PE's activities or may subsequently incur expenses relating to the PE's activities. The question in these cases is whether and if so to what extent the host jurisdiction may or should take these items into account in computing the taxable profits of the PE. In addition, the very termination of the PE's existence (*e.g.* whether through mere cessation of its activities, movement of its activities to another location, incorporation of its operations or sale of its operations to another party) may raise issues as to effects on the PE's taxable profits.

223. This Report does not seek to resolve these issues. It is recognised that countries' domestic laws may vary widely on how they treat various items of this type. For example, whether a host country would take particular items of this kind into account in computing a PE's taxable profits could depend upon that country's domestic laws relating to methods of accounting, start-up expenses, winding-up expenses, incorporations, liquidations, etc. Countries' approaches to some of these items are more consistent than others. For example, many of the member countries' domestic laws generally prohibit deductions for start-up expenses incurred by their domestic enterprises, and there is widespread agreement that it would not be unreasonable to apply similar principles to expenses incurred in connection with the establishment of a PE. In general, however, it was acknowledged that further work would be needed to arrive at a comprehensive consensus view on these types of issues.

#### **D-4. Documentation**

224. The authorised OECD approach would also apply, by analogy, the guidance on transfer pricing documentation in Chapter V of the Guidelines. In particular, the same standards would apply to the documentation of the arm's length nature of the profit determination relating to dealings as currently apply to the documentation of transactions and the summary of recommendations at paragraphs 5.28 and 5.29 of the Guidelines should be followed. In particular, by analogy to the guidance found at paragraph 5.28, taxpayers should make reasonable efforts at the time the profit from dealings is determined to ascertain whether their approach to determining that profit is in accordance with the arm's length principle. Tax administrations should have the right to obtain the documentation prepared or referred to in this process as a means of verifying compliance with the arm's length principle. As noted at paragraph 5.28, "[d]ocumentation requirements should not impose on taxpayers costs and burdens disproportionate to the circumstances."

225. It should be borne in mind that the transfer pricing-like documentation required to determine the arm's length nature of profit determinations relating to a PE's "dealings" with other parts of the enterprise may be quite different from the documentation referred to in Section D-2(vi)(b) above, relating to the very existence of, the characterisation of and the terms of the dealings. The latter form of documentation is relevant to the recognition of the dealings under step one, whereas the transfer pricing-like documentation is relevant to whether the profit determination relating to those dealings is consistent with the arm's length principle.

226. However, as dealings have not always been recognised for the purposes of attributing profits to PEs, taxpayers may not be in the habit of documenting dealings or the arm's length nature of the profit determinations relating to those dealings to the same extent as they would document transactions with associated enterprises. This may explain some of the potential difficulties in applying the authorised OECD approach in practice that have emerged from the testing process. It may therefore be necessary for tax administrations to encourage documentation efforts by taxpayers in this matter so as to ensure that dealings are in fact adequately documented for purposes of their recognition, and also that the arm's length nature of the profit determinations relating to those dealings is adequately documented in accordance with the guidance in Chapter V of the Guidelines. Tax administrations and taxpayers should also follow the general guidance in Chapter V on how to document compliance with the arm's length principle.

#### **D-5. Dependent agent PEs**

##### **(i) Introduction**

227. As already stated in paragraph 6, this Report does not examine the issue of whether a PE exists under Article 5(5) of the OECD Model Tax Convention (a so-called "dependent agent PE"), nor is it intended to affect in any way the currently existing standards under Article 5 for determining the existence of a PE. It does, however, discuss the consequences of finding that a dependent agent PE exists in terms of the profits that should be attributed to the dependent agent PE. An inevitable consequence of having a PE threshold is that there will be cases which are otherwise quite similar but where one reaches the threshold and the other does not. There may be significant differences in host country taxing rights on the two activities depending on which side of the threshold the activities lie. This "cliff effect" is not however a consequence of the authorised OECD approach to attributing profits under Article 7, but of the way in which Article 5(5) works. Indeed the authorised OECD approach may mitigate some of the cliff effect compared to the current Article 7 rules where it would be possible for the host country to tax all the income once the threshold had been reached. It is worth re-emphasising at the outset that the discussion below is not predicated on any lowering of the threshold of what constitutes a PE under Article 5. However, a responsible approach to the development of guidance under Article 7 must take into account that certain

business arrangements may meet the threshold conditions and so give rise to dependent agent PEs within the meaning of Article 5(5).

228. The current lack of guidance on how to determine the profits to be attributed to a dependent agent PE has created uncertainty as to the consequences of finding dependent agent PEs under Article 5(5). There is a concern from business that in the absence of such guidance a “force of attraction” rule may become the default position; so that, for example, the finding of a dependent agent PE would have the automatic effect of drawing in profits to the host country irrespective of whether those profits are generated by, or as a consequence of, activity undertaken by the dependent agent. This section is intended to remedy the current unsatisfactory situation by providing specific guidance on the attribution of profits to a dependent agent PE using the same principles that are applied to attribute profits to other types of PEs. Moreover, as will be seen below, the authorised OECD approach, grounded in a functional and factual analysis of the activities of the dependent agent and emphasising the importance of determining the significant people functions relevant to the assumption and/or management of risk and the significant people functions relevant to the determination of economic ownership of assets, provides a measurement of the amount of profits attributable to a dependent agent PE that is consistent with the arm’s length principle. Consequently, there is no presumption that a dependent agent PE will have profits attributed to it. In some circumstances, the functional and factual analysis may determine that the amount to be attributed to the dependent agent PE is a negligible profit, nil or a loss.

229. The situation where global trading in financial instruments or the insurance business is conducted by a dependent agent PE under Article 5(5) is discussed in detail in Parts III and IV of the Report. The example discussed below primarily focuses on situations where the dependent agent is an associated enterprise. However, the same principles are applicable to situations where the dependent agent is not an associated enterprise.

**(ii) *The authorised OECD approach for dependent agent PEs***

230. In cases where a PE arises from the activities of a dependent agent, the host country will have taxing rights over two different legal entities - the dependent agent enterprise (which may be a resident of the host country) and the dependent agent PE (which is a PE of a non-resident enterprise). In respect of transactions between the associated enterprises (the dependent agent enterprise and the non-resident enterprise), Article 9 will be the relevant article in determining whether the transactions between the associated enterprises, *e.g.* commission paid to the dependent agent enterprise based on volume of product sold, were conducted on an arm’s length basis.

231. In respect of the dependent agent PE, the issue to be addressed is one of determining the profits of the non-resident enterprise which are attributable to its dependent agent PE in the host country (*i.e.* as a result of activities which have been carried out by the dependent agent enterprise on the non-resident enterprise’s behalf). In this situation, Article 7 will be the relevant article. Finally, it is worth stressing that the host country can only tax the profits of the non-resident enterprise where the functions performed in the host country on behalf of the non-resident enterprise meet the PE threshold as defined under Article 5. Further, the quantum of that profit is limited to the business profits attributable to operations performed through the dependent agent PE in the host country.

232. Where a dependent agent PE is found to exist under Article 5(5), the question arises as to how to attribute profits to the PE. The answer is to follow the same principles as used for other types of PEs, for to do otherwise would be inconsistent with Article 7 and the arm’s length principle. Under the first step of the authorised OECD approach a functional and factual analysis determines the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise. On the one hand the dependent agent enterprise will be rewarded for the service it provides to the non-resident

enterprise (taking into account its assets and its risks (if any)). On the other hand, the dependent agent PE will be attributed the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident, together with sufficient “free” capital to support those assets and risks. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those assets, risks and capital. The analysis also focuses on the nature of the functions carried out by the dependent agent on behalf of the non-resident enterprise and in particular whether it undertakes the significant people functions relevant to the assumption and/or management of risks or to determining the economic ownership of assets. In this regard an analysis of the skills and expertise of the employees of the dependent agent enterprise is likely to be instructive, for example in determining whether negotiating or risk management functions are being performed by the dependent agent on behalf of the non-resident enterprise. In general the functional and factual analysis focuses on the nature of the functions carried out and in particular whether the above-mentioned significant people functions are carried out by the dependent agent enterprise on behalf of the non-resident enterprise, such that the associated assets and risk of the non-resident enterprise should be attributed to its dependent agent PE (in which case the profits associated with those assets and risks would be taxable in the host country) rather than to another part of the non-resident enterprise (in which case the associated profits would not be taxable in the host country).

233. In practice the dependent agent enterprise may not perform the significant people functions relevant to the assumption and/or management of risk or the significant people functions relevant to the determination of economic ownership of assets and if it does not then the attribution of the assets, risks and profits to the dependent agent PE is correspondingly reduced or eliminated. In particular, it should be noted that the activities of a mere sales agent may well be unlikely to represent the significant people functions leading to the development of a marketing or trade intangible so that the dependent agent PE would generally not be attributed profit as the “economic owner” of that intangible.

234. In calculating the profits attributable to the dependent agent PE it would be necessary to determine and deduct an arm’s length reward to the dependent agent enterprise for the services it provides to the non-resident enterprise (taking into account its assets and its risks if any). Issues arise as to whether there would remain any profits to be attributed to the dependent agent PE after an arm’s length reward has been given to the dependent agent enterprise. In accordance with the principles outlined above (and illustrated in the example below) the answer is that it depends on the precise facts and circumstances as revealed by the functional and factual analysis of the dependent agent and the non-resident enterprise. However, the authorised OECD approach recognises that it is possible in appropriate circumstances for such profits to be attributed to the dependent agent PE.

235. Before moving on to the example, it is worth first considering an alternative approach put forward by some commentators (referred to here as the “single taxpayer” approach), which contends that in all circumstances the payment of an arm’s length reward to the dependent agent enterprise fully extinguishes the profits attributable to the dependent agent PE. The reasoning behind this approach is that the compensation to the dependent agent enterprise, if arm’s length under Article 9, is considered to adequately reward the dependent agent enterprise for its functions performed, assets used and risks assumed, and since there are no other functions performed, assets used and risks assumed in the host country there can be no further profits to attribute. The functional and factual analysis may show that certain risks, for example, inventory and credit risks under a sales agency arrangement, belong not to the dependent agent enterprise but to the non-resident enterprise which is the principal. Although it is agreed that the risks are legally borne by the non-resident enterprise, the difference between the two approaches is that under the “single taxpayer” approach, those risks can never be attributed to the dependent agent PE of the non-resident enterprise, whilst the authorised OECD approach would attribute those risks to the dependent agent PE for tax purposes if, and only if, the dependent agent performed the significant people functions relevant to the assumption and/or subsequent management of those risks.

236. Whilst superficially attractive the “single taxpayer” approach in fact contains a number of fundamental flaws. Firstly, this approach would not result in a fair division of taxing rights between host and home jurisdictions as it ignores assets and risks that relate to the activity being carried on in the source jurisdiction simply because those assets and risks legally belong to the non-resident enterprise. Indeed, such an approach would go against one of the fundamental rationales behind the PE concept, which is to allow, within certain limits, the taxation of non-resident enterprises (including their assets and risks) in respect of their activities in the source jurisdiction. The “single taxpayer” approach simply does not consider that if the risks (and reward) legally belong to the non-resident enterprise it is nonetheless possible to attribute those risks (and reward) to a PE of the non-resident enterprise created by the activity of its dependent agent in the host country.

237. A second problem with the “single taxpayer” approach is that if accepted it would mean the authorised OECD approach’s being applied differently depending on what type of PE was involved. For PEs other than dependent agent PEs, the authorised OECD approach attributes assets and risks to the PE that are created or economically owned as a result of functions carried on by the PE, and attributes profits accordingly, notwithstanding the fact the assets and risks legally belong, of course, to a non-resident enterprise. In contrast, under the “single taxpayer” approach outlined above, no profits would be attributed to a dependent agent PE in respect of the risks and assets of the non-resident enterprise, even though they arise from activities carried out through the dependent agent PE. Such a distinction between enterprises carrying on business through dependent agent PEs and enterprises carrying on businesses through fixed place of business PEs, would seem inconsistent with Article 7 and the arm’s length principle.

238. Or to look at this issue from another perspective, the “single taxpayer” approach would lead to the same result in terms of profit attribution for dependent agent PEs, even where the facts are substantially different. The attribution of profits to a dependent agent PE would be the same in situations where the functional and factual analysis demonstrated that the PE’s activities generated risks and assets for the enterprise and in situations where the functional and factual analysis determined that the activities did not generate such risks and assets.

239. Finally, it is recognised that a basic principle of statutory interpretation is that the drafters of a statute (or treaty) intend every word to have a meaning and consequently, the text should not be interpreted in a manner that renders a portion of it superfluous. The “single taxpayer” approach to attributing profits, however, would mean that there would never be profit consequences resulting from the finding of a dependent agent PE, thereby making Article 5(5) largely redundant.

(a) *Practical illustration of the application of the authorised OECD approach - dependent sales agents*

240. The following illustration is intended to better explain the approach taken under the authorised OECD approach. It is recognised that in practice most situations will be significantly more complex and difficult to deal with. The objective however is to illustrate the principle that the host country’s taxing rights are not necessarily exhausted by ensuring an arm’s length compensation to the dependent agent enterprise under Article 9 (the following example is one where the dependent agent is an associated enterprise).

241. Under a typical sales agency agreement, the dependent agent enterprise never takes title to the goods, which remain the property of the non-resident enterprise in whose name the contracts with customers are concluded. Thus where the dependent agent enterprise warehouses a stock of goods belonging to the foreign enterprise in order to fulfil the customer orders generated by the dependent agent’s sales activities, the associated inventory risk is assumed by the non-resident enterprise. An arm’s length agency fee paid by the non-resident enterprise to the dependent agent enterprise would not therefore

include an element to reward the assumption of these risks – they are assumed by the non-resident enterprise.

242. Assuming the activities performed by the dependent agent enterprise on behalf of the non-resident enterprise create a dependent agent PE under Article 5(5), the question is whether any of the reward for the assumption of inventory risk should be attributed to the dependent agent PE of the non-resident enterprise. As already noted, this will be determined by the identification of whether the significant people functions relevant to the assumption and/or subsequent management of the risk are undertaken by the non-resident enterprise itself outside the jurisdiction where the dependent agent PE is located or by the dependent agent enterprise on behalf of the non-resident enterprise. This analysis should be undertaken on a case-by-case basis given the wide variety of risk management strategies used by different types of business. The creation and management of inventory risks may involve different people functions in different business sectors, and even different businesses within the same sector. Those functions may be undertaken by the non-resident enterprise outside the jurisdiction where the dependent agent PE is located, or they may be undertaken by the dependent agent enterprise on behalf of the non-resident enterprise. Moreover, the result of some business models, for example “just in time” manufacturing, may be to eliminate such risks as inventory risk (though such business models may create new risks – the risk for example that the sale is lost because the goods are not available at the time the customer wants them).

243. Having said all this, and for the purpose of illustrating the application of the authorised OECD approach to a dependent agent, suppose that the personnel that perform the significant people functions relevant to the assumption and/or subsequent management of inventory risk and the significant people functions relevant to determining the economic ownership of the inventory are employed in the dependent agent enterprise and are performing those functions on behalf of the non-resident enterprise. This would mean that the “economic ownership” of the inventory and the reward for the assumption of the associated inventory risk are attributable under the authorised OECD approach to the dependent agent PE. And, of course, under the authorised OECD approach, so is the associated profit or loss.

244. The above result is determined under the functional and factual analysis. There is no presumption that assets or risk should be attributed to the dependent agent PE. In other circumstances, the functional and factual analysis might show that the relevant significant people functions are undertaken by people in the head office of the non-resident enterprise, and the personnel of the dependent agent enterprise in the host country do not carry out these activities on behalf of the non-resident enterprise. In such circumstances the economic ownership of the inventory and the reward for the assumption of the associated inventory risk would not be attributable under the authorised OECD approach to the dependent agent PE of the non-resident enterprise but to its head office.

245. A similar analysis can be carried out on a case-by-case basis in respect of other types of risks, *e.g.* the credit risk in respect of the customer receivables of the non-resident enterprise. Again, under a typical sales agency agreement customer receivables and the associated credit risk legally belong to the non-resident enterprise, not the dependent agent enterprise and so the remuneration paid by the non-resident enterprise to the dependent agent enterprise should not reward the assumption of this risk. Once again the key question is whether any of the reward for the assumption of credit risk should be attributed to the dependent agent PE of the non-resident enterprise. As already noted, this will be determined by reference to the identification of where the significant people functions relevant to the assumption and/or subsequent management of the risk are undertaken, *i.e.* in the dependent agent or the non-resident enterprise.

(b) *Administrative matters and documentation*

246. The danger of overlooking the assets used and risks assumed in the performance of the functions in the PE jurisdiction is minimised if the existence of the dependent agent PE is formally recognised so that it is clear that the host country has taxing rights over two different legal entities - the dependent agent PE and the dependent agent enterprise - and an attribution of profit based on a functional analysis is made to the dependent agent PE on the basis described in this section. This should also ensure that any other tax consequences arising from different rules for PEs and subsidiaries in the PE jurisdiction are taken into account. One way to formally recognise the existence of dependent agent PEs is to require the filing of tax returns for all such PEs. However, nothing in the authorised OECD approach would prevent countries from using administratively convenient ways of recognising the existence of a dependent agent PE and collecting the appropriate amount of tax resulting from the activity of a dependent agent. For example, where a dependent agent PE is found to exist under Article 5(5), a number of countries actually collect tax only from the dependent agent enterprise even though the amount of tax is calculated by reference to the activities of both the dependent agent enterprise and the dependent agent PE. In practice what this means is taxing the dependent agent enterprise not only on the profits attributable to the people functions it performs on behalf of the non-resident enterprise (and its own assets and risks assumed), but also on the reward for the free capital which is properly attributable to the PE of the non-resident enterprise. Such administrative matters related to the taxation of dependent agent PEs are for the domestic rules of the host country and not for the authorised OECD approach to address.<sup>12</sup> It follows that the home country with a PE in a host country that operated such an administratively convenient procedure would not be obliged to give relief or entitled to tax on the basis that there was no dependent agent. The taxing rights of the home country are not altered by administratively convenient procedures of the host country.

247. Dependent agent PEs may sometimes give rise to documentation issues that are often not found in other types of PE. A fixed place of business PE, which is typically an economically distinct business unit, may have its own set of financial accounting records that provide a starting point for the attribution of profit for tax purposes. This may well not be the case with the dependent agent PE, particularly where the taxpayer has not set out with the intention of creating a dependent agent PE. Even without this complicating factor, difficulties can arise for tax administrations in trying to obtain the information necessary to determine the profits attributable to the dependent agent PE of the non-resident enterprise in the host jurisdiction. The non-resident enterprise may have no physical presence in the host jurisdiction and the dependent agent enterprise may ordinarily have little information about the operations of the non-resident enterprise. However, under the authorised OECD approach the non-resident enterprise would, just as for other types of PEs, be required to document how it has attributed profit to its dependent agent PE.

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12 That being said, the potential burden on the non-resident enterprise of having to comply with host country tax and reporting obligations in the event it is determined to have a dependent agent PE cannot be dismissed as inconsequential, and nothing in the authorised OECD approach should be interpreted as preventing host countries from continuing or adopting the kinds of administratively convenient procedures mentioned above.



## **PART II: SPECIAL CONSIDERATIONS FOR APPLYING THE AUTHORISED OECD APPROACH TO PERMANENT ESTABLISHMENTS (PEs) OF BANKS**

### **A. Introduction**

1. Part I of this Report sets out the principles of the authorised OECD approach and provides guidance on the practical application of these principles to attribute profits to PEs in general. However, it is also considered necessary to provide more specific and practical guidance on the application of the authorised OECD approach in commonly occurring factual situations. This Part of the Report (Part II) looks at the banking sector and discusses how the authorised OECD approach applies to a number of factual situations commonly found in enterprises carrying on a banking business through a PE.

2. 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”). 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 for Multinational Enterprises and Tax Administrations 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 20<sup>th</sup> century.

3. This part of the Report considers what might be called traditional banking activities, the borrowing and on-lending of money,<sup>1</sup> and provides guidance on how the profits from such activities 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. Some 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 authorised OECD approach, 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. In this context, it should be noted that the aim of the authorised OECD approach is not to achieve equality of outcome between a PE and a subsidiary in terms of profits but rather to apply to dealings among separate parts of a single enterprise the same transfer pricing principles that apply to transactions between associated enterprises. There are generally economic differences between using a subsidiary and a PE. Application of the authorised OECD approach will not achieve equality of outcome between subsidiaries and PEs where there are economic differences between them. The legal form chosen, PE or subsidiary, may have some economic effects that should be reflected in the determination of taxable

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

profits. In many cases, businesses operate through permanent establishments rather than separate entities precisely because the PE structure provides for efficient capital utilisation, risk diversification, economies of scale, etc., making the structure more profitable.

## **B. Functional and factual analysis of a traditional banking business**

5. This section analyses the most important functions of a traditional banking business (*i.e.* the borrowing and lending of money) both in terms of the functions performed, assets used and risks assumed when creating a financial asset (a loan) and the subsequent functions performed over the life of the financial asset.

### ***B-1 Functions performed***

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

6. 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*

7. 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*

8. 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 acceptance and/or management (subsequent to the transfer) of individual risks and portfolios of risks. For a bank, the creation of a financial asset and its subsequent management are likely to be the key entrepreneurial risk-taking functions and so, as discussed in Section D-1(i), economic ownership of the financial asset (and the income and expense associated with holding that asset, lending it out, or selling it to third parties) is generally attributed to the location performing those functions.

9. 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 6 that is likely to be the key entrepreneurial risk-taking function in the creation of a financial asset, where the asset is a loan in a wholesale commercial lending business. As can be seen from the description in Section B-1(ii) above, the risk management function as described in point c) of paragraph 7 is likely to be the function most relevant to the ongoing management of an existing financial asset. Together these functions will be most relevant to the attribution of economic ownership of the financial asset. However, the determination of the most important functions bearing on economic ownership should be made on a case-by-case basis, as the functions and their relative importance are likely to vary according to facts and circumstances, *e.g.* product differences, type of business (wholesale versus retail, commercial versus individual, etc.), business strategies, etc.

10. One 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. Such activity, whilst clearly important, would not generally constitute a key entrepreneurial risk-taking function in the creation or subsequent management of a loan. This is because whilst such committees may set the parameters which define the potential for the assumption of risk they do not generally perform functions which result in the actual assumption of risk. Nor do they generally actively intervene in the creation and management of individual loans or portfolios of loans and so do not perform the key entrepreneurial risk-taking functions in respect of those particular loans or portfolios of loans.

11. Whether a given activity constitutes a key entrepreneurial risk-taking function for a particular enterprise depends upon such factors as the type of banking operation and the business model employed

(see paragraph 64 for further details). For example, the functional and factual analysis of a particular retail bank may reveal that the key entrepreneurial risk-taking function is carried out by the marketers rather than the people setting the reference or base price of the loans. In such circumstances it is the marketing function which creates the financial asset and economic ownership of the financial asset is thus attributed to the marketing function. For a particular syndicated loan business, on the other hand, the key entrepreneurial risk-taking function may prove to be performed by the people negotiating the terms of the loan. As always the analysis depends on the facts and circumstances of the individual case.

*iv) Support, middle or back office functions*

12. A certain infrastructure is necessary to support the key entrepreneurial risk-taking functions in a bank, often centralised in the head office. Most of these functions - general management, setting of business strategies, development of computer systems, research, personnel functions and other supporting functions - are not confined to banking operations. Such functions are sometimes classified either as “back office” or as “middle office” functions, to be distinguished from “front office” functions. “Back office” functions are said to add less economic value to the business than the middle or front office functions and so deserve a lower reward. It should be borne in mind, however, that although the terms “back”, “middle” and “front office” are commonly used in describing the functions of a banking enterprise, there is nothing in the authorised OECD approach that requires attention to be given to such distinctions. The authorised OECD approach rather is concerned with identifying the key entrepreneurial risk-taking functions without regard to the label given to the function or activity, but based on a functional and factual analysis. Whether a particular activity is a key entrepreneurial risk-taking function will depend on the facts and circumstances of the particular business. The functional and factual analysis will determine whether the activity is a key entrepreneurial risk-taking function or a support function (*e.g.* economic analysis of interest rate trends). Functions other than key entrepreneurial risk-taking functions still need to be taken into account in attributing arm’s length profits to the PE, but economic ownership of assets is not attributed to such functions.

**B-2 Assets used**

13. The Guidelines note at paragraph 1.42 that compensation will usually reflect not just functions performed but also the assets used and risks assumed in performing those functions. So the functional and factual 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. As noted in section D-2(iii)(b) of Part I of this Report, there is a broad consensus among member countries for applying place of use as the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view. The assets may need to be taken into account in making any comparability analysis under the second step of the authorised OECD approach. 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 fewer expensive physical assets (such as branch premises).

15. Further, as with any other business, the functional and factual 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 trade 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 banks as they reflect the importance of measuring and optimising use of capital and of monitoring and managing financial risks in the financial sector.

16. The attribution of tangible and intangible assets to a banking PE and the pricing of dealings involving such assets give rise to issues that are identical to those found in non-financial enterprises. The guidance in Sections D-2(iii) & (iv) and D-3(iv)(a) & (b) of Part I is therefore applicable to banks as well. Part II is primarily concerned with the attribution of those assets to a PE which are not covered in Part I, namely financial assets. In the case of banks' financial assets, the creation and management of such assets (and their attendant risks) is itself the key entrepreneurial risk-taking function relevant to determining the initial economic ownership of the assets, so the initial attribution of economic ownership of those assets to the part of the enterprise performing that function has primary importance not only for determining characterisation of the "separate and independent enterprise" under step one of the authorised OECD approach, but also to the attribution of profits under step two, since attributing economic ownership of financial assets attributes the income and expenses associated with holding those assets or lending them out or selling them to third parties.

### ***B-3 Risks assumed***

17. 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 risks which are particularly relevant when performing a functional and factual analysis under the authorised OECD approach 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 agreement. 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 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), the exchange rate will move from the rate used when entering into the loan agreement.

18. 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 affect settlement risk. Solvency risk and general business risk will also be relevant. Further, the Basel Committee on Banking Supervision ("Basel Committee") recently concluded its review of risks that set 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 and factual analysis.

19. 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 authorised OECD approach by way of contrast is not restricted to an analysis 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 may need to be taken into account in the application of the arm's length principle.

20. Between legally separate 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 a second 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 second enterprise (unless they also decide to transfer those risks to a third enterprise). This raises the question of whether, and if so, in what circumstances, transfers 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(ii)(e).

21. 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.). Being attributed risks in the Article 7 context means the equivalent of bearing risks for income tax purposes by a separate enterprise, with the attendant benefits and burdens, in particular the potential exposure to gains or losses from the realisation or non-realisation of said risks. However, it is possible for the bank not to ultimately bear all the different types of assumed risks. For example, it is possible for a banking enterprise to bear all the assumed risks apart from the credit risk by retaining ownership of the financial asset but transferring the majority of the credit risk by executing a credit derivative with another enterprise. Credit risk is not completely eliminated, but is still present to the extent of the risk inherent in the counterparty to the credit derivative. Bank regulators generally treat the risk as having been reduced, but not to zero. In traditional banking activities, credit risk is generally the most important risk assumed as a result of the creation of the financial asset because the bank is potentially at risk for the whole of the principal sum advanced to a customer in the form of a loan, even though it may subsequently try to pass on that risk to an independent enterprise.

22. 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 profits attributed to the part of the enterprise performing that function (see Section D-2(ii)(e)).

#### **B-4 Capital and funding**

##### *i) Introduction*

23. 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 risk, a bank needs "capital", *i.e.* the ability to absorb any 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 significantly 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.

24. 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 regulatory “capital” as the investors in this type of loan place funds at the bank’s disposal over a period which allows any 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.

25. 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 do not give rise to a return to investors in the nature of interest which is deductible for tax purposes by the bank under the rules of the host country, 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 Report as “free” capital and is of obvious significance for tax purposes (see sub-section (v) below).

26. 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, including subordinated debt, certain types of which in some jurisdictions will give rise to tax deductible interest. 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.

27. In conclusion, it is suggested that for banks and other financial institutions, a functional and factual 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*

28. Creditworthiness is an important factor to be taken into account in any transfer pricing analysis of a bank 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 lower the creditworthiness of the bank the higher the interest rate it pays to its investors. 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).

29. Creditworthiness is the perception by an independent party, *e.g.* a credit rating agency, of the likelihood that a company (*e.g.* a bank) 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 borrowing 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 enterprises with the highest creditworthiness (*e.g.* some borrowers will only transact with AAA-rated counterparties).

30. 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 liability 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.

31. In general, however, the factual situation of a PE determines that it necessarily has the same creditworthiness as the enterprise of which it is a part. In contrast, a subsidiary may or may not have the same creditworthiness as its parent.<sup>2</sup>

*iii) Capital adequacy requirements*

32. 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.

33. The Basel Committee on Banking Supervision of the Bank for International Settlements (BIS) is the body that sets internationally accepted standards for capital adequacy, see the June 2006 publication, “International Convergence of Capital Measurement and Capital Standards: A Revised Framework” (the “Revised Framework” or “Basel Accord”).<sup>3</sup> This document represents a compilation of a number of previous publications by the Basel Committee, including the June 2004 Basel II Framework,<sup>4</sup> the elements of the 1988 Basel Accord<sup>5</sup> that were not revised during the Basel II process, the 1996 Amendment to the Capital Accord to Incorporate Market Risks,<sup>6</sup> and the 2005 paper on the Application of Basel II to Trading Activities and the Treatment of the Double Default Effects.<sup>7</sup> The 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. In this Report, unless otherwise stated, a reference to the Basel Accord means the comprehensive version issued in June 2006.

34. 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-cumulative and non-redeemable preference shares, non-repayable share premiums, disclosed reserves and retained earnings. Tier 2 capital includes items such as subordinated debt instruments, long-dated debt, and certain reserves (*e.g.* certain undisclosed, asset revaluation, and general loan-loss reserves). One other matter of interest is that, in calculating Tier 1 and Tier 2 capital, a deduction

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2 See the discussion on the attribution of creditworthiness in Part I, Section D-2(v).

3 <http://www.bis.org/publ/bcbs128.htm>.

4 <http://www.bis.org/publ/bcbs107.htm>.

5 <http://www.bis.org/publ/bcbssc111.htm>.

6 <http://www.bis.org/publ/bcbs119.htm>.

7 <http://www.bis.org/publ/bcbs116.htm>.



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 104 and 105 in the context of attributing “free” capital to the PE.

35. 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 so-called “Cook ratio” introduced by the 1988 Basel Accord, or the up-dated “McDonough ratio” applicable as of 1 January 2007 under the Revised Framework). The assets are weighted to take into account both credit and market risk (and, under the McDonough ratio, operational 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.

36. 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 in the nature of interest (it is “free” capital for tax as well as accounting purposes), there may be some instruments that qualify as Tier 1 capital for regulatory purposes but 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.

37. 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 agreement 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*

38. 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.

39. 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 for accounting purposes 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.

40. 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*

41. 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).

42. 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.

43. 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 for the bank 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**

44. 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. One important distinction is that within a single enterprise, risks follow functions and under no circumstances can one be segregated from the other, which means that capital is attributed to the PE to support the risks created by the key entrepreneurial risk-taking functions performed by the PE. Between associated enterprises, on the other hand, as discussed in Part III, Section C, it may be possible to enter into arrangements whereby the capital necessary to support the risk resides in a different legal enterprise from the enterprise which performs the functions giving rise to the risks.<sup>8</sup> Aside from this issue, the guidance in

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<sup>8</sup> The efficacy of such arrangements would need to be evaluated following the guidance at paragraphs 1.48-1.49 of the Guidelines. In circumstances where the arrangements are recognised and the activities of the

Section D-2 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.

45. In reviewing transactions between a subsidiary and an associated non-resident enterprise it may sometimes be relevant to consider whether the subsidiary is acting as an agent for its non-resident associated enterprise and whether there is a so-called dependent agent PE as defined in Article 5(5). Dependent agent PEs are not generally an issue in traditional banking where, as indicated above, business is conducted either by a subsidiary or a branch PE rather than through an agent. The consequences of finding such a PE are therefore discussed in Sections B-6 and D-5 of Part I and Section D-3 of Part III, which discuss business situations where they are more likely to be encountered. The more likely “agency” issue in traditional banking is whether, on individual transactions, the PE or subsidiary is performing an agency or conduit function and this is discussed in Section D-2(iii).

#### **D. Applying the authorised OECD approach to banks operating through a PE**

46. This Section discusses how to apply the authorised OECD approach to a PE of a bank. The approach taken is first of all to introduce the basic principles before describing in Section D-1 how to hypothesise the banking PE as a separate and independent enterprise under the first step of the authorised OECD approach. Section D-2 discusses in detail how to apply the Guidelines by analogy to the hypothesised separate enterprise under the second step of the authorised OECD approach to specific situations commonly found in the banking sector.

##### **Basic principles used to attribute profits to a bank PE**

47. 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 separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise”. A PE is not the same as a subsidiary since 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 natural outcome, resulting from the decision to operate through a PE rather than a subsidiary. The following issues are of particular significance when applying the authorised OECD approach to bank PEs.

##### *Functional and factual analysis*

48. In the context of the authorised OECD approach the functional and factual analysis is used to delineate the PE as a hypothesised separate and independent enterprise. The functional and factual analysis will also take into account the assets used and risks assumed as a result of performing those functions. Of particular importance will be the determination of the key entrepreneurial risk-taking functions of the enterprise and the extent to which the PE undertakes those functions. This is because it is the performance of those functions that leads to the assumption of the greatest risks and the authorised OECD approach attributes economic ownership of the income-generating assets, *i.e.* the loans associated with those functions and risks, to the part of the enterprise which performs those functions. In short, the functional and factual analysis determines the attribution of profits to the PE in accordance with its

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enterprise performing the risk-taking functions create a dependent agent of the non-resident capital provider the guidance in Part III, Section D-3 would be relevant.

functions performed, assets used and risks assumed by the PE, and informs also the attribution of “free” capital and interest-bearing debt to the PE.<sup>9</sup>

49. The functional and factual analysis is of critical importance. In delineating the PE it is not sufficient to record loan assets in the books without consideration of where the key entrepreneurial risk-taking functions leading to their creation are performed. Nor is it sufficient in attributing profits to a PE to prepare symmetrically balanced books attributing profits in the books of the PE that correspond exactly to the values used in the books of the head office. Ideally, book entries will be consistent with, and follow from, the functional and factual analysis. Where this is in fact the case, the books provide a starting point for determining the profits attributable to the PE.

#### *Attribution of assets and risks*

50. Financial assets and related risks will be attributed to the PE in accordance with a functional and factual analysis of the banking enterprise of which the PE is a part 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 relate to:

- the creation of financial assets, typically loans;
- 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.<sup>10</sup> As noted in Part I, other assets and risks will be attributed to the PE in accordance with a functional and factual analysis that seeks to identify the significant people functions relevant to the economic ownership of assets and the significant people functions relevant to the assumption and/or management (subsequent to the transfer) of risks, except that the economic ownership of tangible assets will be attributed to their place of use in the absence of circumstances in a particular case that warrant a different view.

#### *Attribution of capital*

51. 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.

52. As discussed in Section B-4(v) the attribution of “free” capital can have a significant impact upon the amount of profit attributed to the PE. It is therefore important that the attribution of capital should be carried out in accordance with the arm’s length principle, to ensure that an appropriate amount of profits is attributed to the PE. 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.

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9 See paragraph 16 of Part I which describes the fact-specific nature of the significant people functions for a given business.

10 See paragraphs 18-20 and 73-74 of Part I which describe the consequences of attributing assets to a PE.

53. 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 is consistent with the arm's length principle. 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.

#### *Recognition of dealings*

54. 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. It follows that:

- save in exceptional circumstances, all parts of a banking enterprise 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 banking enterprise of which it is a part should generally 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 banking enterprise of which it is a part.

55. 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 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. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist and considering the uniqueness of this issue, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealing.

56. 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 independent enterprises acting at arm's length. Only once that threshold is passed can a dealing be reflected in the attribution of profits under Article 7(2). A functional and factual analysis will determine whether a real and identifiable event has occurred and should be taken into account as a dealing of economic significance between the PE and another part of the enterprise. Thus, for example, an accounting record and contemporaneous documentation showing a "dealing" that purports to transfer economically significant risks, responsibilities and benefits would provide a useful starting point for the purposes of attributing profits. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the authorised OECD approach. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that:

- the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving

in a commercially rational manner or, if they do so differ, the structure as presented in the taxpayer's documentation does not practically impede the tax administration from determining an appropriate transfer price; and

- the dealing presented in the taxpayer's documentation does not violate the principles of the authorised OECD approach by, for example, purporting to transfer risks in a way that segregates them from functions.

For guidance on economic substance see paragraphs 1.48-1.54 and 1.64-1.69 of the Guidelines by analogy.

57. It is important to note, however, that the authorised OECD approach is generally not intended to impose more burdensome documentation requirements in connection with intra-enterprise dealings than apply to transactions between associated enterprises. Moreover, as in the case of transfer pricing documentation under the Guidelines, the requirements should not be applied in such a way as to impose on taxpayers costs and burdens disproportionate to the circumstances.

58. Third, where dealings are capable of being recognised, they may reflect a transfer of assets and/or risks between the PE and other parts of the enterprise to which it belongs. As a consequence the characterisation and recognition of dealings will affect the attribution of risks, assets and therefore capital to the PE. Moreover, the dealings 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 functional and factual analysis.

59. 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.

#### *Attribution of profits*

60. The attribution of profits to a PE of a bank on an arm's length basis will follow from the calculation of the profits (or losses) from all its activities, including transactions with other unrelated enterprises, transactions with related enterprises (with direct application of the Guidelines), and dealings with other parts of the enterprise (under step 2 of the authorised OECD approach). This analysis involves the following two steps:

##### *Step One*

A functional and factual analysis, leading to:

- The attribution to the PE as appropriate of the rights and obligations arising out of transactions between the enterprise of which the PE is a part and separate enterprises;
- The identification of the key entrepreneurial risk-taking functions relevant to the economic ownership of financial assets and the assumption and/or management (subsequent to the transfer) of related risks, and the attribution of those assets and risks to the PE;
- The identification of significant people functions relevant to the attribution of economic ownership of other assets, and the attribution of economic ownership of those assets to the PE;

- The identification of significant people functions relevant to the assumption of other risks, and the attribution of those risks to the PE;
- The identification of other functions of the PE;
- The recognition and determination of the nature of those dealings between the PE and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test; and
- The attribution of capital based on the assets and risks attributed to the PE.

### *Step Two*

The pricing on an arm's length basis of recognised dealings through:

- The determination of comparability between the dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the PE; and
- Selecting and applying by analogy to the guidance in the Guidelines the most appropriate method to the circumstances of the case to arrive at an arm's length compensation for the dealings between the PE and the rest of the enterprise, taking into account the functions performed by and the assets and risks attributed to the PE.

The pricing on an arm's length basis of any transactions with associated enterprises attributed to the PE should follow the guidance in the Guidelines and is not discussed in this Report. The order of the listing of items within each of the steps above is not meant to be prescriptive, as the various items may be interrelated (*e.g.* risk is initially attributed to a PE as it performs the significant people functions relevant to the assumption of that risk but the recognition and characterisation of a subsequent dealing between the PE and another part of the enterprise that manages the risk may lead to a transfer of the risk and supporting capital to the other part of the enterprise). The resulting determination of the profits attributable to the PE reflects both its income and expense from recognised dealings in amounts equal to an arm's length compensation for the functions that the PE and the rest of the enterprise of which it is a part respectively perform, taking into account the assets and risks attributed to the PE and the other parts of the enterprise.

61. 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 principles outlined in the previous paragraph.

#### ***D-1 First step: determining the activities and conditions of the hypothesised separate and independent enterprise***

62. It is necessary under the first step of the authorised OECD approach to hypothesise the PE as a separate and independent enterprise "engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise". This entails the performance of a functional and factual analysis, conducted in accordance with the guidance found in the Guidelines, in order to appropriately hypothesise the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks (and liabilities, in particular free capital and interest-bearing debt) and entering into dealings with each other and transactions with other related and unrelated enterprises. As explained in Part I of this Report (see Sections B-3 and D-2) the functional and factual analysis performed in the first step must identify the economically significant activities and responsibilities undertaken by the PE. This analysis should, to the extent relevant, consider the PE's activities and responsibilities in the context of the

activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the PE. Ideally, book entries will be consistent with, and follow from, the functional and factual analysis. Where this is in fact the case, the books provide a starting point for determining the profits attributable to the PE. Section B provides a brief general overview 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. Of particular importance under the first step of the authorised OECD approach is the identification of the key entrepreneurial risk-taking functions for the business, since this affects the attribution of assets, risks and “free” capital and interest-bearing debt to the PE. As explained in Part I what is a significant function in one business will not necessarily be so in another business.<sup>11</sup> It is a matter of facts and circumstances.

63. Having identified the functions performed, risks assumed and other relevant factors of the enterprise in relation to traditional banking operations, and identified which of those functions are performed by the PE and which risks assumed by the PE, the authorised OECD approach is to attribute assets created as a result of performing those functions and assuming those risks. 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*

64. Section B-1 above describes the key entrepreneurial risk-taking functions and the ancillary or “back office” functions normally necessary both to create a new financial asset [loan] for the bank and/or subsequently to manage that asset. The creation of financial assets may often be a key entrepreneurial risk-taking function in a particular banking business, but it may not be the only significant people function. There may be other such functions that relate to non-financial assets, for example, the development of valuable trade intangibles such as certain IT systems or marketing intangibles. All functions have to receive an arm’s length remuneration. It can be seen that all of the functions, whether or not of a key entrepreneurial risk-taking nature, are performed by personnel: “people functions”. So the functional analysis should in the first instance determine which functions represent the key entrepreneurial risk-taking functions of the particular business, since it is these functions which attribute the economic ownership of financial assets and related risks to a particular part of the enterprise. Similarly, the analysis should determine which functions are the significant people functions relevant to the economic ownership of other assets and to the assumption and/or management (subsequent to the transfer) of other risks, as those functions will attribute those assets and risks to a particular part of the enterprise (except that tangible assets will be attributed to the place of use unless circumstances warrant a different view). In the second instance, the analysis should determine which of those key entrepreneurial risk-taking functions and significant people functions are performed by the PE by looking at whether the people performing those functions are located in the PE. It may also be necessary to determine whether some of the other 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 in Section D-3(iv)(d) of Part I of this Report. The application of the general guidance to the banking context is discussed in Section D-2 (ii)(g) below.

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11 See paragraph 16 of Part I on the fact-specific nature of the significant people functions for a given business.



65. 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 separate 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. Where, following evaluation, such arrangements are recognised, the capital needed to support the risks assumed would reside in a different legal entity from that in which the transactions giving rise to the risks are booked and it would be necessary to determine an arm’s length reward for providing the capital.<sup>12</sup>

66. 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 authorised OECD approach. Rather, as can be seen from later sub-sections, the authorised OECD approach uses a functional and factual 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.

67. As discussed in Section B-1, in a traditional banking business in wholesale commercial lending it is the sales/trading function and the risk management function that are generally the key entrepreneurial risk-taking functions, with the former responsible for the initial assumption of the risk, and the latter the ongoing management of the risks assumed. Tax issues arise particularly where the key entrepreneurial risk-taking functions involved in the creation and management of financial assets are, or appear to be, performed in more than one location, a “split function business”, *e.g.* where the loans originate in one location and are subsequently managed in another. In such cases, the functional and factual analysis would have to examine in detail the true nature of the functions performed by the originating part of the enterprise in order to determine whether they are key entrepreneurial risk-taking functions and hence whether that part of the enterprise is the sole or part “economic owner” of the asset under the first step of the authorised OECD approach. Factors to be taken into account in making the determination include the nature of the lending business (wholesale or retail, commercial or personal) and the importance of the sales/marketing function within that business. Whichever part of the enterprise is treated as the economic owner of the financial asset would then be required under the second step of the authorised OECD approach to deal with the other part of the enterprise as if it were a separate and independent enterprise. An arm’s length price for that dealing is determined by applying the Guidelines by analogy.

68. Also as noted in Section B-1, it should be stressed that in addition to the key entrepreneurial risk-taking functions, it will also be important to take account of other functions. Where the PE provides services to the part of the enterprise performing the key entrepreneurial risk-taking functions, that part is required under the second step of the authorised OECD approach to deal with the PE as if it were a separate and independent enterprise, *i.e.* by recognising an intra-entity dealing to compensate the service provider in accordance with the arm’s length principle. It should also be noted that there is no presumption that these other functions are by nature of low value. This will be determined by the functional and comparability analyses based on the particular facts and circumstances. A whole spectrum of rewards from performing these other functions can be expected.

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12 As further discussed in Part III (paragraph 154), if the relationship between the operating enterprise and the capital-providing enterprise were to create a dependent agent PE of the capital provider enterprise under Article 5(5), it would be necessary to consider whether any profits should be attributed to the dependent agent PE of the capital provider, after taking account of remuneration to be paid to the operating enterprise.

69. 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 found in Section D-3(iv)(b) of Part I. In terms of risks assumed in relation to financial assets, it is the performance of the key entrepreneurial risk-taking functions that leads to the assumption of the greatest risks (credit risk, operational risk and market risk). 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.

70. The authorised OECD approach is to attribute the financial assets based on where the key entrepreneurial risk-taking functions in respect of those assets described in Section B-1(iii) are 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. The profit attributed to the part of the enterprise attributed the asset will also take into account any dealings at arm’s length to reward other parts of the enterprise for functions performed in relation to that asset and the interest expense related to funding the asset, including any adjustment as a consequence of the “free” capital attributed to the PE.

71. 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 attribution 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 financial assets and risks may be booked in a location where none, or very few, of the key entrepreneurial risk-taking 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.

72. This is why the theoretical basis of the authorised OECD approach is that the assets and risks of the bank are attributed, for the purposes of Article 7, by reference to a functional and factual analysis, especially the identification of the key entrepreneurial risk-taking functions for financial assets. Following the aggregation principle of the Guidelines (see paragraph [3.9]) this analysis may be performed at the level of portfolios of similar assets and risks, rather than for each individual asset and risk.

73. Where the functional analysis has determined that the PE alone has performed the key entrepreneurial risk-taking functions, the PE will be attributed the economic ownership of the newly created financial assets and risks. Where the functional and factual 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 “free” capital). This determination is to be based on the functional and factual analysis.

74. In traditional banking activities it would often be possible from the functional and factual analysis to determine that the key entrepreneurial risk-taking functions leading to the creation of the financial 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 financial asset attributed to it and so be treated as the “economic owner” of the financial asset and be attributed 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 “economic owner” of the asset

and the locations performing the other functions. The dealings would be priced in accordance with the arm's length principle, using an appropriate OECD transfer pricing method under the second step of the authorised OECD approach.

75. In other cases, the functional analysis may show that the key entrepreneurial risk-taking functions leading to the creation of the financial 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.

76. The guidance in the Guidelines will be applied, by analogy, in order to determine the relative contribution of the key entrepreneurial risk-taking functions performed in the different parts of the enterprise. Again, following the aggregation principle of paragraph 3.9 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.

77. Events subsequent to the creation of the financial assets (*i.e.* the loans) may also affect the attribution of assets and risks within the enterprise. Subsequent transfers of the financial assets 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 Part I on the recognition of dealings and Section D-2(ii)(f) below on transfers of existing financial assets. 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(ii)(e) below), but only if part of the risk remains with the initial risk-taker.

78. As indicated in Part I, the profits (or losses) of the PE will be based on all its activities, including transactions with other unrelated enterprises, transactions with related enterprises, and dealings with other parts of the enterprise to which it belongs. Accordingly, as part of the functional and factual analysis carried out in step one, it will be necessary to attribute to the PE those rights and obligations of the enterprise of which it is a part which arise out of that enterprise's transactions with separate enterprises as are properly attributable to the PE. In effect, this involves identifying those of the enterprise's transactions with separate enterprises which should be hypothesised to have been entered into by the PE. This should become clear as a result of analysing the PE's functions in light of its assets used and risks assumed. The PE's profits (or losses) attributable to its participation in these transactions can be computed directly in the case of transactions with unrelated enterprises, or through direct application of the Guidelines under Article 9 in the case of transactions with related enterprises, in either case taking into account the effect of the PE's dealings with other parts of the same enterprise under step two of the authorised OECD approach.

*ii) Attributing creditworthiness to the PE*

79. 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.

80. 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-rated enterprise at 5.05%, making a profit of 0.10%.

81. Conversely, assume the branch is a legally separate and independent 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. (N.B. 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 41 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). 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.

82. 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. However, for the reasons set out in Part I, Section B-3(iv), paragraphs 30-31, and Section D-2(v), this proposal is not acceptable under the authorised OECD approach.

83. Under the authorised OECD approach the hypothesised separate enterprise should have the same creditworthiness as the bank as a whole, except in the exceptional circumstances referred to in Section B-4(ii) above. In such cases it will be necessary to determine the creditworthiness of the PE, for example by reference to independent enterprises in the host country 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*

84. Under the authorised OECD approach, 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 arising on 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 do not give rise to a return to investors in the nature of interest that is tax deductible under the rules of the host country (“free” capital). This section looks in detail at (a) attributing “free” capital and (b) attributing capital other than “free” capital.

a) Attributing “free” capital to the PE

85. 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 25, “free” capital refers to capital which does not give rise to a tax

deductible return in the nature of interest under the rules of the host country, 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 host country.

86. 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 host country will ordinarily not attempt to determine capital adequacy levels for the bank or, importantly, insist on separate minimum capital requirements for the PE.

87. Consequently, for regulatory purposes in both home and host countries, there is no need for any "free" capital to be formally allotted to the PE and so its operations (unlike those of the bank itself) may be wholly debt-funded.

88. 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 allotted to the PE for regulatory or other purposes.

#### *Stage 1 - measuring the risks attributed to the PE*

89. As noted in Section D-1(i), the authorised OECD approach uses a functional and factual analysis to attribute assets and risks to the PE and the same section also notes that when applying the authorised OECD approach, capital and risk are not segregated within a single legal entity. It follows that under the authorised OECD approach 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. The authorised OECD approach 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 19, the authorised OECD approach 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 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. Notwithstanding any differences in the two authorised OECD approaches to capitalisation and the safe harbour quasi thin capitalisation/regulatory minimum capital approach (discussed below), one thing they have in common is that they are not based on book value of assets, but require risks to be measured. Approaches which are based on book values only are not authorised OECD approaches.

90. 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 below, *i.e.* under the capital allocation, thin capitalisation or quasi thin capitalisation/regulatory minimum capital methods.

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 Basel Accord. There are differences in the possible regulatory based approaches depending on whether or not standardised measures are used for particular types of risk and 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.

91. The 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, and the Revised Framework also takes into account operational risk (see paragraph 35 above). 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.

92. 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, which is now incorporated in the Revised Framework, 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.

93. The June 2004 Basel II Framework, which is now also incorporated in the Revised Framework, also opens up the possibility of allowing approaches other than the "standardised (credit risk) approach" mandated by the 1988 version of the Accord to measure credit risk. In particular, it may be possible 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 under the Revised Framework to use either a standardised approach or the 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 (see paragraph 103 of Part III for a further discussion of operational risk).

94. In conclusion and subject to the next paragraph, the "standardised" approaches of risk-weighting assets under the latest version of the 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. Recent regulatory developments to maintain and improve the reliability of the standardised (credit risk) approach relative to the 1988 Basel Accord 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.

95. However, given the need for flexibility, it is suggested that a variety of regulatory based approaches to measure risks may be acceptable. When using banks' own risk measurement models care needs to be taken to ensure that they are consistent with the arm's length principle. They should be approved by the regulators and applied consistently. Sufficient details, for example, the assumptions underlying the bank's internal model, should be made available to both affected 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.

96. Moreover, it should be borne in mind that the authorised OECD approach measures risks in accordance with the arm's length principle, rather than following 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.

*Stage 2 - determining the "free" capital needed to support the risks attributed to the PE*

97. 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. The authorised OECD approaches to capital attribution are:

- 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 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.

An alternative safe harbour approach is

- quasi thin capitalisation/regulatory minimum capital approach, 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.

1. Capital allocation approaches

98. 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.

99. 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 attribute 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.

100. A number of issues arise when applying this approach. Since the capital allocation approach seeks to attribute the actual capital of the enterprise, in theory it distributes the benefits of synergy around the enterprise in a way that minimises the likelihood of double taxation. In practice, however, differences in definition of “capital” between home and host countries may result in the attribution of more or less than the total amount of capital of the enterprise.

101. Secondly, 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? This issue is discussed in general terms in Section D-2(v)(b)(2)(B)(1) of Part I and no special issues arise in connection with applying the general principles to traditional banking businesses.

102. There might also be instances where the PE conducts a very different type of business from the bank as a whole (*e.g.* a private banking part of a retail bank) or the market conditions in the PE’s country are very different from those applying to the rest of the bank (*e.g.* where the home country is a protected market such that all banks can operate there with very high levels of capital but where the host country is very competitive so that banks operate much closer to the regulatory minimum). In general, the focus of the authorised OECD approach 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.

103. 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).

104. General tax principles are based on respecting the separate legal entities within a MNE group. Those principles therefore suggest the authorised OECD approach 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 authorised OECD approach 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.<sup>13</sup>

105. 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, or how to deal with foreign exchange 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.

## 2. Economic capital allocation approach

106. 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 authorised OECD approach 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. Thin capitalisation approach

107. 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 country of the PE by undertaking a comparability analysis of such independent banking enterprises (*a thin capitalisation approach*).

108. The key to undertaking the comparability analysis is that the comparison is not just with 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 PE 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.

109. There are a number of factors relevant to the determination of an arm’s length amount of debt and “free capital” for PEs. These include in practice:

- the capital structure of the enterprise as a whole;

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13 See Part I, paragraphs 125 and 140-145 which provide guidance on how the authorised OECD approaches to the attribution of capital to a PE deal in general with the situation where the enterprise of which the PE is a part is thinly capitalised.

- 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; and
- the range of actual capital structures of independent host country banks carrying on the same or similar activities under the same or similar conditions (including the condition discussed in Sections B-3(iv) and D-2(v)(a) that generally the PE has the same creditworthiness as the enterprise as a whole to reflect the fact that independent host country banks generally operate with levels of “free” capital above the regulatory minimum).

As indicated in paragraphs 1.3 and 1.36 of the Guidelines, if there are material differences between the economically relevant characteristics of the PE and of the host country banks, reasonably accurate adjustments should be made to account for those differences so that the comparability standard is fulfilled.

110. In determining the assets and risks attributed to the PE under a thin or quasi thin capitalisation approach intra-entity balances are to be ignored, except to the extent that they are recognised as a valid economic dealing with another PE.

111. Like the quasi thin capitalisation/regulatory minimum capital approach discussed below, 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. Against that, under a thin capitalisation approach, it is possible for either more or less capital than the enterprise as a whole possesses to be attributed amongst its various parts.

#### 4. Safe harbour approach - Quasi thin capitalisation/regulatory minimum capital approach

112. Another possibility would be to require the PE to have at least the same minimum amount of “free” capital as the regulator in the host country would set for an independent banking enterprise operating in the host country (*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 country. 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.

113. The focus of the “quasi thin capitalisation/regulatory minimum capital” 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. This approach is not an authorised capital attribution approach as it ignores important internal conditions of the authorised OECD approach, *e.g.* that the PE generally has the same creditworthiness as the enterprise as a whole. However, it may be acceptable as a safe harbour as long as it does not result in the attribution of profits to the PE that are beyond the range of profits that would result if one of the authorised OECD approaches to capital attribution had been applied.<sup>14</sup>

114. 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 attributed to it) 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

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14 As explained in paragraph 115, in many cases the effect of a regulatory minimum capital approach would be that the host country taxes less than it would using a capital allocation or thin capitalisation approach.

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).

115. There are situations where there may be problems with this approach. The effect of attributing only the regulatory minimum for each of the countries 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 country 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 country were to relieve double taxation by reference to the full arm’s length amount of profit even though the host country has taxed less than that amount, as frequently occurs in the case of certain exemption systems.<sup>15</sup>

b) Attributing capital other than “free” capital to a PE – the determination of funding costs.

116. As explained in Section D-2(v)(b) of Part I, the authorised OECD approach acknowledges that the PE requires a certain amount of funding (made up of both “free” capital and interest-bearing debt). Once that amount has been determined, one of the authorised capital attribution approaches described in the preceding section is used to determine the amount of the funding that is made up of free capital. The balance of the funding requirement is therefore the amount by reference to which the interest deduction is calculated. Section D-2(v)(b) of Part I explains how to determine funding costs generally, but there is a feature of capital attribution which is peculiar to the banking sector and is discussed below, namely the fact that regulatory capital includes not just “free” capital, but also interest-bearing capital. As in Part I, the discussion is couched in terms of “debt” and “interest” but the comments below are applicable to any financial instrument and any funding costs, whether strictly classified as interest for tax purposes or not.

117. 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.

118. 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 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 host country of the PE. Similarly, 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.

119. The second would be only to attribute “free” capital under either of the authorised OECD approaches to capital attribution. 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 and Tier 2 to a PE (the “cleansed” BIS ratio approach described in the Annex). However, the capital other than “free” capital would be taken into

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15 See Part I, Section D-2(v)(b)(2) for a general discussion of safe harbour approaches to the attribution of capital.

account when determining the interest expense of the PE and/or the interest receipt of the part of the enterprise performing the treasury function. Although such matters are dealt with in general under the second step of the authorised OECD approach (see Section D-2(ii)(b)), it is convenient to deal with them here. There are different ways to address this issue, depending on the approach chosen for computing the interest rate on internal “interest” dealings.

120. Under some approaches 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.

121. Under other approaches, an adjustment would need to be made because the approach 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. It should be stressed that the goal of the approaches to attributing funding costs to a PE described above is the same, *i.e.* that the amount of interest expense (defined according to the classification rules of the host country) 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. Either treatment of capital other than “free” capital under the capital allocation approach or the thin capitalisation approach would be consistent with the authorised OECD approach.

c) Conclusion on attributing capital to the PE

122. 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 authorised OECD approach 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.

123. 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. As can be seen from the discussions above, there is no single approach which is capable of dealing with all circumstances.

124. Rather, the focus of the OECD work is on articulating the principles under which such an attribution of capital should be made and on providing guidance on applying those principles in practice and in a flexible and pragmatic manner. As such, whilst either of the authorised OECD approaches described in this section is capable of producing an arm’s length result, there may be particular situations where an authorised approach (and hence domestic rules based on that approach) does not produce an arm’s length result.

125. It is 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 2.11 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.

126. Where the two Contracting States have interpreted paragraph 2 of Article 7 differently and it is not possible to conclude that either interpretation is not in accordance with paragraph 2 of Article 7, it is important to ensure that any double taxation that would otherwise result from that difference will be eliminated. As explained in the Commentary on Article 7, paragraph 3 of Article 7, where applicable, will ensure that this result is achieved.

*iv) The authorised OECD approach for adjusting interest expense*

127. Once the amount of capital attributable to a PE has been determined in accordance with the preceding principles (*i.e.* an arm's length amount of capital), 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 host country, subject to Article 7.

128. It should be noted that the PE host country 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 host country 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 countries 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 country 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 D-2(v)(b)(5) of Part I and are equally applicable to banks. Section D-1(iii)(b) of this Part on attributing capital other than "free" capital may be relevant. Moreover, regard should be had to the discussion in Section D-2(ii)(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.

129. 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 country 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 amount of capital would be restricted by Article 7 to an arm's length amount.

130. Under the authorised OECD approach, 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. 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 Report. 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. A variation of this example is where the PE conducts one business line which creates off-balance sheet exposures significantly in excess of on-balance sheet assets created in a second business line. Here the "free" capital required to support the off-balance sheet assets

could conceivably exceed the funding requirements of the on-balance sheet business, with the consequence that the attribution of the “free” capital more than extinguishes the need for debt funding in the PE.

131. 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, including the assets of other business lines undertaken by the enterprise (see paragraph 38 above for a discussion of the constraints and opportunities for the deployment of the bank’s capital). Therefore, by analogy, the PE could also be attributed an income based on the likely investment of its capital. The return on such a hypothetical investment would depend upon the facts and circumstances. For example, it may be appropriate to impute a “loan” from the PE to the treasury location within the enterprise when the risks assumed in the PE are not identifiable with specific items outside the PE. This approach would have the effect of giving interest income to the PE. The amount of, and the rate of interest to be imputed to, such a loan would depend on the precise facts and circumstances. Attribution of profit other than by reference to an imputed loan may be appropriate in other circumstances, for example, if the off-balance sheet risks hedge or are hedged by specific assets situated elsewhere in the enterprise. Even in such a case, a functional and factual analysis would be required to determine the appropriate allocation of income with respect to such assets; the agency or conduit treatments would not necessarily apply. See *e.g.* Section D-2(iii).

132. 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 separate and independent 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.

133. 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 “treasury 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.

(v) *Recognition of dealings*

134. As noted in Part I, Section D-2(vi)(b) of the Report, the guidance at paragraphs 1.48-1.54 and paragraphs 1.64-1.69 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. The conclusion of Part I is that a dealing between different parts of the enterprise as documented by the enterprise will be recognised for purposes of attributing profits, provided 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, or a change in the conditions of use of the asset, the transfer of a financial asset, etc.)” that has transpired between them. Part I further concludes that, “A functional and factual analysis should be used to determine whether such an event should be taken into account as an internal dealing of economic significance” (paragraph 177).

135. The general principles set out in Part I are applicable to the recognition of dealings in traditional banking businesses. 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(ii)(g) below.

136. There are more problems when trying to apply principles 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. 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. A second complicating feature of banking business is that 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 D-2(ii) below for (e) risk management of an existing financial asset and (f) transfers of financial assets.

138. As discussed above, in the context of a PE it is not possible to rely on contractual arrangements in the same manner as can be done between legally separate enterprises and so instead the authorised OECD approach relies ultimately on the functional and factual analysis to determine where financial assets and risks are "economically owned". Financial assets and risks are only "economically owned" where they are booked if the key entrepreneurial risk-taking functions related to their creation have been performed there. The same principles also apply in relation to any dealings purporting to transfer "ownership" of financial assets to another part of the enterprise. 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. 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 paragraph 1.65 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).

139. 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 dealing is a transfer of "ownership" of the financial assets from one part of the enterprise to another, or whether the dealing is the provision of a service by one part of the enterprise to another, which is to be priced according to the arm's length principle. Again, 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 independent enterprises would structure the dealing in similar circumstances. These issues are dealt with in more detail later (see Section D-2(ii)(e) for risk management and transfers of risks and Section D-2(iii) where the transfer of the asset results from the performance of an agency or conduit function).

140. In summary, an accounting record and contemporaneous documentation showing a "dealing" that transfers economically significant risk, responsibilities and benefits would be a useful starting point for the purposes of attributing profits. Ultimately the authorised OECD approach relies on a functional and factual analysis to determine the economic reality behind any documented dealing relating to the attribution of

risk. This issue is discussed in more detail in Section D-2(ii)(e) and (f) dealing with risk management (including transfer of risk) and transfers of financial assets, and also at paragraph 56 above.

141. Once the above threshold has been passed and a dealing recognised as existing, the authorised OECD approach applies, by analogy, the guidance at paragraphs 1.48-1.54 and 1.64-1.69 of the Guidelines. The guidance is applied not to transactions but to the dealings between the PE and other parts of the enterprise. So the examination of a dealing should be based on the dealing actually undertaken by the PE and the other part of the enterprise as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapter II of the Guidelines. Except in the two circumstances outlined in paragraph 1.65, tax administrations should apply the guidance in paragraph 1.64 when attributing profit to a PE and so “should not disregard the actual dealings or substitute other dealings for them”.

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

142. As discussed in more detail in Part I, Section D-2 of this Report, the functional and factual analysis of the first step of the authorised OECD approach will have appropriately hypothesised the PE and the rest of the banking enterprise as associated enterprises, each undertaking functions, using assets and assuming risks. Under the first step financial assets will also have been attributed to the PE as the “economic owner” of those assets and their associated income which has the effect of rewarding the key entrepreneurial risk-taking functions leading to the creation and subsequent 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 banking enterprise. Moreover, in fully hypothesising the PE, it will have been necessary to identify and determine the nature of its internal “dealings” with the rest of the enterprise of which it is a part.

143. The second step of the authorised OECD approach goes on to apply, by analogy, the guidance in the Guidelines to any economic relationships (dealings) between the hypothesised separate enterprise and the rest of the banking enterprise. 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 taken into account in order to ensure that the PE in Country A is attributed an arm’s length profit. The authorised OECD 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.

144. General guidance on making such comparisons has been provided in Section D-3(iii) 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) 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 authorised OECD approach 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. For example, the traditional transaction methods may be examined to see if comparable uncontrolled transactions are available. In this context, the guidance at paragraphs 2.14, 2.23 and 2.41 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 2.14,

[A]n uncontrolled transaction is comparable to a controlled transaction ... if one of two conditions is met: a) 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, b) 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 1.39 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, though it is worth bearing in mind that financial instruments which were once exotic can quickly become commoditised.

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 the Guidelines contain guidance on the methods to be applied in such situations. 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 1.52 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 two 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 1.55 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 authorised OECD approach.

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 paragraph 3.9 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 authorised OECD approach to attribute profit to a bank PE, the next sub-section looks at some specific, and commonly occurring, situations in more detail.

ii) *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 price dealings between the part of the enterprise which performs the key entrepreneurial risk-taking functions and other parts of the enterprise performing other functions. 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(iii) below).

157. The first step of the authorised OECD approach will have determined which parts of the enterprise have undertaken the functions listed at paragraph 6 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 the amount of profit to be attributed to the PE. 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 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 authorised OECD approach 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 authorised OECD approach 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 is 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 6 above, although there may be many fewer situations where the sales and 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 authorised OECD approach to equate, for the purposes of the 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 authorised OECD approach 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 authorised OECD approach, 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-1(v)). 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 authorised OECD approach 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 two circumstances outlined in paragraph 1.65 of the Guidelines. The five comparability factors discussed in Section D-2(i) 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 basic operations. At the other extreme, where there is considerable integration of treasury functions, it may be that 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 cost contribution arrangement 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 30 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 authorised OECD approach, the function that results in the assumption or management (subsequent to a transfer) of the FX risks in respect of those assets would be attributed the profit for assuming or managing (subsequent to a transfer of) the FX risks and 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. 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(iv) 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(iii)). 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 Part I, Section D-2(v)(a), an issue arises as to whether dealings similar to guarantees should be hypothesised between the PE and head office. As discussed there, dealings similar to guarantee fees will not be imputed under the authorised OECD approach.

d) Sales/trading functions

171. In traditional banking activities it would often be possible from the functional and factual analysis to determine that the key entrepreneurial risk-taking functions leading to the creation of the asset were performed in only one location. In wholesale or commercial banking the function leading to the creation of the asset is likely to be the sales/trading function. In such cases, the economic ownership of the financial asset would be attributed to the sales/trading location together with the associated interest income and expense, as adjusted to take account of “free” capital. 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.<sup>16</sup>

172. This leaves the issue of how to price dealings with other parts of the enterprise performing aspects of the sales/trading function that are not determined to be key entrepreneurial risk-taking functions, and thus are not attributed the “economic ownership” of the financial assets and risks. The performance of such sales/trading functions will be characterised as dealings between the different parts of the same enterprise and comparisons will be sought with transactions between independents. All the methods approved in the Guidelines are available to make this determination. No particular theoretical difficulties are envisaged in making this determination.

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 authorised OECD approach, risks are initially assumed by reference to where the related functions are performed. In commercial or wholesale banking 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. In retail banking the marketing function may be the key entrepreneurial risk-taking function that leads to the initial assumption of all risks relating to the newly created financial assets. Those risks will subsequently be borne by the location that carried out the sales/trading function or the marketing function (as appropriate) associated with the creation of the financial asset, unless there is a dealing that could lead to another location assuming and bearing those risks. Following the authorised OECD approach, 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.

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16 See Section D-1(i), paragraphs 73-75 for a discussion of the issues.

174. The critical question is whether this dealing simply recognises the performance of a risk management service, 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 transaction 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 more appropriate.

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 recognising the performance of the risk monitoring function would not represent a transfer of the risks being monitored, but the provision of a service and would be priced accordingly.

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 Part III of this Report on risk management functions may be helpful in the context of evaluating the performance of risk management functions in a traditional banking business.

178. The profit attributed to the part of the enterprise performing 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-2(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 attribute profits to the part of the enterprise performing the 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 functional and factual analysis. First of all, it is worth noting under the general principles described in Section D-1(v) 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 and factual analysis should also look at the different levels of risk management within the bank. Under the authorised OECD approach, it would be the active 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 separate enterprises the enterprise to which the risks were transferred would 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 attributed 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. A more detailed discussion of this issue is found in Part III, Section D-2(ii)(c) and on credit risk in Part III, Section B-3(iii)(a).

182. The functional and factual 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 key entrepreneurial risk-taking 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 authorised OECD approach, it must be decided whether such a transfer should be recognised at all. As discussed in Part I of this Report, the authorised OECD approach 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 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 economic ownership of the financial asset. “Free” capital will also be moved from the location of the seller of the asset and attributed to the “acquirer” to support the risks associated with the transferred asset (see Section D-1(iii) above). It will also be necessary to recognise dealings between the new owner of the asset and other parts of the enterprise performing the other functions necessary to maintain the financial asset. These dealings will be priced, as already discussed, by applying the Guidelines by analogy.

g) Support, middle or back office<sup>17</sup>

187. A considerable support infrastructure is necessary in order to carry out a banking business. This covers 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. As explained in Part I of the Report the authorised OECD approach is to apply the guidance in the Guidelines, especially Chapters VII and VIII, to determine whether to recognise and how to price dealings in respect of the support functions performed in different parts of the enterprise. The same approach is taken to pricing support service dealings in a banking enterprise.

188. The application of the arm’s length principle will take account not only of the price applied to the service but also 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).

189. Where the head office or other part of a bank provides centralised services to a PE that are similar to those provided by an associated centralised service provider in an MNE group, similar techniques may be used as apply to associated enterprises. However, services provided by a head office or other part of an integrated enterprise may be different from those provided by the parent or centralised service provider of a MNE group. Accordingly, whilst similar techniques can be used as for associated enterprises, CUPS are more likely to be unavailable, so that cost plus methods are likely to be particularly relevant.

190. Between associated enterprises activities benefiting more than one enterprise are sometimes governed by cost contribution arrangements (CCAs). The guidance in Chapter VIII on determining whether a CCA between associated enterprises satisfies the arm’s length principle can be applied, by analogy, in the PE context. A CCA is, like any other transaction between associated enterprises, an arrangement containing rights and obligations designed to achieve a given economic goal for its members. Notwithstanding the fact that the PE is not a separate legal entity from the rest of the enterprise, the same economic goals can nonetheless be replicated as between a PE and the rest of the enterprise as a notional construct to assist in the attribution of profits to a PE. Given the absence of contracts between parts of the same enterprise, however, countries will wish the enterprise presenting certain activities as being the object of a notional CCA to meet a significant threshold in order to provide reliable evidence in support of its position. Therefore, countries may place the onus on the taxpayer to prepare and produce, where required, the type of contemporaneous documentation that would have been created to document an actual CCA structured in accordance with the Guidance of Chapter VIII of the Guidelines. Beyond the documentation of the notional CCA meant to reveal the intentions of the participants, a functional and factual analysis will

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17 The terms “middle” and “back office” are reproduced here as they are common terms used in describing the functions of banking operations. However as discussed in paragraph 13 above the authorised OECD approach rests upon a functional and factual analysis to determine the key entrepreneurial risk-taking and other functions, not on convenient labels.



be required that will determine the conduct of the participants and, thus, establish the true nature of the economic relationships between different parts of the enterprise. No particular issues of principle are considered to arise in a banking business.

191. 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.

*iii) Agency or conduit functions*

192. 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 ..... [The second branch] 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(ii)(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.

193. 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. As provided at paragraph 73 of the 1984 Report, 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."

194. The tax issues, and concerns of the tax authorities, have not changed significantly since the 1984 Report. Moreover, the authorised OECD approach 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.

195. 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 6 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 essential, 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.

196. 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).

197. 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.

198. 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 and Chapter III of the Guidelines should be of considerable assistance in this matter.

199. 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 and Chapter III 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 paragraphs 1.39-1.41 of the Guidelines and paragraph 147 of this Report), especially the size of the funds raised and the currency involved.

200. 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 paragraphs 1.55-1.58 of the Guidelines) is likely to be less important, as comparables are likely to be available in a similar market and under similar 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.

201. 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 III of the Guidelines (see above for factors to be taken into account).

202. 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 they are expressed in a different form. However, where it is not possible to apply the CUP method in a manner that is equally or more reliable than the other approved methods in the Guidelines, those other methods will need to be applied in order to resolve the issue.

## ANNEX - 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.* consisting of 4% ordinary share capital, 2% retained profits, 3% subordinated term debt and 1% 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 10% 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 authorised OECD approach this issue is of wider significance and is not confined to PEs.

4. A number of OECD member countries already apply a BIS ratio approach that uses BIS ratios to attribute only the “free” capital 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.* consisting of 4% ordinary share capital and 2% 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.

## **PART III: SPECIAL CONSIDERATIONS FOR APPLYING THE AUTHORISED OECD APPROACH TO PERMANENT ESTABLISHMENTS (PE) OF ENTERPRISES CARRYING ON GLOBAL TRADING OF FINANCIAL INSTRUMENTS**

### **A. Introduction**

1. Part I of this Report describes the principles of the authorised OECD approach and provides guidance on the practical application of these principles to attribute profits to PEs in general. However, it is also considered necessary to provide more specific and practical guidance on the application of the authorised OECD approach in commonly occurring factual situations. Part II of this Report examines the special considerations that need to be taken into account when applying the authorised OECD approach to attribute profit to a PE carrying on a traditional banking business, the borrowing and on-lending of money.

2. This Part of the Report (Part III) looks at the global trading of financial instruments (global trading), an activity that is commonly carried out by banks but also by financial institutions other than banks. Particular attention is paid to how the authorised OECD approach applies to a number of factual situations commonly found in enterprises carrying on a global trading business through a PE. The starting point for this analysis is naturally the 1998 OECD document: “The Taxation of Global Trading of Financial Instruments” (“Global Trading Report”).

3. However, there have been changes in global financial markets that affect the global trading of financial instruments since the publication of the Global Trading Report (for example increasing use of credit derivatives). More significantly, since 1998 there have been changes in thinking about the taxation of PEs and especially the application of the arm’s length principle of Article 7(2). This led to the development of the authorised OECD approach described in Part I of this Report. Further thinking has also been given to the application of the arm’s length principle of Article 9 and the guidance on that principle in the OECD Transfer Pricing Guidelines (“Guidelines”) to a global trading business conducted between associated enterprises. Particular attention has been paid to the application of the profit split method, the assumption of risk and the evaluation of the reward for provision of capital.

4. Part III of the Report is therefore intended to update the issues and situations described in the Global Trading Report and to provide guidance on the application of both Articles 7 and 9 to global trading. Section B describes the scope of Part III by providing a definition of global trading and goes on to provide a functional and factual analysis of a global trading business. Section C discusses the application of the Guidelines to a global trading business conducted between associated enterprises. Section D discusses how the authorised OECD approach applies to a PE of an enterprise carrying on a business of the global trading of financial instruments (“a global trading PE”).

5. Part III of the Report only discusses the issues related to transfer pricing in relation to associated enterprises and to the attribution of income and expenses within a single legal entity which arise when global trading of financial instruments is conducted in more than one jurisdiction. Other issues related to global trading businesses are not considered. For example, the issue of the source of income from financial products and the possible imposition of withholding tax to income from financial products is not

discussed.<sup>1</sup> Nor does Part III address the question of whether a PE exists in respect of a particular global trading activity, for example through a dependent agent. In particular Part III does not discuss the PE threshold under Article 5(5) so nothing in this Report shall be construed as altering or lowering the existing PE threshold. Rather the Report is concerned with providing guidance on how to attribute profits where a PE is found to exist under the existing rules and interpretations of Article 5(5) and (6). Thus, the key entrepreneurial risk-taking functions referred to in Part III are to be used solely in the determination of the proper profit or loss to be attributed to a PE and not in the determination of whether a PE exists. Part III also does not discuss transfer pricing or attribution issues in relation to other cross-border activities undertaken by financial institutions such as mergers and acquisitions, capital market advisory services, securitisation of financial assets or financial instruments, underwriting or funds management. It should be noted that under the authorised OECD approach, 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.

### **B. Definition, functional and factual analysis of an enterprise carrying on global trading**

6. This section starts by defining what is meant by global trading and what types of income arise as a result of global trading activities. It then goes on to describe the factual background of global trading, concentrating on the economic circumstances and business strategies before describing in general the various functions that make up global trading businesses. Such a functional and factual analysis is essential in order that the discussion of the transfer pricing and attribution of profit issues raised by the global trading of financial products later in this Report is soundly based on an accurate analysis of the current factual situation. Indeed, such an analysis is an essential preliminary step in applying the Guidelines to determine transfer pricing between associated enterprises and to attribute profit to a PE in accordance with the authorised OECD approach. Following the approach in Chapter I of the Guidelines, the analysis of functions performed takes into account the assets used and risks assumed in performing those functions.

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<sup>1</sup> Nor is the issue of withholding tax in respect of assets which the authorised OECD approach treats as being owned by more than one part of the enterprise.

## ***B-1 Definition of global trading of financial instruments***

7. In the financial sector, the term “global trading” has become the catch-all phrase that focuses on the capacity of financial institutions to execute customers’ orders in financial products in markets around the world and/or around the clock. This activity includes underwriting and distributing products on a world-wide basis, acting as a market-maker in physical securities (*i.e.* the traditional bond and equity markets) and in derivative instruments,<sup>2</sup> acting as a broker for client transactions on stock and commodities exchanges around the world, and developing new products to meet the needs of the financial institution’s clients, for example credit derivatives. The income earned by the financial institution from these activities consists of interest and dividends received with respect to the inventory it is required to maintain in order to be a market-maker with respect to physical securities, trading gains from sales of that inventory, income from notional principal contracts and other over-the-counter (OTC) derivatives entered into with clients, fee income from structuring transactions, gains from dealing in liabilities, income from stocklending and repo transactions, and brokers’ fees from exchange transactions executed for clients.

8. Enterprises that engage in global trading in this sense may also seek to make profit by correctly forecasting the movement in market variables (such as interest rates, exchange rates or prices) that affect the value of their portfolio. This involves the deliberate exposure of the portfolio to changes in the market variables and is sometimes referred to as taking a “proprietary position”. Some enterprises manage proprietary positions on a global or 24-hour basis but do not make markets. However, in this Report the term “global trading” refers primarily to those entities that engage in market making on a global or 24-hour basis, but may also refer to the dealing or brokering of financial instruments in customer transactions where some part of the business takes place in more than one jurisdiction.

9. Although the global trading entity typically has a presence in more than one of the three main time zones, the discussion in this paper focuses on the tax issues that arise whenever financial products are offered to customers in more than one jurisdiction (even within the same time zone). Such activities are at the heart of the global trading tax problem as they require the determination of transfer prices between associated enterprises or, in cases where permanent establishments are involved, the attribution of income and expenses within a single legal entity operating in different jurisdictions. In short, for the purpose of this Report, global trading of financial instruments is defined by reference to the fact that some part of the business takes place in more than one jurisdiction.

## ***B-2 Factual situation***

10. This section provides a descriptive background to global trading. It is in three parts. The first part describes the commercial environment in which global trading businesses operate. The second part describes the business strategies that enterprises engaged in global trading may adopt. The third part describes the various organisational structures that businesses conducting global trading may use.

### *i) Commercial environment*

11. It is difficult to make generalisations about the structure of a global trading business because the manner in which the business is conducted is influenced by a number of factors. These include a) the type

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2 A derivative instrument is a contractual right that derives its value from the value of something else, such as a debt security, equity, commodity or a specific index. The most common derivative instruments are forwards, futures, options and notional principal contracts such as swaps, caps, floors, collars and credit derivatives. Unlike traditional debt and equity securities, these instruments generally do not involve a return on an initial investment.

of institution conducting the trading, b) the product being traded and c) the technology available. These factors are discussed in turn below.

a) Institutions

12. Global trading now is conducted by many types of financial institutions, although the commercial and investment banks tend to dominate the marketplace. These entities have the resources to develop or hire the necessary trading expertise and the capital base necessary to engage in global trading. All institutions conducting global trading are subject to regulatory requirements, but these requirements will vary depending, amongst other things, on the type of institution involved. Regulatory authorities are concerned that financial firms under their control adequately evaluate their risk exposure and have sufficient long term capital to cover those risks.

13. The requirement for adequate capital has led to a variety of innovative structures which global trading firms have set up in order to give their clients confidence that they are sufficiently well endowed with capital to be able to assume and manage the risks arising from global trading. In order to participate in the over-the-counter (OTC) derivatives business:

- Some financial institutions that are not sufficiently creditworthy to engage in such transactions directly have established AAA-rated subsidiaries to act as market-makers in derivatives. Such entities may then enter into mirror transactions to transfer the market risk to the location where it can be managed most effectively, while maintaining the credit risk in the subsidiary.
- Other financial institutions have set up special-purpose derivatives subsidiaries, primarily to avoid certain regulatory requirements that would apply to the parent company. In that case, the risk is managed in the subsidiary rather than being passed on to the parent.

b) Products

14. It is now possible to buy almost any financial product, including most currencies, many debt instruments (particularly government securities), and some equities and commodities, at any hour of the night or day. To that extent, it is possible to say that almost all financial products are traded globally. However, the level of global trading in products varies widely, with the deepest world-wide markets found in certain currencies and derivative instruments and the markets for equities perhaps the most localised.

15. A financial institution acts as a dealer in derivative instruments by offering to enter into executory contracts with customers. In OTC derivative contracts, the “product” is created when the financial institution enters into the derivative contract with the end-user. The financial institution remains a party to the transaction until the transaction matures or the financial institution assigns its rights and obligations to a third party or enters into an agreement with the counterparty to terminate the transaction.

16. The financial institution may act only as a broker for a customer that wants to enter into exchange-traded derivatives contracts. In that case, the customer generally enters into the transaction with the broker that in turn contracts with the exchange or clearing house. Accordingly, whilst the broker may be called a “riskless principal”, it may in fact assume the customer credit risk, depending on whether a margin or other collateral is required from the customer to offset some or all of this credit risk. Since the broker does not assume the market risk, the financial institution does not have a “position” on its books from which it can earn trading profits, and the broker’s income from the transaction consists of the commission paid, usually in advance, by the institution’s customer.



c) Technology available

17. Technological advances allow managers, traders, marketers and operations personnel to track, price and measure the various types of risk resulting from thousands of trades occurring around the world on a “real time” basis. Financial intermediaries have invested enormous resources in developing systems that allow them to correlate risks and develop hedging strategies so that they can manage the risk they take on from their customers without subjecting the firms to unacceptable absolute levels of exposure to market changes.

ii) *Business strategy*

18. Differences in business strategies, even as among those institutions that market and trade derivative instruments, may affect where and how business is conducted (and therefore the analysis of the business for tax purposes).

19. Institutions may have different goals in terms of geographic coverage. Some choose to cover all possible markets and client bases, while others choose to concentrate on their traditional client base in their home country (and perhaps affiliates of those clients located in other countries).

20. Another difference is the extent to which institutions are willing to take on risk. For example, one institution may choose (or be required by regulators) to run its business conservatively, incurring little in the way of unhedged risks, and earning most of its income from the dealer “spread” between the bid and asked prices. Other institutions earn a significant portion of their income from taking unhedged, “proprietary” positions to generate significant trading gains. In general, regulators appear willing to allow securities dealers to incur a higher level of unhedged risks than they are willing to tolerate in the case of banks and insurance companies, which have obligations to retail depositors or policyholders.

21. Institutions also differ in their choices of instruments to market and trade. In some cases, the institution may believe that it will be more competitive if it develops a speciality, such as structuring OTC derivatives transactions to meet the individualised needs of the institution’s customers. This strategy, which has been followed by some of the best-known derivatives houses, employs a wide range of highly skilled, highly paid individuals and requires a large spread on each transaction in order to be profitable.

22. Other institutions that are market-makers aim to enter into a large number of fairly “plain vanilla” transactions. Although the profit on each transaction is reasonably low, there is also a relatively small level of risk<sup>3</sup> and they can count on earning a fairly steady profit from the sheer volume of transactions. Yet other institutions combine elements of both strategies.

23. Finally, other financial institutions do not view themselves as being primarily “market-makers”, but view their derivatives transactions as a necessary part of their business of being a full-service financial intermediary. Some of the products offered by such full-service financial intermediaries may be loss leaders or in loss making positions, in order to facilitate other business activities. In that case, a financial institution would normally hedge its customers’ positions and any profits would come from the institution’s ability to provide its customers with any of the basic products that a customer can expect.

24. Following financial market liberalisation, a number of financial institutions have developed business strategies based on creating integrated financial services companies. Banks and brokerage companies have merged; insurance and leasing companies are likely to or are in the process of integrating.

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3 It should be noted that significant risks can also arise in plain vanilla transactions as evidenced by the unexpected announcement in 2001 by the US Treasury that it would cease issuing 30-year bonds.

Further, financial institutions prohibited by regulators from directly carrying on certain types of business have sought ways of indirectly carrying on such business either by buying other financial services businesses or creating special purpose vehicles to carry on that business.

*iii) Business organisation*

25. Firms engaged in global trading can use a variety of legal structures and forms to carry out their business. Some trade exclusively through PEs, others through separate legal entities (which may act in their own right or as dependent agents of other entities), whilst others use a combination of PEs and separate legal entities. In this context, it should be noted that the aim of the authorised OECD approach is not to achieve equality of outcome between branch and subsidiary in terms of profits but rather to apply the same transfer pricing principles that apply to associated enterprises when attributing profits to a PE. There are generally economic differences between using a subsidiary and a PE. Application of the authorised OECD approach will not achieve equality of outcome between subsidiaries and PEs where there are economic differences between them. The legal form chosen, PE or subsidiary, may have economic effects that should be reflected in the determination of taxable profits. In many cases, businesses operate through permanent establishments rather than separate entities precisely because the PE structure provides for efficient capital utilisation, risk diversification, economies of scale, etc., making the structure more profitable.

26. In addition to a diversity of legal structures, there is an almost limitless number of different business structures that firms engaged in global trading can employ regardless of the legal structure adopted. However, most trading structures can be represented along a continuum, with what has become known as the “Integrated Trading” model at one end, the “Separate Enterprise Trading” model at the other, and the “Centralised Product Management” model in the middle. Typical characteristics of these trading models are described in this section. It should be noted that the models are defined only by reference to the organisation of the trading and risk management activities. The classification of a particular global trading business under one of the above models does not therefore mean that other activities, such as marketing and support, are organised in the same manner as the trading and risk management activities. Indeed, the business dynamic is towards de-centralisation of these functions so as to be geographically close to the customer. This should be borne in mind when conducting the functional analysis.

a) Integrated Trading

27. Integrated Trading has the following characteristics:

- Traders in each trading centre (generally London, New York and Tokyo or Hong Kong) set prices and trade off a portfolio of positions called a “book” while the market is open in that location. The book consists of individual market risks that have been aggregated on the basis that they are sufficiently similar to allow for internal set-offs and correlation, e.g. a Euro floating rate interest book (see paragraph 52 for further description).
- When the markets close in a particular location, responsibility for trading the “book” is passed to the next trading location where the open positions form the starting point for trading. Traders in the new location may close positions passed to them and open new ones. In addition to the “book passing” method described above, trading is increasingly being conducted in a more seamless manner, with traders in one location trading at the same time and from the same book as traders in another location. Where global trading is conducted between associated enterprises the change in trading authority is not accompanied by a change in legal ownership of the book, though depending on the facts and circumstances the second associated enterprise may create a

dependent agent PE of the legal owner of the book (see Section D-3 for a discussion of the consequences of finding a dependent agent PE).

- The location of the book does not indicate where the functions necessary to assume risk have taken place. Ordinarily, credit and market risks are initially assumed by the location that enters into the deal with the customer, although the market risks are combined in a portfolio of similar risks and subsequently managed on an ongoing basis by all the trading locations.
- Overall trading limits are generally set by a committee which may or may not also centrally manage the trading operations. There may be a head trader in each location (or a single head trader for the book) whose participation may vary with the circumstances. For example, at one end of the spectrum, a head trader could directly exercise discretionary authority to enter into specific transactions, or the head trade might only apportion aggregate risk limits among individual traders.

28. Many institutions trade foreign currency options (as opposed to spot and forward transactions) in this manner.

b) Centralised Product Management

29. Centralised Product Management has the following characteristics:

- All market risk of a particular product is centralised and managed in one location. For example, trading in gilts may be managed by the London branch and trading in US Treasuries managed by the US branch. The decision where to locate the centralised trading location depends on a range of commercial considerations, *e.g.* market liquidity, ease of hedging, competition, business strategy, location of customers and skilled staff. Consequently, the location of the centralised trading location can change over time as the commercial factors themselves change.
- The financial institution will rely on marketing operations in its other trading centres but will require the marketing location (referred to below as the originating office) to transfer responsibility for managing the market risk to the centralised trading location (“back-to-back transactions”). This is achieved by either:
  - Booking the transaction directly in the centralised trading location. Under this booking practice, credit risk in addition to market risk will be reported in the centralised trading location, or,
  - Having the marketing location reverse the transaction with a trader in the centralised trading location through an inter-branch (or inter-company) transaction (“back-to-back transactions”), thus transferring responsibility for managing the market risk to that location. Under this booking practice, credit risk will still be reported in the originating office. However, the marketing location may still be exposed to market risk for the period between the transaction being entered into and the transaction being reversed out, for example if this is not done until the end of the trading day. It should be noted that with the increasing centralisation of back office functions to reduce operating costs, the general trend is moving towards the elimination of back-to-back transactions.

30. The centralised trading location may or may not be where the natural home<sup>4</sup> or primary market is located.

31. Physical securities appear to be most often traded under a centralised product management approach. However, this structure is also used for other products, including derivatives.

c) Separate Enterprise Trading

32. Separate Enterprise Trading has the following characteristics:

- Each trading location, whether in a subsidiary or PE form, operates as if it were a separate profit centre, with its own marketers and traders, and its own books that reflect products sold by that location.
- Different locations may pursue different trading strategies, and in fact may enter into trades with other trading locations. For example, different PEs of a bank may end up with opposite positions as a result of customer transactions and may seek to close such positions by transactions with other parts of the same legal entity.
- Ordinarily, the assumption of credit risk and market risk takes place in the PE as well as the subsequent management of those risks.
- A central committee sets overall trading limits for each location but does not control trading that is within the prescribed limits.

33. Many banks organise their trading in spot and forward transactions of the most heavily traded currencies on a separate enterprise basis.

d) Dynamic and flexible nature of global trading

34. A bank may use a combination of the models described above for different parts of its operations. For instance, its foreign exchange book may be based on a separate enterprise approach while its trading in physical securities may be based on a centralised product management approach.

35. Also, it is important to emphasise that while these trading models are a convenient means of describing how trading activities can be carried out in different ways, the organisation of the trading activities of a given enterprise may not fall neatly within any of the models. For example, trading authority may be neither completely transferred to one particular location nor located in only one jurisdiction. Thus, there could be close co-operation between the head office and the PE in making trading decisions or the primary responsibility for the performance of the book may be located in one jurisdiction, with limited authority to trade the book passed to another jurisdiction. In the latter case, the head of trading may still have to be consulted by traders in another location if major decisions have to be taken or trades executed over a pre-set limit - even if it means he or she has to be woken up in the middle of the night.

36. Moreover, the way in which a product is traded may change over time. A financial institution may find that it must grant limited trading authority for the product to traders located outside the original centralised trading location in order to satisfy customer demand during non-business hours in the centralised trading location. In practice, the other trading location may often begin by fulfilling a

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<sup>4</sup> Some products, such as government securities, may have a primary trading market - sometimes called a "natural home" - where the bulk of trading in that product occurs.

“nightwatch” function. This is very limited as compared to normal trading and may simply involve monitoring the markets for major events during their trading hours. If such an event occurred, they would not adjust the firm’s position themselves but would be under instructions to wake up the head trader in the centralised location. In some firms the “nightwatch” function may also encompass some trading activities. However, these would usually occur only within very strict pre-set limits or would be restricted to the fulfilment of overnight orders requested by the main trading location. As the amount of trading discretion given to such traders increases, the centralised product management model begins edging toward an integrated trading model.

37. As another example of the way in which global trading activities can change over time, a financial institution may find that the separate enterprise trading model is not the most efficient method for trading a particular product. To reduce costs, it may seek to centralise - or regionalise - some of the trading and risk management operations, moving towards the centralised product management model.

38. In conclusion, although the models described in this section may be a useful analytical tool to assist in the general understanding of global trading, their relevance should not be overstated. In particular, any transfer pricing analysis should proceed as always from the facts and circumstances of the individual taxpayer and should consider the exact functions being performed, assets used and risks assumed, rather than attempt to determine which model the organisation of the trading/risk management functions most closely resembles.

### ***B-3 Functional analysis***

39. This section describes in more detail the important functions of global trading businesses starting with the functions performed by the personnel of the firm - “people functions” - and then moving on to consider the assets used and risks assumed in the performance of each of those functions.

#### *i) Functions performed*

##### **a) Sales and marketing functions**

40. In general, the sales and marketing personnel are responsible for all contacts with customers. Usually, such staff are assigned to a particular geographic area and, within that area, may specialise in clients in a particular industry. Such specialisation allows them to learn about industry-wide problems that may be addressed through the use of particular financial instruments. The organisation of the sales and marketing personnel is determined primarily by the need to be accessible to the firm’s clients and so is largely independent of the structure of the trading models described in Section B-2(iii) above. Indeed, in contrast to the trading function, the business dynamic is towards a de-centralisation of the sales and marketing function.

41. Sales and marketing personnel are distinguished from traders as, normally, they are not allowed to price or trade in a product independently. On the other hand, some marketers may have a role in trading with customers and so perform some aspects of the sales/trading functions described in Part II, although their role may be limited because the final responsibility for pricing and accepting the trade rests with the trader. Both sales and marketing personnel have the responsibility of ensuring that the product sold to the client meets the client’s needs.

42. There are a number of sales and marketing functions that are common to all types of global trading although different financial institutions address the implementation of these functions in different ways. Generally, the approach adopted by any one institution will reflect the institution’s overall business strategy. There is therefore a spectrum and where on that spectrum the activities and value of the sales and

marketing functions fall will be dependent on the particular facts and circumstances. The important question that must be asked is what function the relevant staff perform rather than what is their title.

43. Some types of global trading may require only a basic sales function which consists of little more than introducing the trade. This may be all that is required for those institutions that treat derivatives as just another of the basic financial products they offer their customers and those institutions may largely rely only on their general sales staff to carry out this function. Other staff have greater access to the client base and therefore perform a function of greater value to the institution. Such functions do not normally lead to the assumption of significant risk for the location carrying out the basic sales function.

44. In many instances, on the other hand, a much more sophisticated function is required that involves structuring a product to meet the needs of the client and negotiating the terms with the client. For example, those institutions whose strategy is to earn a fairly large spread on a few, highly customised derivatives transactions generally maintain a dedicated sales force, the members of which are very familiar with the products. In many cases, these marketers understand the rudiments of pricing and hedging and can work with the traders to develop new products. Product development may also involve significant cross-functional integration (sales/marketers, traders/risk managers, system development, etc.).

45. In this Report, the term “marketers” refers only to the dedicated sales staff (and not to the general sales personnel) and the term “marketing/dealing” refers to the function that includes liaising with traders, negotiating the terms of the deal and involvement in structuring a product to meet the client’s requirements. The “marketing/dealing” function includes some elements similar to those typically included in the “sales/trading” function described in Part II, whilst the general sales personnel would normally perform functions similar to the sales/support and sales/marketing functions described in Part II. However, a key difference is that in global trading businesses it is the traders, rather than the marketers, that normally undertake functions leading to the assumption of market risk, though marketer/dealers, *i.e.* those who are integrally involved in tailoring a product to the needs of particular customers, may assume market risk (see paragraphs 125-127 for more details on the range of marketing functions and range of suitable rewards).

46. Usually, the marketer is responsible for “running” the deal, including ensuring that the transaction receives all necessary clearances within the financial institution and closing the deal with the customer with the result that this function generally gives rise to the assumption of credit risk. Clearances may be required from the tax, regulatory and compliance departments, as well as from the credit department. New structures may require extensive consultations with the risk management department to ensure that it is possible to hedge the transaction in a cost-effective way.

47. Although the trader determines the price at which he is willing to take a deal onto his book, the marketer is frequently responsible for negotiating the price with the client based on the parameters set by the trader because the trader often does not deal directly with the customer. Accordingly, in the initial stages of negotiating a specific transaction, the marketer obtains an indicative price from the trader or traders who ultimately will price the transaction. As negotiations with the client progress, the marketer will obtain the final price from the trader; the marketer must then execute the transaction at that price or better, thereby creating a “dealer spread” for the financial institution (see paragraph 132).

48. The extent of the mark-up over the trader’s “final price” depends in large part on the sophistication of the client. One of the marketer’s most significant contributions is determining the price that a client will be willing to pay. It is reasonably clear that there is not one single market price at the retail level at any particular time. The price prevailing in the wholesale market often (but not always) is more consistent. Accordingly, the role of marketers in the wholesale market is much more limited. Some institutions committed to market-making dedicate one or more marketers to handle the entire wholesale

market while other institutions do not use marketers in their wholesale business, but allow the traders to speak directly to the other institution.

b) Trading and day-to-day risk management function

49. In this Report the term “trader” or “trading” is used to denote both the initial assumption of risk (sometimes called dealing or market-making function) and the subsequent management of risk (hedging or risk management function). Whilst these functions are discussed separately in this Report to assist in the functional analysis, it would be misleading to distinguish too sharply between the two functions as a general description of business practice. This is because, given the diversity of financial products on the market, and the diversity of business models for trading in these products, it is not sensible to make any sweeping statements. The dealing or market-making functions and the day-to-day risk management functions described in this section may be carried out by the same person. Or they may be performed by different people in different parts of the global trading business, either through institutional choice or because a functional separation between trading and risk management is imposed by the regulatory authorities.

50. Where the initial assumption of risk is performed in a different place from the ongoing management of risk the two functions may still be integrated to a greater or lesser extent, depending on such factors as business organisation and the nature of the traded product. Different products require different amounts of continuing effort to manage the ongoing risk. For example, the risk profile of a simple forward contract is far less complicated, and thus ordinarily may be more easily managed, than the risk profile of an option contract. And some financial products are so complex that it is not possible to fully manage the risks assumed when the contract is written. Moreover, the price quoted by the trader in writing the contract must take into account assumptions about the firm’s ability to manage the resulting risk. It may therefore be difficult in practice to segregate the risk assumption from the risk management function and the Report uses the term “trader” or “trading” to cover both. However, as always, the important thing is not the labels attached to certain employees, but the functions actually performed.

51. While marketers are involved in only the dealing aspect of the business, traders may be involved in all these activities. Traders may both provide marketers with indicative and final prices at which transactions will be entered into with customers and may additionally be responsible for the management of the market risk that arises from those transactions once they are entered on the institution’s books. Traders and risk managers are not usually responsible for managing credit risk and so unless otherwise stated all references to risk in this section are to market risk. (Section B-3(iii) describes the types of risk typically incurred in a global trading business). Traders may be given the opportunity to earn trading profits by running unhedged positions that may result in substantial gain (or loss), while keeping the ultimate risk incurred by the institution within risk limits that are set by the institution’s management. A trader can perform those functions only if the risks incurred by the financial institution are organised into trading portfolios (or “books”) of similar risks. For example, a trader responsible for US dollar risks should not have Swedish Kroner liabilities included in his trading book. The Swedish Kroner risks must be allocated to the trader who is responsible for Swedish Kroner risks.

52. This process is fairly straightforward in the case of physical securities. For example, one trader may be responsible for European equities, which may further be broken down into baskets of equities relating to high tech industries, transportation industries, etc. Similarly, in the case of commodities, one trader may be responsible for precious metals and another for oil, or the responsibilities may be further broken down into gold, silver and platinum on the one hand and West Texas crude and North Sea oil on the other. However, in either case, once the books are established, it is fairly easy to assign securities and commodities to the appropriate book.

53. The process is somewhat more complicated in the case of derivative instruments, largely because the cash flows in such instruments are not necessarily limited to a single type of risk. Therefore, in order to manage the risks arising from a transaction, the transaction may be “unbundled” into separate risk components so that they can be assigned to the appropriate trading books.

54. In this process, the risk from a single transaction may be assigned to several different books. For example, a financial institution may purchase a Euro-denominated note paying 5%, the principal amount of which is tied to the performance of the German stock market index, DAX. This note involves fixed-income risk (the risk that Euro interest rates will go up, reducing the value of the note), equity risk (the risk that the value of the DAX will decrease) and, depending on the institution’s functional currency, possibly currency risk. These risks must be allocated to the appropriate books, usually by entering into inter-desk transactions negotiated by the trader. Accordingly, a sophisticated derivatives operation may require numerous inter-desk (and inter-branch) transactions simply in order to assign risks to the appropriate trading book.

55. Once the risks are entered into the appropriate books, it is the responsibility of the traders to maximise the financial institution’s expected profit on the transaction by managing the risk assumed, subject to the level of market risk that a financial institution is prepared to take. From the time the transaction has been entered into, throughout the life of the transaction, the trader must decide whether and when to enhance or hedge the aggregate market exposure arising from a transaction, depending on the chosen amount of market risk exposure. Ordinarily, this will be done after netting the risk from the transaction against all the other open risk positions in the book and then hedging some or all of the aggregate market exposure of the book, in accordance with the business strategies of the particular financial institution regarding the exposure to market risk (see paragraph 20). In cases where the market risk created by the customer positions is below the trader’s chosen exposure the trader may enter into transactions to increase the risk.

56. A trader may decide to take a view on prospective market movements by leaving the residual risk in the portfolio unhedged, or may attempt to lock in the existing profits in his book by “hedging down” at the end of the trading day. The residual risk is likely to be hedged either in the over-the-counter market or through purchase of exchange-traded instruments. In any case, however, this process of hedging the residual risk (known as “net” or “portfolio” hedging) generally means that it is difficult to identify particular transactions as “hedges” of other transactions.

57. The trader’s discretion is limited to a greater or lesser degree by the market risk limits that are imposed by all well-run financial institutions and the level of control depends upon choice of business model and the nature of the financial products being traded. At one extreme there may be a highly detailed master hedging strategy the implementation of which may be relatively straightforward. An analysis of how such an approach works in a given case may show that the master strategy intrudes directly on the day-to-day risk management function. Other master hedging strategies, where they exist, may be less intrusive. A highly intrusive master hedging strategy may be more suitable for some products than for others. For example, it may be more likely to be found in a forex book, say, than an equities book. In either event, a financial institution will usually measure several different aspects of risk in order to establish limits on the amount of market risk to which the institution can be exposed. The amount of risk is measured by reference to the effect on trading revenues of a specified hypothetical “extreme” move in market rates.

58. Most financial institutions with a significant trading presence calculate market risk exposure on at least a daily basis. The calculation of the amount of a financial institution’s market risk exposure is generally verified by an administrative group separate from the trading function as it is an important control on the trading business.



59. Depending on the financial institution, there may be a single, institution-wide limit relating to a particular risk. Frequently, the overall limit is subdivided into separate limits that are applicable to particular trading books or to individual traders. The level of risk that a financial institution is willing to incur is one of the most important indications of the institution's overall business strategy.

c) Treasury

60. The treasury function is the function that is most similar to the general trading activities of a financial institution and has been discussed for banks in Part II of the Report. The treasury book traders are responsible for ensuring that the financial institution has sufficient funds to meet its payment obligations but does not have excess cash that is not being used profitably.

61. The task of the treasury book traders is complicated by the fact that the funding needs of the business fluctuate a great deal. This volatility results in part from the use of exchange-traded contracts and securities to hedge OTC positions. In that case, the funding needs of a particular book (and therefore the business) will depend on whether the exchange-traded or the OTC contracts are in the money. If the book has losses on the exchange-traded contracts and gains on the OTC contracts, its funding needs will be greater than in the opposite case because the institution will be required to meet margin calls with respect to the exchange-traded contracts that it would not be required to make if the losses were with respect to the OTC contracts. Thus, the funding needs of the book are not necessarily related to its overall profitability.

62. Many institutions now view the treasury function as a separate profit centre and hire traders for the specific purpose of managing the institution's funding costs. In that case, the treasury desk traders share in the bonus pool on the basis of the "profits" of the book, measured by the difference between the institution's outside funding costs and the "interest" and other "income" or "expense" arising from transactions with other trading books.

63. Inter-desk interest is notionally earned by the treasury book which functions as a clearinghouse in matching cash needs of certain trading books with the excess cash generated by other trading books. The treasury book trader is responsible for entering into any foreign exchange transactions necessary to convert a surplus run by one book into a form that can be used to cover a deficit in another book. Net deficits (which may be denominated in any currency in which the institution trades) must be met through external borrowings, while net surpluses generally are placed with banks overnight.

64. Other "income" and "expense" arise from the treasury desk's internal hedging transactions. Although the institution may borrow in a range of maturities and a number of currencies, the treasury desk traders generally are more comfortable managing short-term risk in the institution's functional currency. Accordingly, the treasury desk trader generally will enter into a number of transactions with the other trading books that are intended to convert long-term interest rate or currency risk into short-term risks. For example, if a German bank issues long-term dollar-denominated debt, the treasury book trader is likely to enter into a currency swap with the bank's dollar book to convert the risk into floating rate Euro-denominated debt (floating rate debt presents "short-term" risk because the rate generally is set quarterly at the beginning of the accrual period).

65. The treasury desk generally is permitted to enter into hedging transactions with other entities. However, it usually is encouraged by management to enter into transactions with the institution's trading desks in order to maximise net hedging within the institution, thus lowering overall hedging costs.

d) Support, back office, middle office

66. The marketers and traders, who generally are identified as "front office", rely on a number of other departments within the financial institution. In some MNEs, there is an Advisory Group that

provides advice with respect to business, legal, accounting and tax treatment of products being developed by the marketing team. Although their functions traditionally have been categorised as “back office” functions, many institutions now designate some of the departments, particularly credit, accounting and product control, research and intangibles development, as “middle office” functions in recognition of their increased importance in the context of global trading. In other institutions the research department may interact very closely with the traders and risk managers and so be very much part of the direct profit-earning process of the “front office”.

67. The business dynamic for most support functions is towards centralisation in order to reduce costs, especially where they are capable of being performed without the direct involvement of front office staff. Even in the centralised product management model where the trading and risk management function is centralised, the back office functions may be centralised in a different location to take advantage of lower local costs. It should be borne in mind, however, that although the terms “back”, “middle” and “front office” are commonly used in describing the functions of a global trading enterprise, there is nothing in the authorised OECD approach that requires attention to be given to such distinctions. The authorised OECD approach rather is concerned with determining the key entrepreneurial risk-taking functions and valuing those functions without regard to the label given to the function or activity, but based on a functional and factual analysis. The key entrepreneurial risk-taking functions are discussed in more detail in Section D-1. Whether a particular activity is a key entrepreneurial risk-taking function will depend on the facts and circumstances of the particular business. The functional and factual analysis will determine whether the activity is a key entrepreneurial risk-taking function or a support function. Functions other than key entrepreneurial risk-taking functions still need to be taken into account, but economic ownership of financial assets is not attributed to such functions.

### **Systems development**

68. Information technology and communications systems are also critical to the proper functioning of a global trading operation. Some may therefore themselves constitute valuable intangible assets, while others may have no additional intangible value independent of the technology and communications services they provide. The valuation of products, the development of new products, the processing and settlement of trades, the real-time global risk management of the portfolio, the management of credit and corporate accounting and reporting are all dependent on the availability of sophisticated computer-based systems. In many cases, financial institutions maintain a large staff of computer specialists to develop proprietary systems to link these different functions. Section D-2(iii)(c) in Part I provides general guidance on how to attribute ownership of internally developed assets and there seem to be no specific issues in relation to the use of intangibles in a global trading operation.

69. In the past, most pricing models were variations of the Black-Scholes option-pricing model or straightforward applications of forward pricing. These basic models frequently were subject to modifications suggested by the traders. Over time, the model itself became proprietary and was viewed as a substantial factor in the institution’s success. Presently, the most widely used measure of market risk a financial institution may use is based on “value at risk” (“VAR”) models. A VAR-type calculation allows a financial institution to measure the maximum amount it would lose over a particular time period at a certain level of probability. Such internal VAR models are increasingly being endorsed by regulators as an acceptable means of measuring market risk for regulatory purposes.

### **Credit**

70. The credit department’s primary responsibility is to analyse new customers and establish appropriate credit limits, monitor the credit exposure throughout the life of a particular transaction and review the total credit exposure compared to the established credit limit with a particular focus on portfolio concentration risk. Many institutions have a centralised credit division that monitors the total credit risk from all of the institution’s dealings with a particular counterparty (including lending transactions) and sets

a global exposure. Counterparty risk in this context may not simply mean credit exposure to a single legal entity, but may represent credit exposure to various members of an MNE group. In many cases, the global credit risk exposure to an MNE group may be determined on a net basis.<sup>5</sup> A great deal of effort is involved in establishing, reviewing and monitoring the global credit exposure, as various business units around the world enter into transactions and use up the exposure limit. The setting and monitoring of the institution-wide limits may be on a product basis as well as on a customer basis. It involves a thorough analysis of the products offered and the particular client. The work may be conducted at the head office level or at the particular PE that services the headquarters of the particular client.

71. Recent evolution has shown an increase in the collateralisation of credit risk exposures, through margining and the use of credit support techniques. The standard swap documentation of the International Swap and Derivatives Association (“ISDA”) includes standard credit support annexes which counterparties can use to minimise their credit risk exposure to each other in respect of transactions executed under the master agreement. In some swap transactions, there is the right of offset, which reduces somewhat the credit risk exposure. The right of offset permits one counterparty to offset amounts receivable from another counterparty with amounts owed to that counterparty such that only net amounts are paid or received. Credit risk exposure is also being minimised on exchange-traded products, through the use of a central clearing house as counterparty. Delivery versus payment (“dvp”) settlement is becoming more common for physical securities and currencies.

72. Credit limits imposed by regulators or by the institution’s directors may limit the ability of the institution to write new business. In that case, the credit department and marketers may suggest terminating some existing transactions with the counterparty in order to enter into new transactions. As credit limits have become more of a problem, some institutions have decided to dedicate traders to “credit risk management” to eliminate those transactions with a relatively lower profit (*i.e.* those with the smallest spread) to allow the institution to enter into other transactions with the counterparty where the profit margin may be higher. Some institutions use credit derivatives to effectively manage and reduce credit risk.

### **Strategic risk management functions**

73. It may also be necessary to consider other “people” functions related to the strategic responsibilities for the allocation of capital and risk within the financial institution (“strategic risk management functions”). Financial institutions do not have an unlimited ability to assume risks. Both the regulatory authorities and the senior management of the firm will be anxious to ensure that the financial institution remains financially sound by having enough capital available to cover the risks it has assumed. The regulatory authority will require that the institution has sufficient regulatory capital available to ensure that any potential losses from the risks assumed would not lead to the bankruptcy of the institution.

74. As part of their duty to the shareholders of the financial institution, senior management will share the goal of the regulators but will also be concerned with maximising the return on the capital raised by the institution. Conventional finance theory suggests that the larger the risk to which an asset is exposed, the larger the expected profit should be. In order to attempt to make more profits, more risks would have to be assumed and more capital would be needed. It should be noted that, theoretically, the assumption of greater risk should increase the *expected* profits. As can be seen from recent experience, the assuming of more risks can lead to the realisation of *actual* losses, rather than the *expected* profits.

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5 That is, aggregate transactions by MNE group members with enterprises within the MNE financial institution which reduce its credit risk exposure to the MNE group will be deducted from aggregate transactions by MNE group members with enterprises within the MNE financial institution which increase its credit risk exposure to the MNE group. Note that a valid netting agreement needs to be in place if aggregation of transactions is to reduce credit risk exposure.

75. The goals of the regulator and the shareholders may not exactly coincide but both create a demand for a scarce resource, the capital of the financial institution. The senior management will therefore need to make the most efficient use of the capital of the institution and to meet the requirements of both the regulator and the shareholders. Capital is therefore allocated to particular business areas and within those business areas to particular products and within the particular products to particular locations and so on. The way this is done is usually in the form of “risk limits”. For credit risk, the risk is allocated right down to the level of the individual customer or, if appropriate netting arrangements are in place, to the level of the MNE group and for market risk the allocation is made right down to the level of the individual trader who makes the day-to-day decision to take on risk. This allocation of risk limits, and the associated capital, has a profound effect on the ability to earn trading profits, or indeed to realise trading losses. For example, if location A has a lower overall market risk limit for a particular product than location B, this would restrict the amount of unhedged trading risk location A could assume and so thereby limit the potential for earning trading profits, or indeed realising trading losses, as compared to location B.

76. It is sometimes argued that the role of senior management in setting overall limits that are passed down through particular business lines, products, individual customers, etc. is so critical to the success of the business that they should be regarded as performing the key entrepreneurial risk-taking functions. However, since overall limits are changed infrequently and the impact of any changes to the overall limit is indirect (since limits do not need to be utilised and regulators generally do not view capital as being placed at risk until the enterprise is contractually committed to particular transactions) the mere setting of the overall limit of itself and with little further active involvement in the managing of risk would not generally be considered a key entrepreneurial risk-taking function. This is because where senior management activity is confined merely to setting the parameters which define the potential for the assumption of risk, there is likely to be a separate trading function which does lead to the actual assumption and subsequent management of risk. Under the authorised OECD approach economic ownership of financial assets is generally attributed in the first instance to the part of the enterprise which performs the functions relating to the creation of the asset and the assumption of the associated risk, *i.e.* the functions closest to the transactions that give rise to the risk. It may be necessary, depending on the facts and circumstances, to transfer ownership to the part of the enterprise which subsequently manages the risk.

77. In determining whether and if so, how the parameter-setting function should be rewarded, the authorised OECD approach is to follow, by analogy, the guidelines that apply to this issue in an associated enterprises context under Article 9. For purposes of this paragraph, “parameter-setting” consists of establishing general parameters regarding the risks to be borne in a particular trading business, as opposed to the active monitoring and adjustment of such risks on an ongoing basis. For Article 9 purposes, whether or not the arm’s length principle warrants the related party that performs parameter-setting functions being compensated by the related party that performs the trading activity would be analysed under Chapter VII of the Guidelines, to determine whether a chargeable service has been provided. Under Article 9, this would involve determining whether the parameter-setting function was performed for the expected benefit of the related party that is the risk-taker for that business. The issue of compensation for a parameter-setting function in the PE context would be analysed in the same manner, by analogy.

78. As always the identity of the key entrepreneurial risk-taking function for a particular business needs to be determined through a detailed functional and factual analysis. There may be cases where the analysis shows that the senior management are simultaneously performing both the parameter-setting and the risk management function. For example, the responsibilities of the “trading” locations may be so narrowly prescribed that the “traders” are in fact acting as no more than “nightwatchmen” for the senior management team. As indicated in paragraph 36 above such limited activity would not constitute the key entrepreneurial risk-taking function. Where the “traders” are performing such a limited function one would expect to see this reflected in lower salaries and bonuses than traders who are authorised to build up significant market exposures.

79. There may also be cases where the senior management intervene in the active, ongoing risk management even where there are traders in the PE who are authorised to build up significant market exposures. To the extent that the senior management do intervene in the active, ongoing risk management it may be that they are, along with the full time active risk managers, performing the key entrepreneurial risk-taking functions. In such circumstances it would be necessary to carefully analyse the functions performed by senior management in order to distinguish between their strategic management and active, ongoing management activities. Under the authorised OECD approach capital would also need to be attributed to the senior management location to support the risks assumed in the creation and holding of the financial assets. In practical terms, this may involve attributing a share of the profits to the location of the senior managers by including an appropriate part of their salary in any compensation factor in the profit split formula. (See Section D, paragraphs 252 and 262 below for a more detailed discussion).

80. It is sometimes also argued that the senior management of the bank should be regarded as “owners” of the enterprise’s capital in a manner similar to investors in a hedge fund. This is because, by deciding which types of business to pursue and setting the limits for particular business lines, etc., it is argued that they are also deciding where and how the enterprise’s capital is put at risk. However, where responsibility for implementing the bank’s strategy is devolved to the PE in a way that means the traders actively take the decisions on an ongoing basis, albeit within the set limits, then it is the traders who are performing the key entrepreneurial risk-taking functions and so are putting the capital at risk, not the senior management. In the context of a PE, the hedge fund model is not applicable since it rests upon the premise that capital can be assigned to a particular part of the enterprise without regard to where the key entrepreneurial risk-taking functions are performed. This is contrary to the authorised OECD approach which starts from the premise that assets and risks follow functions and capital follows risk. The issues arising from the use of the hedge fund model in the context of associated enterprises are discussed in Section C-2(iv).

### **Operational risk management/accounting/product control**

81. Although there is not a uniform approach to operational risk management, primary responsibility for managing operational risk may be assigned to a business line head, or in some instances, product manager. There may also be an important role for internal monitors, such as risk managers, the risk committee, or internal audit, or several different internal monitors who are all important, such as the financial controller, chief information officer and internal auditors. There may be a high-level oversight of operational risk by the board of directors, management committees or audit committees.

82. Accounting is responsible for financial and regulatory accounting and for the specialised accounting required for a trading business. This generally involves preparing daily trading revenue and market risk reports, the preparation of which requires the painstaking process of reconciling the positions shown in computer-generated reports with trade tickets entered during the course of the day’s trading.

83. The existence of reliable product control capabilities was critical to the development of the complex trading and risk management strategies that fostered the explosive growth in global trading, particularly global trading in derivatives. Regulators are increasingly paying attention to the product control function in the light of well-publicised problems at a number of financial institutions over the past few years. In several cases, it appears that substantial losses could have been uncovered at an earlier stage if the product control function had been separated from the trading function. The role of product control may be part of operational risk management.

84. Some business commentators have said that the management of operational risk, though important to the profitability of trading in financial instruments, is not a key entrepreneurial risk-taking function and that the management of operational risk should not be seen in the same way as the

management of, say, market risk. The issue of how to determine which part or parts of the enterprise bear the operational risk is discussed in paragraphs 102 and 103 below.

### **Other support functions**

85. The back office performs various other functions, the relative importance of which varies depending on the type of trading business conducted. The operations department is responsible for the confirmation, processing and settlement of trades as well as trader support on the trading floor. The compliance and legal departments are responsible for ensuring compliance with regulatory requirements (which are increasingly complex as the business becomes more global) and for structuring, executing and documenting transactions (which also become increasingly complex as the products become more tailored to the needs of particular clients). In-house economists and researchers may also play an important role in the market analysis for risk management and strategic purposes.

#### *ii) Assets used*

86. The Guidelines note at paragraph 1.42 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 a global trading business.

87. Section B-2 of Part II describes the financial assets used in a traditional banking business and global trading businesses are likely to use financial assets in the same way. Global trading firms, like banks, also use physical assets such as branch premises, communication systems and computers. As noted in Section D-2(iii)(b) of Part I of this Report, there is a broad consensus among OECD member countries for applying place of use as the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view. The computer hardware constitutes the communication systems used within an MNE financial institution and which with increasing frequency includes access to and utilisation of such communication systems by third party customers (and associated software to facilitate such communication within the MNE financial institution and between it and its customers). It should be noted that there is an increasing trend to outsource the communication systems to independent specialist companies. This may need to be taken into account in making any comparability analysis under the second step of the authorised OECD approach. Of particular importance in this context are the IT and communications systems that a global trader frequently relies upon to carry on and effectively manage its business.

88. Further, as with any other business, the functional analysis should also examine whether any intangible assets have been used. In the global trading area a common intangible is likely to be the marketing intangible represented by the name, reputation, trademark or logo of the global trading firm. Such intangible property will be particularly important for the performance of the marketing function.

89. Other intangibles would be more akin to manufacturing intangibles, such as proprietary (software) systems for pricing financial instruments on prospective third party deals, allocating capital, measuring, monitoring and managing various types of risk. These intangibles result from the efforts of highly skilled personnel and are of particular relevance to the performance of the trading and risk management functions and the “middle office” control functions described at Section B-3(i)(d) above.

#### *iii) Risks assumed*

90. The essence of global trading is the assumption and ongoing management of risk and this must be taken into account when performing a functional and comparability analysis. This section examines the types of risks assumed in a global trading business and examines the consequences of the assumption of risk for the creditworthiness/capital adequacy of the global trading enterprise. Being attributed risks in the

Article 7 context means the equivalent of bearing risks for income tax purposes by a separate enterprise, with the attendant benefits and burdens, in particular the potential exposure to gains or losses from the realisation or non-realisation of said risks. Traditionally, the most commonly identified risk classes were credit risk and market risk. More recently, the importance of operational risk as a separate risk class has become increasingly recognised. Operational risk is discussed in sub-section (c) below and other types of risk which are important in global trading are discussed together in sub-section (d) below.

91. The relative importance of the different types of risk will depend on a number of factors (*e.g.* nature of the product, business strategy, etc.) and can also vary over time. For example in traditional banking activities, credit risk is generally the most important risk assumed as a result of the creation of the financial asset because the bank is potentially at risk for the whole of the principal sum advanced to a customer in the form of a loan, even though it may subsequently try to pass on that risk to an independent enterprise, for example through credit derivatives. In global trading of financial instruments, especially derivatives, there is often little or no cash advanced when entering into the derivative contract whereby payments are based on notional principal amounts and the credit risk will initially be only a small fraction of the notional principal amount. However, the amounts payable under a derivative contract depend on market movements and so market risk will be particularly important for global trading businesses (see Section B-3(iii)(b)). This is reflected in the importance of the market risk management functions for global trading businesses. Further, there may be some interaction between each of these classes of risk (for example although market risk may decline for a financial instrument that is “in the money” for the financial institution, the credit risk increases as there is now the risk that the customer will not pay – see paragraph 94 below).

92. Just as for banks, but even more so in a global trading business, the risks assumed from entering into transactions with customers may arise from items which 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 authorised OECD approach 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 material off-balance sheet items that need to be taken into account in the application of the arm’s length principle. Finally, it will be important to distinguish between the initial assumption of risk and the subsequent bearing of that risk. Further any risk assumed and subsequently borne also has to be managed by personnel undertaking the risk management function. The guidance in Part II is equally applicable to global trading.

a) Credit risk

93. As already explained, credit risk is very important in a traditional banking business where the bank advances considerable sums of money to its customers in the form of loans with the expectation that the customers will pay the interest due and repay the principal of the loans in accordance with their terms and conditions. Credit risk is the risk that the bank will not receive the expected payments from the customer. Development of credit derivatives has now permitted banks to manage this risk, often by passing the credit risk arising from their loans to independent global trading enterprises. The credit risk assumed by the independent global trading enterprise must be managed just like other risks assumed as a result of other customer transactions. It should also be kept in mind that the banks may also be assuming risk through credit derivatives, which should be taken into account in the determination of the overall risk exposure and capital adequacy.

94. Credit risk will arise where for example a bond is sold not for cash but on terms which provide for some deferment of payment. For many derivative instruments, credit risk will arise where the instrument has a positive net present value for the global trading enterprise, for example where market

movements on an interest rate swap mean that the net present value of the payments to be made by the global trading enterprise over the life of the swap is less than the net present value of the payments it is expected to receive. In the case of derivative transactions, credit exposures will change over the life of the transaction as the market value changes. That is, the credit exposure to a counterparty is often almost zero at the inception of a derivative entered into at current market rates. However, as market rates change, one party is “in the money” and has credit exposure to the counterparty to the extent of the inherent gain in the transaction. If the financial institution is in the money, it runs the risk that it will suffer a credit loss if the counterparty is unable to make the payments required with respect to the transaction.

95. Options generally only involve credit risk for the option buyer, whereas for an option seller there is no credit risk once the buyer has paid the premium. Credit risk also differs for instruments that are traded in organised markets (exchange-traded) and those which are traded over-the-counter (OTC). In the former, the process of margining provides credit risk management and, increasingly, credit risks arising from OTC derivatives can also be margined. Where notional principal contracts are utilised, their notional principal amount does not represent the amount at risk, as the loss due to default on a derivative contract is the cost of replacing the contract, less any recovery. Whether a product can be readily liquidated or is typically held until maturity will further affect credit risk. A change in the credit quality of the obligor may signal a change in the credit risk of a transaction. The measurement of credit risk is important to many financial products, with the impact on pricing of particular significance in this respect. Sovereign risk, which is a category of credit risk, may also affect the assessment of credit risk. A credit loss will only occur if the counterparty defaults and the derivative contract has a positive mark-to-market value to the non-defaulting party.<sup>6</sup>

96. Credit risk is assumed as a result of the decision to enter into the transaction with the customer. The key point of the functional analysis will be to determine where the decision to enter into the contract is made. Generally this decision is likely to arise from the performance of the marketing/dealing function - this function is equivalent to the sales/trading function for a traditional bank - and not from the general sales/marketing function. In some cases there may be separate “middle office” functions of credit risk management and credit risk monitoring, two functions which are generally strictly segregated for internal control reasons. The question is whether such functions lead to the assumption of credit risk. This will depend on the functional analysis. It is not unusual for the group within the financial institution that is responsible for evaluating and managing credit risk and/or making credit decisions in respect of a financial asset to actually bear the counterparty credit risk, pursuant to written internal procedures or agreements. Thus, if a counterparty defaults, the loss is not shown in the books of the business division that negotiated, acquired, booked and/or managed the market risk of the financial asset. Rather, the loss is reflected in the books of the division whose credit group evaluated and assumed the credit risk.

b) Market risk

97. Market risk refers to the exposure to adverse changes in financial prices affecting the value of positions typically held for global trading purposes, for example as a result of fluctuations of foreign exchange rates, interest rates, equity prices or commodity prices. The risk of adverse movements of the mark-to-market value of the trading portfolio is particularly relevant in this respect. As with credit risk, market risk is generally assessed on a portfolio basis, not on individual transactions. In addition to the absolute price risk associated with market movements, several higher order risks such as convexity, volatility (of particular relevance to options and products with option-like characteristics), time decay (also of particular relevance to options), discount risk and basis risk, as well as yield curve risk are also types of market risk.

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6 In some situations, derivatives transactions provide a right of offset with respect to amounts owing between counterparties, and this right of offset will reduce the credit risk.



98. In terms of the day-to-day management of market risk, decisions have to be made to accept trading positions which would assume market risk. It is particularly important because global trading frequently involves taking a market position and adverse movements in the market have the potential to leave the enterprise with large liabilities and consequently large losses. This is a day-to-day risk in global trading and is incurred both in dealing and in managing proprietary positions.

99. Once that decision has been made, the market risk thereby assumed has to be managed. The management of market risk can result in the reduction of that market risk as far as possible by means of a hedging strategy or can result in an active taking on of market risk positions in the hope of making profits out of market movements. In practice both approaches may be employed to some extent, even to the same trading book.

100. Market risk is also particularly important in relation to certain derivative products. This is because of the nature of some derivative contracts, *e.g.* options, where the “downside” from adverse market movements can lead to a very large exposure for the global trading enterprise if the position is left unhedged. This contrasts with a traditional bank loan where the “downside” is limited to the outstanding principal and interest payments.

c) Operational risks

101. Operational risk has been defined by the Basel Committee on Banking Supervision (“Basel Committee”) as “the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events”. The Basel Committee has also stated that:

the most important types of operational risk involve breakdowns in internal controls and corporate governance. Such breakdowns can lead to financial losses through error, fraud or failure to perform in a timely manner or cause the interests of the bank to be compromised in some other way, for example, by its staff exceeding their authority or conducting business in an unethical or risky manner. Other aspects of operational risk include major failure of information technology systems or events such as major fires or disasters.

Operational risks in trading activities may be high. Unlike credit and market risk, operational risk is to a considerable extent internal to the MNE.

102. Unlike credit and market risk operational risk is generally not managed by entering into transactions with third parties, though it is possible to insure against some of those risks, but is managed through internal systems and processes. Economists suggest that assigning responsibility for a risk should follow a tiered structure to achieve the best economic incentives. The result of a risk should first be borne by the party best able to prevent it, second by the party that can manage, diversify, or hedge it efficiently, and third by the party that can absorb the loss. The party best able to avoid the risk is usually the party whose operational error has caused the loss, not the party that imposes risk control systems to attempt to prevent the operational loss. As indicated above many operational risks cannot generally be hedged through outside transactions. Within the context of the head office and PE, the third issue is moot since both have equal ability to absorb the loss. This would suggest that in a PE context responsibility for errors should fall on those that made the error. In an associated enterprise context it may fall upon the enterprise supplying capital to support the risks of a second enterprise.

103. Operational risk is difficult to quantify and even more difficult to attribute, as by its very nature it relates to unforeseen occurrences. As noted in paragraph 18 of Part II the Basel Committee has concluded that operational risk should be included in minimum capital requirements (which is a measure of its

importance). However as noted in paragraph 93 of Part II quantification of operational risks is likely to be based on a bank's internal models which are not observable by market data. This makes it difficult for tax administrations to audit. Given the difficulty of quantifying operational risk, the authorised OECD approach would permit operational risk to be allocated proportionately to other risks attributable to the PE, without the need to separately calculate operational risk. This is on the basis that the part of the enterprise with the greatest exposure to credit and marketing risk is, all other things being equal, the part with the greatest exposure to operational risk. This pragmatic approach would seem to work best where the operational risk relates to unforeseen circumstances such as rogue trading. It may be less reliable where the operational risk arises from the capacity of the PE to administer the volume of its activity (*e.g.* clearing and settlements), since in these circumstances the amount of risk assumed in the contracts is not necessarily proportional to the volume of activity. Accordingly, this approach may appropriately be used unless the particular circumstances enable a more reliable and measurable assessment and attribution of operational risk and the reward for such risk to be made.

d) Other risks

104. There are also other types of risk that expose the enterprise to the possibility of very large losses. There is the legal risk that if a particular derivative contract leads to the client making large losses, the client although able to pay may refuse to do so and instead seek compensation for the losses suffered from the global trading firm. 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 affect settlement risk. Solvency risk and general business risk will also be relevant.

105. Further, there are other risks that are not related directly to the financial products. One such risk is a development risk. In particular, companies involved in global trading may devote considerable resources to developing IT and communications systems that are essential in carrying out their business. This involves up-front development expenditure which carries the risk that the systems may not operate as intended or may no longer be needed by the time their development is complete. Similarly, product development carries the risk that the product will not work or will not sell and there is in addition the risk of incurring liabilities if the product is structured incorrectly from a legal point of view.

iv) *Capital and funding*

a) Introduction

106. The discussion at paragraphs 23-27 of Part II on the role of capital for banks is equally applicable for global trading enterprises. In short, global trading enterprises will also need capital in order to assume the risks arising from their business, whether that will be market making or taking proprietary positions. Similarly, they will also use a wide variety of financial instruments, including repos and swaps, to fund their trading positions. One special feature of many derivative instruments is that they create potential funding obligations for the financial institution over the life of the instrument, *e.g.* the need to make periodic payments under an interest rate swap. Such instruments also create an ongoing need for capital to cover the ongoing risks.

b) Creditworthiness

107. The creditworthiness of a global trading enterprise is a crucial factor as a minimum credit rating may be required by some counterparties as a condition to do business with the global trading enterprise and also in the ability to make a profit on its activities. Like banks, global trading enterprises have to fund their operations and their creditworthiness affects the rate at which they can borrow. This has an obvious effect on the profitability of transactions where the global trading enterprise has to borrow, for example to fund

the payments it is obliged to make under an interest rate swap contract. Moreover, as discussed in Section C-2(iv), the price of an interest rate swap may vary according to the credit risk inherent in the transaction. Moreover, certain products (particularly long dated or exotic instruments) can effectively only be sold by the most creditworthy financial institutions - AAA-rated entities may be able to sell a much wider range of products than lower rated institutions.

c) Capital adequacy requirements

108. Paragraphs 32-37 of Part II describe the relevance of capital adequacy for banks. Similar considerations apply for global trading enterprises, although the exact effect will depend on the level or type of regulation. In short, the level and type of risk that is incurred by an enterprise carrying on a global trading business will determine the amount of capital or alternative means of enhancing perceived creditworthiness that it must have available to assume that risk. The role of traders in managing market risk has similarly already been described in Section B-3(i)(b) but this risk cannot be assumed in the first place without a sufficient capital base. The significance of capital is illustrated by the fact that talented teams of traders are not normally able to leave a financial institution to set up in business on their own without having access to capital, either by joining forces with another well capitalised institution or by arranging for guarantees from such an institution.

d) Other regulatory requirements

109. It will also be necessary to bear in mind when conducting any transfer pricing analysis the regulatory impact on global trading businesses. In particular, unlike banking, global trading can be carried out by entities that are not regulated directly. The regulatory environment can affect both where a transaction is booked and the cost of entering into the transaction in a particular location. Indeed, this can often produce an initial discrepancy between the economic activity carried out by a particular global trading entity and the activity recorded in its financial statements. Transactions which were created at least in part by the economic activity of one entity may nevertheless be booked in another entity such as a special purpose vehicle, thereby creating the need for arm's length adjustments to be made between the booking entity and the entity which participated in the economic activity.

e) Significance of "free" capital

110. Paragraphs 41-43 of Part II discuss the significance of "free" capital for banks. The same principles apply for global trading business.

**C. The application of the arm's length principle to global trading conducted between associated enterprises**

111. Section C deals with the application of the arm's length principle to global trading in general and is divided into three main parts. The first part is a general discussion of the application of the guidance given by the Guidelines, including a discussion of transfer pricing methods. The second part seeks to identify the main transactions between associated enterprises related to the various global trading functions each enterprise performs and then considers the most appropriate way of applying the arm's length principle to those transactions so as to appropriately take into account the performance of the related function. The third part looks in greater detail at the application of profit methods to integrated global trading businesses. Specific issues regarding the application of the arm's length principle when global trading is operated through a PE are discussed in Section D.

112. In some cases, the discussions in both Section C which deals with Article 9 and Section D which deals with Article 7 will be relevant to the application of the arm's length principle. Where, for example, one enterprise is acting as agent for a second enterprise and the activities of the first enterprise create a

dependent agent PE as defined in Article 5(5), it will first be necessary to apply the guidance in Section C under Article 9 to establish the arm's length price of the transactions between the first enterprise and the agent enterprise (where the agent is an associated enterprise), and then to apply the guidance in Section D on Article 7 to attribute an arm's length amount of profits to the dependent agent PE. In contrast, where no dependent agent PE is created as a result of the activities between the associated enterprises the guidance in Section D on Article 7 is clearly not applicable. In particular the concept of key entrepreneurial risk-taking and its consequences for the attribution of capital is not applicable. Instead, it is only necessary to refer to the guidance on Article 9 in Section C.

### ***C - 1 General application and methods***

#### *i) Applying the arm's length principle*

113. The Guidelines make clear in Chapter I that "Application of the arm's length principle is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises."<sup>7</sup>

114. The functional analysis described in Section B seeks to identify the different contributions made by capital and the different functions of a global trading business, such as trading and marketing. In the global trading context, the carrying out of a careful functional analysis will be particularly important because of the wide range of significant functions potentially involved, the variety of risks that can be assumed or transferred, the global dispersal of the performance of many functions and the wide variation in business structures and organisation. Once the functional analysis is complete, it is then necessary to identify the transactions between the associated enterprises and, using the methods described below, determine an arm's length price for those transactions.

#### *ii) Transfer pricing methods*

115. In many global trading transactions between associated enterprises (controlled transactions) there may be little difficulty in using traditional transaction methods and in finding comparable transactions so that an arm's length price or gross margin can be determined. This is because, where a business is organised on pure centralised product management model lines, many of the functions apart from marketing (*i.e.* trading and risk management functions) may all be centralised in one location. The profit attributable to those functions is largely produced from transactions with independents. Most controlled transactions will be in respect of simpler functions performed by associated enterprises, such as support and sales, though where arrangements exist between associated enterprises whereby the capital necessary to support the risks resides in a different legal enterprise from the enterprise which performs the functions giving rise to the risks (whether or not a PE is found) it will be necessary to determine a reward for supplying that capital. Comparable market data may be readily available to determine an arm's length price for support and sales functions as long as these functions are not linked to valuable intangibles. The pricing of the capital-supplying function is discussed below in Section C-2(iv). Similarly, where a business is organised on pure separate enterprise trading model lines, with no integration of functions or locations, it may be reasonably straightforward to find comparables for the controlled transactions in sales and support which, again, may be appropriately characterised as service provision.

116. Transactions between independents may still be comparable even though there are some differences from the controlled transaction, provided that "reasonably accurate adjustments can be made to eliminate the material effects of such differences".<sup>8</sup> For example, a transaction may be found which is

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7 Guidelines, paragraph 1.33.

8 Guidelines, paragraphs 2.18, 2.23 and 2.41.

similar except that in the controlled transaction there may be no assumption of credit risk. The price of the uncontrolled transaction may still be able to be used if it is possible to make reasonably accurate adjustments to reflect the differences in the assumption of credit risk, perhaps by using third party data for the pricing of credit derivatives.

117. The Guidelines are intended to be applied flexibly and so the search for comparable data may not be restricted to the derivatives market. Thus third party data on pricing credit risk from, say, the bond markets could be used provided it meets the “reasonably accurate adjustment” standard of paragraph 2.14. However, often the only data from independents are likely to relate to basic or non-discretionary activities, and so it may be difficult to make reasonably accurate adjustments between the controlled and uncontrolled conditions to take account of the considerable differences in functions performed, economic circumstances and business strategies, etc.

118. There will be other cases where there may be real difficulty in reliably applying traditional transaction methods. This is particularly likely to be the case when evaluating the trading/risk management function in the fully integrated trading model. In such a case, the trading and risk management function may itself be split between different entities. Comparable data may be difficult to find as such a trading structure is unlikely to be found amongst independent parties without some kind of formal arrangement to govern the integrated activities. The arrangement can be made in a variety of legal forms, *e.g.* a joint venture, a partnership or an incorporated body. However, under such arrangements, the independent parties may well not attempt to divide the profits from each transaction but instead may well attempt to determine the overall profits for each party. For example, where the legal form is that of an incorporated body or a partnership, the arrangement may divide the profits from the venture at the shareholder or partnership level respectively.

119. Additionally, a feature of some types of global trading is that there may be a high level of integration and co-operation between and within different functions and locations. In such situations, for which a one-sided method would not be appropriate, the transactional profit split method can offer a solution.<sup>9</sup> A question arises as to how to evaluate the level of integration of functions in respect of a particular transaction or transactions. The behaviour of the parties may help in this analysis. For example, if the traders in each location are remunerated out of different bonus pools and their performance evaluated by reference to completely different criteria in each location, it should be possible to similarly evaluate the trading transactions in which they are involved, without reference to the other trading locations. Conversely, if the performance of a trader is judged to a significant extent by reference to how well he or she co-operates with traders in the other location, this may be good evidence that, in reality, the trading function is highly integrated across the locations of the co-operating traders.

120. The question of integration should be dealt with on a function-by-function basis. The fully integrated trading model is defined only by the level of integration of the trading and risk management functions - there is no reason why the integration of these functions means it should not be possible to evaluate separately the other functions, such as support, under a traditional transaction method.

121. In some cases it may be possible to deal with integration by making reasonably accurate adjustments to the remuneration for performing the integrated function. For example, the analysis could identify a comparable commission for performing a basic sales function which could then be increased to reflect the additional functions performed and risks assumed (*e.g.* credit risk) by the marketer who is more integrated into the global business (see paragraphs 116-117). However, where it is not possible to adequately deal with integration in this way, profit methods may be the most reliable way of approximating arm’s length conditions. Although the broad basis for using the transactional profit split methods as

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9 Guidelines, paragraph 2.109.

described in Chapter II of the Guidelines is clear, there can be problems applying them in practice. The Report discusses these issues further in Section C- 3.

122. Finally, care should also be taken to ensure that the business strategy of the taxpayer is taken into account and that the functions are looked at on a case-by-case basis. For example, the importance of the trading function is likely to be greater if the business aims to make a market for particular products, as opposed to simply supplying them as part of a strategy of providing a “full service” to its customers (see Section B-2(ii)). This is because in the latter case, the business is likely to adopt a low risk strategy by immediately and fully hedging the customer transaction. This strategy limits the possibility of trading losses but also reduces the potential for making trading profits. In contrast, the market maker is likely to attempt to make trading profits by more active risk management, for example by deliberately leaving customer positions unhedged and thereby hoping to gain from favourable market movements. Such a strategy can lead to large profits but also the possibility of large losses, with a corresponding impact on the amount of capital needed to support the trading function. This capital may be supplied either by the enterprise itself or by virtue of an arrangement with another enterprise. If the trading function is performed in a separate enterprise from the enterprise supplying the capital a reward for capital under Article 9 will need to be calculated as discussed in Section C-2(iv).

## ***C - 2 Analysis of global trading transactions***

123. This section looks at the types of transactions that commonly occur between associated enterprises engaged in global trading. The analysis of transactions must identify and have regard to the performance of the function that gives rise to the particular transaction. This section discusses the best way of applying the arm’s length principle to transactions to ensure that the role of the related function is appropriately taken into account. Sub-sections i-iii below discuss people functions and in particular functions that lead to the assumption and management of risk. It should be emphasised that where arrangements exist whereby the capital to support the risks created by these functions resides in a separate legal enterprise from the one performing the people functions, the reward for capital belongs with the enterprise in which the capital resides (whether or not a PE is found; see paragraphs 280-281 below). Where no PE is found the use of “key entrepreneurial risk-taking functions” to attribute capital (and the reward for capital) to the location where the people functions are performed is not applicable.

### ***i) Sales and marketing***

124. The functional analysis may show that an enterprise provides sales and marketing services to an associated enterprise. In transactions between unrelated parties, the amount and type of the reward would depend on the level of services provided, which may be particularly related to the type of product, the functions performed, the risks assumed and the intangibles involved. For the sales and marketing functions a key question is whether the performance of the function leads to the assumption of credit risk and whether the performance of the marketing/dealing function leads to some assumption of market risk (see discussion in Section B-3(i)(a)). For example, some general sales personnel merely act as brokers in respect of standardised products and so do not assume any credit risk from the sales transaction. They are likely to be rewarded by a simple fee or commission, *e.g.* a number of basis points, which does not depend on the profitability of the particular deal.

125. At the other end of the spectrum, some marketers are so highly specialised and closely involved in the process of developing and structuring products that they perform functions leading to the assumption of credit risk and carry out some aspects of the trading function leading to the assumption of market risk. They are likely to insist on a share of the trading profits and losses (although, in the former case, the parties might still call this a commission), which will reflect the amount of capital they require to support the risks they have taken on. In the middle of this spectrum are those marketers who, as a functional analysis shows,

act as more than simple brokers and so assume credit risk but who are not as involved in structuring products and so are unlikely to be treated as assuming significant market risk (although as noted in paragraph 29 there may be assumption of market risk for the period before a transaction is reversed out to the centralised product management location).

126. When dealing with the controlled situation, it is necessary first of all to evaluate the exact functions performed (taking into account assets used and risks assumed) by the personnel involved. If the controlled transaction is in respect of general sales functions, market data are likely to be available so that a CUP method, usually in the form of a commission, can easily be applied. However, the situation becomes more difficult if more complex sales and marketing functions are performed. Often the only data available between independents will relate to the basic sales functions which raises the issue as to whether reasonably accurate adjustments can be made to account for the extra functions performed and risks assumed.

127. Another possibility may be to evaluate the sales function by using a resale price method to arrive at an arm's length gross profit margin. A careful comparison of the risks assumed and borne in both the controlled and uncontrolled transaction will be necessary, based on an analysis of the contractual arrangements. A component of the value added by marketing personnel may in certain circumstances be measured by reference to the difference between the price at which a trader would undertake a transaction with a customer and the price actually obtained by the marketer. However, even where there is this relationship, care must be taken to ensure that the rewards attributable to the trader and marketer correctly reflect the functions performed by each, especially taking into account the risks assumed.

128. Flexibility may be needed in order to make reasonably accurate adjustments for any differences between the controlled and uncontrolled transactions under any of the above approaches, perhaps by looking for independent data concerning reasonably comparable marketing functions leading to the assumption of reasonably comparable risks outside the global trading field. It is likely to be easier to find comparables where the function does not give rise to the assumption of significant risk. For example, the search for comparable data for the marketing of a derivative product need not be restricted to the derivative markets.

129. One possibility would be to increase the amount of commission to reflect the increased functions performed and/or risks assumed as compared to commissions found between independent enterprises. Another possibility might be to add some share of the profit of the transaction to the basic commission payment. In other situations it may be appropriate to reward the marketing function by including it in the profit split calculation. It is not unknown in the financial sector for trading firms to motivate independent marketers by allowing them to retain a portion of the profit on the deals they bring to the trader. This is likely to be more common in businesses where the strategy is to encourage the sale of more complex high margin transactions rather than one where the strategy is to pursue simpler and lower margin transactions with the volume of transactions being the key to profitability. The business strategy should therefore be considered when evaluating the appropriateness of rewarding the marketer in a controlled transaction by a profit share.

130. If it is decided in a particular case that a basic commission payment plus some share of the profit is appropriate, the question arises as to how the share of the profit should be determined. Problems arise particularly with derivative products where the profits can be divided into an initial dealer spread resulting from entering into the transaction and then subsequent trading profits or losses resulting from the ongoing management of the position.

131. Often these profits will be limited to the initial profits (dealer spread) on the customer transaction rather than the subsequent trading profit. This is because if the sales personnel are not involved in

structuring the financial products the functions performed would not give rise to the assumption of market risk. Therefore, there would be little justification for them to receive a share in any trading profits, but equally they should be protected from the risk of sharing in any trading losses arising from the realisation of market risks. (N.B. If the dealer spread on a transaction is initially negative then the circumstances surrounding the transaction may need to be examined. For example, if the transaction was entered into even though it was expected that the dealer spread would be negative, it is evidence that the deal had been made for a purpose other than the normal marketing function, e.g. a hedging transaction made at the request of the risk manager in order to hedge another outstanding position. In such a case, the sales function would expect to be rewarded for the broking function being performed and would not expect to bear any of the loss arising from the negative dealer spread. In other cases the marketers should expect to share in the loss they have created as a result of performing a full marketing function.)

132. This approach to compensating a marketer by reference to a share of the initial dealer spread and not a share of the aggregate of the initial dealer spread and subsequent trading profits or losses may not always be appropriate if the functions performed by the marketer are comparable to those performed by the highly specialised marketer described above. Even when working with independent parties, such marketers might expect, by virtue of their close co-operation with the trader in structuring the overall deal, to either gain from, or be penalised by, the subsequent activities of the traders/risk managers in managing the position.

133. Where such highly specialised marketers are employed it may be that the taxpayer has chosen a profit method as the only way of accurately reflecting the contribution of the marketer to the earning of profit, and of dealing with the difficulty of evaluating that function separately from the trading function. A full comparability analysis should help show whether such a profit method is in conformity with the arm's length principle. This will be easier to assess where comparable data from independent parties are available and should be tested by reference to the behaviour of the parties to check that it is consistent with their assigned roles. For example, the highly specialised marketers would only expect to share in the aggregate of the initial dealer spread and subsequent trading profits or losses if they were heavily involved in all material aspects of structuring the deal. This level of integration and co-operation with the traders may be evidenced by the bonus structure for rewarding such personnel and in their working relationships and procedures.

ii) *Trading and risk management*

134. As already noted in Section B-3(i)(b), a functional analysis of a business engaged in global trading is likely to determine the trading and risk management function as one of the most important people functions. The activity involves the assumption of risk and relies upon capital to support these risks. This capital may either be supplied by the enterprise employing the traders or by another enterprise as discussed in sub-section iv below. The trading activity is normally undertaken with third parties and it is this activity where combined with the marketing/dealing function that directly gives rise to gross profit through "dealer spreads". Moreover, the trading and risk management function also gives rise to subsequent trading profits or losses from managing the market risks assumed and the consequent requirement for capital.

135. As a starting point it may be helpful to examine the three basic trading models of global trading: integrated trading, centralised product management, and separate enterprise. Unless otherwise stated, risk management refers only to the management of market risk.

136. Traditional transaction methods are normally the most appropriate methods where trading is organised on a separate enterprise model, where each enterprise will individually undertake the core activities and transactions with associated enterprises are likely to involve service provision or financial



transactions (such as the hedging). For transactions involving basic service provision, there may be no need to consider methods other than traditional transaction methods in order to reach an appropriate profit for each location associated with the provision of such basic services because of the availability of comparable transactions with unrelated parties. Testing whether hedging transactions are undertaken under arm's length conditions is more problematic. At one level, consideration will need to be given to the nature and extent of any comparability adjustments. For example, comparability adjustments for differences in credit risk may frequently be necessary, as will adjustments for timing issues amongst other factors.

137. Further, the transfer pricing analysis would have to examine the situation where, as a result of a hedging strategy, losses can be recognised for tax purposes in a jurisdiction other than that in which the gain from an offsetting position is recognised (generally referred to as "split hedges"). This raises difficult issues where the split hedges occur between associated enterprises and will be the subject of future work. In the meantime, general guidance on transactions which purport to transfer risk from one associated enterprise to another can be found in the Guidelines at paragraphs 1.48-1.54. Problems also arise where financial institutions use "net" hedging strategies so that it is impossible to trace the gain or loss from any particular transaction to the offsetting gain or loss on the customer transaction it hedges.

138. As noted in paragraph 32, under the separate enterprise trading model, one trading location may enter into trades with another trading location. At another level, a question might arise in some situations involving financial transactions (particularly hedging transactions) between associated enterprises in different trading locations as to whether an independent trader would have entered into such a transaction. If the expected dealer spread on the transaction between trading locations is negative or if the NPV on a financial transaction from the perspective of the trading location under examination is negative, then the circumstances surrounding the transaction would need to be examined. It will be important to consider the business strategies of each trading location and of the MNE group as a whole. For example, it may be that the transaction was entered into for a purpose other than the normal trading function of the particular location, *e.g.* an internal hedging transaction made at the request of a central committee managing overall risk limits within the MNE group. In such cases, it may be necessary to eliminate the effect on trading profits of such transactions and to reward the function performed by the trading location by other means.

139. In theory, there should be fewer problems in evaluating the trading or risk management function for the pure centralised product management model, because the centralised trading location takes the full responsibility for trading and hedging. In such a case the functional analysis in many cases is likely to show that the trading and risk management functions are undertaken by this centralised product managing location. Therefore it receives the profits attributable to those activities largely as a result of trading and hedging transactions with independent parties and most of the controlled transactions with other locations are in connection with the provision of services other than trading, such as sales and support functions (unless the capital to support the risks assumed is supplied by another enterprise, in which case it will also be necessary to determine an appropriate reward for supplying the capital).

140. However, problems can arise when, over time, more complex trading activities are carried out away from the central location, so that the organisational trading structure moves away from the pure centralised product management model and more towards the integrated trading model. This raises the issue of how to reward aspects of the trading function performed by an associated enterprise outside the central location. A similar need also arises if risk management is centralised in a different enterprise from the trading location. There is a problem in deciding whether an enterprise which starts to undertake some kind of limited trading or risk management activity under the control of the central location can still be appropriately rewarded by traditional transaction methods, such as a service fee, as opposed to receiving a share of the overall profits. The answer would depend on a full functional and factual analysis based on the facts and circumstances, especially with regard to whether the enterprise takes the trading decisions that lead to the assumption and management of market risk. For example, if the enterprise outside the central

location performs purely a “night watch” function (see paragraph 36), the lack of risk-taking means the activity is unlikely to require much capital (either its own or the capital of another enterprise) and the night watch enterprise would be unlikely to receive a share of the trading profits (even when it supplies its own capital).

141. In the integrated trading model, as in the separate enterprise model, each location has the capacity to perform the full range of trading and risk management functions necessary to conduct the business and thus performs an entrepreneurial role (assuming it also supplies its own capital). The difference is that in the integrated trading model, the trading and risk management functions with respect to a particular third party transaction may be split between locations and the gross profit arising from that transaction may be recognised in any or all of the locations. Trading or risk management in integrated form is unlikely to be found between independents and so it may not be possible to make “reasonably accurate adjustments” to make the data comparable. Additionally, in the integrated trading model each location cannot act independently but must co-operate with the others in order to successfully enter into a transaction and subsequently manage the resulting risk. Therefore, it may not be possible that traditional transaction methods could be applied reliably and so consideration should be given to transactional profit methods.

142. In reality, the actual trading or risk management operations may be a hybrid that does not fall completely within one of the three models but may include aspects of the others. Moreover, the manner in which global trading is conducted may change over time as the business evolves. For example, a product may start being traded on a fully integrated basis outside of its original “natural home”, as trading authority is delegated, or the “natural home” may change in the long run. In short, the answer must depend on the functional and factual analysis rather than on the label given to the trading/risk management organisation in terms of the three models described in Section B-2(iii).

*iii) Support, middle or back office*

143. Following the Guidelines, the first step when evaluating the support, middle office or back office functions described in Section B is to see if the CUP method can be reliably applied. In some cases it may be difficult to find a CUP for all such functions because these activities have typically taken place within the same enterprise. However, many support functions, such as settlement, are provided in a similar manner for independent parties and so CUPs may be readily available perhaps even without the need to make reasonably accurate adjustments for any material differences in order to ensure comparability. In other cases reasonably accurate adjustments may be needed to reflect differences in the functions performed or risks assumed. Market data may be available to support such adjustments, even though sometimes the comparables may have to be found outside the global trading context (*e.g.* independent enterprises providing administration services to fund managers). Also, trends to disaggregate and, in particular, to outsource some support or back office functions may increase the availability of comparable uncontrolled transactions.

144. Back office activities include various types of activities, some of which constitute significant parts of global trading, and some of which are quite remote from its main activity. Since activities of key back office staff such as product control staff (sometimes called “middle office” staff) play significant roles in determining the profitability of the whole operation, for example by trying to minimise operational risks, it may be necessary to give further consideration to those activities. CUPs may not be available as a reliable benchmark to evaluate the contribution made by such staff but one possible measure of the contribution of such activities is the amount of compensation to key staff, especially to the extent that their compensation is performance related. The cost plus method may be particularly applicable to such situations.

145. Section B also described the role of support staff in systems and intangible development. In the non-financial sector both the CUP and cost plus methods have often been used to measure the role of such

staff, although profit methods have had to be used in some cases, especially where the development of highly valuable and unique intangibles is involved. In the global trading situation, the role of the support staff may often be similar to the contract researchers found in other industry sectors and it may be possible to use a cost plus methodology. In other cases any intangibles will have been developed by the “front office staff” and so have already been taken into account when evaluating their contribution.

146. Given the wide range of functions carried out under the heading of “back office”, “middle office” or “support” it is probably best to deal with the question of the role of such activities on a case-by-case basis. However, once it has been determined that the functions are truly support functions (and not closely related to the direct profit-generating activities of the business), it will usually be possible to use a traditional transaction method to arrive reliably at an arm’s length price for the support functions described in Section B. Independent parties are also unlikely to include basic functions in such a profit-sharing partnership because the volatile nature of global trading profits makes it very difficult to devise a profit share that would give the low but steady economic return which is appropriate for the performance of such functions. The most likely circumstances are where the particular function is so integrated with the other functions that traditional methods could not be applied reliably.

147. In some cases it may be that independent enterprises would have entered into a cost contribution arrangement of the type discussed in Chapter VIII of the Guidelines. Here, also on a case-by-case basis, it would be important to ensure that “each participant’s proportionate share of the overall contributions to the arrangements will be consistent with the participant’s proportionate share of the overall expected benefits to be received under the arrangement, bearing in mind that transfer pricing is not an exact science.”<sup>10</sup>

*iv) Role of capital*

148. In many cases there may be no need to measure any arrangements involving capital as all the capital of the MNE group which underpins the assumption, bearing and management of risk is centralised in the one enterprise where the risk management and trading actually takes place. The other enterprises of the MNE group which perform other functions, *e.g.* sales, will still require some capital to support their activities but this is likely to be insignificant compared with the capital necessary to undertake the dealing, trading and risk management functions. However, in other situations, where the trading and risk management functions are split between different enterprises, or where the capital of the MNE group is centralised in a different legal enterprise from the enterprise that carries out the “people” functions of trading and risk management, it will be necessary to evaluate any arrangements related to capital in order to determine, first, whether they should be recognised and, second if they are recognised, how to arrive at an arm’s length reward. As indicated above, in circumstances where a dependent agent PE is created in accordance with Article 5(5), it is necessary to follow the guidance with respect to the attribution of an arm’s length profit to dependent agent PEs in Section D. In this sub-section, guidance is provided on how to calculate the separate reward for capital under Article 9 that is required when one associated enterprise provides capital for a second associated enterprise.

149. There are two situations where the influence of capital needs to be considered in a global trading business. The first is when undertaking the comparability analysis necessary to apply any transfer pricing method. When undertaking such an analysis it will be important to check that the controlled and uncontrolled transactions being compared are similar with respect to the capital situation, or if there are material differences, that reasonably accurate adjustments can be made for any material differences. The capital situation may be relevant in this case because it may have an effect on the creditworthiness of the entity which, in turn, has an effect on the terms in place with third parties. For example, the price of an interest swap may vary according to the credit risk inherent in the transaction.

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10 Guidelines, paragraph 8.3.

150. A possible approach to making adjustments for differences in capital or risk assumption between the controlled and uncontrolled conditions could be based on the capital “used” or “put at risk” in the transaction. Financial businesses need capital to be able to cover the risks they assume and there is a cost to maintaining this capital base. The more risky a transaction the more capital has to be set aside to cover it and the price charged for entering into the transactions should be greater to take account of the increased capital cost. Often such data may be available from independents or the taxpayer may bring forward its own contemporaneous data on the basis that the data have been created for business and management purposes and have been validated by the regulatory authorities, although such data require careful analysis and evaluation.

151. As always when conducting a comparability analysis, it is necessary to consider, in addition to the functions performed, a variety of other factors that may affect the transaction, such as the economic circumstances of the particular market, the business strategy of the taxpayer, the risk profile, and the type and nature of the product. In markets that are not de-regulated, the capital position of the financial institution may not be so important because there is an explicit or implicit government guarantee of the institution and so there is less incentive for customers to pay a premium in order to deal with a highly rated institution. Also the influence of capital is likely to be more important for products that are complex and innovative rather than of a “plain vanilla” type and where the duration of the contract is long rather than short.

152. The second situation is where it is necessary to separately evaluate the role of capital, *i.e.* where arrangements exist between the associated enterprises whereby the capital necessary to support the risks resides in a different legal enterprise from the enterprise which performs the functions giving rise to the risks actually assumed as a result of the global trading activity. This may take one of two forms: the capital possessor may provide a guarantee or other arrangement by which it provides credit support with respect to transactions entered into by a second enterprise; or it may directly book the transactions onto its own balance sheet or enter into back-to-back transactions with the second enterprise mirroring the transactions the second enterprise has with its customers. It should be noted that in neither case does the enterprise possessing the capital contribute actual debt or equity capital to the associated enterprise carrying on the functions giving rise to the risk.

153. In the first case, the arrangement allows the second enterprise to enter into global trading transactions with counterparties in its own name. The enterprise possessing the capital assumes risks in accordance with the terms and conditions of the arrangement. The transaction or arrangement may be disregarded under the guidance of paragraph 1.65 of the Guidelines. Furthermore, there are circumstances in which the arrangement would not be recognised because it was not made under the normal commercial conditions that would apply between independent enterprises (see paragraph 1.66 of the Guidelines which discusses the circumstances in which transactions between associated enterprises would be restructured in accordance with economic and commercial reality). For example, the enterprise possessing the capital must have sufficient capital to be able to bear any losses resulting from the risks assumed under the arrangement with the other enterprise carrying on the trading activity.

154. In the second case, the entity possessing the capital directly assumes some or all of the risks arising from the global trading activities but it does not carry out the functions giving rise to such risks. As described in paragraph 13, there are various business reasons for such a structure and various forms that it can take. In some cases a question may also arise as to whether the enterprise possessing the capital has a dependent agent PE in the jurisdiction in which the associated enterprise is located, or whether the services provided by the associated enterprise to the entity legally bearing the risk to capital are services of an agent of independent status. Some guidance is provided in Section D-3 in respect of cases in which a dependent agent PE is found to exist.

155. In either of these cases, it needs to be determined, firstly whether the arrangements should be recharacterised or disregarded under paragraphs 1.65 and 1.66 of the Guidelines and, secondly, if the arrangements are recognised, how such arrangements should be rewarded in accordance with the arm's length principle. The question must be answered by a full functional and factual analysis of the functions performed (and value added) and the risks assumed under the arrangements by all the associated enterprises.

156. For example, in the first case, the entity possessing the capital may guarantee a single transaction entered into by the other enterprise. In these circumstances it may be possible to determine the arm's length compensation by reference to the developing credit-swap market. At the other end of the spectrum, the entity possessing the capital may guarantee all global trading transactions entered into by the other entity, subjecting itself to significant and fluctuating risk. In those exceptional circumstances, the enterprise possessing the capital may insist on receiving a share of the net profits arising from counterparty transactions. The reward for the guaranteeing enterprise will of course be dependent on the capital strength of both the guarantor and the guaranteed. Notably, the provision of capital ordinarily would be viewed as unlike the provision of a guarantee, the value of which is primarily a function of the guaranteed party's creditworthiness (assuming that the guarantor itself is creditworthy). The more creditworthy the guaranteed party, the less the reward for the guarantor.

157. Similarly, in the second case, where a low risk asset is created, the credit risk management activities may be expectedly less significant such that an arm's length arrangement might be that the trader would be rewarded on a commission basis (for which a suitable CUP should be available) and the enterprise possessing the capital would receive the balance of the return on the asset (that residual return may of course be very little as low risk assets require little if any capital, and are funded largely by interest-bearing debt). Where the activity undertaken is high risk, the potential reward will be higher, and in situations where the activity is more complex, there may be fewer transactional comparables. In such circumstances, the capital provider and trader may enter a profit split arrangement and, at the extreme, a profit split methodology may be an appropriate method of rewarding the parties.

158. In short, in both cases there are numerous paradigms along the spectrum and the range of acceptable pricing methodologies available will vary according to the facts of each case. Where the entity possessing the capital has assumed relatively little risk, traditional transaction methods may be more suitable while some form of transactional profit split method might be appropriate in cases where the entity possessing the capital has assumed higher levels of risk.

159. Issues also arise as to exactly how to reward the enterprise possessing capital under the profit split methodology. Third party data may well be available to help decide on how the profits could be split. For example, where the capital resides in a different legal enterprise from the enterprise employing the traders and risk managers, data may be available showing the division of profits in joint ventures between independent traders and enterprises possessing capital. However such data would have to meet the comparability standard of Chapter I and Chapter III of the Guidelines. For example, data are unlikely to be comparable unless they relate to current market conditions, or there is sufficient information about the risk assumptions or business strategies that gave rise to the allocation of profits between the joint ventures, etc.

160. These concerns are particularly relevant with respect to the suggestion that a "hedge fund" model would provide an appropriate comparable for purposes of determining a reward to capital. The suggestion is that the traders employed by a bank to manage the bank's risks are in a position similar to the manager of a hedge fund, who has found investors who are willing to delegate management of their capital to the manager in return for what they believe will be a higher overall return. Hedge fund managers are typically rewarded with a fee calculated as a small percentage of assets under management, plus a share of profits. A further feature of hedge fund manager remuneration is that the hedge fund manager's share of the profits

reflects the fact that they do not take any share of the losses. However, notwithstanding the desirability of finding a pragmatic solution to a difficult transfer pricing problem, the arm's length principle dictates that the hedge fund model can only be used if it is in fact a reliable comparable, *i.e.* there are no material differences or it is possible to make reasonably accurate adjustments for any material differences.

161. The first concern is whether it is possible to make reasonably reliable adjustments to account for any material differences between the potential hedge fund comparable and the controlled transaction, *i.e.* the provision of capital by one enterprise to support the global trading activities of another associated enterprise. The fact that the individuals involved in hedge fund management are often former traders for financial institutions does not of itself mean that the reward for investing capital in a hedge fund is comparable to the reward for supplying capital to support a market-making activity. The extent to which the hedge fund model may provide a reliable comparable depends to a large extent on the financial institution's business strategy. Thus, the hedge fund model may be a useful analogy for a proprietary trading business, or a trading book in which the strategy is to earn a significant proportion of the income by taking unhedged, proprietary positions to generate significant trading gains. This is because the strategy of proprietary and quasi proprietary businesses is to undertake whatever trades or transactions they believe will generate the largest overall returns. Hedge fund investors generally charge the fund's managers with the same objective, so, depending on the facts and circumstances, the remuneration arrangements commonly observed in hedge funds may provide a reasonably reliable comparison for allocating profit between participants in a firm's proprietary or quasi proprietary trading arrangements.

162. The analogy to hedge fund arrangements becomes less reliable, however, when a trading book is run on a more conservative basis, incurring little in the way of unhedged risks, and earning most of its income from the dealer spread between bid and ask prices. Customer businesses tend to be driven primarily by commissions and spreads rather than trading gains. Although execution and hedge management may result in gains or losses that far outstrip commission and spread gains (indeed, the price and structure of a particular customer transaction may depend upon the global dealing operation's assessment of trading risks and rewards), the customer business of a global trading operation is grounded by definition in taking spreads from facilitating customer wishes rather than in taking gains from trade. In such circumstances, the hedge fund model is unlikely to be a reliable comparable. This is because a business which has a steady service fee income in addition to trading gains/losses on the unhedged part of the portfolio is less risky than a business that has no such income and relies wholly on trading gains, with the result that the reward for capital for supporting such a business is different (see paragraphs 156-157 above). Additionally, a customer flow and market-making business relies upon a substantial selling infrastructure (involving personnel and both physical and intangible assets) which is largely absent in a hedge fund manager business. It may be possible to make adjustments to the hedge fund comparable to account for some of the differences, but the more adjustments one is required to make, the less reliable the comparable becomes. Accounting for differences in intangibles is particularly difficult. Where the global trading business relies upon intangible assets the differences with the hedge fund manager may not be reliably accounted for by computing arm's length remuneration for the sales/marketing function.

163. It should be noted that global traders generally leave at least some of their positions unhedged, but it is only when the business strategy is to leave a significant percentage of positions unhedged that it becomes sensible to describe the business as quasi proprietorial, and hence potentially appropriate for comparison with a hedge fund. This is a question to be decided on the facts and circumstances of a particular case.

164. Estimated future profits can be more readily ascertained for lower expected risk of particular kinds. Accordingly, although a capital provider bears the risk of loss as counterparty to transactions, a low expectation of such risk may warrant a CUP for measuring the appropriate return to capital by reference to fixed rates lenders obtain for similarly low risks. This comparable operating condition will more likely be

present when the activity undertaken by the traders is merely to manage market risks with respect to lower risk counterparties.

### ***C - 3 Transactional profit methods***

#### *i) Types of transactional profit methods to be used*

165. Chapter II of the Guidelines describes the transactional profit methods that might be used to approximate arm's length conditions. These are divided into two types of methods.

- The first type is the transactional profit split. This involves splitting the net or gross profits derived from a transaction (or combined transactions) between entities according to the relative contribution of the enterprises involved. The profit to be split may be the entire net or gross profit earned by the enterprises involved (contribution analysis) or the residual profit after the enterprises involved have each been allocated a basic functional reward (residual analysis).
- The second type of transactional profit method is the transactional net margin method (TNMM).

Only profit methods of the type authorised by Chapter II of the Guidelines are to be applied and so any method based on global formulary apportionment must be rejected.

166. Issues arise as to how to calculate the “combined profit” when the various jurisdictions involved compute taxable profit on a different basis (realisation, accruals, mark to market). In general, combined profit is likely to be computed under mark to market rules as these are used both for business and for regulatory purposes, even if the profit shares computed under mark to market rules may be adjusted in some jurisdictions in accordance with their rules on computing taxable profits. Even where all jurisdictions use mark to market, there can still be differences in the computation of profits to be split due to differences in the way the various jurisdictions involved apply mark to market. Similar issues arise whenever profit split methods are used and so are not discussed further in this Report.

167. Issues also arise as to what revenues should be included in the profits to be split. A common problem is in deciding whether the revenues of a treasury book should be taken into account in the global profit split. These revenues could include interest or other income from investing surplus cash or capital and gains or losses from hedging transactions. The resolution of these issues affects the aggregate amount of profits from global trading which is to be allocated among the different jurisdictions. If the decision is taken to exclude the treasury book from the scope of the profit split, it is essential that the transactions with the global trading book are undertaken under arm's length conditions. This is a transfer pricing issue if the treasury book is in a different legal enterprise from the global trading book and it should normally be possible to apply traditional transaction methods because comparable market data should be available, particularly since, as mentioned in paragraph 62 above, the treasury desk enters into transactions with third parties.

168. Issues also arise as to whether the profit split should be applied to either gross or net (operating) profits. Guidance can be found at paragraph 2.131 of the Guidelines, which states that:

Generally, the combined profits to be split in a transactional profit split method are operating profits. Applying the transactional profit split in this manner ensures that both income and expenses of the MNE are attributed to the relevant associated enterprise on a consistent basis. However, occasionally, it may be appropriate to carry out a split of gross profits and then deduct the expenses incurred in or attributable to

each relevant enterprise (and excluding expenses taken into account in computing gross profits).

169. Given that both gross and net profit split methods are expressly permitted by the Guidelines, it is more important in a particular case to ensure that whichever approach is used gives a result within the arm's length range, rather than attempting to determine that one approach should have priority over the other as a general rule.

170. The residual profit split method may be particularly applicable to some global trading situations because of the wide range of functions that are performed. These range from extremely basic data processing functions to extremely complex marketing, trading and risk management functions performed by highly skilled and paid personnel which risk the capital of the enterprise concerned. Under this method, first of all the more basic or non-integrated functions can be rewarded by traditional transaction methods based on comparable data, leaving the more complex functions, for which it may be very difficult to find comparables, to share in the residual profit or loss.

171. For example, the basic trading function could be rewarded in the first stage by reference to market data on non-discretionary or low level activities leaving the discretionary or complex elements to be rewarded by a share in the residual profit or loss. The approach also has the potential to produce a result in accordance with economic theory as the low level functions may receive a lower but more certain economic return, whilst the more complex functions will receive a potentially higher but much more volatile return, with a real risk of making a loss, as well as the possibility of making large profits, in any one year. The residual profit or loss can then be split by reference to an appropriate profit split methodology based on the relative contributions of the parties. In a residual profit split, however, routine functions are not equated with low economic returns. Such functions are those for which market benchmarks are more readily available for determining compensation. For example, the reward for the possession of capital that supports the risks deriving from global trading transactions may be accurately remunerated by reference to market benchmarks and thus may be classified as "routine" even though the market benchmarks may yield a high economic return.

172. However, in some global trading situations, the residual profit split method may not adequately capture the synergy that the integration of functions found in global trading operations creates and so underestimates the value of functions that do not share in the residual profit or loss. In such cases, the contribution profit split method may be more reliable because it ensures that all the functions that contribute to the earning of the profits from global trading (*i.e.* the aggregate of the initial profits (dealer spread) and any subsequent trading profits (or losses)) are included in the profit split and avoids having to make an evaluation of which functions in an integrated global trading business are low level and which are not.

173. The sheer diversity of the organisation, business strategies, products and functions of global trading businesses has meant that to date taxpayers and tax authorities have been reluctant in global trading cases to use the other acceptable profit method described in Chapter II of the Guidelines, the transactional net margin method (TNMM). In the core trading function particularly, such diversity makes it very difficult to be sure that the net margins of the uncontrolled transactions are indeed comparable to those found in the controlled transactions. There may be greater scope for using the TNMM when considering middle and back office support functions though there remain problems in that area. In respect of support functions, it might be possible to use TNMM in conjunction with other methods. For example, if it is decided to reward a support function by a traditional cost plus method based on the gross margin of the transaction, in some circumstances it may be useful to also compare the net margin on the transaction, especially where it is not entirely clear exactly what functions are covered by, or what costs are deducted in arriving at, the gross margin found in the independent transactions.



ii) *Application of profit split methods to global trading*

174. To apply a profit split method to global trading first of all requires an identification of the functions that need to be rewarded by a profit method following the guidance in Section C-2. It should be noted that when the residual profit method is applied it is only the functions producing the residual profit or loss that need to be included in the profit allocation. The reward for performing the other functions will have already been deducted in calculating the residual profit or loss.

175. Once the relevant functions have been identified, it will be necessary to determine the relative contribution of each function to the earning of the combined profit from global trading. The final step is to determine the relative contribution of each location to the performance of the function. As with all transfer pricing, the above determination of the reward for particular functions should consider the assets used and risks assumed in the performance of those functions. A common approach to applying the profit split method (a multi-factor formula) is to select factors to represent one or more of the relevant functions, to weight the factors to determine the relative contribution of the function(s) represented by each factor and to use the factors to allocate the profit to the locations performing those functions.

176. The rest of this sub-section provides further guidance on how to apply the profit split method in accordance with the arm's length principle, with particular reference to the multi-factor formula approach.

a) Identification of the functions to be rewarded by a profit share

177. Section C-2 identified the various functions of global trading and discussed how those functions could be rewarded, including by the use of profit split methods. Any of the functions listed in that Section could be included in the profit split method. However, given that the trading and risk management functions are generally the most important people functions in a global trading operation, whenever a profit split method is applied, the performance of the trading and risk management functions will need to be rewarded by a share of the combined profit that those functions have helped to create.

178. Similarly, there may be global trading cases where the marketing function may be rewarded by a share of the profits from global trading. Under a residual profit method, it is only likely to be those marketers who are involved in the structuring or dealing aspects that need to be rewarded by a share of the profits from global trading. Other marketing function(s) are likely to have already been adequately rewarded by means of a service fee or commission (perhaps including a share of the dealer spread) that reduces the residual profit available to be shared.

179. As discussed in Section C-2(iii) it is normally possible to reward the performance of most support, middle office or back office functions by means of traditional transaction methods. In the cases where support functions are to be rewarded by means of a share of profits from global trading, it is only likely to be the activities of some key support staff who play significant roles in determining the profitability of the whole operation, for example by managing and minimising operational risk, that are to be included in the profit split. This may be either because it is not possible to reliably adjust for the extra functions they perform or because they are so integrated with the trading or risk management functions that they cannot be evaluated on a separate basis.

180. As discussed in Section C-2(iv), there may also be a need to reward the enterprise possessing the capital necessary to be able to support the risks assumed from the performance of "people" functions, sometimes through a share of the profits from global trading. As discussed in paragraphs 152-159, this would only be included in the profit split if it was not possible to apply reliably traditional transaction methods to reward that enterprise. Similarly for capital, it should be emphasised that in profit splits

involving associated enterprises the reward for capital, whether included in the profit to be split or whether rewarded separately, only goes to the enterprise(s) that have the capital.

181. Having identified the functions that need to be rewarded with an allocation of profit, the next step where a multi-factor formula approach is used is to select the factors to represent the functions to be included in the profit split. Historically, a “front office” factor has been used in global trading profit splits to represent the performance of the marketing, trading and risk management functions. These functions are lumped together in a single factor because the factor is usually measured by the compensation of the marketers and traders/risk managers. This is discussed in more detail below.

182. However, this approach should be viewed with caution and may not be appropriate in all cases. Regard must be had to the precise functions performed by the various personnel groups and to the different types of risks which each assumes. Marketers, for example, will sometimes have primary responsibility for judging the status of a counterparty and deciding to assume the credit risk whereas traders will be primarily concerned with the market risk and decisions on whether or not to take a proprietary position. The institutions’ higher-level risk managers will have regard to both types of risks. In some cases it may therefore be more appropriate to select a separate factor representing each of the functions to be rewarded in the profit split. For example, there might be separate factors for marketing, trading and risk management.

183. It is also the case that some locations may trade “riskier” products than others and when that is the case the use of a “risk factor” may be required. The importance of this factor and the weighting assigned to it would depend on the nature of the trading activities and the risk assumed as a result. Business indicators such as measures of initial values of particular transactions and representative figures from internal risk management models of risk limits and value at risk assigned to particular trading locations may be taken into account. One purpose of including a risk factor in the profit split is to account for the variation in business (and thus the use of capital) that may exist between locations where this variation is not adequately reflected in the remuneration factor.

b) Measuring the relative contribution of functions - weighting of the factors

184. It is very unlikely that each function contributes equally to the whole profit. Therefore, where a multi-factor formula is used it is generally appropriate to weight the factors according to the relative contributions of the functions they represent to the overall profitability of the global trading operations. It may not be necessary to weight the factors where compensation is used to measure more than one factor and the relative differences in the contributions of the factors are reflected in the relative differences in the compensation. The weights given to the factors should be determined on a case-by-case basis to ensure that the profit split method results in an arm’s length profit allocation, which distinguishes it from global formulary apportionment. Whatever type of profit split method is employed (whether based on a residual or on a contribution analysis) it is essential that functions are fully evaluated in order to arrive at an arm’s length result. This is discussed in detail in Chapter II of the Guidelines.

185. The determination of the relative contribution of each function (or weighting of the factors where a multi-factor formula is used) should be carried out objectively, for example by reference to an economic analysis of the key functions contributing to the earning of the profits from that particular transaction. The determination should also be based as far as possible on empirical data and external benchmarks of how independent parties would allocate profits, taking care to adjust for differences in economic circumstances, characteristics of the product, and business strategies, etc., as described in Chapter I of the Guidelines. The internal data of the taxpayer may be a useful starting point in making this determination, especially where the taxpayer has tried to measure for management purposes the relative contributions of particular functions to the earning of profit. For example, where compensation is used to measure both the trading

and marketing functions, the compensation of the traders could be multiplied by 1.5 where it could be demonstrated that trader compensation results in the earning of 1.5 times the profit earned from marketers' compensation. Such an exercise may, however, be too subjective and difficult to implement reliably.

c) Determining the relative contribution of each location - measurement of factors

186. Where the function(s) are performed in more than one location, it will be necessary to determine the relative contribution of each location to the performance of the function. Under a multi-factor formula it will be necessary to determine the relative contribution of the various locations under each factor. For "people" functions, the compensation of the personnel performing those functions in each location could be used as a factor that reflects the relative contribution of that location to the earning of the global trading profit. This is on the basis that there is a good correlation between the earning of profit for the firm and the earning of compensation for the individuals. The correlation arises because the performance of key global trading personnel, especially traders, risk managers and specialised marketers, is crucial to the profitability of global trading. They require adequate compensation for their performance and, if not rewarded adequately, often move to an enterprise which does so reward them.

187. In the rather specialised field of global trading, the compensation negotiated with wholly independent enterprises would also seek to measure the relative contribution of key global trading personnel to the realised profits. Therefore, their compensation is generally correlated with the arm's length value of the functions that they perform and so can be used as a factor to measure the relative contribution of each location to the performance of the particular function. For example, if the total compensation of "front office" personnel in location A is 20% more than "front office" compensation in location B, then location A should be allocated 20% more of the profit arising from the performance of the front office function. However, to keep this correlation, care should be taken to exclude any part of the compensation package which is unrelated to performance.

188. Problems may arise where a single front office factor is used to represent a number of different global trading functions and the factor is measured by the compensation of the people performing those functions. For such a factor to adequately reflect the contributions to profit, it is essential that there is the same relative correlation between compensation and the earning of profits for each function. In other words, each dollar of compensation should result in the same relative amount of dollar profit. Where the correlation differs significantly between functions, it would not be appropriate to use a single "front office" factor without some kind of weighting to reflect the differences between the functions making up the factor.

189. Moreover, if the relationship between compensation and the relative performance of "people" functions breaks down for any reason, then an alternative way of measuring such functions needs to be considered. For instance, the relative contribution of different locations to the marketing function could perhaps be determined by measuring relative volumes, such as the number of transactions or notional amounts of contracts written at a particular location. Differences in exchange rates and in the nature of the underlying products (*e.g.* vanilla products may require less skill, time, and effort than structured products and so may be higher volume but lower value than structured products) may need to be taken into consideration. The same caveats would apply as for the inclusion of any other factor. The inclusion of a separate volume factor, for example, could lead to double counting of the marketing function if the compensation of some marketers is included in another factor.

190. There are two other issues that need to be addressed when using compensation as a factor to allocate the reward for performing one or more "people" functions between different locations. The first issue arises where a global trading activity that is the subject of a profit split method results in a trading loss in any year. This is because the correlation between bonus compensation and losses may be less clear

than the correlation between bonus compensation and profits. In such circumstances a careful analysis of the enterprise's compensation policy for loss years and the reasons for a particular loss would be needed to construct a sensible methodology based on a proper analysis of the facts and circumstances of the particular case. Any solution that taxpayers adopt for dealing with losses should be consistent with the arrangements that would have been made, up front, by independent enterprises. In particular, a profit split model that is consistent with the *ex ante* risk of losses should not be altered simply because of an *ex post* realisation of losses.

191. The second issue relates to possible geographical differences in the level of average compensation. There seems to be a general agreement that there are significant differences in compensation levels between countries and that, in theory, adjustments may be needed to exclude any variations not directly related to performance but caused entirely by local factors such as cost of living, local employment conditions and local business practices.

192. There are a number of possible ways to tackle this problem. The first is to ignore the geographical effect on the grounds that there is no completely satisfactory evidence that the cost of living is not reasonably comparable in the major global trading centres and that it is difficult in practice to make accurate adjustments. The second is to focus only on the part of compensation that reflects the value of the traders' (or marketers') performance, *e.g.* the bonus element, and ignore basic salary and guaranteed compensation, etc. This appears to be administratively simple, but in fact may be difficult to apply in practice because performance-related payments could be made in other forms (*e.g.* tangible goods) or from other sources (*e.g.* under a dual contract) and the bonus element of the total salary package may vary, not because of performance, but for other reasons such as cultural differences and employee expectations. The third way is to apply available indices to correct for purely geographical differences. However, care should be taken to apply indices that reflect circumstances specific to global trading and not simply the relative performances of the national economies. Moreover, only those portions of the compensation that reflect differences in the cost of living should be adjusted and such a solution would only deal with the problem of cost of living and not differences in local costs of employment and business practices.

193. In the view of some countries, however, it does not appear appropriate to make a cost of living adjustment to the factors because the justification for using traders' compensation as an allocation factor is the assumption, based on empirical evidence, that it correlates with profit. Such an adjustment would undermine that assumption, and could lead to proposals for further adjustments such as the differences in business tradition regarding the manner in which traders are rewarded. The proponents of this view argue that traders in some countries are compensated more highly than traders in others regardless of the cost of living. Furthermore, any such adjustments would increase the administrative burdens on taxpayers and the taxing authorities.

194. It is not possible to provide a general rule to deal with all the issues raised above. Following the arm's length principle, a case-by-case approach is necessary and data on how independent parties would have dealt with these issues should be sought and used if available. Some data may be available from the "joint venture" arrangements already referred to in this paper, provided regard is had to the caveats about comparability discussed in paragraph 149. Some light may also be shed on the subject by examining the internal data of the company, for example with respect to whether management, "middle office" or marketing staff share in the same bonus pool as traders.

#### Losses and regulated enterprises

195. A particular issue in global financial trading arises when one or more of the enterprises involved is a regulated entity, which is not licensed to bear significant risk, and hence is not capitalised to support significant risk. In such circumstances regulatory restraints may prevent the regulated enterprise from

sharing in losses booked in a non-resident enterprise. In some cases a correct analysis of the situation (in accordance with the guidance in Section D-3 below) may reveal that the losses generated by functions performed by the regulated enterprise on behalf of the non-resident enterprise do not belong to the regulated enterprise, but to a dependent agent PE of the non-resident enterprise for whom the regulated enterprise acts as agent, subject to the Article 5(5) PE threshold being passed. In those circumstances no issue would arise. In other cases, where no dependent agent PE is created as a result of the activities between the regulated enterprise and the non-resident enterprise there can be a problem where the transfer pricing analysis attributes a loss to an enterprise which is legally not permitted to bear such a loss. However, whether or not an enterprise is prohibited by regulations from performing functions which may create significant losses is not determinative of where profits and losses are attributed for tax purposes. This is because an enterprise may in practice, either accidentally or otherwise, perform functions that are prohibited by the regulator. In such circumstances, the enterprise would be taxed on what it actually did, not on what it was supposed to do if it had kept within regulatory limits as profits and losses are attributed by applying the authorised OECD approach based on a functional and factual analysis of all the circumstances of a particular case. Where the functional and factual analysis shows that it is appropriate for one party to be shielded from losses, one solution would be to factor into the profit split up front the fact that one of the parties will not bear losses in the loss years. This would mean that the party insulated from losses would not expect such a big share of the profits in profitable years.

d) Assets used and risks assumed

196. As noted in Section C-2(iv), the enterprise or enterprises possessing the capital necessary to be able to support the risks assumed from the performance of the “people” functions may in some circumstances be compensated using the profit split method. This raises the issue of how to determine the arm’s length reward, especially where there is more than one entity so that there is a need to measure the relative contribution of the different entities. This would be determined on a case-by-case basis. However, unlike the “people” functions described above, it may not be possible to use a factor based on compensation and so it may be necessary to find other ways of measuring the relative contribution. Possibilities might include internal management data such as capital allocation models or measures of capital “put at risk”, Value at Risk (VAR), etc.

197. Finally, just as in the situation where traditional transaction methods are applied, it will also be necessary when weighting or measuring factors to consider whether “risks assumed” or “assets used” have been appropriately taken into account when measuring the contribution of the functions included in the profit split. To illustrate, suppose that the relative contribution of each location to the trading and market risk management functions is determined by the use of a single measure, the “front office” factor, based on the compensation of the marketers, traders and market risk managers. Following the guidance in the Guidelines, it will be necessary when undertaking a functional analysis of the trading and market risk management function in each location to analyse what intangibles were used and what risks were assumed in that location.

198. Suppose that differences are found between the various locations, perhaps because the trading and market risk management function is organised not on fully integrated trading lines but more as a hybrid between the integrated trading and centralised product management models. The traders in location X are found to use an intangible (“trader know-how”) which was developed by them. Further, they are found to have higher risk limits, and have accordingly assumed more market risk. The profit split methodology must ensure that the differences in the “assets used” and “risks assumed” in location X are reflected appropriately in the reward given to the performance of the trading and risk management function in location X.

199. There are a number of possible ways of doing this. For example, it might be that the traders and market risk managers in location X are paid more than those in other locations to reflect their “know-how” and greater ability to assume market risk. In that case, using their compensation as the measurement of the “front office” factor should ensure that location X gets a greater share of the profits. However, if for some reason these differences are not appropriately reflected in the compensation of the traders and market risk managers in location X, these differences would have to be taken into account in some other way. Perhaps the traders in location X should have their compensation multiplied by an appropriate amount so as to give it more weight in the calculation? Perhaps, as well as the “front office factor”, there would have to be appropriately weighted “intangible” and “risk assumption” factors, provided that doing so would not result in a double counting of these functions. Another possibility may be to reward the owner of the intangible by way of a royalty. Again, this determination would have to be made on a case-by-case basis.

#### **D. Applying the authorised OECD approach to global trading enterprises operating through a PE**

200. This Section discusses how to apply the authorised OECD approach to a PE of a global trading enterprise. The Section is divided into three parts. Section D-1 describes how to apply the first step of the authorised OECD approach to determine the activities and conditions of the hypothesised separate and independent global trading enterprise. Section D-2 describes how to apply the second step of the authorised OECD approach to determine the profits of the hypothesised separate and independent global trading enterprise. Section D-3 discusses some special issues arising where global trading is conducted through agency PEs.

##### ***D-1 First step: determining the activities and conditions of the hypothesised separate and independent enterprise***

201. It is necessary under the first step of the authorised OECD approach to hypothesise the PE as a separate and independent enterprise “engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise”. As explained in Part I of this Report (see Sections B-3 and D-2) this will be determined by a thorough functional and factual analysis, conducted in accordance with the Guidelines, in order to appropriately hypothesise the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks (and liabilities, in particular “free” capital and interest-bearing debt) and entering into dealings with each other and transactions with other related and unrelated enterprises. The functional and factual analysis performed in the first step must identify the economically significant activities and responsibilities undertaken by the PE. This analysis should, to the extent relevant, consider the PE’s activities and responsibilities in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the PE. In the global trading context, the function of market risk management is likely to be of particular importance. The accounts or books of the PE will be a useful starting point in this analysis but will not be determinative. For example, as with banks, while taxpayers may book financial assets or instruments 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 definition of global trading and a brief general functional and factual analysis of global trading activities. This should assist in carrying out the functional and factual analysis of a global trading enterprise.

202. Having identified the functions performed, including the key entrepreneurial risk-taking functions, and other relevant factors of the enterprise in relation to global trading operations, and identified which of those functions are performed by the PE and which risks assumed by the PE, the authorised

OECD approach is to attribute assets created as a result of performing those functions and assuming those risks. As for a bank, capital adequacy (especially “free” capital) and creditworthiness are likely to be particularly important for global trading enterprises as both affect the profitability of the enterprise, for example by affecting the margins that can be earned on derivative instruments (the amount independent parties may effectively pay for a derivative instrument may depend in part on the credit rating of the enterprise providing the instrument). This section 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 global trading PE.

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

203. Looking at the description of the key entrepreneurial risk-taking and any supporting functions necessary to create a new financial instrument, or to subsequently manage that instrument, at Section B-3(i) above, it can be seen that all of the functions are performed by personnel: “people functions”. The functional analysis should therefore 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 functions, 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 where appropriate the general guidance in Section D-3(iv)(d) of Part I of this Report. It may also be relevant to consider the impact of intangible assets described in generating income in a global trading business (see Section B-3(ii)). Guidance on the application of the arm’s length principle to intangibles is found in Section D-2(iii)(c) of Part I.

204. In addition to the input from the relevant personnel, the performance of such “people functions” also requires capital in order to initially assume and subsequently bear the risks associated with the performance of the functions. Pure capital and risk-taking arrangements, *i.e.* arrangements that relate simply to possessing the capital necessary to initially assume and subsequently bear risks, can exist between independent 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. As noted in paragraph 156 the extent to which a guarantee arrangement transfers risk to the guarantor enterprise depends on the respective capital strength of the guarantor enterprise and the enterprise carrying out the business functions.

205. However, one of the key factual conditions of a global trading 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 authorised OECD approach. Rather, as can be seen from later sub-sections, the authorised OECD approach uses a functional and factual analysis to attribute 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 have been properly attributed to another part of the enterprise following the functional and factual analysis. Consequently, models that provide a separate reward for capital and purport to assign capital ownership to one part of an enterprise without regard to the performance of the key entrepreneurial risk-taking functions, such as hedge fund models, are fundamentally inapplicable in a single enterprise context.

206. As noted for banks, tax issues arise particularly where the same function is 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 instrument 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. The location that had actually evaluated the risks related to the transaction and had made the decision to accept and manage those risks would therefore be treated as the “economic owner” under the first step of the authorised OECD approach and so would be allocated the financial instrument and its associated income. The economic owner of the financial asset would then be required under the second step of the authorised OECD approach to deal with the part of the enterprise which performed the origination function as if it were a separate and independent enterprise. An arm’s length price for that dealing is determined by applying the Guidelines by analogy.

207. This issue is very important for global trading, especially when trading/risk management activities are organised under the centralised product management or integrated trading models (see Section B-2(iii) above). In the centralised product management model, the marketing function is decentralised so as to be easily accessible to clients whilst the market risk management function for a particular book is centralised in one location. This means that the marketing and trading/risk management functions will often be conducted in different geographical locations leading to the existence of dealings between the centralised product management location and the various marketing locations. In the integrated trading model, all the marketing, trading and risk management functions are split as each trading location carries out all these functions in respect of common books of financial products. Therefore, there are potential dealings between all trading locations in respect of the marketing, trading and risk management functions.

208. Additionally, as noted in Section C-2(ii), in some centralised product management models and in all integrated trading models there is not just a splitting of a particular function but also some level of integration between different functions, for example between the marketers and traders. The functional analysis of the PE should therefore evaluate the level of integration both within, and between, functions performed by the PE. As discussed for global trading undertaken between associated enterprises, such integration may need to be taken into account when determining the arm’s length remuneration for the performance of an integrated function.

a) Assets used and conditions of use

209. 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 intangible assets used, the most important intangibles used in a global trading business have already been identified in Section B-3(ii) above. It is not considered that the determination of the economic owner of intangible assets used in global trading gives rise to any specific problems which require guidance beyond the general guidance already given in Section D-2(iii)(c) of Part I of this Report.

b) Risks assumed

210. Part II of the Report found that for banks involved in wholesale commercial lending, it is generally the performance of the sales/trading function that 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 subsequently successfully borne so that losses from the realisation of the risks assumed are minimised. Consequently, as noted in Part II, it is the undertaking of these key entrepreneurial risk-taking functions that creates the possibility of significant loss for the bank and the need for minimum regulatory, including “free”, capital. The attribution of risks to a dependent agent PE is discussed in Section D-3.

211. The overall conclusion for global trading businesses is similar. However, there may be differences between global trading and banking due to their different nature and the different risk profiles



of loans and financial instruments. These differences are reflected generally in the types of functions performed and, in particular, the fact that functions equivalent to the sales/trading functions in a traditional banking business may be performed to some extent jointly by marketers and traders in global trading.<sup>11</sup>

212. Where this occurs, the type of risks assumed will depend on the exact nature of the functions performed. As noted in Section B, marketers are particularly likely to be involved in the negotiation aspects of the marketing function, especially the evaluation of the credit risk, negotiation of the final price with the customer and the subsequent contact with the client. Consequently, under the authorised OECD approach, it is the performance of such marketing/dealing functions that leads to the assumption of credit risk. Conversely, if the marketing location does not play a meaningful part in the negotiation of the contract but plays a general sales role of just introducing the client to the firm and the products it offers, then the sales function is unlikely to lead to the assumption of credit risk, or indeed any other risks related to the financial product.

213. Even where the marketing function includes some aspects of the marketing/dealing functions (*e.g.* the negotiation of the terms of the contract with the client), the minimum price at which the contract would be acceptable is still likely to be determined by the trader. This is because in order to commit the capital of the global trading enterprise the trader needs to work out the market risk assumed under the contract as well as how to manage the market risk so assumed in the most cost-efficient manner. Consequently, it is the performance of those functions that leads to the assumption of market risk.

214. Accordingly, the determination of which part of the enterprise assumes market risk will be influenced by the organisation of the trading/risk management function. Under the centralised product management model, a functional analysis is likely to show that the functions performed by the marketing location do not normally lead to the assumption of market risk by the marketing location. The functions leading to the assumption of market risk, as well as the functions related to the subsequent management of that risk, are performed by the centralised product management location. However, where the marketing location undertakes the negotiation aspects of the sales/trading function, that function may lead to the assumption of credit risk by that location.

215. Where neither credit nor market risks are assumed, this may be properly reflected by the fact that the financial instrument is never shown on the books of the PE, or if it is, the financial instrument is immediately transferred to the part of the enterprise undertaking the centralised product management. In other cases, where credit risk but not market risk is assumed by the marketing location, the booking of the contract in the marketing location together with the immediate transfer of the market risks to the centralised product management location, perhaps by means of a back-to-back derivative dealing at an arm's length price, would properly reflect the assumption of market risk by the centralised product management location and the assumption of credit risk by the marketing location. Between separate enterprises, the residual risk held by the parties to the derivative would inform the pricing of the transaction under normal transfer pricing principles and the same result is sought by Step 2 of the authorised OECD approach in the case of a single entity. Alternatively, this situation could be reflected by booking the financial instrument in the centralised product management location, which would then deal with the marketing location as if it were a separate and independent enterprise. Dealings between the PE and the other parts of the enterprise, such as the back-to-back derivative dealing referred to above, would be evaluated under the second step of the authorised OECD approach (discussed in Section D-2).

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11 As noted in Part II, the marketing function may be the key entrepreneurial risk-taking function in a retail banking business, though marketing in that context is different from the kind of marketer/dealer function under discussion in Part III.

216. Under the separate enterprise model, the PE operates as if it were a separate profit centre and so a functional analysis is likely to show that the assumption of credit risk and market risk takes place in the PE as well as the subsequent management of those risks.

217. Under the integrated trading model, a functional analysis is likely to show that both the credit and market risks are initially assumed by the location that enters into the deal with the customer, although those risks are subsequently managed by all the trading locations on a portfolio basis. However, the other transactions making up the portfolio will have originated in other trading locations. Therefore, each trading location in fact carries out the marketing, trading and risk management functions in respect of a common book of financial products. Therefore, there are potential dealings between all trading locations in respect of the marketing, trading and risk management functions.

218. As noted in Section B-2(iii), the organisation of some global trading businesses may not fall neatly within any of the models. In particular, some of the marketing/dealing and trading/risk management functions or even some aspects of those functions may be split between locations to some extent. In such cases, the assumption of risks associated with the performance of those functions might also need to be split between the various locations undertaking the related functions.

219. In conclusion, a thorough functional analysis will be needed in order to determine which part of the enterprise performs the various aspects of the marketing/dealing and trading/risk management functions that are the key entrepreneurial risk-taking functions and so will be treated as assuming the risks associated with the performance of those aspects. Particularly in the centralised product management model, or hybrids between that model and the integrated trading model, different parts of the enterprise may assume different risks. For example, the various marketing locations might assume the credit risk, whilst the assumption of market risk is concentrated in the centralised product management location. Further, where functions are split between locations there will be a similar split in the assumption of risk. A functional and factual analysis will also be needed in order to determine whether the part of the enterprise that assumes the risk also performs the function of managing the risks once assumed and, if not, which other part of the enterprise is performing the risk management function.

c) Consequences of attributing assets and risks to a PE

220. Under the first step of the authorised OECD approach economic ownership of financial assets is attributed to the part of the enterprise which performs the key entrepreneurial risk-taking functions described in this section, and the PE should be considered as assuming any related risks created by, or inherent in, those functions performed by the PE. This will give the location performing those functions (the “economic owner”) the income and expenses associated with holding the financial instruments or lending them out or selling them to third parties. This income can be viewed as representing an arm’s length reward for performing the various functions necessary to create and manage the financial instrument (taking into account assets used and risks assumed). The functional and factual analysis should also determine which functions are the significant people functions relevant to the economic ownership of other (non-financial) assets and to the assumption and/or management (subsequent to the transfer) of other risks, as those functions will attribute those assets and risks to a particular part of the enterprise (except that tangible assets will be attributed to the place of use unless circumstances warrant a different view). In turn “free” capital is attributed to the PE to support the various risks assumed. All functions have to receive an arm’s length remuneration, even if they are not key entrepreneurial risk-taking functions or significant people functions which attract financial or non-financial assets, respectively. Thus, under the second step of the authorised OECD approach, the part of the enterprise that is attributed the financial asset is required to deal with the parts performing non-key entrepreneurial risk-taking functions as if those parts were separate and independent enterprises. Guidance on when to recognise and how to price such internal dealings in accordance with the arm’s length principle is provided in Sections D-1(v) and D-2 below. The

profit attributed to the part of the enterprise attributed the asset will thus also take into account any dealings at arm's length with other parts of the enterprise for functions performed in relation to that asset and the interest expense related to funding the asset.

221. Under the arm's length principle the transfer price of goods or services is determined by reference to functions performed, assets used and risks assumed. Under the authorised OECD approach for attributing profits to a PE in respect of financial assets and risks, the key entrepreneurial risk-taking functions affect all three components and, because capital is needed to support risk, key entrepreneurial risk-taking affect particularly the attribution of capital to the PE. Key entrepreneurial risk-taking functions are amongst the most important people functions performed by the enterprise and this should be reflected in the amount of profits attributed to the PE. It may be necessary to adjust the interest expense attributed to the PE to take account of any "free" capital attributed to the PE to support the risks inherent in the financial assets.

222. The financial instruments and risks recorded in the accounts and books of the PE form a practical starting point for this attribution and should be respected for tax purposes, provided they are consistent with the functional analysis. There may however be cases where the accounts and records are inconsistent with the functional analysis, for example because material amounts of financial instruments and risks may be booked in locations even though none, or very few, of the functions related to their creation or subsequent management were performed there. Respecting the booking location in such cases would not lead to an arm's length attribution of profit.

223. This is why the basis of the authorised OECD approach is that financial instruments and risks would be attributed to a global trading PE by reference to a functional and factual analysis. Following the aggregation principle of the Guidelines (see paragraph 3.9) this analysis may be performed at the level of portfolios of similar instruments and risks, rather than for each individual instrument and risk.

224. 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 instruments and risks. Where the functional analysis shows that key entrepreneurial risk-taking functions related to the creation of the instrument 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 instrument and so have attributed to it the benefits and risks of ownership of the instrument, in the form of the associated income and expense. This determination is to be based on the functional and factual analysis. For a global trading enterprise this will generally be based on where the marketing/dealing and trading/risk management functions were performed. This is on the basis that it is the performance of those functions that generally leads respectively to the assumption of credit and market risks and it is the assumption and management of those risks that requires capital to meet any losses resulting from the realisation of those risks.

225. Where the functional analysis has determined that the PE alone has performed all aspects of the marketing/dealing and trading/risk management functions (*e.g.* under the separate enterprise model and in some cases in which the centralised product management model is used), the PE will be attributed the portfolio of newly created financial instruments and risks (both credit and market risks) associated with the performance of those functions. However, as noted in Section D-1(i) above, especially where global trading is organised under the integrated trading model, or a hybrid between that model and the centralised product management model, the functional analysis under the first step of the authorised OECD approach is likely to show that the functions related to the creation and subsequent risk management of the portfolio of financial instruments are performed partly in one jurisdiction and partly in another. This raises the issue of which part of the enterprise should be considered the "owner" of the portfolio of financial instruments

and risks. As noted in Section D-1(i)(b), this determination is to be based on the functional and factual analysis of where the key entrepreneurial risk-taking functions are performed.

226. Where the functional analysis determines that the key entrepreneurial risk-taking functions were performed in only one location and that the other locations performed support functions, the location performing the key entrepreneurial risk-taking functions would have the individual assets and risks or the portfolio of financial instruments and risks attributed to it and so be treated as the “economic owner” of the individual assets or the portfolio and the associated income and expense. Especially in the integrated trading model, the functional analysis may show that the key entrepreneurial risk-taking functions have been performed in more than one location so that the financial instruments or portfolio of financial instruments can be considered as owned jointly. The issue of how to attribute jointly owned portfolios of assets and risks is discussed in Section D-2 below.

227. Events subsequent to the creation of the financial instruments and risks may also affect where they are ultimately attributed. Subsequent transfers may lead to the financial instruments and risks being wholly or partly attributed to another part of the enterprise, provided those transfers are recognised for tax purposes following the guidance given in Section D-2(ii)(c) below. Further, that attribution would also have to take into account any subsequent events leading to the financial instruments and risks portfolio becoming jointly owned.

228. For example, where key entrepreneurial risk-taking functions, such as market risk management, are transferred to another part of the enterprise, the financial instruments and risks might be treated as partly attributable to the part of the enterprise that created them and partly attributable to the part of the enterprise that is performing the risk management functions. This attribution would be made on the basis of the functions performed and would also need to take into account the risks transferred and the risks retained.

229. As indicated in Part I, the profits (or losses) of the PE will be based on all its activities, including transactions with other unrelated enterprises, transactions with related enterprises and dealings with other parts of the enterprise to which it belongs. Accordingly, as part of the functional and factual analysis carried out in step one, it will be necessary to attribute to the PE those rights and obligations of the enterprise of which it is a part which arise out of that enterprise’s transactions with separate enterprises as are properly attributable to the PE. In effect, this involves identifying those of the enterprise’s transactions with separate enterprises which should be hypothesised to have been entered into by the PE. This should become clear as a result of analysing the PE’s functions in light of its assets used and risks assumed. The PE’s profits (or losses) attributable to its participation in these transactions can be computed directly in the case of transactions with unrelated enterprises, or through direct application of the Guidelines under Article 9 in the case of transactions with related enterprises, in either case taking into account the effect of the PE’s dealings with other parts of the same enterprise under step two of the authorised OECD approach.

ii) *Attributing creditworthiness to the PE*

230. Just as for bank PEs, global trading PEs generally enjoy the same creditworthiness as the enterprise as a whole, which for example enables them to enter into interest rate swap contracts with customers on the same terms as the head office. As concluded for banks, there is no justification for hypothesising dealings similar to guarantee fees in order to give the PE the same creditworthiness as the global trading enterprise of which it is a part.<sup>12</sup>

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12 Section D-2(v) and paragraphs 103-104 of Part I discuss the reasons why internal guarantee fees are not recognised under the authorised OECD approach.

231. In conclusion, just as for banks, the hypothesised separate and independent enterprise should have the same creditworthiness as the global trading enterprise as a whole, except in the exceptional circumstances referred to in paragraph 30 of Part II (*i.e.* 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). 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*

232. The general principle on the need to attribute capital to the PE is set out in paragraph 30 of Part I, “The starting point for the attribution of capital is that under the arm’s length principle a PE should have sufficient capital to support the functions it undertakes, the assets it economically owns and the risks it assumes.” Section D-2(v)(b) of Part I provides general guidance on how to attribute capital to PEs. Part II describes how capital attribution and funding issues should be dealt with for banks under the authorised OECD approach. In particular, guidance is provided to deal with the special feature of banks that some capital for regulatory purposes can be interest-bearing. The conclusion in Part II was that the impact of regulatory requirements did not require any modification of the basic principles. On the contrary, if anything, the regulatory impact often makes the attribution of capital less problematic than in non-regulated environments.

233. Not all enterprises that carry on global trading are subject to banking financial regulation (though many are), but even those that are not will measure their risks as a necessary part of their business. In any event, Part I sets out the general principle that capital should be attributed to all PEs to support the functions, assets and risks, whether regulated or non-regulated, financial sector or non-financial sector. Against this backdrop there appears to be no reason to exclude global trading from the authorised OECD approach just because some global trading enterprises may not be regulated. Accordingly, the principles for attributing capital developed in Part I and Part II will apply to global trading activity whether or not the activity is carried on in a regulated entity.

234. Just as for banks, there may be no regulatory requirement in either home or host country, to formally allot any “free” capital to a global trading PE and so its operations (unlike those of the enterprise itself) may be wholly debt-funded. 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 capital has actually been allotted to the PE for regulatory or other purposes.

*a) Attributing “free” capital to the PE*

*Stage 1 - Measuring the risks attributed to the PE*

235. As noted in Section D-1(i), the authorised OECD approach uses a functional and factual analysis to allocate financial instruments 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 authorised OECD approach 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. Accordingly, attributing capital based on the quantum of risks (including risks arising from off-balance sheet items) reflects the role of 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 institutions.

236. The question remains as to how to apply the principle stated above in practice. Measuring risks is difficult and flexibility is required. The approach to measuring the risks associated with financial instruments is similar in principle to the approach used for banks (see Part II). For global trading enterprises that are regulated as banks, it may be possible to follow the regulatory approaches for measuring risk.

237. The importance of risk for global trading enterprises means that such institutions are likely to try to measure the risks arising from their global trading operations. This may be done for business reasons and/or to meet local regulatory requirements. The approach set out in Part II for banks can therefore be followed for global trading enterprises. Accordingly, it should be possible to use the global trading business's own risk measurement models, provided that they are consistent with the arm's length principle, are approved by the regulators (where appropriate), are applied consistently and sufficient details, for example the assumptions underlying the bank's internal model, are made available to all the relevant 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.

238. Moreover, it should be borne in mind that the authorised OECD approach is to measure risks in accordance with the arm's length principle, rather than to follow regulatory approaches for measuring risks. 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 determining an arm's length attribution of financial assets and risks to a global trading PE.

#### Stage 2 – Determining the “free” capital needed to support the risks attributed to the PE

239. Having measured the risks attributed to the global trading PE, the next step in order to apply the arm's length principle is to determine how much of the enterprise's “free” capital is needed to cover those risks under the arm's length principle. The general principles and approaches were set out in Section D-2(v)(b) of Part I and specific guidance was provided in Part II for traditional banking businesses. There are no reasons not to apply the valid approaches described in Parts I and II for all global trading enterprises even if they are not banks.

#### b) Attributing capital other than “free” capital to the PE - determining the funding costs of the PE

240. As indicated in Part II (Section D-1(iii)(b)), banks are likely, for commercial or tax reasons, 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 significantly 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. The approach here is again to follow the conclusion for banks and to apply the valid approaches described in Part I and Part II for all global trading enterprises even if they are not banks.<sup>13</sup>

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13 Section D-2(v)(b)(3) of Part I describes the general principles of determining the funding costs of a PE.

iv) *Adjusting the funding costs claimed by a PE*

241. Finally, 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, if any, allotted to the PE by the enterprise. Where the amount of capital allotted by the enterprise is less than the arm's length amount as determined above, an appropriate adjustment may need to be made to the amount of funding costs claimed by the PE in order to reflect the amount of the enterprise's capital that is actually needed to support the activities of the PE. The guidance in Part II (Section D-1(iv)) for adjusting the interest expense of bank PEs can be applied in the global trading context. The term "funding cost" is used instead of interest expense as global trading enterprises use a variety of financial instruments to fund their positions, *e.g.* repos and swaps, and the return on some of these instruments may not be treated as interest under the law of the PE jurisdiction.

v) *Recognition of dealings*

242. As noted in Section D-2(vi)(b) of Part I, the guidance at paragraphs 1.48-1.54 and paragraphs 1.64-1.69 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. The conclusion of Part I is that a dealing between different parts of the enterprise as documented by the enterprise will be recognised for purposes of attributing profits, provided 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, or a change in the conditions of use of an asset, the transfer of a financial asset, etc.)" that has transpired between them. The paragraph concluded that, "A functional and factual analysis should be used to determine whether such an event has occurred and should be taken into account as an internal dealing of economic significance" (paragraph 177).

243. Just as for banks, it is considered relatively straightforward in principle to apply the above guidance to dealings related to the provision of services within a global trading enterprise. As noted in Section D-2(ii)(e) below, the general guidance in Part I should be capable of being applied in the global trading context.

244. However, there are more problems when trying to apply that guidance to dealings in relation to financial assets, given the nature of a global trading business. Its stock in trade is its financial assets - its financial instruments such as bonds, repos, derivative products, etc. However, such instruments are not physical in the sense that they exist only as contractual arrangements and as entries in the accounting records. Unlike a physical asset, it can be difficult to determine where in a global trading enterprise the financial instruments 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. A particular problem for global trading is that the various risks associated with a particular financial instrument can be "unbundled" and risk managed in different locations (see example of a Euro-denominated note with principal amount tied to the performance of the DAX index in Section B-3(i)(b)). These difficulties are compounded by the impact of regulation which can mean that financial instruments are "booked" in a location where none of the functions related to the creation, or ongoing management, of that instrument have been, or will be, carried out (see Sections B-3(ii) and (iii)). The effect of the above is that there are likely to be a lot of internal dealings within a global trading enterprise which will have a significant impact on the attribution of profit.

245. The factual complexity of a global trading business does not alter the principle of the authorised OECD approach which relies ultimately on the functional and factual analysis to determine where financial instruments and risks are "economically owned". Financial instruments and risks are only "economically owned" where they are initially booked if the key entrepreneurial risk-taking functions related to the creation of the financial instrument have been performed there. The same principles also apply in relation

to any dealings purporting to transfer “economic ownership” of financial instruments and risks to another part of the enterprise. An accounting entry resulting from an internal swap dealing that removes the market risk in respect of a financial transaction from the books of one PE and transfers it to the books of another part of the enterprise would not amount to a dealing unless the transfer was accompanied by a transfer of the key entrepreneurial market risk management function. The use of internal swap arrangements to move market and credit risk within the global trading enterprise is discussed in more detail in Section D-2(ii)(c).

246. In summary, an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risk, responsibilities and benefits would be a useful starting point for the purposes of attributing profits. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the authorised OECD approach. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that:

- the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner or, if they do so differ, the structure as presented in the taxpayer’s documentation does not practically impede the tax administration from determining an appropriate transfer price; and
- the dealing presented in the taxpayer’s documentation does not violate the principles of the authorised OECD approach by, for example, purporting to transfer risks in a way that segregates them from functions.

See paragraphs 1.48-1.54 and 1.64-1.69 of the Guidelines by analogy.

247. Once the above threshold has been passed and a dealing recognised as existing, the authorised OECD approach applies, by analogy, the guidance at paragraphs 1.48-1.54 and 1.64-1.69 of the Guidelines. The guidance is applied not to transactions but to dealings between the PE and other parts of the enterprise. So the examination of a dealing should be based on the *dealing* actually undertaken by the *PE and the other part of the enterprise* as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III of the Guidelines. Except in the two circumstances outlined in paragraph 1.65 of the Guidelines, tax administrations should apply the guidance in paragraph 1.64 when attributing profit to a PE and so “should not disregard the actual dealings or substitute other dealings for them”.

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

248. As noted in Part I of this Report, the functional and factual analysis of the first step of the authorised OECD approach will have appropriately hypothesised the PE and the rest of the global trading enterprise as separate enterprises, each undertaking functions, using assets and assuming risks. Portfolios of financial instruments and risks will also have been attributed to the part of the enterprise which performs the key entrepreneurial risk-taking functions leading to the creation (marketing/dealing and trading) and subsequent risk management of those portfolios. 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 enterprise. Moreover, in fully hypothesising the PE, it will have been necessary to identify and determine the nature of its internal “dealings” with the rest of the enterprise of which it is a part.



249. The second step of the authorised OECD approach goes on to apply, by analogy, the guidance in the Guidelines to any economic relationships (“dealings”) between the PE and the rest of the enterprise. For example, although a portfolio of financial instruments and risks may have been attributed to the PE in Country A by virtue of the fact that the PE undertook the relevant functions, it may be that other parts of the enterprise performed other functions related to the portfolio. These functions would need to be taken into account in order to ensure that the PE in Country A is attributed an arm’s length profit. Under the authorised OECD approach all the income from the financial instruments would be recorded in the books of the PE in Country A as the “economic owner” of the portfolio and an expense or outgoing is attributed to Country A in respect of dealings representing an arm’s length reward for the functions performed by other parts of the enterprise. Further, 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.

250. General guidance on making such comparisons has been provided in Section D-3(iii) of Part I of this Report. This section discusses how to apply that guidance to some special situations found in global trading.

i) *Applying transfer pricing methods to dealings within a single enterprise*

251. 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 is at arm’s length. This is done by applying the guidance in the Guidelines on comparability, by analogy, in the global trading PE context and making a comparison of the reward earned from *dealings* within the global trading enterprise with comparable *transactions* between independent enterprises, having regard to the 5 factors for determining comparability set out in Chapter I of the Guidelines.

252. Further, the authorised OECD approach 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. Section C-3 discusses the use of profit split methods where global trading is conducted solely through associated enterprises. It is considered that generally that guidance can be applied, by analogy in the PE context.

253. An important distinction does however arise in respect of capital. Within a single enterprise risks follow functions and under no circumstances can one be segregated from the other which means that capital is attributed to the PE to support the risks created by the key entrepreneurial risk-taking functions performed by the PE. Between independent as well as associated enterprises, on the other hand, it is possible to enter into arrangements whereby the capital necessary to support the global trading risks resides in a separate legal enterprise from the enterprise where the risks are actually assumed as a result of the global trading activity. The enterprise possessing the capital may not perform very many, if any, of the global trading functions. The efficacy of such arrangements between associated enterprises would need to be evaluated following the guidance at paragraphs 1.48 and 1.49 of the Guidelines. In cases where the arrangements are recognised and the activities of the enterprise performing the trading functions create a dependent agent PE of the capital provider the guidance in Section D-3 below is relevant. In cases where any arrangement involving the possession of capital between associated enterprises is recognised, the provision of capital might be rewarded in the form of a share of profits under a profit split method. However, under the authorised OECD approach, where one enterprise both possesses the capital and performs the global trading functions, the total capital of the enterprise that supports the risks would be attributed to the parts of the enterprise performing the global trading functions that created and subsequently managed those risks. There would not therefore be a part of the global trading enterprise that

could be identified as just a “capital possessor”, *i.e.* that possesses capital but does not perform very many, if any, of the global trading functions.

ii) *Global trading functions*

254. Part II of the Report discusses a number of issues related to traditional banking functions. This section discusses some issues of particular relevance for global trading.

a) Analysis of trading/risk management models

255. If all the key entrepreneurial risk-taking functions necessary to create and subsequently manage the portfolio of financial instruments and risks were performed by the PE, there may be little difficulty in determining an arm’s length attribution of profits to the PE. This is the situation normally found under the separate enterprise trading model. Any transactions related to the performance of the functions are likely to 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.

256. However, it should also be noted that there may still be some attribution issues in relation to other functions not related to the creation and subsequent management of the portfolio — for example, the provision of general support and an appropriate infrastructure, *e.g.* centralised head office functions. There are no issues particular to global trading for these functions and so the guidance in Parts I and II of the Report should be followed. However, especially where global trading is organised under the centralised product management or integrated trading model, the first step of the authorised OECD approach is likely to have shown that some of the key entrepreneurial risk-taking functions leading to the creation and subsequent management of the portfolio of financial instruments and risks were performed by different parts of the enterprise (split functions). Those functions represent dealings between the PE and the other parts of the enterprise which will have to be taken into account under the second step of the authorised OECD approach in order for the PE to receive an arm’s length attribution of profit.

257. As noted in Section C, under the centralised product management model, the key entrepreneurial risk-taking functions (negotiation, trading and risk management) are all undertaken in one location. Just as when global trading is conducted only through associated enterprises, there should, in theory, be few problems in evaluating the trading or risk management functions for the pure centralised product management model in the PE context. Only one part of the enterprise is taking the full responsibility for these key entrepreneurial risk-taking functions and so will receive the profits attributable to the performance of those functions as a result of transactions with independent parties. Other parts of the enterprise are likely to perform support or sales functions. These are dealings which must be evaluated but as noted in Section C there may often be comparable transactions between independent enterprises that can be used in order to attribute an arm’s length profit to these dealings. The guidance in Section C should therefore be followed, by analogy, in such cases and it is not considered that there are any particular difficulties in principle in applying that guidance, by analogy, in the PE context.

258. As noted in Section C, under the integrated trading model, the key entrepreneurial risk-taking functions (negotiation, trading and risk management) with respect to a particular third party transaction may be split between locations (that is, the entrepreneurial risk-taking role itself is split) and the gross profit arising from that transaction may be recognised in any or all of the locations. Negotiation, trading or risk management in integrated form is unlikely to be found between independents and so it may not be possible to make “reasonably accurate adjustments” to make the data comparable. Additionally, in the integrated trading model each location cannot act independently but must co-operate with the others in order to successfully enter into a transaction and subsequently manage the resulting risk. Therefore, it may

not be possible that traditional transaction methods could be applied reliably and so consideration should be given to profit methods.

b) Attributing assets and risks to more than one part of the enterprise

259. Under the first step of the authorised OECD approach, the financial instruments and risks created by the performance of the key entrepreneurial risk-taking functions by the PE will have been attributed to the PE. The effect of this would be to attribute to the PE performing these functions the income or losses produced by those instruments. This will be at arm's length prices, either by definition, because it is received from independent enterprises, or, by application of the usual transfer pricing rules, if received from associated enterprises. Where the financial instruments have been attributed wholly to the PE, in order to attribute an arm's length profit to the PE, all that is necessary would be to determine the arm's length prices for any dealings resulting from the performance of the other global trading functions described in Section B.

260. However, as noted in Section D-1, some financial instruments might be jointly attributed to the PE and another part of the enterprise. This joint ownership creates a dealing that has important consequences for the attribution of profit. This is because the attribution of the financial instruments, the profits from those instruments and the associated "free" capital follow the key entrepreneurial risk-taking functions. The relative value of the key entrepreneurial risk-taking functions performed in the different parts of the enterprise may be used to attribute the portfolio and consequently the "free" capital necessary to support that portfolio.

261. The guidance in the Guidelines will be applied, by analogy, in order to determine the relative contribution of the key entrepreneurial risk-taking functions performed in the different parts of the enterprise. All the methods approved in the Guidelines are available to make this determination, starting with the traditional transaction methods described in Chapter II.

262. However, as noted in Section C for associated enterprises, it may be difficult to find uncontrolled transactions comparable to the dealings. Such problems are not confined to PEs and occur with increasing frequency in transactions between associated enterprises. Again, Chapter II of the Guidelines provides guidance on the use of profit methods which could be applied in such situations. Such profit methods when used to attribute profits under Article 7 would determine both the share of the profits earned from the financial instruments as well as how they would be attributed for the purposes of capital attribution. For example, taking into consideration similar issues to those outlined in Section C-3 and the general guidance in Chapter II, if it were determined under a profit split method that 40% of the key entrepreneurial risk-taking functions in a global trading book were performed by the PE in Country A, 40% were performed by the head office in Country B and 20% were performed by a PE in Country C, the financial assets represented by the global trading book would similarly be attributed 40% to the PE in Country A, 40% to the head office in Country B and 20% to the PE in Country C, which in turn would mean a 40/40/20 share of the reward for capital. As indicated in paragraph 129, this would not necessarily equate to a 40/40/20 split of the profits, since it may be appropriate under the arm's length principle to reward another function with a share of the profits even though that function is not a key entrepreneurial risk-taking function.

c) Risk management functions and internal transfers of risk

263. The authorised OECD approach applies equally to the functions described in Section B above that are necessary to monitor and manage the risks associated with global trading. Section C-2(ii) above looks in detail at risk monitoring and risk management functions and Section D-2(ii)(e) of Part II discusses risk management functions particularly in relation to transfer of market risk between associated enterprises

and transfer of risks in the context of a bank PE. It is considered that the guidance in those Sections can be applied in the global trading context. However, given the importance of market risk management in a global trading business this section discusses the transfer of market risk between different parts of a global trading enterprise in more detail.

264. This problem may be analysed by considering one popular form of internal derivative contract - the so-called “mirror swap”. In a mirror swap, the branch marketing a transaction with a third party enters the customer transaction on its books and then enters into a related internal “transaction” with the trading location that will manage the trading or market risk arising from the real transaction. There is usually a difference in terms that leaves a “spread” in the marketing branch, for example a number of basis points on an interest rate swap. The spread is intended to reward the marketing branch for the sales/marketing functions it has performed, for the credit risk it has assumed and for any ongoing credit risk monitoring or credit risk management activities it undertakes. In short, “mirror swaps” provide a potential mechanism for rewarding the different functions performed by an enterprise engaged in some form of global trading and reflecting the fact that different locations assume different risks as a result of the different functions performed. In the transaction described above, the mirror swap, if entered into on arm’s length terms, should reward the performance of the market risk management function, provided that the location that receives the mirror swap actually carries out that function. Of course, mirror swaps that are not entered into on arm’s length terms and that do not appropriately reflect where the market risk management functions are performed would have the effect, if recognised, of inappropriately shifting future trading profit or loss between different locations, and are therefore unacceptable for tax purposes.

265. Therefore, under the authorised OECD approach, first of all it must be decided whether such internal derivative contracts that purport to transfer market risk should be recognised as a dealing to be taken into account when attributing profits. As discussed in Part I of this Report, the authorised OECD approach relies on a functional and factual 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 “mirror swap”, the book entry showing the transfer between the different parts of the enterprise must be accompanied by a real and identifiable event, *i.e.* a genuine change in the part of the enterprise that is managing the market risks assumed as a result of the customer transaction. Further, the transfer of the market risk management function must also be accompanied by the assumption of the market risk and the appropriate portion of the dealer spread (after deducting the portion which should remain with the marketing location) and the trading profit potential of the financial instrument relating to the customer transaction. The part of the enterprise receiving the mirror swap would also have to suffer any future losses related to the realisation of the market risks from the transaction, *e.g.* from adverse market movement, whilst the marketing branch would have to suffer any future losses related to the realisation of the credit risks from the transaction, *e.g.* as a result of customer default.

266. If the mirror swap is recognised as a dealing under the recognition test of the authorised OECD approach, the next stage is to attribute profit in respect of that dealing. It will be necessary to check that the conditions of the mirror swap or other internal swap payment are at arm’s length. As noted in the paragraph 251 of the Global Trading Report, there may be problems with using mirror swaps without adjustment. Due to the large number of transactions the spread is not usually negotiated individually for each transaction but is often set at a fixed level depending on broad categories of instruments. There are however differences between marketing, for example, a simple fixed-for-floating US dollar interest rate swap that took two minutes to conclude and marketing a complicated cross-currency equity swap with an equivalent notional principal amount that took three months to negotiate and structure. Unless these differences can be taken into account, the spread earned by the marketing branch will generally not reflect the arm’s length principle.

267. Further, an evaluation may have to be made of exactly what types of risk are transferred and what types of risk are retained. All the different types of risks, including credit risk and market risk, are assumed by the enterprise when the transaction is entered into by the customer with the marketing branch. If that transaction is with the market risk management location, the marketing branch is no longer responsible for market risk, even though it was responsible for the initial assumption of those risks. However, the credit risk will remain in the marketing branch unless there is a change of function in respect of that risk.

268. Another form of internal risk transfer relates to credit risk. Increasingly financial enterprises are not only active in assessing credit risk at the point of sale but are also active in managing credit risk during the lifetime of the financial instrument. The part of the enterprise with the credit risk management department may purport to indemnify the other parts of the enterprise against default by the counterparty. Such a transfer may be recognised provided that the credit department actually carries out the evaluation, monitoring, and ongoing management of the credit risk. Such a dealing only transfers the credit risk - the market risk remains with the part of the enterprise that entered into the transaction with the customer.

269. An internal dealing transferring credit risk from one part of the enterprise to another would be recognised where that second part actively manages the credit risk — if it was, for example, a dedicated credit management centre, entering into credit risk transactions with third parties. Where, on the other hand, there is simply a book entry transferring risk from one part of the enterprise to another part which does not in fact manage that risk, then the credit risk would not have been transferred.

270. The recognition of the internal dealing will also affect the attribution of capital to the PE (see Section D-1(iii) above). For example, suppose that net present value is used as a proxy for measuring the assets and risks for capital attribution purposes and that the net present value (NPV) of a derivative transaction when entered into with the customer was 10. Where all the risks of the customer transaction are transferred as a result of the mirror swap then the trading/risk management location would be treated as having financial assets and risks with an NPV of 10 for the purposes of capital attribution. Where however a spread was left in the sales branch with an NPV of 1, then the trading/risk management location would be treated as having financial assets and risks with an NPV of 9.

d) Treasury functions and internal movement of funds

271. Section D-2(ii)(b) of Part II contains guidance on this issue for banks that can be applied to global trading businesses. Global trading is often conducted by enterprises that are not banks and so a further issue relates to the determination of whether an internal transfer of funds should be recognised as a “real and identifiable event”, *i.e.* a dealing that could give rise to “interest” for a global trading enterprise that is not a bank. In principle, this would depend on a functional and factual analysis of the dealing and the conditions under which it was performed.

272. As already noted, global trading is frequently undertaken by “non-bank financial institutions”. The funding of global trading operations was described in Section B-3(i)(c) and this shows that the functional and factual analysis of such activities is likely to produce similar results as for traditional banking activities (see Part II of this Report). Recognition of internal “funding costs” in relation to those activities could be appropriate for the attribution of an arm’s length profit to a PE. Accordingly, it would not be necessary to separately attribute the actual funding expense of the enterprise, although it would still be necessary to attribute the actual “free” capital (see above).

e) Support services

273. It is considered that there are no considerations peculiar to global trading that need to be taken into account in respect of such services, apart from the discussion in Section C-3 on rewarding back office

service functions under a profit split method. Consequently, the guidance in Parts I and II of the Report can be applied in the global trading context. Further, it is not thought that there are any particular problems about applying, by analogy, the guidance in Section C-3(ii)(a) on rewarding back office service functions under a profit split method to global trading PEs as opposed to associated enterprises.

### **D-3 Dependent agent PEs**

274. As indicated in Sections B-6 and D-5 in Part I, this Report does not examine the issue of whether a PE exists under Article 5(5) of the OECD Model Tax Convention (a so-called “dependent agent PE”) but discusses the consequences of finding that a dependent agent PE exists in terms of the profits that should be attributed to the dependent agent PE. It is worth emphasising at the outset that the discussion below is not predicated on any lowering of the threshold of what constitutes a PE under Article 5, and in particular it should be noted that the performance of key entrepreneurial risk-taking functions by a dependent agent enterprise on behalf of a separate enterprise capital provider is a tool for attributing profits, including the reward for capital, to a PE, not a threshold test for determining the existence of a PE.<sup>14</sup> However, it is a fact that the functions associated with a global trading business may be undertaken by dependent agents within the meaning of Article 5(5). General guidance on the attribution of profits to dependent agent PEs is contained in Section D-5 of Part I and this section applies that guidance to the specific and commonly occurring factual situation of global trading.

275. In cases where a PE arises from the activities of a dependent agent, the host country will have taxing rights over two different legal entities - the dependent agent enterprise (which is a resident of the PE jurisdiction) and the dependent agent PE (which is a PE of a non-resident enterprise). In respect of transactions between the associated enterprises (the dependent agent enterprise and the non-resident enterprise), Article 9 will be the relevant article in determining whether the transactions between the associated enterprises, for example a volume-based commission, were conducted on an arm’s length basis.

276. In respect of the dependent agent PE, the issue to be addressed is one of determining the profits of the non-resident enterprise which are attributable to its dependent agent PE in the host country (*i.e.* as a result of activities carried out by the dependent agent enterprise on the non-resident enterprise’s behalf). In this situation, Article 7 will be the relevant article. Finally, it is worth stressing that the host country can only tax the profits of the non-resident global trading enterprise where the functions in the host country performed on behalf of the non-resident enterprise meet the PE threshold as defined under Article 5. Further, the quantum of that profit is limited to the business profits attributable to global trading operations performed through the PE in the host country.

277. Where a dependent agent PE is found to exist under Article 5(5), the question arises as to how to attribute profits to the PE. The answer is to follow the same principles as used for other types of PEs for to do otherwise would be inconsistent with Article 7 and the arm’s length principle. Under the first step of the authorised OECD approach a functional and factual analysis determines the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise. On the one hand, the dependent agent enterprise will be rewarded for the services it provides to the non-resident enterprise (taking into account its assets and its risks) usually by means of a fee from the non-resident enterprise. On the other hand, the dependent agent PE will have attributed to it the assets and risks of the non-resident enterprise relating to the functions performed on its behalf by the dependent agent enterprise, together with sufficient free capital to support those assets and risks. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those assets, risks and free capital. The analysis focuses on the nature of the functions carried out by the dependent agent on behalf of the non-resident enterprise and in particular whether it undertakes key entrepreneurial risk-taking functions. In this regard

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14 See paragraph 5 of introduction.

an analysis of the skills and expertise of the employees of the dependent agent enterprise is likely to be instructive, for example in determining whether trading, negotiating or risk management functions are being performed by the dependent agent on behalf of the non-resident enterprise.

278. In calculating the profits attributable to the dependent agent PE it would be necessary to determine and deduct an arm's length reward to the dependent agent enterprise for the services it provides to the non-resident enterprise (taking into account its assets and its risks). Issues arise as to whether there would remain any profits to be attributed to the dependent agent PE after an arm's length reward has been given to the dependent agent enterprise. In accordance with the principles outlined above, the answer is that it depends on the precise facts and circumstances as revealed by the functional and factual analysis. The reward should provide the appropriate remuneration for the functions performed (taking into account the assets used and risks assumed) by the dependent agent enterprise in its own right. However, a functional analysis of a transaction may show that the ability to assume the risks arising from the transaction is not found in the dependent agent enterprise, for example because it has insufficient capital to support the risks assumed. Rather the ability to assume the risks is generally found in the non-resident enterprise in whose books the transaction - and the resultant risk - appears. The reward for the capital to support those risks clearly belongs to the non-resident enterprise, not the dependent agent enterprise. The question is which part of the non-resident enterprise. The answer is that under the authorised OECD approach, these risks, and therefore the capital needed to support them, will be attributed to the dependent agent PE to the extent that they arise from functions performed by the dependent agent in the host country on behalf of the non-resident enterprise. In short, when attributing profits to the dependent agent PE, there are likely to be profits (or losses) over and above the arm's length reward paid to the dependent agent enterprise. This principle can be illustrated by the following commonly occurring situation where the trades of a broker-dealer in the host country are booked in the accounts of a non-resident enterprise. The analysis applied to the functions performed by the dependent agent for attributing the assets and risks to the dependent agent PE is the same analysis applicable to determining the assumption of risk within a single enterprise as discussed in Section D-1(i)(b).

279. The following illustration is intended to better explain the approach taken under the authorised OECD approach. It is recognised that in practice most situations will be significantly more complex and difficult to deal with. Even where the non-resident enterprise is a special purpose vehicle (as in the example below), and all the trading functions are performed in the dependent agent enterprise, the special purpose vehicle may have employees of its own to maintain the vehicle's enhanced creditworthiness, or to perform strategic risk management or operational risk management functions. In other cases, where the special purpose vehicle itself does not have employees performing such functions, the functions may be performed either by another company in the group or by a dependent agent PE in a different location from the traders. Similarly the traders in the dependent agent enterprise may be relying on proprietary systems developed elsewhere in the group for which an arm's length reward is due. Finally, there may be traders in more than one location. The objective of the highly simplified example, however, is to illustrate the principle that the host country's taxing rights are not necessarily exhausted by ensuring an arm's length compensation to the dependent agent enterprise under Article 9 (the following example is one where the dependent agent is an associated enterprise).

280. Assume that a special purpose enterprise in Country A, with no employees, has a broker-dealer subsidiary in Country B. For regulatory and other reasons the equity derivatives business of Country B is not booked in the broker-dealer subsidiary, but in the non-resident (special purpose) enterprise. Assume further that all the functions (key entrepreneurial risk-taking and support) in connection with the derivatives business is conducted in the host country by the broker-dealer subsidiary and its employees, who are authorised to conclude contracts in the name of the enterprise in Country A. Assume, finally that the circumstances are such that the broker-dealer is a dependent agent enterprise and that a dependent agent PE is found to exist under Article 5(5). There are two steps to the transfer pricing analysis.

281. Firstly, it is necessary to attribute an arm's length reward to the dependent agent enterprise (the broker-dealer) for the functions it performs on behalf of the non-resident enterprise. A suitable third party comparable should be used to arrive at an arm's length fee for the service provided by the dependent agent enterprise to the non-resident enterprise. This is because the market and credit risk associated with the financial assets created by the dependent agent enterprise do not belong to the dependent agent enterprise, but to the legal owner of the assets – the non-resident enterprise. An arm's length fee paid by the non-resident enterprise would not therefore under Article 9 as discussed in Section C take account of the assumption of these risks nor the return on the capital needed to support those risks. The risks are assumed by the non-resident enterprise and so the reward for capital properly belongs to that non-resident enterprise.

282. The question is whether any of the reward for the assumption of the market and credit risk by the non-resident enterprise should be attributed to its dependent agent PE. On the facts of the present example the answer would be yes, since the key entrepreneurial risk-taking functions are undertaken, not by the non-resident enterprise itself but by the dependent agent enterprise on behalf of the non-resident enterprise. The reward for the assumption of the market and credit risk, *i.e.* the return on the associated capital, is therefore attributed to the dependent agent PE. In this highly simplified example the profits attributed to the PE would be the profits of the book as a whole less the amount of the arm's length fee (determined by reference to a suitable comparable) given to the dependent agent enterprise. In more realistic cases, the residual profits attributed to the PE would be the profits of the book less an arm's length reward for one or more of the functions described in paragraph 278.

283. The above outcome, in addition to being technically correct, also gives a commonsense result; if in fact all the key entrepreneurial risk-taking and other functions are performed by the dependent agent enterprise on behalf of the non-resident enterprise in Country B then it is appropriate that all the profits should be taxed there. This analysis also gives a sensible policy outcome in that it produces the same outcome as performing the same functions in Country B through a branch of Company A. It is worth emphasising that the above analysis is only applicable if a dependent agent PE is found to exist under Article 5(5).

284. An alternative approach, the "single taxpayer approach", has been suggested by some business commentators, but this was rejected as an authorised OECD approach in Section D-5 of Part I.

285. The danger of overlooking the assets used and risks assumed in the performance of the functions in the PE jurisdiction is minimised if the existence of the dependent agent PE is formally recognised so that it is clear that the host country has taxing rights over two different legal entities - the dependent agent PE and the dependent agent enterprise - and an attribution of profit based on a functional analysis is made to the dependent agent PE on the basis described in this section. This should also ensure that any other tax consequences arising from different rules for PEs and subsidiaries in the PE jurisdiction are taken into account. One way to formally recognise the existence of dependent agent PEs is to require the filing of tax returns for all such PEs. However, nothing in the authorised OECD approach would prevent countries from using administratively convenient ways of recognising the existence of a dependent agent PE and collecting the appropriate amount of tax relating to the non-resident enterprise resulting from the activity of a dependent agent. For example, where a dependent agent PE is found to exist under Article 5(5), a number of countries actually collect tax only from the dependent agent enterprise even though the amount of tax is calculated by reference to the activities of both the dependent agent enterprise and the dependent agent PE. In practice what this means is taxing the dependent agent enterprise not only on the profits attributable to the people functions it performs on behalf of the non-resident enterprise (and its own assets and risks assumed), but also on the reward for the free capital which is properly attributable to the PE of the non-resident enterprise. Such administrative matters related to the taxation of dependent agent PEs are for



the domestic rules of the host country and not for the authorised OECD approach to address.<sup>15</sup> It follows that the home country with a PE in a host country that operated such an administratively convenient procedure would not be obliged to give relief or be entitled to tax on the basis that there was no dependent agent PE. The taxing rights of the home country are not altered by administratively convenient procedures of the host country.

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15 That being said, the potential burden on the non-resident enterprise of having to comply with host country tax and reporting obligations in the event it is determined to have a dependent agent PE cannot be dismissed as inconsequential, and nothing in the authorised OECD approach should be interpreted as preventing host countries from continuing or adopting the kinds of administratively convenient procedures mentioned above.

**PART IV: SPECIAL CONSIDERATIONS FOR APPLYING THE AUTHORISED OECD  
APPROACH TO PERMANENT ESTABLISHMENTS  
OF INSURANCE COMPANIES**

**A. Introduction**

1. Part I of this Report sets out the principles of the authorised OECD approach and provides guidance on the practical application of these principles to attribute profits to a permanent establishment (PE) in general. However, it is also considered necessary to supplement this general guidance with more specific and practical guidance on the application of the authorised OECD approach in commonly occurring factual situations. Parts II and III of this Report discuss special considerations in applying the authorised OECD approach to PEs in the context of traditional banking businesses and global trading in financial instruments. This Part of the Report (Part IV) looks at the insurance industry and discusses how the authorised OECD approach applies to situations commonly found in enterprises carrying on an insurance business through a PE. More specifically, Part IV applies the authorised OECD approach to the operation of property and casualty insurance, life insurance, and reinsurance activities. For greater certainty, to the extent that an insurance company carries on activities other than insurance activities, Part I, II or III, as the case may be, of this Report will apply.

2. The insurance industry presents a number of unique challenges to tax authorities. Traditionally, the nature of the ongoing relationship created by insurance resulted in customers dealing largely with domestic insurers with whom they were comfortable. However, the insurance industry rapidly is becoming more global. Cross-border merger and acquisition activity is increasing, which will result in greater consolidation of the industry. As a result, tax authorities may find it difficult to find useful comparable transactions for the purpose of doing a transfer pricing analysis. Insurance companies may find it advantageous to operate through PEs in a number of jurisdictions, rather than through subsidiaries, because certain host state regulators rely on regulation by the home state and so may impose a lower capital requirement or none at all. Host states may not have developed rules for attributing profits to such PEs, or there may be questions about whether those rules, where they exist, are fully compatible with their existing treaty obligations.

3. Finally, some companies are exploring the use of electronic and faxed communications, or the Internet, to issue policies cross-border. Whether a PE arises in such cases and whether a profit may be allocated to such a PE depends on the facts and circumstances (see *e.g.* paragraphs 42.1 to 42.10 of the Commentary on Article 5 of the Model Tax Convention and Part I, paragraph 66).

4. Section B of this Part provides a general but not definitive functional and factual overview of an insurance business. Section C discusses how the authorised OECD approach applies to a PE of an enterprise carrying on insurance business. Finally, Section D discusses Article 7(4). It should be noted, that under the AOA, 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.

**B. Functional and factual analysis of an insurance business**

***B-1. General overview***

5. This section is intended to provide a broad functional and factual overview of the insurance business, without attempting to be exhaustive or to reflect all the variations within the industry, and it

should be understood in that light (*e.g.* some of its description may reflect certain sectors of the industry more closely than others). As a general matter, the insurance business is the business of accepting obligations or liabilities in respect of uncertain losses arising from the realisation of events outside the control of the insured. Insurance businesses are able to do this by pooling the potential losses of many risk-averse persons via the payment of an amount by the insured to the insurer, called a premium (see paragraph 8 below for a description of how losses can arise in different types of insurance business). In consideration of the payment of the premium, when the insured incurs a loss or a specified event occurs, he, she or a beneficiary is indemnified for the amount of the value of his or her loss or receives an agreed payment or service.

6. The pricing of the premiums must take into account the insurer's expected costs of claims and the time when claims are expected to be paid. It will also have to take into account the ratio of expected operating expenses to premiums. The insurer will invest premiums to earn a return, and this return will be taken into account in the insurer's calculation of the appropriate level of premium.

7. The term "risk" may have different meanings and it is important to differentiate between risks of losses to which the policyholder (premium payer) may be exposed and the risks assumed by an insurance corporation in extending insurance coverage to policyholders. For the rest of this document, the term "insured risk" refers to the potential losses of the policyholder for which the policyholder seeks coverage and for which the insurer agrees to provide coverage, and the term "insurance risk" refers to the risk assumed by the insurer (the very essence of the business of insurance) in agreeing to extend coverage to policyholders. Thus, in agreeing to extend insurance coverage to policyholders by accepting their insured risks, an insurer must assume and manage insurance risk.

8. In agreeing to cover insured risks, the insurer, to the extent that there is potential for the amount and timing of actual claims cash flows to differ from the expected claims profile, takes on insurance risk. This is also called underwriting risk (see paragraph 56 for a description of the subcomponents of insurance risk). Generic business risks that the insurer faces are discussed in Section B-4(i), below, where it is indicated that the approach in Part I is to be followed. To the extent that an insurer assumes insurance risk, it will command a risk premium that will compensate it for the risk it is assuming. Thus for an insurer that takes on very risky or more volatile forms of insurance, the premium required by the insurer will include a greater element of profit than for less risky forms of insurance.

9. Three parts of the insurance industry can be distinguished and are the focus of this Report: the life and health industry (usually referred to as the "life" or "long-term" insurance industry), the property and casualty industry (usually the "P&C" or "general" industry) covering all insurance business other than life or health, and the reinsurance industry. Life insurers concentrate on replacing the financial loss resulting from the death or illness of individuals. Life insurers also provide insurance-related services for which the insurer earns fees (*e.g.* large group health plans) and savings products with no or negligible elements of insurance risk. To the extent that an insurance company carries on activities other than insurance activities, Part I, II or III, as the case may be, of this Report will apply. P&C insurers generally insure the risk of financial loss arising from damage or loss of property through fire, theft or third party liability. Reinsurers provide insurance on risk of underwriting loss for both P&C and life insurers.

10. An insurance enterprise may be organised in one of many possible legal forms. The enterprise can take the form of stock insurers (those with share capital), mutual insurers (no share capital; policyholders are effectively the owners), co-operatives (such as farmer co-operatives), and fraternal or affinity benefit societies (which may typically be created by athletic associations, religious or ethnic groups).

11. Insurance businesses may organise themselves in foreign jurisdictions in both subsidiary and PE form, in some cases dictated by regulatory requirements (and in other cases a reduced cost of capital may ensue).

*i) Income and capital (surplus) in the insurance business*

12. Two important sources of income for insurers are underwriting income and investment income. Underwriting income is the insurer's net income from the pure insurance elements of its business, being the balance found after deducting expenses, claims (including any movement in provisions for outstanding claims) and reinsurance premiums from the premium income and reinsurance recoveries. It does not include investment returns (income and gains on investment assets). Insurance companies hold substantial amounts of investment assets. These assets may arise from premiums received from policyholders in exchange for insuring risks, from the balance of retained profits and losses and from capital provided by stockholders.

13. In the case of life insurance, it may be more difficult to separate profit into underwriting and investment components due to the long-term nature of the business, especially in jurisdictions where the enterprise is not required to report the two separately in its financial statements. In addition, life insurers may earn fees for providing insurance-related services (*e.g.* large group health plans). Another source of income for all three types of insurance companies may come from providing "fronting services", such as underwriting and claims administration, to foreign unlicensed insurance companies (including offshore captives).

14. Insurance contracts give rise to claims for insured losses or benefits that may not be payable for many years, while the premium income received from those contracts (and returns from its investment) and associated with those future expenses is received and reported as income in the current year. But a substantial portion of the income is simply to fund future insured losses or benefits. Accordingly it is appropriate to set aside an amount to reflect the future costs in the form of a reserve taking into account the cyclicity of different business lines. Since this reserve is for a future claim or benefit payment it is a liability to the insurer. An attempt is made to place the insurer's income on an accrual basis by matching the timing of the inclusion of premiums (and investment returns) in income with the timing of the deduction from income for the reserve.

15. The nature of insurance business creates a requirement for surplus to absorb any losses or benefits in excess of reserves from the realisation of those insured risks. Surplus may also be used to support product development, marketing, and other functions depending on the nature of the business. Capital means the equity of an insurance company, but the term has a multitude of facets. It is used as an accounting term (paid-in capital and accumulated profits or losses not distributed to shareholders). It is also extremely relevant for regulatory purposes (where capital is often referred to as "surplus" or "free assets") and is defined under the various country-specific regulatory provisions. It is also used in connection with creditworthiness (ratings issued by independent rating agencies to indicate level of financial strength to clients and creditors), which is particularly important for long-term business (also see Section B-4(ii) which discusses the importance of creditworthiness).

16. Throughout Part IV of this Report, equity in the insurance industry will be referred to as "surplus". Surplus consists of the excess of assets over reserves and other liabilities and includes paid-in capital of shareholders plus any accumulated profits (and net of any losses) not paid out as dividends. The insurer, in order to be able to assume and manage insurance risk, must have surplus, and the amount of surplus it has determines the amount and type of insurance risk it can assume and manage. The marketplace, rating agencies and regulators determine the minimum amount of surplus required in order to undertake insurance risk in various lines of business.

17. Part IV of this Report seeks to provide guidance on how to determine which part of an insurance enterprise performs the various functions involved in the assumption and management of insurance risk (and so should receive the associated insurance underwriting income). It also acknowledges that insurance companies may provide services other than pure insurance, for example the administration of medical plans or asset management services. Guidance will also be provided on how to determine an attribution of an appropriate amount of investment assets, representing surplus and reserves, to the various parts of the enterprise, taking into account any regulatory conditions imposed by the host country, thereby determining the attribution of the associated investment income.<sup>1</sup>

ii) *Role of reinsurance*

18. Reinsurance is a mechanism through which insurers can manage insurance risk by shifting or ceding one or more insured risks to reinsurers in exchange for payment of premiums. As a result of the reinsurance, the ceding company may reduce or credit its reserves for the insured risks ceded to the reinsurer. Its assets may also be reduced by the amount of the consideration paid to the reinsurer for accepting those insured risks. Accordingly, reinsurance agreements reduce the risk assumed by the insurance company, thus alleviating the requirement for surplus with respect to the insurance risk. The reinsurer is able to pool the risks ceded to it by one insurance company with risks ceded by other insurance companies, thereby diversifying its risk pool and potentially allowing the reinsurer to maintain a lower amount of surplus with respect to the risks ceded to it by any single insurer than that insurer might have been required to maintain on its own with respect to those risks. It should be noted that even if all the insured risks were to be reinsured, some risk would remain to the original insurer, *e.g.* the credit risk that the reinsurer does not pay up under the reinsurance contract. This default risk has led some regulators to limit the amount the insurance liabilities can be “credited” for the ceded insured risks; *i.e.* the amount by which the technical reserves are reduced. Insurers may try to minimise this default risk by ceding risks to more than one reinsurer. By allowing insurers to tailor their insurance risk, reinsurance plays an important role in the efficient functioning of insurance markets.

19. Reinsurance provides a means for freeing up surplus that will allow the insurance enterprise to take on other types of insured risks. Since regulators are responsible for assuring that a minimum level of surplus is available to support the risk assumed by an insurance business they are very concerned with creditworthiness of the reinsurer and its ability to fulfil the payments provided for under the reinsurance contract. If a reinsurer does not have the necessary funds to provide payment when the reinsurance policy calls for that payment, the ceding company, in effect has not freed up surplus by entering into the reinsurance contract. Regulators, who recognise this problem, will frequently require that the reinsurer set up a trust or other type of fund or collateral that contains the necessary amounts called for in the reinsurance contract. When the reinsurer is in another jurisdiction, the regulator has no control over the financial health of the reinsurer, and thus some jurisdictions require that such a fund be created in the home country of the ceding company. The creation of a trust or similar type of fund raises a number of issues under the authorised OECD approach (see Section C-1(iii) for further discussion).

20. A reinsurance contract is an agreement between an insurer and a reinsurer. The insurer writes the policy for the policyholder and is contractually responsible for any payments to the policyholder that come due under the policy, even if those insured risks are ultimately met by a reinsurer as part of a reinsurance contract. The insurer markets the policy, bears the costs of its sale and ongoing administration and receives the premium income associated with the policy. In a reinsurance contract, the insurer (cedant) cedes the insurance risk to a reinsurer and pays a reinsurance premium to the reinsurer. In many cases, the cedant receives a payment (referred to as a ceding commission) intended to cover the portion of the costs that it

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<sup>1</sup> In this Report the terms “reserves”, “technical reserves” and “technical liabilities” are used interchangeably.

incurred in obtaining the policy and to produce a profit. Generally, the result is a net payment made by the cedant to the reinsurer. However, it is acknowledged that reinsurance contracts may in certain market conditions create a loss where ceding commission paid by the reinsurer does not cover the insurer's costs or where a negative ceding commission is paid to the reinsurer.

21. Reinsurance agreements can take several forms including:

- *Facultative reinsurance*, which is a form of reinsurance agreement in which the reinsurer assesses each insurance policy before agreeing to reinsure the insured risk. Facultative reinsurance is typically used for very large single insured risks.
- *Treaty reinsurance*, which is a form of reinsurance agreement in which a contract (which may be for some fixed period of time) is undertaken whereby the reinsurer agrees in advance to accept a specified amount or proportion of all insured risks or losses as defined in the treaty, for example, from a particular line of business or product. A reinsurer will base its willingness to accept the insured risk upon the experience and reputation of the ceding company.

Under either type of contract, the reinsurer and insurer share insured risks on some agreed basis. There are two main types of insured risk sharing arrangements:

- *Proportional reinsurance (e.g. quota-share reinsurance)* is an insured risk sharing arrangement where the reinsurer reinsures a certain percentage of each of the policies written by the ceding company during the term of the contract.
- *Excess of loss reinsurance* is an insured risk sharing arrangement that provides that the reinsurer will pay the ceding company to the extent that the ceding company's losses from a particular line of business or specified event exceed a certain amount.

This sub-section does not deal with assumption or novation reinsurance, *i.e.* a form of insurance transfer under which the reinsurer acquires the policies whose risks are reinsured and has a direct contractual relationship with the policyholder thereafter.<sup>2</sup>

22. Section C-1(vi) discusses the difficult question of internal reinsurance within a single enterprise.

### **B-2. Functions performed**

23. This section analyses the most important functions of a traditional insurance business. It does not attempt to be definitive, as other functions might have an important role in the insurance business, too. 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. The focus of the discussion in this section relates primarily to the functions performed in a property and casualty business. However, most of these functions are also performed by life insurance and reinsurance companies, to varying degrees. In addition, the relative importance of these functions to the profitability of an insurance business depends upon various factors, including the type of insurance business (P&C, life or reinsurance), the line of insurance business and products sold in that business.

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2 Depending upon applicable law, assumption reinsurance may effect a novation which relieves the ceding insurer of any further liability to a policyholder.

24. The operational functions are the functions that must be performed in order for an insurance enterprise to assume insurance risk. The following sub-section describes the most important operational functions of a traditional insurance business.

*i) Functions of an insurance business*

25. The functions are discussed in this Report in terms of a value chain describing the business processes in the insurance industry starting with the development of the insurance product and ending with administration of claims made under the insurance policy and the long-term investment of the assets supporting the insurance liabilities. There are other functions related to management and support processes, *e.g.* planning, human resource management, etc., but only those particular to the insurance industry are discussed in this Report. The functions comprising the business process are similar for each of the three parts of the industry listed above (life, P&C and reinsurance), but the relative importance of each function may vary considerably from one category to the next and between different businesses, lines of business and products. When the functions are generally more important in one category of insurance, that importance will be highlighted in the following sections but it should be stressed that the relevant importance of these functions will vary according to the particular facts and circumstances of each taxpayer.

*a) Product management/product development*

26. This process comprises the risk-technical, legal and mathematical structuring of the product. In concrete terms, it means assessing the quantitative, qualitative, geographical and time-related features of insurance cover in the context of insured risk acceptance and savings processes. In addition, it involves determining the scope and features of advisory and processing services. The structuring of insurance products must be adapted on an ongoing basis in line with developments in the market, in legislation (including tax legislation) and in claims performance.

27. Important processes of product development involve the following activities: market research, gathering and maintaining (claims) statistics, legal stipulation of the extent of cover, mathematical calculation of the premium depending on the features of insurance cover (geographical, temporal, demographics, policy surrender and settlement options, investment returns guaranteed or anticipated in the pricing of the premium, insurance excess options, etc.).

28. The pricing/setting of premiums for the insured risks to be underwritten for new lines of insurance or products may be performed by the underwriters, although that is generally not the case for life insurance products (where premium rate tables are developed by actuaries). In some cases arm's length third parties may perform some of these functions by providing specialist services to insurance companies. For example, some organisations compile claim statistics and make them available to member institutions. Other enterprises use proprietary mathematical models and processes to produce data for use by their clients in estimating the cost of claims resulting from the weather (flooding, hurricanes, hail, etc.) or other events. Brokers may provide market analysis and research and structure programs to meet client needs.

*b) Sales and marketing*

29. At first, the general marketing strategy is defined, based on a process that allows identification and analysis of customer needs. The marketing strategy may be segmented into products, regions, countries, etc. The marketing strategy also encompasses the definition of marketing and acquisition programs, and the development and application of training and educational programs.

30. At the sales stage, the customer's scope of losses and requirements are analysed and a suitable proposal is made. In certain business lines (*e.g.* life insurance), risks of losses and financial security

problems are increasingly linked to a multitude of legal parameters of a judicial and fiscal nature, and consumers are frequently overwhelmed when it comes to evaluating their risk of losses and formulating their security needs. In these lines the advisory function is increasingly important, and the advisory process only when provided to the customer by or on behalf of the insurer should be seen as a component of the actual market service regardless of how this added value is organised (in-house or independent sales force, brokers, internet methods, etc.). The various sub-processes involved in sales, marketing and acquisition include acquiring clients, assessing requirements, advising clients and providing quotes and proposals.

31. An insurance contract guarantees the fulfilment of a function over a contractually agreed period of time. The prospect of entering into a longer-term relationship leads to an extension of the business effort beyond the time of the actual sale of the service by providing sales/support functions. The Customer Relationship Management services area's task is to strengthen client relationships, even if no claims payments are made in a certain period. Functions in the "CRM" field include: ongoing analysis of the client's insurance needs, adjusting requirements, preventing termination, utilising cross-selling opportunities, handling complaints, etc. Customer relationship management potentially benefits insurance companies in a number of ways. It may help reduce persistency ("lapse") risk (specific risks are commented on in Section B-4) encountered in the life insurance industry by encouraging policyholders not to terminate their policies or cause them to lapse. It may reduce insurance risk by providing direct claims experience with the policyholder over longer time spans. It may also assist the insurer in differentiating itself from other insurers thus lowering marketing costs/efforts. There also are risks to the insurance enterprise if the sales and marketing functions are not properly performed so that its products are mis-sold to a customer, *e.g.* the products were not properly explained to the customer or the product was not suitable.

32. Insurance agents and brokers undertake sales and marketing functions by trying to cultivate potential clients and to create client relationships. The exact nature of the sales and marketing functions depends on the type of insurance, *e.g.* life insurance is aimed at the retail market and so the nature of the marketing function will be quite different from that of a life reinsurer where the market is other insurance companies and insurance agents or brokers are often not involved. The relative importance of the function will also depend on the facts and circumstances. For example, for some products that are intrinsically profitable in insurance terms, such as travel insurance, the marketing function is likely to be important, whilst for other products such as credit card insurance the development of a relationship with the credit provider will be vital. To carry out the sales and marketing functions, many insurers rely on independent agents and brokers; others rely on their own sales staff including those of other companies, such as a bank, in a financial group. There is a growing trend to selling directly by phone and the internet. In general, brokers act as an intermediary and represent the insurance buyer. Agents represent the insurance company. In the case of reinsurance, the broker's client is the insurance company (cedant). The use of brokers may be more prevalent in the large commercial and reinsurance market segments whereas agents may be found more frequently in small commercial risks and personal lines. The significance of each of these distribution channels may also vary by country as well as by geographic region.

33. Companies in the international property and casualty business and the reinsurance business rely very heavily on brokers to source or provide insurance. In many cases, these brokers are under fiduciary obligations to act on behalf of clients and buy insurance from many insurance companies. Such brokers may perform underwriting-related functions to facilitate the underwriting, *e.g.* by gathering information relevant to the insured risk, preparing the preliminary terms of a contract and managing any claim. In some cases, the brokers have authority to bind insurance companies, provided that the prospective insured satisfies a specified profile. Thus, in many cases, brokers perform functions that go beyond sales and marketing.



c) Underwriting insured risk

34. Underwriting is the process of classifying, selecting and pricing the insured risks to be accepted. Again, the exact nature and importance of these functions (and who performs them) will vary depending on the type of insurance product and the facts and circumstances of the taxpayer. For example, the risk selection part of underwriting is likely to be less important for certain types of standardised products (*e.g.* low value life insurance products) and for reinsurance where product development and pricing, sales, marketing and risk management/reinsurance functions may be more important. There are a number of activities that can be part of the “underwriting” process. It will be important in the functional and factual analysis to evaluate the relative contributions of the following activities to this process (see paragraph 69):

- *Setting the underwriting policy.* Defining an underwriting policy which the underwriters have to follow is part of risk management. The underwriting policy may set broad or detailed parameters for determining the amount of risk to underwrite and can be designed to ensure that the insurer writes a book of business that is profitable and reasonably stable. The extent to which it actively contributes to the underwriting process will need particularly careful analysis (see paragraphs 70 and 94).
- *Risk classification and selection.* The process of classifying and selecting the insured risk is underwriting in a narrow sense. The underwriter analyzes the specific risk and related risk category, and determines the pricing according to risk, cost and market conditions, or according to the applicable premium rate tables. Further, the underwriter may select the risk and verify capacity limits. The basic requirements are the classification of risks on the basis of selected criteria and the use of relevant statistics.
- *Pricing.* The underwriter may be involved in the pricing or setting of premiums for a contract but, where the product is standardised and premiums are set by reference to applicable premium rate tables, the underwriter is generally less involved in the pricing of the contract once the risk has been classified. In the life insurance business, the underwriter is generally only involved in the selection and classification of the insured risk and the pricing of the insured risk is done by actuaries.
- *Risk retention analysis.* Part of the underwriting decision may involve an analysis of how much of the insured risk should be retained and how much can and should be simultaneously laid off to a reinsurer and on what terms.
- *Acceptance of insured risk.* The decision to enter into the contract is the underwriting activity that exposes the enterprise (and its surplus) to insurance risk. That may be performed by an underwriter who at one extreme will exercise considerable independence and skills and at the other will be more like a salesperson with look-up tables.

35. The objective of underwriting is not the selection of insured risks that will not generate losses but to avoid the misclassification of insured risks according to the pricing of insurance contracts. Defining an underwriting convention or practice which the underwriters have to follow is part of risk management and will be appropriate to the technical skills and abilities of the insurer’s personnel. The underwriting policy may set broad or detailed parameters for determining the amount of risk to assume, determines the nature and size of business of an insurance company and may, depending on the facts and circumstances of the taxpayer, be one of the major factors affecting the profitability of insurance operations. Factors which may influence the underwriting practice are:

- (1) the financial capacity of the company, essentially its surplus;
- (2) the regulatory framework concerning the maximum risk capacity;
- (3) the technical skills and abilities of personnel;
- (4) the availability and cost of third party reinsurance; and
- (5) strategic business goals.

36. The basic requirements are the classification of insured risks on the basis of selected criteria and the use of relevant statistics. For standardised products, this procedure may be to a certain extent automated. In the case of complex contracts, the process is very complex (comprehensive insured risk verification) and requires very strong specialist skills (insured risk engineering, explanation of judicial, medical, physical implications, etc.). In particular, the following sub-processes are involved in executing the contract: processing the proposal, underwriting insured risk, preparing the contract and commissioning. These activities may be carried on by underwriters but may require the assistance or approval of other personnel such as actuaries (*e.g.* to assist with pricing and assess the likelihood of claims), legal staff (*e.g.* for contractual advice) and support staff for administrative matters (*e.g.* premiums and claims processing).

37. Underwriters may be located in the head office of the insurer or in the PE depending on the product line involved. The underwriting/risk acceptance function may be supported by the head office's provision of broad underwriting guidance or parameters to be followed by the PE while the PE performs the underwriting decisions of individual risks. In the case of large or specialised policies, the head office may be performing the underwriting/risk acceptance function. Even when the underwriting/risk acceptance function occurs in the head office, there may be situations where valuable underwriting support is provided by the PE, such as where there is a need for an underwriter in the PE to visit the client, or for a sales agent to make a presentation or just to get a better understanding of the insurance needs of the client's business. It will be necessary to determine, through a functional and factual analysis, where the underwriting/risk acceptance components are being performed and the value of those components in the particular circumstances.

d) Risk management and reinsurance

38. The overall risk of an insurance company is comprised of separate elements (insurance risk, commercial risk, environmental risk and investment risk). The management of these risk elements may take place on a strategic level and/or a more active, operational level (see *e.g.* paragraphs 70 and 94 below and also paragraphs 73-80 of Part III). Insurance risks are often the most important risk elements, although risks associated with investment may be just as (or more) important, particularly in the case of longer-term business. These risks include asset/liability mismatch, asset default, reinvestment and volatility risks. Insurance risk and investment risks are traditionally dealt with within the overall risk management function. To manage these risks, insurers have a comprehensive range of risk management tools (including claims adjustment policy, portfolio policy, reinsurance policy and investment policy including ALM (asset/liability management)). The calculation of premiums and the analysis of the claims experience (probabilities, claims distribution, etc.), the setting of investment assumptions, as well as setting aside the necessary reserves, are the tasks of actuaries. For long-term and other insurance business, it is important to match the maturity of asset portfolios with liabilities for the period of risk. ALM establishes investment guidelines for a specific line of business or a specific product line. These investment guidelines generally define the longer-term asset allocation policy (including acceptable classes of securities, credit and other risk parameters, maturities) taking into account the nature and term of the liabilities, product guarantees and options, and regulatory requirements. ALM in respect of a specific line of business or a specific product line is generally conducted within the ambit of a general enterprise-wide ALM policy set by the home office.

39. The risk management function also comprises the capital management, *i.e.* establishing and maintaining a capital management process (including the setting of target rates of return on capital and monitoring progress against those targets), performing the capital allocation to the various lines of business and parts of the organisation (considering, among others, the different solvency regulations and capital requirements). Accordingly, capital management and allocation is a highly complex area.

40. Of central importance to the risk management process is the decision whether to use reinsurance to manage the insurance risk exposure of an insurance company. As discussed at paragraphs 18-21, reinsurance involves the partial transfer of insurance risk to a reinsurer. Key components of this process are: analysis of the insured risk portfolio, establishing the reinsurance requirements, negotiating, structuring and concluding agreements with the reinsurer, financial execution of the reinsurance transaction, ongoing co-operation with the reinsurer (managing statistics, distributing information, etc.). From the reinsurer's perspective, its functions relative to insurers are broadly similar to those of primary insurers relative to policyholders. Thus, the reinsurer diversifies the risks that are ceded to it by multiple insurers and may in turn cede risks to other reinsurers. The reinsurer has a sales function (*e.g.* through performing marketing activities), performs underwriting activities (*e.g.* by accepting ceded risks from insurance companies and determining reinsurance premiums), performs pooling activities (*e.g.* by pooling the risks ceded to it by multiple insurance companies, and undertaking similar risk management activities as described for insurance companies herein). A reinsurance company may decide to (retro) cede risks that it does not want to bear.

41. Over and above this traditional form of risk transfer, new methods of risk financing have been discussed and employed for some time now (ART: Alternative Risk Transfer). The multitude of innovative approaches are firstly aimed at overcoming the barriers to insurability and secondly at optimising the management of the insurance risk from the point of view of both diversification and cost. The essential feature of ART products appears to be that they import the techniques of the capital markets into insurance through securitisation, often through use of special purpose vehicles to issue securitised financial products. The most common form of securitised insurance product is the catastrophe (CAT) bond. This offers a high coupon subject to a specified but infrequent insurance event, *e.g.* an earthquake. If the event occurs the investor's return is reduced or eliminated and in the riskier bonds part or all of the coupon (and possibly part of the principal) may also be lost.

e) Contract and claims management

42. This function includes the monitoring of a contract (or a group of contracts) over its life cycle, *i.e.* maintaining the information on contractual developments, insured risk and occurrences, as well as maintaining accounts on premiums, claims reserves and commissions. It also includes the loss and claim reporting process -- the establishment and maintenance of a loss reporting system, developing reliable claims statistics, defining and adjusting claims provisions and introducing measures to protect and reduce claims in future). Claims management includes all the activities related to a client's claim including, processing the claims report, examining cover, handling the claim (working out the level of the claim, clarifying causes, claims reduction measures, legal analysis) and seeking recovery.

43. In today's competitive environment, insurance companies may also provide tangible and intangible emergency help (assistance, replacement in kind, and physical/emotional help for clients) in addition to the purely financial settlement. This can be one way for an insurance company to differentiate itself from its competitors in an attempt to gain market share.

f) Asset management

44. The asset management process has two primary functions:

- **Investment Management:** The investment management function comprises the short-term asset allocation, security selection, and investment accounting functions. Short-term asset allocation involves the execution of investment transactions within the boundaries of the investment guidelines established by the asset/liability management function (ALM). Security selection is limited by both the investment guidelines and local regulatory requirements. Investment accounting is a necessary part of investment management, ensuring proper recording and performance monitoring.
- **Asset/Liability Management:** see paragraph 38 for a discussion of ALM.

45. Investment managers carry out the asset management functions of the insurance business. They make investments out of the reserves and surplus that the company maintains and monitor the risks associated with those investments. In the property and casualty industry they tend to work independently of the underwriters and marketers and since they do not have to interact with the company's clients they can be located far from them. In the life industry the insured may have more control over the investments made so that the connection between the client and investment advisor is closer and requires closer proximity. Investment managers work with the regulatory compliance personnel since the risk associated with assets is closely monitored by regulatory agencies.

46. Asset management may be carried out in whole or in part by third parties. This may be the case even for large insurance companies with their own in-house asset management group.

g) Support processes

47. An insurance business will also have to undertake a number of support functions some of which are particular to the industry, while others are of a more general nature. Important support functions include:

- *Treasury functions.* The Treasury may hedge investments in order to make sure that cash flow is secure and to make sure that the timing of investment income meets the cash flow requirements. It is generally responsible for cash management such as borrowing funds on the most advantageous terms possible. The relationship or distinction between this function and the asset management function would have to be determined through a functional and factual analysis.
- *Regulatory compliance* (e.g. monitoring assets and liabilities, often on a daily basis to make sure that surplus requirements of regulators are met).
- *Systems and development of intangibles* (e.g. development of information technology and systems that can be used to determine pricing and calculate reserves, advertising, claims experience data).
- *Other back office* (e.g. premiums handling, accounting, auditing, legal services, training).
- *Loss control* tries to prevent those losses that can be prevented, minimise those that cannot be prevented and verify valid claims or deny claims for uninsured losses. The loss control department provides input to the underwriters and marketers.

- *Credit analysis* assesses the creditworthiness of the enterprise's various counterparties, including reinsurers, policyholders and persons in whom investments are made.

ii) *Analysis of the functions performed*

48. As can be seen from the previous sub-section, there are a number of functions necessary to undertake an insurance business. It will be important to identify not just what functions are performed (taking into account assets used and risks assumed) but also their relative importance.

49. Clearly the determination should be on a case-by-case basis as the relative importance of a given function is likely to vary according to facts and circumstances, *e.g.* product differences, type of business, business strategies, etc.

50. One area of particular significance for types of insurers that focus on accepting complex insured risks is the identification of the functions which create the greatest value and risks. Such functions require a key decision: the decision as to what insured risks to accept and on what terms. Other functions are usually consequential, for example, which insured risks to reinsure. However, the relative significance of a given activity for a particular enterprise depends upon such factors as the type of insurance operation and the business model employed. As always the analysis depends on the facts and circumstances of the individual case. For example, the process of underwriting insured risks is likely to be far more important for complex risks such as life or earthquake insurance than for standardised products such as travel insurance sold over the internet.

**B-3. Assets used**

51. The Guidelines note at paragraph 1.42 that compensation will usually reflect not just functions performed, but also 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 accepting an insurance contract. For insurance companies, the most important assets used are investment assets which generate a return in the form of interest, dividends, rents and capital gains. Investment assets include debt instruments, stocks, derivatives, real estate, policy loans and cash. Certain assets are technically not investment assets but are receivables that will be converted to cash in the short term (*e.g.* due and accrued premiums (to the extent included in the calculation of reserves), investment income due and accrued and reinsurance recoverable) or that equate to investment assets in their use (*e.g.* a funds withheld receivable). For the purposes of this Part, the abovementioned receivables, though they may not generate an investment return, are considered to be investment assets since they arise from the insurance business and are used to support specific insurance liabilities. Due to the strong link in the insurance business between insurance risk assumed and the need for investment assets to back that risk, the analysis of investment assets used by the PE of an insurance enterprise will have to pay close attention to where insurance risk is assumed. (See paragraphs 59-62 and 95-106 for a description of the relevance of regulatory requirements to this link between insurance risk and investment assets.)

52. Insurance companies also use physical assets such as sales offices, claims offices, information processing centres, etc., and so the functional analysis will have to consider which non-investment assets are used by the PE. As noted in Section D-2(iii)(b) of Part I of this Report, there is a broad consensus among member countries for applying the place of use as the basis for attributing economic ownership of tangible assets in the absence of circumstances in a particular case that warrant a different view. These assets may need to be taken into account in making any comparability analysis under the second step of the authorised OECD approach. For example, selling insurance through the internet may be substantially less expensive than selling insurance through a broker or agent, or even directly by phone, because no physical

facilities or personnel may be required to make internet sales. Section D-2(i) of Part I of this Report provides further guidance on how to address e-commerce operations under the authorised OECD approach.

53. Further, as with any other business, the functional analysis should also examine whether any intangible assets have been used. In the insurance business, common intangibles are marketing intangibles represented for example by the name and logo of the insurance company. Insurance companies also may have licenses to sell insurance in various markets that are intangible assets obtained at the cost of complying with regulatory licensing procedures. Other intangible assets would be more akin to trade intangibles, such as underwriting tools/tariffs and proprietary systems for efficiently accounting for insurance contracts and monitoring insurance risk and financial risks.

54. The attribution of tangible and intangible non-investment assets to an insurance PE and the pricing of dealings involving such assets give rise to issues that are identical to those found in non-financial enterprises. The guidance in Sections D-2(iii) & (iv) and D-3(iv)(a) & (b) of Part I is therefore applicable to insurance enterprises as well.

#### ***B-4. Risks assumed***

55. This section discusses the various types of risk assumed as a result of the performance of the various functions necessary to undertake an insurance business. Part II of this Report noted (paragraph 23) that, “[i]n order to assume risk, banks need ‘capital’, *i.e.* the ability to absorb any losses due to the realisation of assumed risks.” Part II went on to note (paragraph 27) that, “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.” In the context of an insurance business, this section therefore goes on to discuss issues related to the requirement for adequate surplus (capital) as well as other regulatory requirements.

##### *i) Types of risk*

56. An insurance company is subject to many risks for which surplus must be maintained. Aside from direct business risks, significant risks to insurers are generated on the liability side of the balance sheet. These risks are referred to as technical liabilities and relate to the actuarial or statistical calculations used in estimating liabilities. On the asset side of the balance sheet, insurers incur market, credit, and liquidity risk from their investments and financial operations as well as risks arising from asset-liability mismatches. Being attributed risks in the Article 7 context means the equivalent of bearing risks for income tax purposes by a separate enterprise, with the attendant benefits and burdens, in particular the potential exposure to gains or losses from the realisation or non-realisation of said risks. The principal types of risks are as follows.

a. Insurance risk is the potential for the amount or timing of actual claims cash flows to differ from expected cash flows. Insurance risk varies by line of business and its related “tail” (“tail” refers to the lag between the policy inception and loss payment dates), *i.e.* short-tail lines such as auto collision generally have a tail less than two years whereas long-tail lines such as commercial liability may have a tail of 10 to 15 years. Life insurance business (including annuity business) may have an even longer tail which ends upon the death of the life insured or the annuitant.

This risk may include as components/factors:

- Cumulations or correlated risk - Occurs when there are many simultaneous losses from a single event – such as an earthquake, storm, quake, flood, hail.
- Geographical diversification

- High parameter risk – uncertainty over the true value of expected losses
- Adverse Selection – Occurs when the insurer cannot distinguish between the probability of a loss for good and poor risk categories. If an average probability of loss is used to set a premium those at the highest risk will be the most likely to purchase coverage.
- Moral Hazard – Occurs when an insurer cannot predict the behaviour that will result from providing insurance coverage to an individual. An individual could act with less care, for example, and if data from uninsured individuals is used to estimate rates then premiums could be too low to cover losses.

b. Risks associated with investment activities that might affect the coverage of technical provisions (the amount set aside on the balance sheet to meet obligations arising out of insurance contracts including administrative expenses, embedded options, dividends to policyholders or bonuses and taxes) and/or solvency margins (capital), include:

- Market risk, also referred to as investment yield risk, relates to the ultimate amount of investment income that will be earned on the assets resulting from the investment (including reinvestments) that the insurance business makes. Since the income from assets provides an important part of the income needed to pay policyholder claims in longer term business, the risk of lower than expected returns makes an important claim on the insurer's surplus.
- Credit risk is the risk that the amounts due to the insurer may not be paid. The types of credit risks include:
  - *Asset credit risk* – the risk that the insurer will not receive a return or indeed a repayment of the capital on its investments due to the person receiving the investment failing to pay.
  - *Reinsurance credit risk* – the risk that the amounts to be paid by the reinsurer to the insurer under a reinsurance contract may not be fully collectible.
  - *Instalment payment risk* (including retrospective premiums) – the risk that the insured will not be able to pay the premium to the insurer.
- Concentration risk which may arise from the limited availability of suitable domestic investment vehicles.

c. Risks associated with risk management and reinsurance include:

- Basis Risk – an imperfect correlation between actual losses caused to the insurer and the payments received from a CAT bond.
- Intertemporal Basis Risk – the risk associated with changes in the book of business from the time when the model was used to price the policy.
- Retrocession risk – insurance on reinsurance – the transfer of ceded premiums to other reinsurers or primary insurers – creates credit risk and the possibility of a domino effect in the event of failure by the end reinsurer.

57. As well as the risks assumed as a result of performing functions relating to underwriting, investment and risk management as noted in the previous paragraph, an insurance enterprise is also exposed to other types of risk and to operational risk. Operational risk is the risk that a business may incur liabilities in connection with its business activities. Operational risk includes liabilities arising from

employees making errors in judgement, being negligent or careless, and conducting illegal or improper activities while acting within the scope of their employment. Recent examples (*e.g.* selling of products with a guaranteed rate of return that the insurance company cannot achieve in a low inflation environment) highlight the importance of managing this risk, as failure to do so can lead to the effective bankruptcy of the insurance enterprise.

58. Examples of other types of risks include:

- *Foreign exchange rate risk.* An international insurance company may have substantial foreign exchange rate risk. This is the risk that foreign exchange rates fluctuate compared to the balance sheet currency. Insurers generally seek to manage currency risk, including by using natural hedges, such as holding reserves and surplus in the currency of the jurisdiction in which the PE is located.
- *Liquidity risk* - the risk that assets need to be liquidated at unfavourable conditions if cash is needed immediately to meet unexpected obligations to policyholders. The latter risk is typically managed using an appropriate asset/liability management.
- *Reputation risk* – in many markets intermediaries serve as important distribution channels of insurance – an interface between consumers of insurance and providers of insurance. Their conduct may affect the insurer.
- *Some risks particular (or more significant) to the Life and Health Insurance lines:*
  - Asset default risk - the risk of loss resulting from on-balance sheet asset default and from contingencies in respect of off-balance sheet risks and related loss of income
  - Mortality and morbidity risk – the amount and timing of death and disability benefits paid
  - Longevity risk – increase in longevity increases aggregate payouts on annuities with life contingencies
  - Interest rate risk (asset/liability mismatch risk) – changes in interest rates that may cause an insurer's assets to lose value or yield relative to its liabilities
  - Persistency/lapse risk – if policyholders surrender their policies before prepaid (front end loaded) expenses are recovered – correlation with interest rates creates interest rate risk and market systematic risk
  - Cash flow risk – policies contain embedded options, *i.e.* to offset minimum interest payment guarantees, etc.
  - Guarantee and option risk - the risk of loss arising from guarantees and options embedded in policies, especially in segregated funds (variable or linked) policies.

ii) *Surplus requirements/solvency margins*

59. As noted in Parts I-III, capital is an important condition for all enterprises, in particular those in the financial sector that accept and manage financial risks in the ordinary course of their business. In the context of insurance, the capital required in excess of the other liabilities and reserves in order to assume the risks described above is commonly referred to as surplus, and the surplus of assets over liabilities is commonly referred to as the solvency margin. Minimum levels of surplus are required by regulatory agencies based upon the lines of business of the insurer. Third parties doing business with the insurance enterprise would be concerned that the insurance enterprise will have sufficient financial resources to meet claims when they arise in the future. This is particularly important in the more long-term types of business, *e.g.* life insurance, where considerable periods of time might arise between the acceptance of the insured risk and the event triggering a claim.



iii) *Other regulatory requirements*

60. Regulators not only regulate the amount of surplus required to do insurance business, but also may regulate:

- the relative amounts or types of investments that can be made based upon the market risk of those investments and the lines of business conducted by the insurer and sometimes the pricing of contracts,
- the types of products or lines of business that can be sold,
- the amount and timing of the reserves that can be established to provide for future losses or claims,
- where there is specific host country regulation, this may also determine not just the amount of surplus, types of investment, etc. but also their location, *e.g.* by requiring specific assets to be held in the host country, and
- which particular reinsurance companies may be used in order for the ceding company to receive credit for premiums transferred.

61. In some jurisdictions, local insurance regulators require a foreign company to maintain assets in a local trust as a condition of conducting an insurance business in that jurisdiction. These “trusteed assets” generally must be sufficient in the regulators’ perspective to support the foreign company’s activities in that jurisdiction. Typically, the trusteed assets are equal in amount to the PE’s regulatory reserves and minimum surplus. The PE generally must obtain permission from insurance regulators to remove the trusteed assets and the trusteed assets may only be used to pay the PE’s liabilities. Thus, the trusteed assets are not available to pay other obligations of the foreign insurance company.

62. In some cases, a foreign insurance company reinsures insured risks in a country but is not licensed to do business in that country and may not have a PE in that country. Local insurance regulators may not allow a domestic company to claim credit (reduce regulatory reserves) for reinsurance purchased from the unlicensed foreign insurance company unless the foreign company places assets supporting the reinsurance contract in a trust fund. The trust fund typically holds assets at least equal to the amount of the regulatory reserves supporting the insured risks reinsured under the contract (see paragraph 19 above).

**B-5. *Dependent agent PEs***

63. Insurance companies sell insurance to customers through a number of different marketing channels (*i.e.* the internet, vending machines, telephone solicitation, etc.). Most insurance is sold through a broker or agent, though in the insurance industry the term “agent” sometimes means simply an employee of the insurance company as well as an agent proper, *i.e.* someone who is not an employee but who acts on behalf of the company with authority to conclude contracts in the name of the company. In some cases, the broker or agent may only sell policies issued by the company. Alternatively, a broker or agent may be paid on a commission basis and sell insurance policies of a number of different insurance companies. The activities of an insurance company in a foreign country may be limited to selling its products there through brokers or agents paid on a commission basis and complying with various regulatory requirements related to the policies sold (*i.e.* filing documents with the regulators and establishing trust funds in the country to hold insurance premiums).

64. An insurance company that sells insurance in a country through agents may have a PE in that country if the activities conducted by those agents fall within the definition of a “dependent agent” under Article 5(5) of the OECD Model Tax Convention. It should be stressed that the determination of whether an insurance company has a dependent agent PE for tax purposes is legally quite independent of whether the insurance company faces a licensing requirement for regulatory purposes, although to the extent that the criteria for identifying a dependent agent PE for tax purposes happen to overlap with the criteria for triggering a licensing obligation for regulatory purposes, there may be a practical connection. However, an insurance company that sells insurance through an agent of “independent status” would not be deemed to have a PE in that country through the agent’s activities provided it is “independent” within the meaning of Article 5(6) of the OECD Model Tax Convention. In short, an insurance company may engage in a large-scale business in a country but not have a PE because it sells insurance exclusively through “independent” agents under Article 5(6). See paragraph 39 of the OECD Model Commentary on Article 5. To obviate this possibility, some bilateral conventions include a provision that stipulates that insurance companies have a PE if they collect premiums in that country through an agent. Again see paragraph 39 of the OECD Model Commentary on Article 5. Discussion of the rules for determining whether an insurance company has a PE in a country through an agent is beyond the scope of this paper. The scope of this paper is limited to considering how much profit is attributable to a PE once a PE has been created through a dependent agent (dependent agent PE) or through a fixed place of business, as defined in Article 5 of the OECD Model Tax Convention.

65. Given the different types of activities that can be carried on through an agency PE, once it has been established that there is a dependent agent PE under Article 5(5), it will be essential to determine the exact functions performed by or through the dependent agent in order that profit can be appropriately attributed to that PE. In particular, a key question will be whether or not the PE is accepting insured risk, and assuming and managing the associated insurance risk, and therefore requires surplus to be attributed to it. This is discussed in detail in Section C-1(i)(d).

### **C. Applying the authorised OECD approach to insurance companies operating through PEs**

66. This Section discusses how to apply the authorised OECD approach to attribute profits to a PE of an insurance enterprise. The approach taken is first of all to introduce the basic principles before describing in Section C-1 how the authorised OECD approach would apply generally to insurance businesses. Particular attention is paid to how the transfer pricing concepts of functional and comparability analyses, which are necessary to perform both steps of the authorised OECD approach, can be applied, by analogy, to an insurance PE. Section C-2 discusses in detail how this general guidance would apply to specific situations commonly found in the insurance sector.

#### **Basic principles used to attribute profits to a PE of an insurance company**

67. For insurance, no less than for other businesses, the key aim is to attribute profits of an insurance enterprise 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, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise”. A PE is not the same as a subsidiary since 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 natural outcome, resulting from the decision to operate through a PE rather than a subsidiary.

This section provides an introduction to the basic principles of the authorised OECD approach as applied to insurance PEs. The basic principles described below are discussed in more detail in the rest of the Report.

#### Functional and factual analysis

68. In the context of the authorised OECD approach, the functional and factual analysis is used to (1) delineate the PE as a hypothesised separate and independent enterprise engaged in the same or similar activities under the same or similar conditions; and (2) to attribute profits to the PE under Article 7, using the guidance on the application of the arm's length principle of Article 9 given by the Guidelines, by applying these Guidelines by analogy and, where required, by adapting and supplementing these Guidelines to take into account factual differences between a PE and a legally separate enterprise. The functional and factual analysis will also take into account the assets used and risks assumed as a result of performing those functions. The functional and factual analysis will therefore have to identify the most important risks for the particular taxpayer and which functions give rise to those risks. Of particular importance will be the determination of the key entrepreneurial risk-taking functions of the enterprise and the extent to which the PE undertakes those functions. Generally, a key entrepreneurial risk-taking function is one which requires active decision-making with regard to the assumption and/or management (subsequent to the transfer) of the individual risks and portfolios of risks that have been identified as the most important under the functional and factual analysis. It is the key entrepreneurial risk-taking function that is likely to affect most directly the profitability of the insurance enterprise. This is because it is the performance of that function that leads to the assumption of the greatest risks and therefore the requirement for capital in the form of reserves and surplus. As explained further in Section C-1(vi), the assumption of insurance risk is the key entrepreneurial risk-taking function for an insurance enterprise, and the management of that risk subsequent to its assumption generally does not involve the kind of active decision-making that justifies treating that management function as a key entrepreneurial risk-taking function. Accordingly, the balance of Part IV focuses on the assumption of insurance risk.

69. It should be stressed that an insurance business will have one key entrepreneurial risk-taking function, the assumption of insurance risk (see paragraph 94). Various activities will contribute to that process, and their relative importance is likely to vary according to the particular facts and circumstances: *e.g.* product differences, type of business, business strategies, etc. Such activities require a key decision: what insured risks to accept and on what terms. Whether a given activity constitutes a part of the key entrepreneurial risk-taking function for a particular enterprise depends upon such factors as the type of insurance operation and the business model employed. As always the analysis depends on the facts and circumstances of the individual case.

70. The question of whether particular risk management functions (*e.g.* strategic parameter-setting and/or more active, operational decision-making) may constitute part of the key entrepreneurial risk-taking function is discussed at paragraph 94.

71. Once a location performing the insurance risk assumption function has been determined and the respective insurance risk has been attributed to it, it will be necessary to attribute an appropriate amount of assets to that location to back that risk (*i.e.* assets representing both reserves and surplus). Further, it will also be important to reward other functions in accordance with the arm's length principle. It should also be noted that there is no presumption that these other functions are by nature of low value. This will be determined by the functional and comparability analyses based on the particular facts and circumstances. A whole spectrum of rewards from performing these other functions can be expected ranging from, at one end, low value rewards to at the other end rewards based on a share of the residual profit of the part of the enterprise acting as the key entrepreneurial risk-taker. In short, the functional and factual analysis

determines the attribution of profits to the PE in accordance with its functions performed, assets used and risks assumed, and informs also the attribution of assets and investment income to the PE.

72. The functional and factual analysis is of critical importance. In attributing profits to a PE it is not sufficient to prepare symmetrically balanced books attributing profits in the books of the PE that correspond exactly to the values used in the books of the head office. Nor is it sufficient to record insured risks and the associated surplus, reserves and investment assets in the books without consideration of where the key entrepreneurial risk-taking function leading to their creation is performed. The extent to which taxpayers' accounting records and other contemporaneous documentation is to be given effect is described in Section B-3(v) of Part I of this Report (see in particular paragraph 36).

#### *Attribution of investment assets and risks*

73. Investment assets and related risks will be attributed to the PE in accordance with a functional and factual analysis of the enterprise concerned that, in particular, seeks to identify the key entrepreneurial risk-taking function relevant to determining the economic ownership of those assets. Unlike the banking industry, where the key entrepreneurial risk-taking function is the creation of (and subsequent management of the risks associated with) financial assets,<sup>3</sup> the key entrepreneurial risk-taking function in the insurance industry is the assumption of insurance risk. It is the assumption of insurance risk that creates the need for an insurance enterprise to hold an amount of assets sufficient to support the reserves and surplus relevant to that risk. Accordingly, the economic ownership of investment assets of an insurance enterprise will be attributed to the part or parts of the enterprise that perform the function of assuming insurance risk, to the extent appropriate to support that risk.<sup>4</sup> This is based upon the principles set forth in Part I of this Report, which require a determination of the assets used by the PE in its hypothesised status as a separate enterprise. The determination of where insurance risk is assumed should be made on a case-by-case basis as the activities comprising that key entrepreneurial risk-taking function and especially their relative importance will depend on the type of insurance business and its particular facts and circumstances. As noted in Part I, other assets and risks will be attributed to the PE in accordance with a functional and factual analysis that seeks to identify the significant people functions relevant to the economic ownership of assets and the significant people functions relevant to the assumption and/or management (subsequent to the transfer) of risks, except that the economic ownership of tangible assets will be attributed to their place of use in the absence of circumstances in a particular case that warrant a different view.

74. An insurance company earns income from holding investment assets (e.g. bonds and stocks). In general, investment assets are attributable to reserves and surplus (amounts set aside from premiums and investment returns to pay future claims and expenses and other liabilities, plus any amounts held in excess of the former amounts) held by the company. Thus, the amount of investment income includible in the taxable income arises from investment of assets representing both the reserves and surplus held by the company.

75. The authorised OECD approach must therefore provide guidance on how to determine the total amount of investment assets that need to be attributed to a PE in order to support the insurance risk assumed by that PE. Such assets are needed to fund both the reserves and surplus needs of the PE. One difficulty that presents itself in this regard is that there is no internationally accepted standard for determining either the amount of reserves to be established in respect of any particular pool of insured risks or the amount of surplus that should be maintained to absorb any losses or benefits in excess of the reserves. Countries' domestic law requirements for determining reserves and surplus vary widely, both from a regulatory and from a tax perspective. That being said, the different domestic law requirements tend

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3 See paragraph 50 of Part II.

4 See paragraph 19 of Part I which describes the consequences of attributing assets to a PE.

to converge when it comes to the determination of the total amount of investment assets of insurance enterprises. This is the case, for example, because a jurisdiction with relatively high reserve requirements will tend to have relatively low surplus requirements compared to other jurisdictions in respect of comparable insurance enterprises. For this reason, the focus of the authorised OECD approach in the insurance industry is on determining the total amount of investment assets attributable to a PE in light of the insurance risk assumed by that PE, rather than on determining the separate reserves and surplus needs of the PE.

76. Parts I-III of this Report provide guidance for determining the extent to which a PE's activities are funded by "free" capital and interest-bearing debt for the primary purpose of being able to determine the interest deduction to which the PE may be entitled in calculating its taxable profit. Insurance enterprises typically do not have interest-bearing debt as a significant part of their capital structure, so it was not thought necessary to focus on the capital attribution approaches of Parts I-III in Part IV. Of course, insurance enterprises like any others are subject to the requirement of having "free capital" (*i.e.* funding that does not give rise to deductible expenses in the nature of interest) that would have to be taken into account in determining interest expense attributable to a PE.

77. To some extent, the insurance industry corollary to other enterprises' capital structure based on "free" capital and interest-bearing debt is the distinction between surplus and reserves. The distinction can be relevant in determining taxable profits, because movements in reserves are typically taken into account in determining an insurance enterprise's taxable insurance income. It is worth noting, however, that countries' domestic law approaches to determining the relative proportions of reserves and surplus making up the capital structure of any particular insurance enterprise tend to vary much more than their approaches to determining debt versus "free" capital for other enterprises. There is no internationally agreed approach to determining particular ranges for the relative proportions of reserves and surplus making up the capital structure of insurance enterprises. For that reason, the question of the separate determination of reserves and surplus is regarded as one that is more appropriately left to the domestic law of the PE jurisdiction, and Part IV focuses instead on the attribution of total investment assets to the PE.

78. As described further below, different authorised approaches are identified as appropriate to determine the total investment assets attributable to a PE. These approaches, which bear some similarities to the approaches described in the other Parts of this Report for the attribution of "free" capital to a PE, are referred to as the "capital allocation approach" and the "thin capitalisation / adjusted regulatory minimum approach". They differ from those capital attribution approaches, however, in that their aim is to determine the total amount of investment assets attributable to a PE, not the extent to which those assets have been funded by "free" capital or debt, nor the extent to which they represent surplus or reserves.

79. That being said, it is important to bear in mind that the attribution of a total amount of investment assets to a PE under the authorised OECD approach is intended to reflect the total amount of such assets the PE would hold in order to fund its aggregate surplus and reserves needs, determined as if the PE were a separate enterprise operating at arm's length. Thus, it is useful to consider the relationship between that arm's length amount of total investment assets and regulatory requirements that may be applicable.

80. The amount of an insurance company's reserves is calculated based upon certain assumptions about estimated payouts, projected interest rates, and other assumptions with respect to revenue and expenses and includes a margin for adverse experience. In general, the assets of a company (including its investments) less its reserves for insured risks (or technical liabilities) and other liabilities will equal the surplus. Thus, the amount of the surplus held by a company is based on the methods used to record its assets, calculate its reserves and record its other liabilities. The goal is to attribute the appropriate amount of investments and other assets to different parts of the enterprise (generally, equal to the reserves, liabilities and surplus of those parts of the enterprise).

81. The factual starting point for the attribution of investment assets to an insurance PE is that the assets representing surplus and reserves are primarily required to support the risks assumed by the enterprise. These assets must be regarded as following those risks. In other words, investment assets are to be attributed to a PE by reference to the insurance risk arising from its acceptance of insured risks, and not the other way round.

82. This attribution of investment assets to an insurance PE should be carried out in accordance with the arm's length principle, to ensure that the insurance PE, just like any other PE, has sufficient assets (to cover surplus and reserves) to support the functions it undertakes and, crucially, the risks it initially assumes and subsequently bears. Until such time as assets are called upon to meet any claims for which reserves have been established, to meet any excess of claims over reserves or to meet other liabilities, they are invested and the income from these investments is attributed to the PE as described above. The Report describes a number of different possible approaches for applying that principle in practice, recognising that the attribution of investment assets 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 investment assets attributable to a PE, not a single figure. As noted earlier, the goal is to attribute the appropriate amount of investments and other assets to the PE (generally, equal to the reserves, liabilities and surplus of the PE).

83. The different possible approaches for attributing the total amount of investment assets needed to cover the surplus and reserves appropriate to the risk assumed by the PE 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 an appropriate amount of total investment assets 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 results in an attribution of total assets (covering reserves and surplus) that is consistent with the arm's length principle. 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.

#### *Recognition of dealings*

84. 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. It follows that:

- all parts of an insurance enterprise have the same creditworthiness, except where due to host country regulation certain assets are held as trustee assets and so can only be used to meet claims in the host country. This means that dealings between a PE and the rest of the enterprise of which it is a part should generally be priced on the basis that both share the same creditworthiness; and
- there is no scope for the rest of the enterprise guaranteeing the PE's creditworthiness, or for the PE to guarantee the creditworthiness of the rest of the enterprise of which it is a part.

85. Second, dealings between a PE and the rest of the enterprise of which it is a part have no legal consequences for the enterprise as a whole. This 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. This also implies a greater scrutiny of documentation (in the inevitable absence, for example,

of legally binding contracts) that might otherwise exist and considering the uniqueness of this issue, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealing.

86. 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 independent enterprises acting at arm's length. Only once that threshold is passed can a dealing be reflected in the attribution of profits under Article 7(2). The functional and factual analysis must determine whether a real and identifiable event has occurred and should be taken into account as a dealing of economic significance between the PE and another part of the enterprise.

87. Thus, for example, an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the authorised OECD approach. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that:

- the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner or, if they do so differ, the structure as presented in the taxpayer's documentation does not practically impede the tax administration from determining an appropriate transfer price; and
- the dealing presented in the taxpayer's documentation does not violate the principles of the authorised OECD approach by, for example, purporting to transfer risks in a way that segregates them from functions.

See paragraphs 1.48-1.54 and 1.64-1.69 of the Guidelines by analogy. See also Section C-1(vi) of this Part IV regarding internal reinsurance.

88. It is important to note, however, that the authorised OECD approach is generally not intended to impose more burdensome documentation requirements in connection with intra enterprise dealings than apply to transactions between associated enterprises. Moreover, as in the case of transfer pricing documentation under the Guidelines, the requirements should not be applied in such a way as to impose on taxpayers costs and burdens disproportionate to the circumstances.

89. Third, where dealings are established and 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 functional and factual analysis.

#### *Attribution of profits*

90. The attribution of profits to an insurance PE on an arm's length basis will follow from the calculation of the profits (or losses) from all its activities, including transactions with other unrelated enterprises, transactions with related enterprises (with direct application of the Guidelines) and dealings with other parts of the enterprise (under step 2 of the authorised OECD approach). This analysis involves the following two steps:

### *Step One*

A functional and factual analysis, leading to:

- The attribution to the PE as appropriate of the rights and obligations arising out of transactions between the enterprise of which the PE is a part and separate enterprises;
- The identification of the functions forming part of the key entrepreneurial risk-taking function relevant to the assumption of insurance risk and the attribution of that risk to the PE;
- The determination of the appropriate amount of investment assets required to support the insurance risk assumed by the PE and the attribution of those assets to the PE (see paragraphs 123 ff. below);
- The identification of significant people functions relevant to the assumption of other risks, and the attribution of those risks to the PE;
- The identification of significant people functions relevant to the attribution of economic ownership of other assets, and the attribution of economic ownership of those assets to the PE;
- The identification of other functions of the PE; and
- The recognition and determination of the nature of those dealings between the PE and other parts of the same enterprise that can be appropriately recognised, having passed the threshold test.

### *Step Two*

The pricing on an arm's length basis of recognised dealings through:

- The determination of comparability between the dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the PE; and
- Selecting and applying by analogy to the guidance in the Guidelines the most appropriate method to the circumstances of the case to arrive at an arm's length compensation for the dealings between the PE and the rest of the enterprise, taking into account the functions performed by and the assets and risks attributed to the PE

The pricing on an arm's length basis of any transactions with associated enterprises attributed to the PE should follow the guidance in the Guidelines and is not discussed in this Report. The order of the listing of items within each of the steps above is not meant to be prescriptive, as the various items may be interrelated.

The resulting determination of the profits attributable to the PE reflects both its income and expense from recognised dealings in amounts equal to an arm's length compensation for the functions that the PE and the rest of the enterprise of which it is a part respectively perform, taking into account the assets and risks attributed to the PE and the other parts of the enterprise.

91. 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 principles outlined in the previous paragraph.



***C-1. First step: determining the activities and conditions of the hypothesised separate and independent enterprise***

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

a) General

92. It is necessary under the first step of the authorised OECD approach to hypothesise the PE as a separate and independent enterprise “engaged in the same or similar activities under the same or similar conditions taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.”. This entails the performance of a functional and factual analysis, conducted in accordance with the guidance found in the Guidelines, in order to appropriately hypothesise the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, owning and/or using assets, assuming risks (and liabilities) and entering into dealings with each other and transactions with other related and unrelated enterprises. As explained in Part I of this Report (see Sections B-3 and D-2), the functional and factual analysis performed in the first step must identify the economically significant activities and responsibilities undertaken by the PE. This analysis should, to the extent relevant, consider the PE’s activities and responsibilities in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the PE. Ideally, book entries will be consistent with, and follow from, the functional and factual analysis. Where this is in fact the case, the accounts or books of the PE will be a useful starting point for determining the profits attributable to the PE. For example, while taxpayers may show insured risks in the books of a particular jurisdiction, the results of such booking practices should not be respected where they are inconsistent with the functional and factual analysis, such as where the booking location does not perform the key entrepreneurial risk-taking function in respect of the insured risks.

93. Section B above provides a brief general functional analysis of insurance operations which should assist in carrying out the functional and factual analysis of an insurance enterprise. Of particular importance in a PE context is the conclusion that the determination of the key entrepreneurial risk-taking function for a particular business is a matter of facts and circumstances. All facts and circumstances need to be considered to determine which function assumes insurance risk for the enterprise, because the assumption of insurance risk is the key entrepreneurial risk-taking function for an insurance enterprise. Other functions performed by an insurance enterprise may be important and valuable functions and should be compensated accordingly, but these other functions are not functions that form part of the key entrepreneurial risk-taking function.

94. In determining which functions within a particular insurance enterprise are the functions that make up the key entrepreneurial risk-taking function of assuming insurance risk, it is important to identify those activities that constitute the most important active decision-making functions relevant to the assumption of insurance risk. As a general matter, the relevant activities are those, typically falling within the category of underwriting activities described at Section B-2(i)(c) above, which are most important to the decision to accept a particular insured risk. Depending on particular circumstances, however, other functions (*e.g.* product development, sales and marketing, and risk management) may themselves represent active decision-making functions relevant to the assumption of insurance risk. As described in Section C-1(i)(b) below (relating to split functions), special consideration may need to be given to cases where the activities constituting the key entrepreneurial risk-taking function of assuming insurance risk are carried out in more than one location. The underwriting activity typically includes risk management functions related to setting the underwriting policy and the parameters for determining the amount of risk to underwrite. Such parameter-setting, without further involvement in assuming or managing the risk, would not generally be considered a function forming part of the key entrepreneurial risk-taking function

of the assumption of insurance risk. This is consistent with the conclusion reached on similar activities performed in banking and global trading businesses (see Part II, paragraph 10 and Part III, paragraph 76). As described in those Parts, senior management's setting of overall strategic parameters which are changed infrequently, with little further ongoing, active involvement in the decision-making relating to the assumption of risk, would not generally be considered a key entrepreneurial risk-taking function. A contrary conclusion may be warranted if in the particular facts and circumstances the activity is more in the nature of ongoing operational than purely strategic parameter-setting, thus involving sufficiently active decision-making as to the acceptance of particular insured risks.

#### *Impact of regulation*

95. One question that arises is the extent to which regulation determines where the insurance risk is assumed. Consider the following example where the host state (State A) requires the PE of the insurance enterprise to have a licence to conduct insurance business, to hold assets in State A to cover the risks from the policies written under that licence and to show those assets and liabilities on the balance sheet of the PE. Does it therefore automatically follow that the PE in State A should be treated as assuming the insurance risk even if in fact all the necessary functions are carried out in the head office and not in State A?

96. The answer is that regulation of itself is not the sole determinant of where insurance risk is assumed as the authorised OECD approach ultimately looks to the functional and factual analysis to determine such matters. The position taken under host state regulation would be the starting point of the functional and factual analysis and there would be a presumption that it reflects the actual position. In many cases, there will be a convergence between this presumption and what actually happens because of the impact of regulation on the functions that are likely to be performed by the PE. However, this is a rebuttable presumption and the position taken by the regulator would not be followed if it were found to be inconsistent with the functional and factual analysis.

97. One good reason for treating the position taken by the regulator as persuasive but not determinative is the fact that often there is no host state regulation (*e.g.* where both home state and host state are within the European Union) or sometimes any regulation at all (*e.g.* for reinsurance in certain countries). In such cases, the starting point would be the properly drawn up books and records of the PE and again as noted in paragraphs 87-88 these would be followed provided they accurately reflect the functional and factual analysis.

98. The function of assuming insurance liabilities is performed by personnel. So it should be possible to determine whether the key entrepreneurial risk-taking function is performed by the PE by considering whether the people performing that function are located in the PE.

99. 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 risks assumed in performing those functions. In terms of assets used, the most important assets have been identified in Section B-3 above. As noted above (see paragraphs 73-83), investment assets will have to be attributed to the PE to the extent necessary to meet the reserves and surplus needs created by the PE's assumption of insurance risk. Further guidance on the attribution of investment assets to a PE is provided in Section C-1(iii) below. With respect to non-investment assets, there are no problems particular to insurance which require guidance beyond that found in Section D-2(iii)(b) and (c) of Part I.

100. In terms of risks assumed, the guidance in Part I should be followed. In particular, as noted in paragraph 70 of Part I, "to the extent that risks are found to have been assumed by the enterprise as a result of a significant people function relevant to the assumption of those risks being performed by the PE, the

assumption of those risks should be taken into account when attributing profit to the PE performing that function.” This raises the question of what functions of an insurance business lead to the assumption of particular types of risk. In terms of risk assumed, it is the performance of the key entrepreneurial risk-taking function that leads to the assumption of insurance risk. Consequently, it is the undertaking of the key entrepreneurial risk-taking function that creates the possibility of significant profit or loss from insurance risk and the need for surplus and reserves in relation to that risk. Other types of risks may be attributed to a PE based on the performance there of significant people functions relevant to the assumption of those risks, as explained in Part I, and the PE will require surplus to support those risks as well.

101. Having appropriately determined the functions performed, the assets used and the risks assumed by the PE, the next question is how to attribute profit in respect of those functions. For insurance, a key part of an insurance company’s profits is the income from its investment assets. The authorised OECD approach is to attribute the investment assets (and therefore the associated income and expenses) to the PE that performs the key entrepreneurial risk-taking function of the insurance business (*i.e.* the assumption of insurance risk), as required to cover the surplus and reserves needs created by the assumption of that risk. This will give the PE to which such assets are attributed (the “economic owner”) the income from the investment assets attributed to it, *e.g.* the investment income from a government bond.

102. The profit attributed will also take into account any dealings at arm’s length to reward other parts of the enterprise for functions performed, *e.g.* for marketing the insurance product and introducing the customer, use of valuable intangibles, management of the investment assets, etc.

103. As noted in Part II of this Report, the part of a banking enterprise performing the sales/trading function would be attributed the financial asset created by the performance of that function (*e.g.* the loan) where this function was found to be the key entrepreneurial risk-taking function in respect of the creation of that asset and would also have attributed to it the capital supporting that asset. In the insurance business, the key entrepreneurial risk-taking function is not the creation of an asset (*e.g.* a loan) but is instead the assumption of a potential liability (*i.e.* the assumption of insurance risk) for compensation (*i.e.* a portion of the premium). It is the performance of that function that creates the need for surplus and reserves appropriate to the level of insurance risk assumed and hence the need for investment assets to cover that amount of surplus and reserves. Thus, that amount of investment assets, along with the associated income and expense, is attributed under the authorised OECD approach to the PE that has assumed the relevant insurance risk.

104. It is necessary to identify which functions form part of the key entrepreneurial risk-taking function of assuming insurance risk and whether such functions accordingly require surplus and reserves to support their performance and the assumption of associated insurance risk. The assumption of insurance risk by a PE requires the attribution to that PE of the economic ownership of investment assets sufficient to cover the surplus and reserves necessary to support that risk. The economic ownership of investments has a *prima facie* link with market risk (or investment yield risk), which suggests that surplus for that risk should be attributed to the PE to which the investments are attributed, even if this location is different from the location that performs the investment management function. The marketplace and regulators appear to require the maintenance of surplus in respect of the other types of risks as well. It follows that the assumption of those risks also requires surplus. A more difficult question is which part of the enterprise assumes any of the risks. In making that determination, it is acknowledged that a PE may perform certain functions without assuming the associated risks where the functions are performed as a service to another PE (which assumes the associated risks) under a dealing that the taxpayer is able to establish between the two PEs and that is recognised. In such circumstances, the PE performing the services would be compensated by the other PE on normal transfer pricing principles.

105. The assets and liabilities recorded in the accounts and books of the PE form a practical starting point for determining whether the economic ownership of assets and risks have been assigned to the location where the key entrepreneurial risk-taking function was performed. The accounts and books should be respected for tax purposes, provided they reflect an attribution of assets and risks that is consistent with the functional and factual analysis (including any dealings). If assets and risks are booked in a PE even when the PE does not perform the key entrepreneurial risk-taking function, then respecting the booking location in such cases would not lead to an arm's length attribution of profits.

106. This is why the theoretical basis of the authorised OECD approach is that assets and risks are attributed by reference to a functional and factual analysis, especially the identification of the key entrepreneurial risk-taking function. Following the aggregation principle of the Guidelines (see paragraph 3.9) this analysis may be performed at the level of portfolios of similar assets and risks, rather than for each individual asset and risk.

b) Split functions

107. Where the functional analysis has determined that the PE alone has performed the key entrepreneurial risk-taking function, the PE will be attributed the newly created insurance risk, together with the associated underwriting income and investment income from the assets required as surplus and reserves to support the insurance risk. Tax issues will arise where all functions relevant to the acceptance of a particular insured risk are not performed in the same location. The part or parts of the enterprise performing the key entrepreneurial risk-taking function are the "economic owners" of the underwriting income and investment income associated with the performance of that function. "Economic ownership" of insurance contracts is not split unless the key entrepreneurial risk-taking function is performed in more than one location.

108. Where the functional analysis shows that the functions forming part of the key entrepreneurial risk-taking function leading to the assumption of insurance risk have been performed in more than one location, that insurance risk can be considered as economically owned jointly. The relative value of those functions performed in the different parts of the enterprise will be used to attribute the insurance risk and the associated underwriting and investment income from investment assets. For example, if it were determined that 60% of the value of the key entrepreneurial risk-taking function was performed in the PE and 40% in the head office, the insurance risk and associated underwriting and investment income would similarly be attributed 60% to the PE and 40% to the head office. The guidance in the Guidelines will be applied, by analogy, in order to determine the relative value of the functions forming part of the key entrepreneurial risk-taking function performed in the different parts of the enterprise. Again, following the aggregation principle of paragraph 3.9 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.

c) Indirect benefits provided by sales PEs

109. A particular situation found in insurance is that in some instances an insurer may operate in a country in a number of ways. It may have a permanent establishment as a result of a fixed place of business under Article 5(1) of the OECD Model Tax Convention, but it may also have agent(s) or subsidiaries carrying out business in that location. The question arises as to how such a structure will affect the profit to be attributed to the permanent establishment.

110. For example, look at the situation where the enterprise operates in country A through a permanent establishment and also through independent sales agents. A PE may only deal with a limited range of products, and the independent agents may be selling other products which are run and managed by the head office or other PEs. In this case it would not be appropriate to attribute the sales and marketing

function and the risk underwriting function of contracts entered into by the independent agents to the permanent establishment, and to attribute relevant costs such as commission to the PE, as the permanent establishment is functionally not involved with the contracts sold by the independent agents. This demonstrates that there is no “force of attraction” element in the authorised OECD approach – we cannot say that just because an enterprise has a permanent establishment in a country, the PE will have the risks and rewards of all activity carried out there.

111. However, it will also be important to further examine whether the permanent establishment is in practice performing some services which need to be rewarded. The permanent establishment may have engaged in a major advertising campaign designed to raise the profile of the insurer and its brand name. This may well be enhancing the sales by the agents, and the profits of these sales can be attributed to the head office. It would then be a matter of applying the Guidelines to the particular situation. The Guidelines would determine whether any benefit to the head office was purely incidental to the benefit to the PE, whether the PE would be treated as providing a service of promoting the insurer’s brand name and product image, or whether the PE would be treated as the “economic owner” of a new or developed intangible.

112. The same general approach is needed where the PE may be directly or indirectly benefiting a subsidiary of the entity operating in the same country. It is a general transfer pricing issue as to whether charges should be imposed in respect of services rendered in either direction and the guidance in Chapters VII and VIII of the Guidelines should be followed by analogy for insurance PEs.

d) Dependent agent PEs

113. As indicated in Section D-5 in Part I, this Report does not examine the issue of whether a PE exists under Article 5(5) of the Model Tax Convention (a “dependent agent PE”)<sup>5</sup> but discusses the consequences of finding that a dependent agent PE exists in terms of the profits that should be attributed to the dependent agent PE. It is worth emphasising at the outset that the discussion below is not predicated on any lowering of the threshold of what constitutes a PE under Article 5. Also, even if tax and regulatory standards may provide similar prerequisites for constituting a PE, the determination for both standards needs to be performed independently, and a finding of a PE under one standard should not affect the other except to the extent that the prerequisites actually overlap. It is a fact that some of the functions associated with an insurance business are commonly undertaken by dependent agents within the meaning of Article 5(5). For example, an insurance company may employ one or more dedicated brokers (“dependent agent enterprise”) to market their policies within the host jurisdiction and may give that broker authority to bind the insurance company with respect to those policies. General guidance on the attribution of profits to dependent agent PEs is contained in Section D-5(ii) of Part I and this section applies that guidance to the specific factual situation of cross-border insurance.

114. In cases where a PE arises from the activities of a dependent agent, the host jurisdiction will have taxing rights over two different legal entities - the dependent agent enterprise (which may be a resident of the PE jurisdiction) and the dependent agent PE (which is a PE of a non-resident enterprise). In respect of transactions between the associated enterprises (the dependent agent enterprise and the non-resident enterprise), Article 9 will be the relevant article in determining whether the transactions between the associated enterprises were conducted on an arm’s length basis.

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5 Some tax conventions between OECD members contain a special provision that deems an insurance company to have a PE when the company insures a risk situated in that country through an agent of independent status. See paragraph 39 of the Commentary on Article 5 of the OECD Model Tax Convention. The principles discussed in this Report would apply to attribute profits to these types of PEs.

115. In respect of the dependent agent PE, the issue to be addressed is one of determining the profits of the non-resident enterprise which are attributable to its dependent agent PE in the host country (*i.e.* as a result of activities carried out by the dependent agent enterprise on the non-resident enterprise's behalf). In this situation, Article 7 will be the relevant article. Finally, it is worth stressing that the host country can only tax the profits of the non-resident insurance company where the functions in the host country performed on behalf of the non-resident enterprise exceed the PE threshold as defined under Article 5. Further, the quantum of that profit is limited to the business profits attributable to the insurance functions performed through the PE in the host country.

116. Where a dependent agent PE is found to exist under Article 5(5), the question arises as to how to attribute profits to the PE. The answer is to follow the same principles as used for other types of PEs for to do otherwise would be inconsistent with Article 7 and the arm's length principle. Under the first step of the authorised OECD approach a functional and factual analysis determines the functions undertaken by the dependent agent enterprise both on its own account and on behalf of the non-resident enterprise. On the one hand, the dependent agent enterprise will be rewarded for the services it provides to the non-resident enterprise (taking into account its assets and its risks, if any) usually by means of a fee from the non-resident enterprise.

117. On the other hand, the dependent agent PE will have attributed to it the assets and risks of the non-resident enterprise relating to the functions performed by the dependent agent enterprise on behalf of the non-resident enterprise, including a sufficient amount of investment assets to cover the reserves and surplus required to support risks. The authorised OECD approach then attributes profits to the dependent agent PE on the basis of those assets and risks. The analysis focuses on the nature of the functions carried out by the dependent agent on behalf of the non-resident enterprise and in particular whether it undertakes the key entrepreneurial risk-taking function. In this regard an analysis of the skills and expertise of the employees of the dependent agent enterprise is likely to be instructive, for example in determining whether underwriting or negotiating functions are being performed by the dependent agent on behalf of the non-resident enterprise. The collection of premiums does not mean that the dependent agent PE is accepting the insured risk, if the decision to accept the risks associated with the insurance policy is not made by the dependent agent.

118. In calculating the profits attributable to the dependent agent PE, it would be necessary to determine and deduct an arm's length reward to the dependent agent enterprise for the services it provides to the non-resident enterprise (taking into account its assets and its risks, if any). Issues arise as to whether there would remain any profits to be attributed to the dependent agent PE after an arm's length reward has been given to the dependent agent enterprise. In accordance with the principles outlined above, the answer is that it depends on the precise facts and circumstances as revealed by the functional and factual analysis of the dependent agent and the non-resident enterprise. However, the authorised OECD approach recognises that it is possible in appropriate circumstances for such profits to be attributed to the dependent agent PE.

119. However, a functional and factual analysis of a transaction may show that the risks arising from the transaction are being assumed by the dependent agent enterprise for the account of its principal, *i.e.* the non-resident enterprise in whose books the transaction - and the resultant risk - appears. These risks, and therefore the assets needed to support them, will be attributed to the dependent agent PE to the extent that they arise from functions performed by the dependent agent in the host country on behalf of the non-resident enterprise. In short, when attributing profits to the dependent agent PE, there may be profits (or losses) over and above the arm's length service fee paid to the dependent agent enterprise. This is particularly true in the case of insurance as the assumption of risk, and the corresponding need to maintain both reserves and surplus to provide a cushion against the realisation of losses from those risks, is fundamental to the business.

120. In addition to selling insurance through a dependent agent, a company may also sell insurance through agents of “independent status”, the activities of which generally will not constitute a PE. Thus, an insurance company may have PEs resulting from the activities of some agents (dependent agents) but not other agents (independent agents) selling insurance in the same country. In these cases, independent agents may derive substantial benefits from a PE (arising either from a fixed place of business or from a dependent agent) located in the same jurisdiction. For example, independent agents may only be able to sell insurance of a company because a PE has obtained a license to sell insurance in that jurisdiction. The PE may also be engaging in activities that indirectly support insurance sales made by the independent agents such as marketing activities and ensuring that the company’s policies comply with tax and regulatory requirements. Accordingly, the functional analysis must consider the functions performed, assets used and risks assumed through the fixed place of business or dependent agents that benefit the business conducted through independent agents. See discussion in Section C-1(i)(c) above.

121. The PE should receive appropriate compensation for performing these functions, either directly from the independent agent (adjusted, if necessary, to an arm’s length reward where the independent agent is an associated enterprise) or indirectly, from the part of the enterprise that benefits from the activities of the independent agents. In the latter case, the compensation should be determined under the same principles that are discussed below in the second step of the authorised OECD approach described in Section C-2.

*ii) Attributing creditworthiness/solvency margin to the PE*

122. For similar reasons as stated for banks in Part II of this Report, the starting point of the authorised OECD approach is generally to attribute the same creditworthiness or solvency margin to the PE as enjoyed by the insurance enterprise as a whole. Third parties doing business with the PE would assume that all the assets of the enterprise would be available to support its insurance liabilities. However, in the insurance industry there may be cases where because of regulatory or other restrictions (see discussion on “trusteed” assets at paragraphs 61-62) this is often not the case in a particular jurisdiction and so the creditworthiness or solvency margin of the PE may need to be determined on a “stand-alone” basis taking into account the regulatory and other restrictions in that jurisdiction and other jurisdictions. In such cases, it will be necessary to determine the creditworthiness of the PE, for example by reference to independent enterprises in the host country that are comparable in terms of assets, risks, management, etc. or by reference to objective benchmarks such as evaluations of creditworthiness 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 investment income/assets to the PE*

123. Section B-1(i) described the importance of investment income for an insurance company. That investment income arises largely due to the investment of the surplus and reserves that are required (by regulators, the marketplace, the rating agencies or good business practice) in order to undertake insurance business. In order to arrive at an arm’s length attribution of taxable profits to an insurance PE, it is therefore vital to ensure an appropriate attribution to the PE of investment assets resulting from the investment of surplus and reserves required to appropriately cover the risks attributed to the PE. Taking this special relationship between risks and investment assets into account, this section considers how to determine the arm’s length amount of investment assets that should be attributed to the PE.

*a) General overview*

124. As described in Section B-1, the acceptance of insured risks leads to the assumption of insurance risk, *i.e.* the potential for the amount (or timing of) actual claims and expenses to exceed (or differ from)

the amount (or timing) of expected claims and expenses. This insurance risk (along with the other types of risk described in Section B-4(i)) can only be assumed if reserves are established to meet the potential claims and there is surplus available to provide a cushion in the event that reserves are insufficient to meet claims. Thus, an insurance enterprise must have sufficient assets to cover both its reserves and surplus requirements.

125. The question arises as to what is the effect of attributing reserves and surplus to a PE. As described in Section B-1(i), in the insurance business, the acceptance of insured risks results in the creation of liabilities in the form of reserves representing the future claims of the insureds. Assets used to back those liabilities (in the form of reserves) obtain a return (referred to as investment income) which may help to pay the future claims. Assets representing the surplus also obtain an investment return, which may be used to pay out claims, in the case where insurance or investment risks have been realised and reserves are insufficient, or to increase surplus through an increase in profit. Thus, the investment return from both the reserves and surplus is part of the “investment income” attributable to an insurance business, and therefore, an essential component in determining the taxable income of the business.

126. How then can the authorised OECD approach be applied to an insurance business and the investment return derived from it? The authorised OECD approach requires that a PE of an insurance company be hypothesised as a separate and independent enterprise from the enterprise of which it is a part. There must then be attributed to the PE the total investment assets that it would have if it were a separate and independent enterprise carrying on the same activities and incurring the same risks (*i.e.* an amount of investment assets sufficient to cover the reserves and surplus appropriate to the level of insurance risk assumed by the PE).

127. Parts I through III of this Report determine the assets attributable to a PE through a functional and factual analysis that seeks to identify the significant people functions relevant to the determination of the economic ownership of assets (in the case of assets other than financial assets of a financial enterprise) or the key entrepreneurial risk-taking functions (in the case of financial assets of a financial enterprise). They then focus on the extent to which those assets are funded either by “free” capital or by debt. The application of the authorised OECD approach to the insurance industry requires a slightly different focus, though one based on the same fundamental principles. For insurance enterprises, the key entrepreneurial risk-taking function is the assumption of insurance risk, which itself creates the need for the maintenance of an adequate pool of assets to support that risk.

128. As explained above (see paragraphs 73-83), the authorised OECD approach must therefore provide guidance on how to determine the total amount of investment assets that need to be attributed to a PE in order to support the insurance risk assumed by that PE. The goal of this guidance is to reflect the total amount of such assets the PE would hold in order to fund its aggregate surplus and reserves needs, determined as if the PE were a separate and independent enterprise operating at arm’s length. Whilst the authorised approaches that have been developed for attributing total investment assets to the PE (*i.e.* the “capital allocation approach” and the “thin capitalisation / adjusted regulatory minimum approach”, described further below) are not intended to determine separately the portion of the PE’s investment assets reflecting its reserves and surplus, the link between total investment assets and total reserves and surplus must not be forgotten.

129. For example, in considering how the authorised OECD approach may apply to determine what reserves and surplus and therefore what investment income and gains are attributable to a PE, it must be appreciated that a company will not be able to carry on business if it holds merely the minimum amount of surplus required by regulators. Those placing business with insurers are heavily influenced by a company’s financial strength – particularly in life and other long-term business where the policyholder needs assurance not only that the company is in a position to meet its liabilities at the time the policy is taken out



but also that it is likely still to be in business and able to meet its liabilities many years or decades later. This means that to attribute to a PE only an amount of investment assets adequate to cover its reserves and the minimum regulatory surplus may not produce arm's length results.

130. Two authorised approaches to allocating total investment assets have been chosen: (1) capital allocation, and (2) thin capitalisation / adjusted regulatory minimum, although a third approach — quasi thin capitalisation / regulatory minimum — can be applied albeit only as a domestic law safe harbour. The rest of this section examines the strengths and weaknesses of the authorised approaches to attributing a total amount of investment assets to an insurance PE.

b) Capital allocation approach

131. There are two principles that underlie the allocation of investment assets to the PE under the capital allocation approach. First, that the investment assets of an insurance business support all of its business, without regard to where such business is conducted (see paragraph 140 below for discussion of an exception to this rule). Second, that all of the investment assets of the entire business must be attributed to the various parts of the business, and accordingly, the sum of the attributable investment assets will be neither more nor less than the total investment assets belonging to the business as a whole. The amount of investment assets to be allocated under the authorised OECD approach is the actual amount of investment assets of the insurance business. These investment assets support the insurance risk assumed by the enterprise as a whole and allocation should be made in proportion to the insurance risk assumed by each part of the enterprise. However, the above principles do not always apply to all insurance enterprises. As noted in paragraphs 61-62, in some jurisdictions the host country regulatory rules will mean that assets (“trusteed assets”) are only available to meet claims in the host country jurisdiction and so the capital of the insurance enterprise is in fact segregated to some extent.

132. It will be necessary to properly allocate the total investment assets of the enterprise and not just the amount of assets representing the regulatory minimum of reserves and surplus, 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 risks have been attributed to the various parts of the enterprise, including the head office, under the functional analysis. Given a functionally based attribution of risks, there is no reason to attribute part of the investment assets to the head office simply on the basis that the head office would be expected to absorb any extraordinary and unforeseeable losses arising from the realisation of risks. Instead, this determination would be based on the functional analysis.

133. However, Article 7(2) requires that the PE be regarded as a separate and independent enterprise from the enterprise of which it forms part. It might therefore be argued that, as a separate and independent enterprise, the PE and the rest of the enterprise would require more investment assets to support activities than is actually the case in operating as one larger enterprise. The reason would be that an insurance enterprise pools the risks incurred in each of its parts and thus, in terms of requirement of reserves and surplus to meet claims, it benefits from spreading such risk across a wider range of potential claims.

134. However, Article 7(2) also requires that the PE be hypothesised, as a separate and independent enterprise from the enterprise of which it forms part, but performing the same or similar functions under the same or similar conditions. The advantage of pooling should thus be attributed to each of the hypothesised separate and independent enterprises (*i.e.* the PE and the rest of the enterprise), so that the reserves and surplus (and hence investment asset) requirements of each are reduced to those of the actual overall legal enterprise. The concept might best be understood if the two hypothesised separate and independent enterprises are treated as having entered a risk pooling agreement which reduces their total need for investment assets. Where such agreements exist between actual separate legal enterprises, neither party has a claim to the reduction in reserves and surplus and this result should be reflected when applying

the Guidelines by analogy. That is, the investment assets to be allocated to the different parts of the overall legal entity are the actual investment assets held by the entity and not a hypothetical amount.

135. This raises an important question of whether there are internationally accepted risk-based regulatory standards that could be adapted so as to approximate an arm's length attribution of investment assets to parts of an insurance business in most situations. All OECD member countries regulate insurance business and set minimum asset and surplus requirements for insurance companies regulated in their jurisdiction. However, in insurance there is not an internationally accepted standard as exists in banking where the Basel Accord plays an important part in setting global standards. Each jurisdiction sets its own standards, though in the European Economic Area there is a single approach set out in the Insurance Directives. However, even in those states where the regulator requires a minimum amount of assets to be allocated to a PE, this amount may not approximate an arm's length allocation. Also it may be that assets are required to be held by the PE for regulatory reasons even though the PE has not undertaken any of the functions leading to the assumption of insurance risk and so would not be attributed those assets under the authorised OECD approach.

136. In applying the capital allocation approach, it is necessary to consider the treatment of trustee assets, as described in paragraphs 61 and 62. To the extent that such assets may not be used to support activities outside the jurisdiction in which the trusts are located, the factual premise underlying the capital allocation approach would be violated. Several points are worth noting in relation to the implications of trustee assets for the use of the capital allocation approach to attributing an arm's length amount of investment assets to the PE.

137. First, the use of the capital allocation approach is intended only to attribute a total amount of investment assets to the PE based on the risk it has assumed, not to identify specific assets to be so attributed. The determination of the specific assets to be considered attributable to the PE is discussed below in the context of determining the PE's yield on its investment assets. Thus, the fact that some assets of the enterprise may be trustee in another location does not necessarily mean that they are irrelevant to the determination of the total investment assets of the enterprise relative to its total risks (*i.e.* one step in the capital allocation approach).

138. Second, the focus of the authorised OECD approach on locating the performance of the key entrepreneurial risk-taking function of assuming insurance risk means that in some circumstances there may be a difference between the location where such risk is considered assumed for tax purposes and the location where it is booked for regulatory purposes. Whilst such differences are not expected to arise commonly, they do illustrate why the attribution of investment assets to a PE under the authorised OECD approach cannot be totally dependent on the regulatory requirements to hold certain amounts of trustee assets in particular locations. For example, the fact that investment assets may be trustee in the PE country does not necessarily mean that that amount of assets should be attributed to the PE under the capital allocation approach if that allocation does not represent an arm's length allocation appropriate to the level of risk assumed by the PE (*e.g.* as may be the case if the key entrepreneurial risk-taking function of assuming the risk which those assets support was performed elsewhere).

139. Similarly, if the key entrepreneurial risk-taking function of assuming risk is performed in the PE jurisdiction, the absence of any regulatory requirement to hold trustee assets there will not prevent an allocation of investment assets to the PE under the capital allocation approach. In addition, the fact that the enterprise may have assets trustee in a location other than the PE which are considered for regulatory purposes to back the risk considered to have been assumed by the PE for tax purposes should not prevent an allocation of an appropriate amount of such assets to the PE under the capital allocation approach (*i.e.* since those assets are factually available to back the risk assumed by the PE).

140. A question may theoretically arise in the case where, notwithstanding a convergence between the tax and regulatory conclusions as to where risk has been assumed, the amount of investment assets of the enterprise that are trusted in jurisdictions other than the PE jurisdiction would not leave a sufficient amount of “uncommitted” investment assets of the enterprise to satisfy an adequate allocation of investment assets to the PE under the capital allocation approach if the trusted assets were considered unavailable to the PE. Whilst such a case is considered highly unlikely to arise in practice, it would justify an appropriate adjustment to the application of the capital allocation approach (*i.e.* reducing the allocation of investment assets to the PE to take into account the insufficiency of uncommitted assets in the enterprise). On the other hand, where such an adjustment would leave the PE with a lower amount of investment assets than would be held by an independent insurance enterprise carrying on the same or similar activities and assuming the same or similar risks under the same or similar conditions, that would indicate that the capital allocation approach did not produce an arm’s length result in the particular case and therefore should not be used.

141. Another question that could theoretically arise is where, notwithstanding a convergence between the tax and regulatory conclusions as to where risk has been assumed, the investment assets required to be held in trusted accounts in the PE jurisdiction (representing both reserves and minimum surplus) exceed the amount of investment assets that would be attributed to the PE under the capital allocation approach. In many cases this will not be a problem in practice, as the amount of reserves and minimum surplus held as trusted assets may be less than the amount of investment assets that would have been allocated to that jurisdiction if the entire investment assets of the insurance company were taken into account. Accordingly, it might still be necessary to attribute more investment assets to the permanent establishment than is represented by the trusted assets. In this respect, the amount of the reserves and minimum surplus held as trusted assets is treated similarly to minimum regulatory capital in the banking context. Where, however, the reserves and minimum surplus required by the regulator to be held as trusted assets in the PE jurisdiction exceed the investment assets that would be attributed to the PE under the capital allocation approach and there is no conflict between the tax and regulatory attribution of risk to the PE, an appropriate arm’s length result would attribute those trusted assets to the PE, as they reflect the amount of assets the PE would be required to hold if it were a separate and independent enterprise.

142. Life insurers may maintain separate account assets that are identified with specific clients and are generally more like investment holdings for which the insurer acts as investment manager for the clients. When determining the total investment assets to be allocated within the multinational enterprise the separate account assets (also called unit-linked, segregated fund, etc. assets, depending upon the jurisdiction) should be taken into consideration to the extent that they are available to the insurer to pay claims or support risk.

143. As discussed in Part II (paragraph 94), allocating capital under the “standardised” approaches of risk-weighting assets under the Basel Accord is felt to be a reasonable approximation of an arm’s length result based on the relative risk-weighted assets properly attributed to each part of the banking enterprise. In the insurance industry, the absence of an internationally accepted regulatory standard makes it much more difficult to come up with a method for allocating total investment assets that both is a reasonable approximation of an arm’s length result and retains the main advantage of the standardised regulatory based approach, *i.e.* that the investment assets allocated to each part of the enterprise when added up should be neither more nor less than the actual investment assets of the enterprise. The rest of this sub-section examines a number of possible allocation keys that could be used to allocate the surplus to a PE in a manner that approximates an arm’s length result for an enterprise conducting an insurance business.

## 1. Reserves for insurance risk

144. A potential key for allocating total investment assets could be to use the relative level of reserves for insurance risk in each part of the enterprise. However, this raises a number of problems. Countries differ quite a lot in their regulatory requirements for such reserves and some countries are more stringent in their requirements for such reserves than other countries (*e.g.* whether or not catastrophe or equalisation reserves are required), whilst other countries do not require such reserves at all. Further, there may be a particular problem in using such reserves in the case of variable annuities (linked life assurance) which carry little risk to the insurer but require very high reserves for policyholder liabilities.

145. If reserves for insurance risk are to be used, questions also arise as whether home or host country regulations should be used. A potential problem with using host country rules is that there may well be a trade-off in terms of a host country's regulatory policy for requiring reserves and surplus. For example, if stringent reserves for insurance risk are required then there is less need for surplus and vice versa. Consequently, investment assets would be over-allocated to countries under the host country approach where the regulatory regime focuses on reserves rather than on surplus.

146. Conceivably, insurance reserves (liabilities), as shown on the books and records of the home office, could be used as a key for apportioning the company's total investment assets to individual parts of the company and adjusting those investment assets, as needed, to take into account material distinctions (if any) between the type of insurance business conducted by the PE and the type of insurance business conducted by other parts of the company. An insurance company maintains books and records for regulatory and financial accounting purposes under uniform standards, showing the amount of reserves that are held to support its world-wide insurance business. In general, the amount of surplus that a company holds to support its insurance business is equal to its total investment assets less its insurance reserves. In Part II of this Report, one of the methods used to allocate capital to a PE in a banking business relies on the relative risk of the PE's assets, as compared to the assets held by the banking enterprise as a whole. Applying a somewhat analogous approach to an insurance enterprise in Part IV, total investment assets may be allocated to the reserves (liabilities) and surplus of an insurance PE by reference to the relative risk of the PE's reserves, as compared to other reserves held by the insurance enterprise. Of course, use of such an allocation key would be feasible only if the home country regulatory regime required the determination of reserves on a country-by-country basis by reference to the countries where the insurance enterprise assumes insurance risk, or where that regime uses a methodology for the determination of reserves that could be adapted to determine such a country-by-country breakdown.

147. Initially, a portion of the total investment assets of an insurance company is allocated to a particular PE, based upon that PE's relative share of the company's overall reserves. Adjustments are then made to this initial amount of investment assets allocated to the PE, by reference to the relative level of risk in the PE's business, as compared to the risks of the businesses carried on by other parts of the company. Of necessity, the nature and extent of adjustments in this regard will take into account the facts and circumstances, including for example assessments by the company concerning the relative riskiness of the insurance risk assumed by the PE. As distinguished from international banking, for example, which is governed by the Basel Accord, the insurance industry is not subject to internationally-agreed standards for evaluating the relative risk associated with reserves. Consequently, no uniform basis is available on which to allocate reserves (liabilities) and surplus (equity) to an insurance PE, as is the case for allocation of risks and subsequently capital to a banking PE. At the same time, many countries have developed or are developing methods for determining the relative risk associated with insurance reserves. Such methods might prove useful in allocating an appropriate amount of investment assets to an insurance PE.

148. Using the reserves as shown on the books and records of the home office as an allocation key (subject to the adjustments described herein), if feasible, may present certain practical advantages. These

reserves are computed under uniform rules and they are used for both business and regulatory purposes. Thus, they should provide a reasonable estimate of the economic liabilities that the company, its stockholders, creditors, and regulators view as arising from the insurance risk that the company has assumed from third parties. In some cases, the books and records maintained by the home office may in fact be the only accounting records available for evaluating the reserves and surplus of a PE, as for example if the host country relies on the home country to regulate insurance business conducted in the host country (*e.g.* among EU members). In such cases, the PE prepares no separate regulatory statements that might provide a starting point for evaluation of the amount of reserves and surplus held by the PE.

## 2. Premiums

149. Historically, a number of countries have used premiums as an allocation key when applying the formulary approach of the pre-2010 version of Article 7(4) and therefore it should at least be considered whether it would be possible to use premiums as a key to the allocation of total investment assets in a manner consistent with the arm's length principle. Clearly, there are a number of situations where this would lead to an inappropriate result, especially where the premium key was applied to allocate total investment assets supporting different types of business where there was not a similar relationship between the level of premium and investment assets (and in particular, between the level of premium and assets representing surplus). For example, insurance for extremely unlikely but potentially catastrophic events like earthquakes might carry the same premium as motor insurance but would require vastly more in the way of surplus and hence investment assets. However, there may be scope for using premiums for lines of similar business where there is likely to be a direct relationship between the amount of premium and investment assets, for example, the sale of standardised insurance products marketed in only a few countries.

## 3. Other regulatory and hybrid approaches

150. There are other regulatory measures, such as solvency margins, minimum regulatory asset requirements, etc. which could potentially be used as keys to allocate the total investment assets. Moreover, any of the quasi thin capitalisation/regulatory minimum capital or thin capitalisation/adjusted regulatory minimum capital approaches described in the sub-sections below could also potentially be used not in their own right but as keys to allocate the actual investment assets (hybrid approaches). For example, the actual investment assets of the enterprise could be allocated according to the relative regulatory minimum surplus requirement in each part of the enterprise. These approaches are discussed in more detail in the sub-section below discussing quasi thin capitalisation approaches.

## 4. Provisional conclusion for capital allocation approach

151. The choice of the appropriate method for allocating the total investment assets so as to approximate to an arm's length result will depend upon the facts and circumstances. It is however clear that it is unlikely that a single allocation key could be found to allocate the total investment assets of a diversified insurance enterprise.

152. Moreover, it should be borne in mind that the authorised OECD approach attributes risk and investment assets in accordance with the arm's length principle, rather than following regulatory approaches for measuring risks or determining 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 an insurance PE under the arm's length principle.

c) Thin capitalisation/adjusted regulatory minimum approach

153. Another authorised OECD approach is the thin capitalisation approach. This would attribute investment assets to an insurance PE by reference to the amount of investment assets of an independent insurance enterprise carrying on the same or similar activities and assuming the same or similar risks under the same or similar conditions. The strengths and weaknesses of this type of approach, which is broadly similar to the thin capitalisation approach discussed in Parts I and II, are discussed in those Parts (Section D-2(v) of Part I and Section D-1(iii) of Part II). Similar issues are likely to arise for insurance companies.

154. One proposal put forward by commentators is that the amount of reserves and surplus on the regulatory filings of the PE might be viewed as the appropriate amount of investment assets attributable to the PE under the authorised OECD approach. As discussed below in sub-section (d), the amount of the regulatory reserves and surplus of the PE is not necessarily a reliable metric under the authorised OECD approach, given that it may not reflect an arm's length amount of investment assets in relation to the risk-weighted liabilities. An acceptable variant of the thin capitalisation approach, however, would start with the amount of reserves and surplus indicated in the PE's regulatory filings and would then make adjustments to reflect economic reality. Clearly, the facts and circumstances of each case will dictate the nature and the reliability of the starting point of the adjustments needed to apply this approach in an acceptable manner. It should be noted that, under certain facts and circumstances, the PE's regulatory reserves and minimum surplus may in fact constitute an arm's length amount, without material adjustments, but the essence of the adjusted regulatory minimum approach, and what distinguishes it from the quasi thin capitalisation / regulatory minimum approach described below in sub-section (d), is that an analysis would have to be conducted to determine whether adjustments were necessary to achieve an arm's length result.

155. The nature and extent of adjustments that must be made to the regulatory reserves and surplus of the PE will vary. For example, the PE may use a substantially greater amount of investment assets in conducting its insurance business in the host jurisdiction than the reserves and minimum surplus amounts indicated in the PE's regulatory filings, which in some cases might mean that the PE has assumed more risks in the host country than it reported for regulatory purposes. Ideally, the books and records of the PE would allow identification of the nature of the business activities carried on by the PE and the level of assets that the PE requires to perform those activities. Adjustments may be needed, for example, to ensure that the amount of reserves and surplus attributed to the PE is comparable to the reserves and surplus held by insurance businesses that engage in similar activities and that accept similar levels of insured risks in the host country. Adjustments may also be needed to ensure that the amount of investment assets allocated to the PE is not excessive, in view of the total investment assets of the insurance company as a whole.

d) Safe harbour – quasi thin capitalisation/regulatory minimum approach

156. Another possibility would be to require the PE to have an amount of investment assets at least equal to its reserves (as determined under the host country's regulatory regime) plus the same minimum amount of surplus required for regulatory purposes (regulatory minimum surplus) as would an independent enterprise conducting insurance business in the host country (*a quasi thin capitalisation approach*). The regulatory minimum surplus would be determined in accordance with the regulatory standards of the host country. Insurance regulatory standards generally determine the minimum amount of surplus that an insurance company must possess before it is given regulatory permission to carry on business in a particular jurisdiction. Therefore, it is useful to see what these standards require and how they define those requirements to see if they could be used to attribute surplus, either directly as part of a safe harbour quasi thin capitalisation approach or indirectly as an allocation key under the capital allocation approach described above. Generally, the standards differ in the way the minimum surplus amount is calculated, but the amount required will bear a close relationship to the nature of the risks undertaken.

157. The extent to which differing types of risk assumed by the enterprise affect respectively the reserves and minimum surplus required varies from jurisdiction to jurisdiction. This may be because in some cases, particularly in life insurance, matters such as risks inherent in the assets used to back the business may be taken into account in determining the reserves for policyholder liabilities. The more such risks are taken into account in that area, the less they need to be taken into account in determining the surplus needed. For example, a regulator may require a company to calculate its reserves by assuming only a risk-free rate of return such as can be obtained on Government securities, even though the company holds equity investments likely to produce a greater return.

158. It should be possible to determine for any given PE what the minimum assets required for that PE by the host state regulator will be (although there are problems in the European Union due to the liberalisation of host country regulation). The regulators will generally be concerned with “admitted assets”, or those assets that are sufficiently liquid so that they can be used to pay claims. Either the regulator will actually require the PE to demonstrate that the amount of admitted assets is available in the jurisdiction, for example, by being retained in a trust, or the regulator’s criteria can be applied to the PE. However, this may not be the arm’s length amount of investment assets that should be attributed to the PE. Moreover, this approach does not provide information about which of the assets that satisfy the minimum requirements are subject to taxation, which income and gains will be taxed or what rate of return should be obtained on those assets (see sub-section (f) below).

159. Accounts of the PE may also show more assets than the reserves and bare minimum surplus requirement of the host state regulator. Indeed, if the PE holds assets in excess of the reserves and minimum surplus required it would be expected that any accounts would show this as well as the income and gains arising from them and such assets may also be attributed to the PE under the authorised OECD approach. But the PE’s accounts may not be drawn up on a basis that reflects the separate and independent enterprise approach. It is necessary to start from the authorised OECD approach to establish what amount of assets and what income and gains flowing from them should be attributed to the PE. Similar to the situation described for banks, an arm’s length attribution of reserves and surplus (and hence assets) may have to be made to an insurance PE, even though no such reserves or surplus (or assets) have been formally attributed to the PE for regulatory or other purposes.

160. The focus of the “quasi thin capitalisation/regulatory minimum capital” approach is on providing an administratively simple way of ensuring that the PE cannot have less assets than its regulatory reserves and the regulatory minimum surplus for an independent enterprise conducting insurance business in the same jurisdiction. This approach is not an authorised approach for the attribution of investment assets as it ignores important internal conditions of the authorised OECD approach, *e.g.* that the PE generally has the same creditworthiness as the enterprise as a whole. However, as in the case of the comparable capital attribution method described in Parts I-III, it may be acceptable as a domestic law safe harbour in the host country which is also allowable under the authorised OECD approach as long as it does not result in the attribution of more profits to the PE than would be attributed by an authorised approach. In many cases the effect of using a quasi thin capitalisation/regulatory minimum capital approach as a domestic law safe harbour would be that the host country taxes less than it would using a capital allocation or thin capitalisation/adjusted regulatory minimum approach.

e) Conclusion on attributing investment assets to the PE

161. The attribution of investment assets representing both reserves and surplus among parts of an enterprise involved in an insurance business is a pivotal step in the process of attributing profit to its PE. In particular, it largely determines the amount of investment income that the PE should be considered to have. For insurance enterprises, surplus fulfils a similar role as capital for other enterprises. So an insurance PE, just like any other type of PE, should have sufficient surplus, in addition to its reserves, to support the

functions it undertakes, the assets it uses and, crucially, the insurance and other risks it assumes. For this reason, the method by which investment assets are attributed is an important step in avoiding or minimising double taxation.

162. The consultation process on Parts I-III has shown that there is an international consensus amongst governments and business on the principle that a PE should have sufficient capital to support the functions it undertakes, the assets it uses and the risks it assumes. However, it is not possible to develop a single internationally accepted approach for making that attribution of capital, including “free” capital. As can be seen from the discussions above, there is no single approach which is capable of dealing with all the circumstances of an insurance business and so the same conclusion is reached for the attribution of investment assets to an insurance PE.

163. Rather, the focus of the OECD work in this Part IV is on articulating the principles under which such an attribution of investment assets should be made and on providing guidance on applying those principles in practice and in a flexible and pragmatic manner. As such, whilst any of the authorised approaches described in this section are capable of producing an arm’s length result, there may be particular situations where the approach does not produce an arm’s length result and so flexibility may be required but in a manner that minimises the incidence of double taxation.

164. Where the two Contracting States have interpreted paragraph 2 of Article 7 differently and it is not possible to conclude that either interpretation is not in accordance with paragraph 2 of Article 7, it is important to ensure that any double taxation that would otherwise result from that difference will be eliminated. As explained in the Commentary on Article 7, paragraph 3 of Article 7, where applicable, will ensure that this result is achieved. The fact that it will sometimes be necessary to resolve disputes through MAP is not a weakness of the authorised OECD approach. Rather it reflects the fact that the attribution of investment assets to an insurance PE can be a very difficult and complex issue. The authorised OECD approach describes the strengths and weakness of different approaches and therefore provides a framework for resolving difficult cases.

f) Determining the investment yield from investment assets attributed to a PE

165. The determination of the amount of investment assets (as defined for purposes of this Part) to be attributed to the PE is not the end of the matter. The next question is what investment yield should be attributed to the assets. The answer will depend on the extent to which the method chosen to determine the amount of the investment assets makes it possible to directly identify all the assets supporting the insurance risk. To the extent that is not possible (*i.e.* under either the capital allocation or the thin capitalisation/adjusted regulatory minimum approach) some means of identification would have to be developed.

166. In general, the return earned on the investment assets (supporting reserves and surplus) that are properly attributable to the PE should correspond closely to the return earned on investment assets actually held in the host country (*i.e.* including trustee assets) to support the insurance contracts issued by the PE taking into account that some of those assets may not give rise to income (see paragraph 51). In the case of a PE jurisdiction that has required the non-resident enterprise to place particular assets in trust, it would be appropriate to attribute the investment income earned with respect to those assets to the PE to the extent that key entrepreneurial risk-taking function is performed by a PE in that location. However, it would still be necessary to determine an investment yield with respect to investment of any assets that are attributed to that jurisdiction above and beyond what is represented by the assets actually held by the PE and recorded on its books. For greater certainty, the recognition of investment income on attributed assets is relevant only for the attribution of profits to the PE under Article 7 and does not carry wider implications as



regards, for example, withholding taxes, which are outside the scope of this Report (see also paragraph 11 in Part I of this Report).

**(1) Top-down approach to determining investment yield on additional assets**

167. To the extent that the amount of investment assets attributable to the PE exceeds the amount of investment assets actually held in the host country, those additional assets should earn a rate of return equal to the rate of return (taking into account those assets which do not give rise to income) earned on all investment assets held by the company that are not required to be held in trustee accounts in other countries to support business, which may be referred to as “uncommitted” investment assets (*i.e.* a so-called “top-down” approach to determining investment yield on that additional amount of investment assets). It is acknowledged, however, that determining the appropriate investment return to apply to an insurance company’s “uncommitted” investment assets under the authorised OECD approach may present particular challenges. One practical method of determining the investment return would be simply to assume that the rate of return is equal to the rate of return on all investment assets held by the company. Either way, adjustments may be needed to prevent distortion in investment returns on account of investments in underperforming or non-performing assets or in assets denominated in currencies subject to high rates of inflation.

168. A variation on the top-down approach could try to identify the yield on those categories of the insurance company’s uncommitted investment assets that are most appropriate to associate with the PE, in light of the nature of the insurance risk assumed by the PE. The determination of the types of assets to be attributed to the PE will depend upon the facts and circumstances of each company, but in addition to the accounts of the PE, there are a number of factors that may provide guidance in this regard. Different types of insurance business call for different types of assets. Some types of life insurance business for example may be backed heavily by equities, while, where annuities are in payment, insurance companies may seek to support these obligations with Government and other less risky debt securities that have an investment return profile that matches the expected annuity payment profile. In addition, regulators frequently restrict the type, quality and quantity of each type of asset that can be held by the PE, a factor which should also be taken into account in determining what assets and yield may be attributed to the PE.

169. Another factor in determining the yield on those categories of the insurance company’s uncommitted investment assets that are most appropriate to associate with the PE may be the currency in which assets are denominated. Insurance regulations generally insist on more or less complete matching of the currency of assets and liabilities, to prevent excessive foreign exchange exposure. Accordingly, the identification of assets whose yield is appropriate to take into account in determining the PE’s yield on its uncommitted investment assets must consider the denomination of assets, including any related hedging of currency risks, to ensure both that the appropriate assets are attributed to the PE and that an arm’s length rate of return is determined for those assets.

**(2) Bottom-up approach to determining investment yield on additional assets**

170. Another more direct method would be to assume that the rate of return earned on investment assets held in the host country of the insurance PE is also earned by the “uncommitted” investment assets notionally attributed to the PE to satisfy its investment asset attribution requirement above and beyond the investment assets actually held by the PE. The results under either this approach or the “top-down” approach necessarily constitute proxies for the actual return on free investment assets.

iv) *External reinsurance*

171. When the enterprise of which the PE is a part obtains reinsurance from a separate entity (*i.e.* “external reinsurance”), there can be several potential effects on the determination of the PE’s profits under the authorised OECD approach. One issue relates to the allocation of the cost of the external reinsurance (*e.g.* premiums paid) within the enterprise. Consistent with the functionally separate enterprise approach, the PE should bear the cost of the external reinsurance to the extent that the reinsurance provides a potential benefit to the PE by achieving a cession of insurance risk assumed by the PE (see, *e.g.*, paragraph 98 of Part I). The difficulty of making that determination will vary depending on the facts and circumstances. For example, the determination may be relatively simple in certain situations (*e.g.* in the case of facultative reinsurance or certain forms of proportional reinsurance), but it could be considerably more difficult in other situations (*e.g.* in the case of excess of loss reinsurance). It is clear that no single method would be appropriate for allocating the costs of external reinsurance to a PE in all situations, and taxpayers and tax authorities are urged to approach the task in a flexible and pragmatic matter, always seeking a reasonable approach that will be faithful to the arm’s length principle and will minimize the risk of double taxation.

172. A related issue concerns the extent to which the enterprise’s acquisition of external reinsurance provides grounds, all else being equal, for a reduction in the reserves and/or surplus of the PE, with a consequent reduction in the total investment assets required to be held by the PE under the authorised OECD approach. Here again, the appropriate reduction would depend on the facts and circumstances of each case.

173. A third issue concerns the allocation of recoveries on external reinsurance obtained by the enterprise of which the PE is a part. As with the costs, the appropriate basis for allocating recoveries may be relatively simple in cases such as facultative or proportional reinsurance, but it may be much more difficult in other cases, and no single allocation method would be appropriate for all situations. The need for a flexible and pragmatic approach aimed at achieving an arm’s length result and avoiding double taxation is equally present here.

v) *Recognition of dealings*

174. As noted in paragraph 175 of Part I, because a PE is not legally or economically separate from the rest of the enterprise of which it is a part, and because dealings between a PE and the rest of the enterprise have no legal consequences for the enterprise as a whole, there is a need for greater scrutiny of such dealings than of transactions between two associated enterprises. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist, and considering the uniqueness of this issue, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealings. In short, it will be necessary first 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.

175. It was seen in Parts II and III of this Report that problems may arise when trying to apply the guidance in Part I to dealings in relation to financial assets and risks, given the nature of financial businesses. Similar problems arise in relation to insurance. An insurance business consists of assuming risk of losses arising from the realisation (or timing) of events outside the control of the insured. Insurance businesses are able to assume insurance risk by pooling the insured risks of many risk-averse persons via the payment of an amount by the insured to the insurer, called a premium. To be able to accept the insured risk, and assume the associated insurance risk, the insurer holds investment assets, which give rise to investment income.

176. Once the threshold has been passed and a dealing is recognised as existing, the authorised OECD approach applies, by analogy, the guidance at paragraphs 1.48-1.54 and 1.64-1.69 of the Guidelines. The guidance is applied not to transactions but to the dealings between the PE and other parts of the enterprise. So the examination of a dealing should be based on the *dealing* actually undertaken by the *PE and the other part of the enterprise* as it has been structured by them, using the methods applied by the taxpayer insofar as these are consistent with the methods described in Chapters II and III of the Guidelines. Except in the two circumstances outlined at paragraph 1.65 of the Guidelines, tax administrations should apply the guidance in paragraph 1.64 when attributing profit to a PE and so “should not disregard the actual *dealings* or substitute other *dealings* for them”.

vi) *Internal reinsurance*

177. The potential “dealing” that appears most problematic initially is “reinsurance” within a single legal entity. However, the guidance developed under Part I provides a reasonable answer.

178. Insurance companies commonly buy reinsurance from both unrelated and related reinsurance companies. Through reinsurance, insurers can manage their insurance and investment risk. By buying reinsurance, insurers can “free up” surplus (reduce the amount of surplus needed to support reinsured business) and reduce reserves, which allows insurers to write more insurance contracts.

179. Under the authorised OECD approach, a dealing that internally transfers economic ownership of insurance contracts or associated insurance risk can be recognised only if it can be demonstrated that another part of the enterprise has performed the relevant key entrepreneurial risk-taking function. In general, the risk management function of deciding whether to reinsure contracts held by an enterprise performed after insured risks have been assumed (with or without initial internal reinsurance) does not involve sufficiently active decision-making to be regarded as a key entrepreneurial risk-taking function. Thus, performing such a risk management function generally would not cause economic ownership of insurance contracts or the associated insurance risk to be transferred to the location where the risk management function occurs. Instead, performance of this function would give rise to recognition of a dealing in the nature of a provision of services that should be compensated by an arm’s length fee, which in some cases may be based on the profits earned by the contracts.

**C-2. *Second step: determining the profits of the hypothetical separate and independent enterprise (based on a comparability analysis)***

180. As noted in Section C-1 of this Part, the functional and factual analysis of the first step of the authorised OECD will have appropriately hypothesised the PE and the rest of the insurance enterprise as associated enterprises, each undertaking functions, using assets and assuming risks. Under the first step, investment assets, such as those arising from the investment of reserves and surplus, will also have been attributed in an appropriate amount to the part of the enterprise which performs the key entrepreneurial risk-taking function of assuming insurance risk. Moreover, in fully hypothesising the PE as a separate and independent enterprise, it will have been necessary to identify and determine the nature of its internal “dealings” with the rest of the enterprise of which it is a part.

181. The second step of the authorised OECD approach goes on to apply, by analogy, the guidance in the Guidelines to any economic relationships (dealings) between the hypothesised separate enterprises, *i.e.* the PE and the rest of the insurance enterprise. For example, although insurance risk and the assets backing that risk may have been attributed to the PE in Country A by virtue of the fact that the PE undertook the key entrepreneurial risk-taking function of assuming that risk, it may be that other parts of the enterprise performed other functions, such as investment management services in relation to those assets, or provided valuable intangibles, etc. These functions or intangibles would need to be rewarded in order to ensure that

the PE in Country A is attributed an arm's length profit, using any of the methods authorised by the Guidelines. The authorised OECD approach would be to record all the income associated with the insured risks accepted by the PE and the supporting investment assets in the books of the PE in Country A as the "economic owner" of the portfolio of risks and supporting assets 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 these dealings by making a comparison with transactions undertaken between independent enterprises. It should also be noted that there is no presumption that these other dealings are by nature of low value. This will be determined by the functional and comparability analyses based on the particular facts and circumstances. A whole spectrum of results can be expected ranging from at one end routine low value dealings to at the other end dealings that result in a share of the residual profit of the economic owner.

182. General guidance on making such comparisons has been provided in Section D-3(iii) of Part I of this Report. This section discusses how to apply that guidance to issues specific to a PE conducting an insurance business.

*i) Applying transfer pricing methods to attribute profit*

183. 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 insurance enterprise is at arm's length. This is done by applying the guidance in the Guidelines on comparability, by analogy, in the insurance PE context. A comparison is made of the reward earned from *dealings* within the insurance enterprise with comparable *transactions* between independent enterprises, having regard to the 5 factors for determining comparability set out in Chapter I of the Guidelines.

184. Further, the authorised OECD approach provides that all 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. For example, the traditional transaction methods may be examined to see if comparables from uncontrolled transactions are available. In this context, the guidance at paragraphs 2.14, 2.23 and 2.41 of the Guidelines 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 2.14, the 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."

185. Whilst it is difficult to identify a service sharing the characteristics of writing insurance business, an insurance enterprise itself nonetheless utilises many services for which comparables can be found and makes use of its financial assets, in terms of investing them, in ways similar to other types of enterprises. The guidance at paragraphs 1.39-1.41 of the Guidelines should therefore be applicable to services provided to insurance enterprises in most respects.

186. The second comparability factor, functional analysis, may be more problematic. An insurance business involves numerous functions, not necessarily carried out in sequential order. The trend for increasing mergers and acquisitions reduces the number of potential comparables. Moreover, the dealings related to these functions 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 be performed together by independents. This

makes it difficult to evaluate such integrated dealings in isolation and to apply reliably any of the traditional transaction methods. Such problems also occur with increasing frequency in transactions between associated enterprises and Chapter II of the Guidelines approves other methods (transactional profit methods) to be applied in situations where they can be applied more reliably than the traditional transaction methods of Chapter II. More positively, the trend to outsourcing various parts of the value chain of an insurance business may create additional potential comparables at least for functions that have been outsourced.

187. With regard to the third comparability factor, contractual terms, no particular conceptual difficulties are envisaged in the insurance 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.

188. 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 paragraph 1.52 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 relationship* of the parties must be deduced from their conduct and the economic principles that generally govern relationships between independent enterprises.”

189. The fourth comparability factor, economic circumstances, is of particular importance when attributing profits to an insurance PE. Following the guidance of paragraphs 1.55-1.58 of the Guidelines, different insurance regulatory regimes should be considered as potentially affecting market comparability. For example, it would 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.

190. It is not considered that there are any particular conceptual difficulties in applying the general guidance on the final comparability factor, business strategies, to attribute profit to an insurance PE. The issue is of importance because the strategic management of the insurance enterprise determines the nature, size and even geographical location of the risks underwritten. However, any relevant business strategies should be taken into account and should have been determined by the functional analysis under the first step of the authorised OECD approach.

191. The discussion above is based on the comparison of individual dealings with individual uncontrolled transactions. In practice, an insurance business usually consists of a large number of similar financial assets, risks and dealings. Accordingly, it may be particularly appropriate to apply the guidance on aggregating transactions at paragraph 3.9 of the Guidelines in the insurance 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 investment assets.

ii) *Rewarding specific insurance functions*

192. Having discussed in general terms in the previous sub-section how to apply the second step of the authorised OECD approach to attribute profits to an insurance PE, this sub-section looks at some specific yet commonly occurring situations in more detail.

a) Underwriting insured risk

193. As described in Section B-2(i) and in paragraph 94, the underwriting function is generally a key component of the acceptance of insured risk and the consequential requirement for assets (surplus and

reserves) supporting the insured risks. The underwriting function is therefore crucial to the insurance business in most cases, in that it is a prime determinant of whether risk is assumed at all by the enterprise and of the price at which it is assumed. Accordingly, the part of the enterprise that is determined to have performed the underwriting function is generally to be treated in the first instance as the “economic owner” of the insurance policy and so is entitled to the associated underwriting and investment income. As noted in paragraph 94, however, not all underwriting activities necessarily constitute active decision-making functions relevant to the assumption of insurance risk, and some non-underwriting activities may constitute such functions in some circumstances. Also, as noted in Section B-2 there are a large number of other functions necessary to undertake insurance business. If these are performed by other parts of the insurance enterprise, then there are dealings that have to be taken into account in order to reward the performance of those functions. The rest of this section looks at those dealings in more detail.

194. Exactly what functions have to be performed to amount to the performance of the underwriting/risk acceptance function will depend on the particular facts and circumstances and may vary based on, for example, the products, type of business and manner of distribution. For example, simply issuing the contract or “rubber stamping” a decision made elsewhere does not warrant being treated as performing the underwriting/risk acceptance function. The essence of underwriting is the decision to accept insured risk and this will depend very much on the type of insurance business. For very standardised products, for example travel insurance sold through vending machines at airports, the underwriting/risk acceptance function is not undertaken by the vending machine but by the person who developed the product and set the insurance limits.

b) Risk management and reinsurance

195. In the overwhelming majority of cases, the risk management function of deciding whether to reinsure externally or retain risks assumed by the PE will not give rise to an internal reinsurance dealing. However, the decision to reinsure may be informed by advice and analysis provided by specialists (*e.g.* actuaries) located elsewhere within the insurance enterprise than the “reinsuring PE”. The cost of such services should be considered a legitimate expense of external reinsurance acquired by the PE and an arm’s length compensation should be imputed to the services dealing for tax purposes.

196. Risk management, including asset/liability management, can be an important factor in determining the profitability of insurance enterprises and so would be rewarded accordingly. An issue arises as to the form that reward should take and in particular whether such functions should be rewarded by profit methods. A full comparability analysis should help show whether a profit method is in conformity with the arm’s length principle. Profit methods may be the most appropriate methods to attribute profits to the part of the enterprise performing the 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.

197. Issues also arise as to how to determine where operational risk is being managed. The risk that a liability may arise through the operation of a business resides with the part of the enterprise responsible for managing the activity giving rise to the operational risk. In the case of operational risk arising from the illegal activity of an employee, if a PE was responsible for managing the rogue employee then that PE is treated as assuming the operational risk. Any profit from performing functions related to the undertaking of that risk is properly allocated to the PE. To the extent that the head office performs functions that lead to the assumption of the operational risks that otherwise would be related to the activities of a PE, the head office should be compensated for assuming these risks. It may be possible to find comparables for such dealings as it is becoming common for enterprises to purchase insurance against operational risk from third parties.

c) Asset management

198. Asset management should produce few conceptual difficulties in relation to insurance enterprises. Such enterprises are generally considerably more conservative in their investment activity than, say, banks and may, under their asset/liability matching requirements invest in long term investments rather than seeking trading profits by being continually active in the market. As such it should be possible to find suitable comparables for investment management functions from those organisations, *e.g.* fund managers, that provide asset management services, though the particular requirements of the insurance business may necessitate adjustment to the comparables in order to make them reliable.

199. It should be borne in mind that following the authorised OECD approach (and as described in Section C-1(iii) of this part of the Report), assets are attributed to PEs in an appropriate proportion to the level of insurance risk which the PE has assumed. The risk assumed will therefore reside in the PE so that “ownership” of the supporting assets, the associated investment income, the asset/liability mismatch risk and the market risk (or investment yield risk) also resides in the PE. That part of the enterprise which manages the assets should therefore be rewarded appropriately for the investment management function by the part of the enterprise that is treated as the “economic owner” of the assets. This reward would be determined in accordance with the Guidelines.

200. It may be the case that the head office is explicitly “managing” the investment of assets for its PEs, on the basis that it is able to do so more effectively than the PE, through economies of scale, expertise, etc. Such an arrangement raises issues of compensation for the investment management function under the second step of the authorised OECD approach.

d) Product management/product development

201. It will be part of the functional and factual analysis to determine which part of an enterprise designs and develops particular new products, the customer base at which the product is directed and the probability of a particular PE wishing to benefit and/or benefiting from the new product. In other words, the salient facts in the functional and factual analysis will be which parts of the enterprise have helped develop the product, whether it is a generalised product marketed by all parts of the enterprise (and perhaps capable of being marketed by third parties) or whether it is a specialised product with a customer range limited to only specific PEs.

202. Compensation should be attributed to those parts of the enterprise engaged in development of the product. Generally, following the authorised OECD approach, the compensation should be on arm’s length terms and should be provided by those parts of the enterprise which benefit from the product’s sale. However, determination of the level of benefit enjoyed by a particular PE (and whether it ought to be treated as compensating the product developer for that benefit) is a question which will turn on the facts of the particular case. The guidance in Chapters VI and VII of the Guidelines (or Chapter VIII in the circumstances where the product is developed by something analogous to a CCA) should be followed, by analogy, in such cases.

203. Once it is decided that an arm’s length price should attach to the dealing then, depending on the level of sophistication of the product and the degree to which it has proprietary features, a market comparable may be found using the CUP method. Otherwise it may be necessary to arrive at an arm’s length price using other methods authorised by the Guidelines.

e) Sales and marketing

204. Traditionally, most insurance products have been sold directly (*i.e.* “one-to-one”) by an agent or broker. Where one part of an enterprise markets the insurance product directly to third parties and then

proceeds to contractually commit to underwrite that business, the authorised OECD approach will attribute to that PE the insurance risk arising from the sale together with an appropriate level of assets to support the risk assumed (including investment income associated with those assets).

205. However, with continuing development of telecommunications, it is becoming more common for one part of the enterprise to advertise or “market” products on behalf of the whole enterprise or other specific parts of it. The customer may be directed to approach a part of the enterprise other than the marketer in order to contractually commit to purchase of the product and, if the business is underwritten by the other part of the entity, the “sale” will generally be booked there (although the same effect could be achieved if the premium payments are received by the “marketer” and passed on to the “underwriter” less a commission to reward the marketing function). Subsequent premium payments may similarly be made to parts of the enterprise other than the “marketer”.

206. If the enterprise as a whole is marketing a product on behalf of an independent entity (third party or an affiliate), the reward which the enterprise receives should be at arm’s length (either directly if from a third party or, if it is an affiliated transaction, following application of the Guidelines). That reward should be allocated amongst those parts of the enterprise involved in the marketing and it should be possible to arrive at the arm’s length compensation due to each part of the enterprise using the Guidelines and by making reference to comparable services available from unrelated providers.

207. Where one part of the insurance enterprise markets a product on behalf of another part of the same enterprise, or of the enterprise as a whole, the issues are more complex. In these circumstances it is very important that the facts are fully established by the functional and factual analysis. For example, one part of the enterprise may advertise a product from one jurisdiction (*e.g.* over the phone or internet) but instruct customers to conclude the contract with and pay premiums to a PE in another – possibly a third – jurisdiction. In these circumstances, under the authorised OECD approach the risk incurred in concluding the contract and underwriting the business will reside with the PE that performed the underwriting/risk acceptance functions. Assets to support that risk will accordingly be attributed to that PE. The cost of marketing the product sold will be an allowable expense for tax purposes and an arm’s length compensation to the marketer may be imputed.

208. An issue arises as to whether for some of the more complex insurance products, there is a role equivalent to the “structuring” role in global trading as described in Part III of this Report. (See paragraphs 93-94 above and paragraphs 124-126 of Part III.)

f) Support functions

**1) Credit analysis**

209. The provision of credit analysis should be rewarded on arm’s length terms. This function should not give rise to any conceptual difficulties and suitable arm’s length comparables for the services provided should be fairly readily available.

**2) Treasury**

210. In the insurance industry, the treasury function is normally not seen as a profit centre. One would therefore expect the treasury people to be primarily involved in raising finance and making it available to the profit centres. This raises the issue of whether treasury dealings with PEs should attract arm’s length prices. The discussion at paragraphs 159-161 of Part I of this Report will be helpful in this regard.



### **3) Regulatory compliance**

211. Regulatory compliance may be a requirement of the enterprise as a whole, of the PE itself (in respect of host country regulations) or both (*i.e.* the PE will be subject to both home and host country regulation). Where the PE is subject – because the enterprise as a whole is subject – to home country regulation, it is most likely that the head office will undertake the regulatory compliance function. Under the authorised OECD approach it may be considered appropriate to allocate an arm’s length fee to the head office for providing the service. However, if the PE were a separate and independent enterprise, it is not always clear that it would be subject to “home” country regulation and thus would not require assistance in ensuring regulatory compliance. One approach to this issue would be that compliance with home country regulation is one of the “same or similar conditions” required by Article 7(2). In other words, in determining the arm’s length remuneration to be allocated by the PE to the head office for the provision of this service, the PE would be analogised to a separate and independent enterprise that was subject to regulation in the head office country.

212. Where the PE has to satisfy the requirements of the host country, then an arm’s length compensation will be due to whichever part of the enterprise undertakes the compliance work on behalf of the PE with a corresponding allowable deduction in computing the profits of the PE.

### **4) Systems and development of intangibles**

213. Although the role of information technology is significant (and becoming increasingly so) in the insurance industry, development of IT systems within the industry does not give rise to any conceptual difficulties not met elsewhere. Similarly, intangibles such as trade names are of very great value in the industry, but do not present any transfer pricing challenges not previously addressed. The detailed discussions in Section D-3(iv)(b) of Part I of this Report should be helpful in determining a suitable solution for enterprises using intangibles in conducting their insurance business.

### **5) Other back office functions**

214. The back office support structure is of importance in the insurance industry, though perhaps less so than in banking. The various back office support functions need to be considered when attributing profit to the various parts of the enterprise.

215. Application of the arm’s length principle will take account not only of the price applied to the service but also following the guidance in Chapter VII, whether, at arm’s length, both parties would have contracted for the provision of the service.....[T]he 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 [other parts of the enterprise] in providing it (see paragraph 7.33 of the Guidelines).”

216. In practice, as noted at paragraph 189 of Part II of this Report, “Where the head office or other part of a bank provides centralised services to a PE that are similar to those provided by an associated centralised service provider in an MNE group, similar techniques may be used as apply to associated enterprises. However, services provided by a head office or other part of an integrated enterprise may be different from those provided by the parent or centralised service provider of an MNE group. Accordingly, whilst similar techniques can be used as for associated enterprises, CUPs are more likely to be unavailable, so that cost plus methods are likely to be particularly relevant.”

217. If the enterprise has a CCA-type arrangement in respect of back office services, the guidance in Chapter VIII of the Guidelines on applying the arm's length principle to services that are subject to CCA activity should be followed.<sup>6</sup>

## **6) Claims administration**

218. This is an important, though at times under-recognised, function in the insurance industry. Efficient loss adjustment and effective pursuit of claims against reinsurers can affect very significantly profits earned. Clearly, if the PE performs this function itself and only in respect of business it has underwritten, no problems arise. However, the PE may perform the function on behalf of other parts of the enterprise or the head office or another PE may act for it. Where the functional service is provided in those circumstances, the service provider is entitled to an arm's length compensation. Some fee or commission basis suggests itself as a suitable methodology for attributing the reward. Arm's length comparables may well be available and may provide an alternative basis for compensation of the service provider. If that is the case, the functional and factual analysis should provide a means for testing the suitability of the comparable against the specific circumstances of the PE.

### **D. Article 7(4) – coordination with Article 10(4), etc.**

219. Article 7(4) of the OECD Model Tax Convention provides that: "Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article."

220. Insurance companies, by the nature of their business, frequently invest in assets in connection with their business that give rise to income falling within other Articles – in particular the dividend and interest Articles. So the question arises whether the authorised OECD approach has any application to those items of income where Article 7(4) applies.

221. The clear answer is "Yes". In each of the other Articles referred to, there is a provision under which those parts of the Article which limit the taxing rights of the state where the income arises are made inapplicable where the income or gains is attributable to a PE in that State. And the Commentary on Article 7(4) reinforces this (see paragraphs 73-75 of the Commentary on Article 7, reproduced in the Appendix to this Report).

222. Since provisions such as Article 10(4) provide that, in the case there dealt with, Article 7 applies if the holding in respect of which the dividend is paid is effectively connected with the PE, then Article 7 will apply to dividends (and interest) derived from the State where the PE is established if they are attributable to the PE.<sup>7</sup>

223. From the Commentary on Article 10, it is clear that the requirement that a shareholding be "effectively connected" with a permanent establishment requires more than merely recording the shareholding in the books of the permanent establishment for accounting purposes. A holding in respect of which dividends are paid will be effectively connected with a permanent establishment, and will therefore form part of its business assets, if the "economic" ownership of the holding is allocated to that permanent establishment under the principles developed in this Report. In the case of the permanent establishment of

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6 See paragraph 190 of Part II, which discusses the possibility of a "CCA" within a single legal enterprise.

7 The question of whether particular holdings from which income is derived are "effectively connected" with a PE is relevant under Articles 10(4), 11(4), 12(3) and 21(2). An analogous question arises under Articles 13(2) and 22(2), where it is necessary to determine whether certain movable property "forms part of the business property of a PE" in order to determine the taxing rights of the PE State.

an enterprise carrying on insurance activities, the determination of whether a holding is effectively connected with the permanent establishment shall be made by giving due regard to the guidance set forth in this Report. In this regard, to the extent that Part IV identifies specific assets, the yield on which is to be used to determine the profits attributable to the PE, this in effect amounts to an identification of those assets as “economically owned” by the PE. Similar guidance can be found in the Commentary on similar provisions of Articles 11, 12, 13, 21 and 22.

## **APPENDIX**

For reference purposes, this Appendix includes texts of the following items:

- Article 7 of the OECD Model Tax Convention as published in the 2010 update to the Model Tax Convention; and
- The Commentary on Article 7 as published in the 2010 update to the Model Tax Convention.

### **Text of Article 7, as it reads since the 2010 update:**

#### **ARTICLE 7**

#### **BUSINESS PROFITS**

1. Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.
2. For the purposes of this Article and Article [23 A] [23B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.
3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.
4. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

**Text of the Commentary on Article 7, as published in the 2010 OECD Model Tax Convention:**

**COMMENTARY ON ARTICLE 7  
CONCERNING THE TAXATION OF BUSINESS PROFITS**

***I. Preliminary remarks***

1. This Article allocates taxing rights with respect to the business profits of an enterprise of a Contracting State to the extent that these profits are not subject to different rules under other Articles of the Convention. It incorporates the basic principle that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State unless these profits fall into special categories of income for which other Articles of the Convention give taxing rights to that other State.

2. Article 5, which includes the definition of the concept of permanent establishment, is therefore relevant to the determination of whether the business profits of an enterprise of a Contracting State may be taxed in the other State. That Article, however, does not itself allocate taxing rights: when an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, it is necessary to determine what, if any, are the profits that the other State may tax. Article 7 provides the answer to that question by determining that the other State may tax the profits that are attributable to the permanent establishment.

3. The principles underlying Article 7, and in particular paragraph 2 of the Article, have a long history. When the OECD first examined what criteria should be used in attributing profits to a permanent establishment, this question had previously been addressed in a large number of tax conventions and in various models developed by the League of Nations. The separate entity and arm's length principles, on which paragraph 2 is based, had already been incorporated in these conventions and models and the OECD considered that it was sufficient to restate these principles with some slight amendments and modifications for the main purpose of clarification.

4. Practical experience has shown, however, that there was considerable variation in the interpretation of these general principles and of other provisions of earlier versions of Article 7. This lack of a common interpretation created problems of double taxation and non-taxation. Over the years, the Committee on Fiscal Affairs spent considerable time and effort trying to ensure a more consistent interpretation and application of the rules of the Article. Minor changes to the wording of the Article and a number of changes to the Commentary were made when the 1977 Model Tax Convention was adopted. A report that addressed that question in the specific case of banks was published in 1984.<sup>1</sup> In 1987, noting that the determination of profits attributable to a permanent establishment could give rise to some uncertainty, the Committee undertook a review of the question which led to the adoption, in 1993, of the report entitled *Attribution of Income to Permanent Establishments*<sup>2</sup> and to subsequent changes to the Commentary.

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1. "The Taxation of Multinational Banking Enterprises", in *Transfer Pricing and Multinational Enterprises - Three Taxation Issues*, OECD, Paris, 1984.
  2. *Attribution of Income to Permanent Establishments*, Issues in International Taxation No. 5, OECD, Paris, 1994; reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention at page R(13)-1.

5. Despite that work, the practices of OECD and non-OECD countries regarding the attribution of profits to permanent establishments and these countries' interpretation of Article 7 continued to vary considerably. The Committee acknowledged the need to provide more certainty to taxpayers: in its report *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*<sup>1</sup> (the "OECD Transfer Pricing Guidelines"), it indicated that further work would address the application of the arm's length principle to permanent establishments. That work resulted, in 2008, in a report entitled *Attribution of Profits to Permanent Establishments*<sup>2</sup> (the "2008 Report").

6. The approach developed in the 2008 Report was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus was on formulating the most preferable approach to attributing profits to a permanent establishment under Article 7 given modern-day multinational operations and trade. When it approved the 2008 Report, the Committee considered that the guidance included therein represented a better approach to attributing profits to permanent establishments than had previously been available. It also recognised, however, that there were differences between some of the conclusions of the 2008 Report and the interpretation of Article 7 previously given in this Commentary.

7. In order to provide maximum certainty on how profits should be attributed to permanent establishments, the Committee therefore decided that the 2008 Report's full conclusions should be reflected in a new version of Article 7, together with accompanying Commentary, to be used in the negotiation of future treaties and the amendment of existing treaties. In addition, in order to provide improved certainty for the interpretation of treaties that had already been concluded on the basis of the previous wording of Article 7, the Committee decided that a revised Commentary for that previous version of the Article should also be prepared, to take into account those aspects of the report that did not conflict with the Commentary as it read before the adoption of the 2008 Report.

8. The new version of the Article, which now appears in the Model Tax Convention, was adopted in 2010. At the same time, the Committee adopted a revised version of the 2008 Report in order to ensure that the conclusions of that report could be read harmoniously with the new wording and modified numbering of this new version of the Article. Whilst the conclusions and interpretations included in the revised report that was thus adopted in 2010<sup>3</sup> (hereinafter referred to as "the Report") are identical to those of the 2008 Report, that revised version takes account of the drafting of the Article as it now reads (the Annex to this Commentary includes, for historical reference, the text of the previous wording of Article 7 and that revised Commentary, as they read before the adoption of the current version of the Article).

9. The current version of the Article therefore reflects the approach developed in the Report and must be interpreted in light of the guidance contained in it. The Report deals with the attribution of profits both to permanent establishments in general (Part I of the Report) and, in particular, to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (Part II of the Report, which deals with permanent establishments of banks, Part III, which deals with permanent establishments of enterprises carrying on global trading and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities).

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<sup>1</sup> The original version of that report was approved by the Council of the OECD on 27 June 1995 and was updated a number of times since then. Published by the OECD as *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

<sup>2</sup> Available at <http://www.oecd.org/dataoecd/20/36/41031455.pdf>

<sup>3</sup> *Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

## *II. Commentary on the provisions of the Article*

### *Paragraph 1*

10. Paragraph 1 incorporates the rules for the allocation of taxing rights on the business profits of enterprises of each Contracting State. First, it states that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State. Second, it provides that if such an enterprise carries on business in the other State through a permanent establishment situated therein, the profits that are attributable to the permanent establishment, as determined in accordance with paragraph 2, may be taxed by that other State. As explained below, however, paragraph 4 restricts the application of these rules by providing that Article 7 does not affect the application of other Articles of the Convention that provide special rules for certain categories of profits (*e.g.* those derived from the operation of ships and aircraft in international traffic) or for certain categories of income that may also constitute business profits (*e.g.* income derived by an enterprise in respect of personal activities of an entertainer or sportsman).

11. The first principle underlying paragraph 1, *i.e.* that the profits of an enterprise of one Contracting State shall not be taxed in the other State unless the enterprise carries on business in that other State through a permanent establishment situated therein, has a long history and reflects the international consensus that, as a general rule, until an enterprise of one State has a permanent establishment in another State, it should not properly be regarded as participating in the economic life of that other State to such an extent that the other State should have taxing rights on its profits.

12. The second principle, which is reflected in the second sentence of the paragraph, is that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment. This is a question on which there have historically been differences of view, a few countries having some time ago pursued a principle of general “force of attraction” according to which income such as other business profits, dividends, interest and royalties arising from sources in their territory was fully taxable by them if the beneficiary had a permanent establishment therein even though such income was clearly not attributable to that permanent establishment. Whilst some bilateral tax conventions include a limited anti-avoidance rule based on a restricted force of attraction approach that only applies to business profits derived from activities similar to those carried on by a permanent establishment, the general force of attraction approach described above has now been rejected in international tax treaty practice. The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test, subject to the possible application of other Articles of the Convention. This solution allows simpler and more efficient tax administration and compliance, and is more closely adapted to the way in which business is commonly carried on. The organisation of modern business is highly complex. There are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. A company may set up a permanent establishment in another country through which it carries on manufacturing activities whilst a different part of the same company sells different goods in that other country through independent agents. That company may have perfectly valid commercial reasons for doing so: these may be based, for example, on the historical pattern of its business or on commercial convenience. If the country in which the permanent establishment is situated wished to go so far as to try to determine, and tax, the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment, that approach would interfere seriously with ordinary commercial activities and would be contrary to the aims of the Convention.

13. As indicated in the second sentence of paragraph 1, the profits that are attributable to the permanent establishment are determined in accordance with the provisions of paragraph 2, which provides the meaning of the phrase “profits that are attributable to the permanent establishment” found in paragraph 1. Since paragraph 1 grants taxing rights to the State in which the permanent establishment is situated only with respect to the profits that are attributable to that permanent establishment, the paragraph therefore prevents that State, subject to the application of other Articles of the Convention, from taxing the enterprise of the other Contracting State on profits that are not attributable to the permanent establishment.

14. The purpose of paragraph 1 is to limit the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10).

### ***Paragraph 2***

15. Paragraph 2 provides the basic rule for the determination of the profits that are attributable to a permanent establishment. According to the paragraph, these profits are the profits that the permanent establishment might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed through the permanent establishment and through other parts of the enterprise. In addition, the paragraph clarifies that this rule applies with respect to the dealings between the permanent establishment and the other parts of the enterprise.

16. The basic approach incorporated in the paragraph for the purposes of determining what are the profits that are attributable to the permanent establishment is therefore to require the determination of the profits under the fiction that the permanent establishment is a separate enterprise and that such an enterprise is independent from the rest of the enterprise of which it is a part as well as from any other person. The second part of that fiction corresponds to the arm's length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises (see paragraph 1 of the Commentary on Article 9).

17. Paragraph 2 does not seek to allocate the overall profits of the whole enterprise to the permanent establishment and its other parts but, instead, requires that the profits attributable to a permanent establishment be determined as if it were a separate enterprise. Profits may therefore be attributed to a permanent establishment even though the enterprise as a whole has never made profits. Conversely, paragraph 2 may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

18. Clearly, however, where an enterprise of a Contracting State has a permanent establishment in the other Contracting State, the first State has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with either Article 23 A or 23 B, eliminate double taxation on the profits properly attributable to the permanent establishment (see paragraph 27 below). In other words, if the State where the permanent establishment is located attempts to tax profits that are not attributable to the permanent



establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise.

19. As indicated in paragraphs 8 and 9 above, Article 7, as currently worded, reflects the approach developed in the Report adopted by the Committee on Fiscal Affairs in 2010. The Report dealt primarily with the application of the separate and independent enterprise fiction that underlies paragraph 2 and the main purpose of the changes made to that paragraph following the adoption of the Report was to ensure that the determination of the profits attributable to a permanent establishment followed the approach put forward in that Report. The Report therefore provides a detailed guide as to how the profits attributable to a permanent establishment should be determined under the provisions of paragraph 2.

20. As explained in the Report, the attribution of profits to a permanent establishment under paragraph 2 will follow from the calculation of the profits (or losses) from all its activities, including transactions with independent enterprises, transactions with associated enterprises (with direct application of the 1995 Transfer Pricing Guidelines) and dealings with other parts of the enterprise. This analysis involves two steps which are described below. The order of the listing of items within each of these two steps is not meant to be prescriptive, as the various items may be interrelated (*e.g.* risk is initially attributed to a permanent establishment as it performs the significant people functions relevant to the assumption of that risk but the recognition and characterisation of a subsequent dealing between the permanent establishment and another part of the enterprise that manages the risk may lead to a transfer of the risk and supporting capital to the other part of the enterprise).

21. Under the first step, a functional and factual analysis is undertaken which will lead to:

- the attribution to the permanent establishment, as appropriate, of the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;
- the identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the permanent establishment;
- the identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the permanent establishment;
- the identification of other functions of the permanent establishment;
- the recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test referred to in paragraph 26; and
- the attribution of capital based on the assets and risks attributed to the permanent establishment.

22. Under the second step, any transactions with associated enterprises attributed to the permanent establishment are priced in accordance with the guidance of the 1995 Transfer Pricing Guidelines and these Guidelines are applied by analogy to dealings between the permanent establishment and the other parts of the enterprise of which it is a part. The process involves the pricing on an arm's length basis of these recognised dealings through:

- the determination of comparability between the dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy

(functional analysis, contractual terms) in light of the particular factual circumstances of the permanent establishment; and

- the application by analogy of one of the Guidelines’ methods to arrive at an arm’s length compensation for the dealings between the permanent establishment and the other parts of the enterprise, taking into account the functions performed by and the assets and risks attributed to the permanent establishment and the other parts of the enterprise.

23. Each of these operations is discussed in greater detail in the Report, in particular as regards the attribution of profits to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (see Part II of the Report, which deals with permanent establishments of banks; Part III, which deals with permanent establishments of enterprises carrying on global trading, and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities).

24. Paragraph 2 refers specifically to the dealings between the permanent establishment and other parts of the enterprise of which the permanent establishment is a part in order to emphasise that the separate and independent enterprise fiction of the paragraph requires that these dealings be treated the same way as similar transactions taking place between independent enterprises. That specific reference to dealings between the permanent establishment and other parts of the enterprise does not, however, restrict the scope of the paragraph. Where a transaction that takes place between the enterprise and an associated enterprise affects directly the determination of the profits attributable to the permanent establishment (*e.g.* the acquisition by the permanent establishment from an associated enterprise of goods that will be sold through the permanent establishment), paragraph 2 also requires that, for the purpose of computing the profits attributable to the permanent establishment, the conditions of the transaction be adjusted, if necessary, to reflect the conditions of a similar transaction between independent enterprises. Assume, for instance, that the permanent establishment situated in State S of an enterprise of State R acquires property from an associated enterprise of State T. If the price provided for in the contract between the two associated enterprises exceeds what would have been agreed to between independent enterprises, paragraph 2 of Article 7 of the treaty between State R and State S will authorise State S to adjust the profits attributable to the permanent establishment to reflect what a separate and independent enterprise would have paid for that property. In such a case, State R will also be able to adjust the profits of the enterprise of State R under paragraph 1 of Article 9 of the treaty between State R and State T, which will trigger the application of the corresponding adjustment mechanism of paragraph 2 of Article 9 of that treaty.

25. Dealings between the permanent establishment and other parts of the enterprise of which it is a part have no legal consequences for the enterprise as a whole. This implies a need for greater scrutiny of these dealings than of transactions between two associated enterprises. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist.

26. It is generally not intended that more burdensome documentation requirements be imposed in connection with such dealings than apply to transactions between associated enterprises. Moreover, as in the case of transfer pricing documentation referred to in the Report “*Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*”, the requirements should not be applied in such a way as to impose on taxpayers costs and burdens disproportionate to the circumstances. Nevertheless, considering the uniqueness of the nature of a dealing, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealing. Thus, for example, an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits. Taxpayers are encouraged to prepare such

documentation, as it may reduce substantially the potential for controversies regarding application of the approach. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that:

- the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;
- the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner, or if they do, the structure as presented in the taxpayer’s documentation does not practically impede the tax administration from determining an appropriate transfer price; and
- the dealing presented in the taxpayer’s documentation does not violate the principles of the approach put forward in the Report by, for example, purporting to transfer risks in a way that segregates them from functions.

27. The opening words of paragraph 2 and the phrase “in each Contracting State” indicate that paragraph 2 applies not only for the purposes of determining the profits that the Contracting State in which the permanent establishment is situated may tax in accordance with the last sentence of paragraph 1 but also for the application of Articles 23 A and 23 B by the other Contracting State. Where an enterprise of one State carries on business through a permanent establishment situated in the other State, the first-mentioned State must either exempt the profits that are attributable to the permanent establishment (Article 23 A) or give a credit for the tax levied by the other State on these profits (Article 23 B). Under both these Articles, that State must therefore determine the profits attributable to the permanent establishment in order to provide relief from double taxation and is required to follow the provisions of paragraph 2 for that purpose.

28. The separate and independent enterprise fiction that is mandated by paragraph 2 is restricted to the determination of the profits that are attributable to a permanent establishment. It does not extend to create notional income for the enterprise which a Contracting State could tax as such under its domestic law by arguing that such income is covered by another Article of the Convention which, in accordance with paragraph 4 of Article 7, allows taxation of that income notwithstanding paragraph 1 of Article 7. Assume, for example, that the circumstances of a particular case justify considering that the economic ownership of a building used by the permanent establishment should be attributed to the head office (see paragraph 75 of Part I of the Report). In such a case, paragraph 2 could require the deduction of a notional rent in determining the profits of the permanent establishment. That fiction, however, could not be interpreted as creating income from immovable property for the purposes of Article 6. Indeed, the fiction mandated by paragraph 2 does not change the nature of the income derived by the enterprise; it merely applies to determine the profits attributable to the permanent establishment for the purposes of Articles 7, 23 A and 23 B. Similarly, the fact that, under paragraph 2, a notional interest charge could be deducted in determining the profits attributable to a permanent establishment does not mean that any interest has been paid to the enterprise of which the permanent establishment is a part for the purposes of paragraphs 1 and 2 of Article 11. The separate and independent enterprise fiction does not extend to Article 11 and, for the purposes of that Article, one part of an enterprise cannot be considered to have made an interest payment to another part of the same enterprise. Clearly, however, if interest paid by an enterprise to a different person is paid on indebtedness incurred in connection with a permanent establishment of the enterprise and is borne by that permanent establishment, this real interest payment may, under paragraph 2 of Article 11, be taxed by the State in which the permanent establishment is located. Also, where a transfer of assets between a permanent establishment and the rest of the enterprise is treated as a dealing for the purposes of paragraph 2 of Article 7, Article 13 does not prevent States

from taxing profits or gains from such a dealing as long as such taxation is in accordance with Article 7 (see paragraphs 4, 8 and 10 of the Commentary on Article 13).

29. Some States consider that, as a matter of policy, the separate and independent enterprise fiction that is mandated by paragraph 2 should not be restricted to the application of Articles 7, 23 A and 23 B but should also extend to the interpretation and application of other Articles of the Convention, so as to ensure that permanent establishments are, as far as possible, treated in the same way as subsidiaries. These States may therefore consider that notional charges for dealings which, pursuant to paragraph 2, are deducted in computing the profits of a permanent establishment should be treated, for the purposes of other Articles of the Convention, in the same way as payments that would be made by a subsidiary to its parent company. These States may therefore wish to include in their tax treaties provisions according to which charges for internal dealings should be recognised for the purposes of Articles 6 and 11 (it should be noted, however, that tax will be levied in accordance with such provisions only to the extent provided for under domestic law). Alternatively, these States may wish to provide that no internal dealings will be recognised in circumstances where an equivalent transaction between two separate enterprises would give rise to income covered by Article 6 or 11 (in that case, however, it will be important to ensure that an appropriate share of the expenses related to what would otherwise have been recognised as a dealing be attributed to the relevant part of the enterprise). States considering these alternatives should, however, take account of the fact that, due to special considerations applicable to internal interest charges between different parts of a financial enterprise (*e.g.* a bank), dealings resulting in such charges have long been recognised, even before the adoption of the present version of the Article.

30. Paragraph 2 determines the profits that are attributable to a permanent establishment for the purposes of the rule in paragraph 1 that allocates taxing rights on these profits. Once the profits that are attributable to a permanent establishment have been determined in accordance with paragraph 2 of Article 7, it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed as long as there is conformity with the requirements of paragraph 2 and the other provisions of the Convention. Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 3 of Article 24 (see paragraphs 33 and 34 below).

31. Thus, for example, whilst domestic law rules that would ignore the recognition of dealings that should be recognised for the purposes of determining the profits attributable to a permanent establishment under paragraph 2 or that would deny the deduction of expenses not incurred exclusively for the benefit of the permanent establishment would clearly be in violation of paragraph 2, rules that prevent the deduction of certain categories of expenses (*e.g.* entertainment expenses) or that provide when a particular expense should be deducted are not affected by paragraph 2. In making that distinction, however, some difficult questions may arise as in the case of domestic law restrictions based on when an expense or element of income is actually paid. Since, for instance, an internal dealing will not involve an actual transfer or payment between two different persons, the application of such domestic law restrictions should generally take into account the nature of the dealing and, therefore, treat the relevant transfer or payment as if it had been made between two different persons.

32. Variations between the domestic laws of the two States concerning matters such as depreciation rates, the timing of the recognition of income and restrictions on the deductibility of certain expenses will normally result in a different amount of taxable income in each State even though, for the purposes of the Convention, the amount of profits attributable to the permanent establishment will have been

computed on the basis of paragraph 2 in both States (see also paragraphs 39-43 of the Commentary on Articles 23 A and 23 B). Thus, even though paragraph 2 applies equally to the Contracting State in which the permanent establishment is situated (for the purposes of paragraph 1) and to the other Contracting State (for the purposes of Articles 23 A or 23 B), it is likely that the amount of taxable income on which an enterprise of a Contracting State will be taxed in the State where the enterprise has a permanent establishment will, for a given taxable period, be different from the amount of taxable income with respect to which the first State will have to provide relief pursuant to Articles 23 A or 23 B. Also, to the extent that the difference results from domestic law variations concerning the types of expenses that are deductible, as opposed to timing differences in the recognition of these expenses, the difference will be permanent.

33. In taxing the profits attributable to a permanent establishment situated on its territory, a Contracting State will, however, have to take account of the provisions of paragraph 3 of Article 24. That paragraph requires, among other things, that expenses be deductible under the same conditions whether they are incurred for the purposes of a permanent establishment situated in a Contracting State or for the purposes of an enterprise of that State. As stated in paragraph 40 of the Commentary on Article 24:

Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorised by the taxation law to be deducted from taxable profits. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises.

34. The requirement imposed by paragraph 3 of Article 24 is the same regardless of how expenses incurred by an enterprise for the benefit of a permanent establishment are taken into account for the purposes of paragraph 2 of Article 7. In some cases, it will not be appropriate to consider that a dealing has taken place between different parts of the enterprise. In such cases, expenses incurred by an enterprise for the purposes of the activities performed by the permanent establishment will be directly deducted in determining the profits of the permanent establishment (*e.g.* the salary of a local construction worker hired and paid locally to work exclusively on a construction site that constitutes a permanent establishment of a foreign enterprise). In other cases, expenses incurred by the enterprise will be attributed to functions performed by other parts of the enterprise wholly or partly for the benefit of the permanent establishment and an appropriate charge will be deducted in determining the profits attributable to the permanent establishment (*e.g.* overhead expenses related to administrative functions performed by the head office for the benefit of the permanent establishment). In both cases, paragraph 3 of Article 24 will require that, as regards the permanent establishment, the expenses be deductible under the same conditions as those applicable to an enterprise of that State. Thus, any expense incurred by the enterprise directly or indirectly for the benefit of the permanent establishment must not, for tax purposes, be treated less favourably than a similar expense incurred by an enterprise of that State. That rule will apply regardless of whether or not, for the purposes of paragraph 2 of this Article 7, the expense is directly attributed to the permanent establishment (first example) or is attributed to another part of the enterprise but reflected in a notional charge to the permanent establishment (second example).

35. Paragraph 3 of Article 5 sets forth a special rule for a fixed place of business that is a building site or a construction or installation project. Such a fixed place of business is a permanent establishment only if it lasts more than twelve months. Experience has shown that these types of permanent establishments can give rise to special problems in attributing income to them under Article 7.

36. These problems arise chiefly where goods are provided, or services performed, by the other parts of the enterprise or a related party in connection with the building site or construction or

installation project. Whilst these problems can arise with any permanent establishment, they are particularly acute for building sites and construction or installation projects. In these circumstances, it is necessary to pay close attention to the general principle that income is attributable to a permanent establishment only when it results from activities carried on by the enterprise through that permanent establishment.

37. For example, where such goods are supplied by the other parts of the enterprise, the profits arising from that supply do not result from the activities carried on through the permanent establishment and are not attributable to it. Similarly, profits resulting from the provision of services (such as planning, designing, drawing blueprints, or rendering technical advice) by the parts of the enterprise operating outside the State where the permanent establishment is located do not result from the activities carried on through the permanent establishment and are not attributable to it.

38. Article 7, as it read before [2010], included the following paragraph 3:

In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

Whilst that paragraph was originally intended to clarify that paragraph 2 required expenses incurred directly or indirectly for the benefit of a permanent establishment to be taken into account in determining the profits of the permanent establishment even if these expenses had been incurred outside the State in which the permanent establishment was located, it had sometimes been read as limiting the deduction of expenses that indirectly benefited the permanent establishment to the actual amount of the expenses.

39. This was especially the case of general and administrative expenses, which were expressly mentioned in that paragraph. Under the previous version of paragraph 2, as interpreted in the Commentary, this was generally not a problem since a share of the general and administrative expenses of the enterprise could usually only be allocated to a permanent establishment on a cost-basis.

40. As now worded, however, paragraph 2 requires the recognition and arm's length pricing of the dealings through which one part of the enterprise performs functions for the benefit of the permanent establishment (*e.g.* through the provision of assistance in day-to-day management). The deduction of an arm's length charge for these dealings, as opposed to a deduction limited to the amount of the expenses, is required by paragraph 2. The previous paragraph 3 has therefore been deleted to prevent it from being misconstrued as limiting the deduction to the amount of the expenses themselves. That deletion does not affect the requirement, under paragraph 2, that in determining the profits attributable to a permanent establishment, all relevant expenses of the enterprise, wherever incurred, be taken into account. Depending on the circumstances, this will be done through the deduction of all or part of the expenses or through the deduction of an arm's length charge in the case of a dealing between the permanent establishment and another part of the enterprise.

41. Article 7, as it read before 2010, also included a provision that allowed the attribution of profits to a permanent establishment to be done on the basis of an apportionment of the total profits of the enterprise to its various parts. That method, however, was only to be applied to the extent that its application had been customary in a Contracting State and that the result was in accordance with the principles of Article 7. For the Committee, methods other than an apportionment of total profits of an enterprise can be applied even in the most difficult cases. The Committee therefore decided to

delete that provision because its application had become very exceptional and because of concerns that it was extremely difficult to ensure that the result of its application would be in accordance with the arm's length principle.

42. At the same time, the Committee also decided to eliminate another provision that was found in the previous version of the Article and according to which the profits to be attributed to the permanent establishment were to be "determined by the same method year by year unless there is good and sufficient reason to the contrary." That provision, which was intended to ensure continuous and consistent treatment, was appropriate as long as it was accepted that the profits attributable to a permanent establishment could be determined through direct or indirect methods or even on the basis of an apportionment of the total profits of the enterprise to its various parts. The new approach developed by the Committee, however, does not allow for the application of such fundamentally different methods and therefore avoids the need for such a provision.

43. A final provision that was deleted from the Article at the same time provided that "[n]o profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise." Subparagraph 4 d) of Article 5 recognises that where an enterprise of a Contracting State maintains in the other State a fixed place of business exclusively for the purpose of purchasing goods for itself, its activity at that location should not be considered to have reached a level that justifies taxation in that other State. Where, however, subparagraph 4 d) is not applicable because other activities are carried on by the enterprise through that place of business, which therefore constitutes a permanent establishment, it is appropriate to attribute profits to all the functions performed at that location. Indeed, if the purchasing activities were performed by an independent enterprise, the purchaser would be remunerated on an arm's length basis for its services. Also, since a tax exemption restricted to purchasing activities undertaken for the enterprise would require that expenses incurred for the purposes of performing these activities be excluded in determining the profits of the permanent establishment, such an exemption would raise administrative problems. The Committee therefore considered that a provision according to which no profits should be attributed to a permanent establishment by reason of the mere purchase of goods or merchandise for the enterprise was not consistent with the arm's length principle and should not be included in the Article.

### ***Paragraph 3***

44. The combination of Articles 7 (which restricts the taxing rights of the State in which the permanent establishment is situated) and 23 A and 23 B (which oblige the other State to provide relief from double taxation) ensures that there is no unrelieved double taxation of the profits that are properly attributable to the permanent establishment. This result may require that the two States resolve differences based on different interpretations of paragraph 2 and it is important that mechanisms be available to resolve all such differences to the extent necessary to eliminate double taxation.

45. As already indicated, the need for the two Contracting States to reach a common understanding as regards the application of paragraph 2 in order to eliminate risks of double taxation has led the Committee to develop detailed guidance on the interpretation of that paragraph. This guidance is reflected in the Report, which draws on the principles of the Committee's 1995 report "Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations".

46. Risks of double taxation will usually be avoided because the taxpayer will determine the profits attributable to the permanent establishment in the same manner in each Contracting State and in accordance with paragraph 2 as interpreted by the Report, which will ensure the same result for

the purposes of Articles 7 and 23 A or 23 B (see, however, paragraph 66). Insofar as each State agrees that the taxpayer has done so, it should refrain from adjusting the profits in order to reach a different result under paragraph 2. This is illustrated in the following example.

47. Example. A manufacturing plant located in State R of an enterprise of State R has transferred goods for sale to a permanent establishment of the enterprise situated in State S. For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, the Report provides that a dealing must be recognised and a notional arm's length price must be determined for that dealing. The enterprise's documentation, which is consistent with the functional and factual analysis and which has been used by the taxpayer as the basis for the computation of its taxable income in each State, shows that a dealing in the nature of a sale of the goods by the plant in State R to the permanent establishment in State S has occurred and that a notional arm's length price of 100 has been used to determine the profits attributable to the permanent establishment. Both States agree that the recognition of the dealing and the price used by the taxpayer are in conformity with the principles of the Report and of the Transfer Pricing Guidelines. In this case, both States should refrain from adjusting the profits on the basis that a different arm's length price should have been used; as long as there is agreement that the taxpayer has conformed with paragraph 2, the tax administrations of both States cannot substitute their judgment for that of the taxpayer as to what are the arm's length conditions. In this example, the fact that the same arm's length price has been used in both States and that both States will recognise that price for the purposes of the application of the Convention will ensure that any double taxation related to that dealing will be eliminated under Article 23 A or 23 B.

48. In the previous example, both States agreed that the recognition of the dealing and the price used by the taxpayer were in conformity with the principles of the Report and of the Transfer Pricing Guidelines. The Contracting States, however, may not always reach such an agreement. In some cases, the Report and the Transfer Pricing Guidelines may allow different interpretations of paragraph 2 and, to the extent that double taxation would otherwise result from these different interpretations, it is essential to ensure that such double taxation is relieved. Paragraph 3 provides the mechanism that guarantees that outcome.

49. For example, as explained in paragraphs 105-171 of Part I of the Report, paragraph 2 permits different approaches for determining, on the basis of the attribution of "free" capital to a permanent establishment, the interest expense attributable to that permanent establishment. The Committee recognised that this could create problems, in particular for financial institutions. It concluded that in this and other cases where the two Contracting States have interpreted paragraph 2 differently and it is not possible to conclude that either interpretation is not in accordance with paragraph 2, it is important to ensure that any double taxation that would otherwise result from that difference will be eliminated.

50. Paragraph 3 will ensure that this result is achieved. It is important to note, however, that the cases where it will be necessary to have recourse to that paragraph are fairly limited.

51. First, as explained in paragraph 46 above, where the taxpayer has determined the profits attributable to the permanent establishment in the same manner in each Contracting State and both States agree that the taxpayer has done so in accordance with paragraph 2 as interpreted by the Report, no adjustments should be made to the profits in order to reach a different result under paragraph 2.

52. Second, paragraph 3 is not intended to limit in any way the remedies already available to ensure that each Contracting State conforms with its obligations under Articles 7 and 23 A or 23 B.



For example, if the determination, by a Contracting State, of the profits attributable to a permanent establishment situated in that State is not in conformity with paragraph 2, the taxpayer will be able to use the available domestic legal remedies and the mutual agreement procedure provided for by Article 25 to address the fact that the taxpayer has not been taxed by that State in accordance with the Convention. Similarly, these remedies will also be available if the other State does not, for the purposes of Article 23 A or 23 B, determine the profits attributable to the permanent establishment in conformity with paragraph 2 and therefore does not comply with the provisions of this Article.

53. Where, however, the taxpayer has not determined the profits attributable to the permanent establishment in conformity with paragraph 2, each State is entitled to make an adjustment in order to ensure conformity with that paragraph. Where one State makes an adjustment in conformity with paragraph 2, that paragraph certainly permits the other State to make a reciprocal adjustment so as to avoid any double taxation through the combined application of paragraph 2 and of Article 23 A or 23 B (see paragraph 65 below). It may be, however, that the domestic law of that other State (*e.g.* the State where the permanent establishment is located) may not allow it to make such a change or that State may have no incentive to do it on its own if the effect is to reduce the amount of profits that was previously taxable in that State. It may also be that, as indicated above, the two Contracting States will adopt different interpretations of paragraph 2 and it is not possible to conclude that either interpretation is not in accordance with paragraph 2.

54. Such concerns are addressed by paragraph 3. The following example illustrates the application of that paragraph.

55. Example. A manufacturing plant located in State R of an enterprise of State R has transferred goods for sale to a permanent establishment of the enterprise situated in State S. For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, a dealing must be recognised and a notional arm's length price must be determined for that dealing. The enterprise's documentation, which is consistent with the functional and factual analysis and which has been used by the taxpayer as the basis for the computation of its taxable income in each State, shows that a dealing in the nature of a sale of the goods by the plant in State R to the permanent establishment in State S has occurred and that a notional price of 90 has been used to determine the profits attributable to the permanent establishment. State S accepts the amount used by the taxpayer but State R considers that the amount is below what is required by its domestic law and the arm's length principle of paragraph 2. It considers that the appropriate arm's length price that should have been used is 110 and adjusts the amount of tax payable in State R accordingly after reducing the amount of the exemption (Article 23 A) or the credit (Article 23 B) claimed by the taxpayer with respect to the profits attributable to the permanent establishment. In that situation, since the price of the same dealing will have been determined as 90 in State S and 110 in State R, profits of 20 may be subject to double taxation. Paragraph 3 will address that situation by requiring State S, to the extent that there is indeed double taxation and that the adjustment made by State R is in conformity with paragraph 2, to provide a corresponding adjustment to the tax payable in State S on the profits that are taxed in both States.

56. If State S, however, does not agree that the adjustment by State R was warranted by paragraph 2, it will not consider that it has to make the adjustment. In such a case, the issue of whether State S should make the adjustment under paragraph 3 (if the adjustment by State R is justified under paragraph 2) or whether State R should refrain from making the initial adjustment (if it is not justified under paragraph 2) will be solved under a mutual agreement procedure pursuant to paragraph 1 of Article 25 using, if necessary, the arbitration provision of paragraph 5 of Article 25 (since it involves the question of whether the actions of one or both of the Contracting States have resulted or will result for the taxpayer in taxation not in accordance with the Convention). Through

that procedure, the two States will be able to agree on the same arm's length price, which may be one of the prices put forward by the taxpayer and the two States or a different one.

57. As shown by the example in paragraph 55, paragraph 3 addresses the concern that the Convention might not provide adequate protection against double taxation in some situations where the two Contracting States adopt different interpretations of paragraph 2 of Article 7 and each State could be considered to be taxing "in accordance with" the Convention. Paragraph 3 ensures that relief of double taxation will be provided in such a case, which is consistent with the overall objectives of the Convention.

58. Paragraph 3 shares the main features of paragraph 2 of Article 9. First, it applies to each State with respect to an adjustment made by the other State. It therefore applies reciprocally whether the initial adjustment has been made by the State where the permanent establishment is situated or by the other State. Also, it does not apply unless there is an adjustment by one of the States.

59. As is the case for paragraph 2 of Article 9, a corresponding adjustment is not automatically to be made under paragraph 3 simply because the profits attributed to the permanent establishment have been adjusted by one of the Contracting States. The corresponding adjustment is required only if the other State considers that the adjusted profits conform with paragraph 2. In other words, paragraph 3 may not be invoked and should not be applied where the profits attributable to the permanent establishment are adjusted to a level that is different from what they would have been if they had been correctly computed in accordance with the principles of paragraph 2. Regardless of which State makes the initial adjustment, the other State is obliged to make an appropriate corresponding adjustment only if it considers that the adjusted profits correctly reflect what the profits would have been if the permanent establishment's dealings had been transactions at arm's length. The other State is therefore committed to make such a corresponding adjustment only if it considers that the initial adjustment is justified both in principle and as regards the amount.

60. Paragraph 3 does not specify the method by which a corresponding adjustment is to be made. Where the initial adjustment is made by the State in which the permanent establishment is situated, the adjustment provided for by paragraph 3 could be granted in the other State through the adjustment of the amount of income that must be exempted under Article 23 A or of the credit that must be granted under Article 23 B. Where the initial adjustment is made by that other State, the adjustment provided for by paragraph 3 could be made by the State in which the permanent establishment is situated by re-opening the assessment of the enterprise of the other State in order to reduce the taxable income by an appropriate amount.

61. The issue of so-called "secondary adjustments", which is discussed in paragraph 8 of the Commentary on Article 9, does not arise in the case of an adjustment under paragraph 3. As indicated in paragraph 28 above, the determination of the profits attributable to a permanent establishment is only relevant for the purposes of Articles 7 and 23 A and 23 B and does not affect the application of other Articles of the Convention.

62. Like paragraph 2 of Article 9, paragraph 3 leaves open the question whether there should be a period of time after the expiration of which a State would not be obliged to make an appropriate adjustment to the profits attributable to a permanent establishment following an upward revision of these profits in the other State. Some States consider that the commitment should be open-ended — in other words, that however many years the State making the initial adjustment has gone back, the enterprise should in equity be assured of an appropriate adjustment in the other State. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. This problem has not been dealt with in the text of either paragraph 2 of Article 9 or

paragraph 3 but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which a State should be obliged to make an appropriate adjustment (see on this point paragraphs 39, 40 and 41 of the Commentary on Article 25).

63. There may be cases where the initial adjustment made by one State will not immediately require a corresponding adjustment to the amount of tax charged on profits in the other State (*e.g.*, where the initial adjustment by one State of the profits attributable to the permanent establishment will affect the determination of the amount of a loss attributable to the rest of the enterprise in the other State). The competent authorities may, in accordance with the second sentence of paragraph 3, determine the future impact that the initial adjustment will have on the tax that will be payable in the other State before that tax is actually levied; in fact, in order to avoid the problem described in the preceding paragraph, competent authorities may wish to use the mutual agreement procedure at the earliest opportunity in order to determine to what extent a corresponding adjustment may be required in the other State at a later stage.

64. If there is a dispute between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure provided for under Article 25 should be implemented, as is the case for an adjustment under paragraph 2 of Article 9. Indeed, as shown in the example in paragraph 55 above, if one of the two Contracting States adjusts the profits attributable to a permanent establishment without the other State granting a corresponding adjustment to the extent needed to avoid double taxation, the taxpayer will be able to use the mutual agreement procedure of paragraph 1 of Article 25, and if necessary the arbitration provision of paragraph 5 of Article 25, to require the competent authorities to agree that either the initial adjustment by one State or the failure by the other State to make a corresponding adjustment is not in accordance with the provisions of the Convention (the arbitration provision of paragraph 5 of Article 25 will play a critical role in cases where the competent authorities would otherwise be unable to agree as it will ensure that the issues that prevent an agreement are resolved through arbitration).

65. Paragraph 3 only applies to the extent necessary to eliminate the double taxation of profits that result from the adjustment. Assume, for instance, that the State where the permanent establishment is situated adjusts the profits that the taxpayer attributed to the permanent establishment to reflect the fact that the price of a dealing between the permanent establishment and the rest of the enterprise did not conform with the arm's length principle. Assume that the other State also agrees that the price used by the taxpayer was not at arm's length. In that case, the combined application of paragraph 2 and of Article 23 A or 23 B will require that other State to attribute to the permanent establishment, for the purposes of providing relief of double taxation, adjusted profits that would reflect an arm's length price. In such a case, paragraph 3 will only be relevant to the extent that States adopt different interpretations of what the correct arm's length price should be.

66. Paragraph 3 only applies with respect to differences in the determination of the profits attributed to a permanent establishment that result in the same part of the profits being attributed to different parts of the enterprise in conformity with the Article. As already explained (see paragraphs 30 and 31 above), Article 7 does not deal with the computation of taxable income but, instead, with the attribution of profits for the purpose of the allocation of taxing rights between the two Contracting States. The Article therefore only serves to allocate revenues and expenses for the purposes of allocating taxing rights and does not prejudge the issue of which revenues are taxable and which expenses are deductible, which is a matter of domestic law as long as there is conformity with paragraph 2. Where the profits attributed to the permanent establishment are the same in each State, the amount that will be included in the taxable income on which tax will be levied in each State for a given taxable period may be different given differences in domestic law rules, *e.g.* for the

recognition of income and the deduction of expenses. Since these different domestic law rules only apply to the profits attributed to each State, they do not, by themselves, result in double taxation for the purposes of paragraph 3.

67. Also, paragraph 3 does not apply to affect the computation of the exemption or credit under Article 23 A or 23 B except for the purposes of providing what would otherwise be unavailable double taxation relief for the tax paid to the Contracting State in which the permanent establishment is situated on the profits that have been attributed to the permanent establishment in that State. This paragraph will therefore not apply where these profits have been fully exempted by the other State or where the tax paid in the first-mentioned State has been fully credited against the other State's tax under the domestic law of that other State and in accordance with Article 23 A or 23 B.

68. Some States may prefer that the cases covered by paragraph 3 be resolved through the mutual agreement procedure (a failure to do so triggering the application of the arbitration provision of paragraph 5 of Article 25) if a State does not unilaterally agree to make a corresponding adjustment, without any deference being given to the adjusting State's preferred position as to the arm's length price or method. These States would therefore prefer a provision that would always give the possibility for a State to negotiate with the adjusting State over the arm's length price or method to be applied. States that share that view may prefer to use the following alternative version of paragraph 3:

Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other Contracting State shall, to the extent necessary to eliminate double taxation, make an appropriate adjustment if it agrees with the adjustment made by the first-mentioned State; if the other Contracting State does not so agree, the Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement.

69. This alternative version is intended to ensure that the State being asked to give a corresponding adjustment would always be able to require that to be done through the mutual agreement procedure. This version differs significantly from paragraph 3 in that it does not create a legal obligation on that State to agree to give a corresponding adjustment, even where it considers the adjustment made by the other State to have been made in accordance with paragraph 2. The provision would always give the possibility for a State to negotiate with the other State over what is the most appropriate arm's length price or method. Where the State in question does not unilaterally agree to make the corresponding adjustment, this version of paragraph 3 would ensure that the taxpayer has the right to access the mutual agreement procedure to have the case resolved. Moreover, where the mutual agreement procedure is triggered in such a case, the provision imposes a reciprocal legal obligation on the Contracting States to eliminate the double taxation by mutual agreement even though it does not provide a substantive standard to govern which State has the obligation to compromise its position to achieve that mutual agreement. If the two Contracting States do not reach an agreement to eliminate the double taxation, they will both be in violation of their treaty obligation. The obligation to eliminate such cases of double taxation by mutual agreement is therefore stronger than the standard of paragraph 2 of Article 25, which merely requires the competent authorities to "endeavour" to resolve a case by mutual agreement.

70. If Contracting States agree bilaterally to replace paragraph 3 by the alternative above, the comments made in paragraphs 66 and 67 as regards paragraph 3 will also apply with respect to that provision.

#### **Paragraph 4**

71. Although it has not been found necessary in the Convention to define the term “profits”, it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD Member countries.

72. Absent paragraph 4, this interpretation of the term “profits” could have given rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are dealt with separately in other Articles of the Convention, *e.g.* dividends, the question would have arisen as to which Article should apply to these categories of income, *e.g.* in the case of dividends, this Article or Article 10.

73. To the extent that the application of this Article and of the relevant other Article would result in the same tax treatment, there is little practical significance to this question. Also, other Articles of the Convention deal specifically with this question with respect to some types of income (*e.g.* paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, paragraphs 1 and 2 of Article 17 and paragraph 2 of Article 21).

74. The question, however, could arise with respect to other types of income and it has therefore been decided to include a rule of interpretation that ensures that Articles applicable to specific categories of income will have priority over Article 7. It follows from this rule that Article 7 will be applicable to business profits which do not belong to categories of income covered by these other Articles, and, in addition, to income which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within Article 7. This rule does not, however, govern the manner in which the income will be classified for the purposes of domestic law; thus, if a Contracting State may tax an item of income pursuant to other Articles of this Convention, that State may, for its own domestic tax purposes, characterise such income as it wishes (*i.e.* as business profits or as a specific category of income) provided that the tax treatment of that item of income is in accordance with the provisions of the Convention. It should also be noted that where an enterprise of a Contracting State derives income from immovable property through a permanent establishment situated in the other State, that other State may not tax that income if it is derived from immovable property situated in the first-mentioned State or in a third State (see paragraph 4 of the Commentary on Article 21 and paragraphs 9 and 10 of the Commentary on Articles 23 A and 23 B).

75. It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term “profits” with a view to clarifying the distinction between this term and *e.g.* the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the Articles on dividends, interest and royalties.

76. Finally, it should be noted that two categories of profits that were previously covered by other Articles of the Convention are now covered by Article 7. First, whilst the definition of “royalties” in paragraph 2 of Article 12 of the 1963 Draft Convention and 1977 Model Convention included payments “for the use of, or the right to use, industrial, commercial, or scientific equipment”, the reference to these payments was subsequently deleted from that definition in order to ensure that income from the leasing of industrial, commercial or scientific equipment, including the income from the leasing of containers, falls under the provisions of Article 7 or Article 8 (see paragraph 9 of the Commentary on that Article), as the case may be, rather than under those of

Article 12, a result that the Committee on Fiscal Affairs considers appropriate given the nature of such income.

77. Second, before 2000, income from professional services and other activities of an independent character was dealt with under a separate Article, *i.e.* Article 14. The provisions of that Article were similar to those applicable to business profits but Article 14 used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. However, it was not always clear which activities fell within Article 14 as opposed to Article 7. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits. This was confirmed by the addition, in Article 3, of a definition of the term “business” which expressly provides that this term includes professional services or other activities of an independent character.

## **ADDENDUM:**

### **RECOMMENDATION OF THE COUNCIL ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS [C(2008)106]**

**As amended on 16 July 2009 [C(2009)88] and on 22 July 2010 [C(2010)105]**

#### **THE COUNCIL,**

Having regard to Article 5(b) of the Convention on the Organisation for Economic Co-operation and Development of 14 December, 1960;

Having regard to the Recommendation of the Council of 23 October 1997 concerning the Model Tax Convention on Income and on Capital (hereinafter referred to as the “Model Tax Convention”) [C(97)195/FINAL], in particular Article 7 (Business Profits) thereof on the taxation of business profits attributable to permanent establishments;

Having regard to the Recommendation of the Council of 13 July 1995 [C(95)126/FINAL], amended on 11 April 1996 [C(96)46/FINAL], 24 July 1997 [C(97)144/FINAL], 28 October 1999 [C(99)138/FINAL], 16 July 2009 [C(2009)88] and 22 July 2010 [C(2010)99], on the Determination of Transfer Pricing between Associated Enterprises;

Having regard to the Report of the Committee on Fiscal Affairs on the Attribution of Income to Permanent Establishments [DAFFE/CFA(93)10/REV2] (hereinafter referred to as the “1993 Report”);

Having regard to the Recommendation of the Council of 26 November 1993 concerning the Attribution of Income to Permanent Establishments with respect to the Model Tax Convention on Income and Capital [C(93)147/FINAL];

Having regard to the Report on the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations [DAFFE/CFA(95)19 and Corrigendum I] adopted on 27 June 1995 by the Committee on Fiscal Affairs, as supplemented by the report on intangible property and services adopted on 23 January 1996 by the Committee on Fiscal Affairs [DAFFE/CFA(96)2] and incorporated in Chapters VI and VII; by the report on cost contribution arrangements adopted on 25 June 1997 by the Committee on Fiscal Affairs [DAFFE/CFA(97)27] and incorporated in Chapter VIII; by the report on the guidelines for monitoring procedures on the OECD Transfer Pricing Guidelines and the involvement of the business community [DAFFE/CFA/WD(97)11/REV1], adopted on 24 June 1997 by the Committee on Fiscal Affairs and incorporated in the Annexes; by the report on the guidelines for conducting Advance Pricing Arrangements under the mutual agreement procedure adopted on 30 June 1999 by the Committee on Fiscal Affairs [DAFFE/CFA(99)31] and incorporated in the Annexes; by the report on the transfer pricing aspects of business restructurings, adopted by the Committee on Fiscal Affairs on 22 June 2010 [CTPA/CFA(2010)46] and incorporated in Chapter IX; revised by the report on comparability and profit methods, adopted by the Committee on Fiscal Affairs on 22 June 2010 [CTPA/CFA(2010)55], which replaced Chapters I-III; modified by an update of Chapter IV which was adopted by the Committee on

Fiscal Affairs on 6 June 2008 [CTPA/CFA(2008)30/REV1]; by an update of the Foreword and of the Preface which was adopted by the Committee on Fiscal Affairs on 22 June 2009 [CTPA/CFA(2009)51/REV1]; and by an update of the Foreword, Preface, Glossary, Chapters IV-VIII and Annexes which was adopted by the Committee on Fiscal Affairs on 22 June 2010 [CTPA/CFA(2010)47] (hereinafter referred to as the “Guidelines”);

Having regard to the 2008 Report on the Attribution of Profits to Permanent Establishments adopted on 24 June 2008 by the Committee on Fiscal Affairs [CTPA/CFA(2008)31] (hereinafter referred to as the “2008 Report”);

Having regard to the 2008 update to the Model Tax Convention adopted on 25 June 2008 by the Committee on Fiscal Affairs [CTPA/CFA(2008)36/ANN], and in particular its revised Commentary on Article 7 (hereinafter referred to as the “2008 Commentary”);

Having regard to the 2010 Report on the Attribution of Profits to Permanent Establishments adopted on 22 June 2010 by the Committee on Fiscal Affairs [CTPA/CFA(2010)38] (hereinafter referred to as the “2010 Report”);

Having regard to the 2010 update to the Model Tax Convention adopted on 22 June 2010 by the Committee on Fiscal Affairs [CTPA/CFA(2010)43], and in particular its new version of Article 7 and accompanying Commentary (hereinafter referred to as the “2010 Commentary”);

Having regard to the differences between the version of Article 7 which existed prior to the 2010 update to the Model Tax Convention (hereinafter referred to as the “pre-2010 Article 7”) and the version of Article 7 introduced by the 2010 update to the Model Tax Convention (hereinafter referred to as the “2010 Article 7”);

Having regard to the fundamental need for co-operation among tax administrations in order to remove the obstacles that international double taxation presents to the free movement of goods, services and capital between both Member countries and non-Member economies;

Considering that the Recommendation of the Council of 23 October 1997 [C(97)195/FINAL] recommends to Member countries that, for the purposes of the bilateral tax conventions concluded on the basis of the Model Tax Convention, the determination of the profits that should be attributed to the permanent establishment situated in one State of an enterprise of another State be made on the basis of Article 7 (Business Profits) of the Model Tax Convention and the Commentary thereon, as modified from time to time;

Noting that practices regarding the attribution of profits to permanent establishments and interpretations of the pre-2010 Article 7 of the Model Tax Convention and of the Commentary thereon as it read prior to the 2008 update to the Model Tax Convention have varied considerably and that this lack of a common interpretation and consistent application of Article 7 can lead to problems of double taxation and double non-taxation;

Noting that these problems are of growing importance in view of the large number of multinational enterprises that operate through permanent establishments, particularly in the financial sector;



Acknowledging the need to achieve consistency in the approaches of tax administrations, on the one hand, and of enterprises, on the other hand, in the determination of the profits attributable to permanent establishments;

**I. RECOMMENDS** to the Governments of Member countries:

(i) that their tax administrations follow, when applying the provisions of their bilateral tax conventions that are drafted on the basis of the pre-2010 Article 7 of the Model Tax Convention, the guidance in the 2008 Report to the extent that its conclusions do not conflict with the 2008 Commentary on Article 7;

(ii) that their tax administrations encourage taxpayers to follow the guidance in the 2008 Report when applying the provisions of bilateral tax conventions that are drafted on the basis of the pre-2010 Article 7 of the Model Tax Convention and, to that end, that they give the 2008 Report publicity in their country and have it translated, where necessary, into their national language(s);

(iii) that their tax administrations follow, when applying the provisions of their bilateral tax conventions that are drafted on the basis of the 2010 Article 7 of the Model Tax Convention, the guidance in the 2010 Report;

(iv) that their tax administrations encourage taxpayers to follow the guidance in the 2010 Report when applying the provisions of bilateral tax conventions that are drafted on the basis of the 2010 Article 7 of the Model Tax Convention and, to that end, that they give the 2010 Report publicity in their country and have it translated, where necessary, into their national language(s).

**II. INVITES** non-Member economies whose bilateral tax conventions contain provisions drafted on the basis of either the pre-2010 Article 7 or the 2010 Article 7 of the Model Tax Convention to take account of the terms of this Recommendation.

**III. DECIDES** to repeal the Recommendation of the Council of 26 November 1993 [C(93)147/FINAL].