



JÖNKÖPING INTERNATIONAL
BUSINESS SCHOOL
JÖNKÖPING UNIVERSITY

Attributing Free Capital and Profit to Permanent Banking Establishments

Master thesis in tax law

Author: Niclas Andersson

Tutors: Giammarco Cottani & Camilla Hallbäck

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Author: Niclas Andersson

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Abstract

By September 2010, in its ongoing effort to clarify the subject of taxing a permanent establishment, the OECD launched a new article 7 in its model tax convention together with a revised version of the report on the attribution of profits to permanent establishments. The article and the report contain a new order of taxation, where a permanent establishment should, in almost all aspects, be treated as a separate entity.

The question is if the new approaches, methods and solutions provided by the article and the report will prove effective against double taxation. The thesis has studied this by analysing and then comparing the OECD's authorised approach with the relevant literature and the current practical situation.

The result of the thesis presents that there are problems with the approaches and methods, which in some situations will cause double taxation, not the least regarding allocation of Free Capital. The thesis also concludes that the way in which article 7 of the model tax convention tries to solve double taxation without unnecessary use of the mutual agreement procedure is flawed in relation to differences in national legislation.

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Abbreviations

AOA	Authorised OECD Approach
BIS	Basel Committee on Banking Supervision of the Bank for International Settlement
CUP	Comparable Uncontrolled Price method
Head Office	A multinational enterprise Head Office
Head State	State of which an enterprise Head Office is situated
Host State	State of which a permanent establishment is situated
KERT	Key Entrepreneurial Risk-Taking Function
MAP	Mutual Agreement Procedure
MC	OECD Model tax Convention on income and on capital 2010
OECD	Organisation for Economic Co-operation and Development
PE	Permanent Establishment
Profit Split	Transactional profit split method
RPM	Resale Price Method
The Report	OECD Report on the Attribution of Profits to Permanent Establishments
TNMM	Transactional Net Margin Method
TP Guidelines	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax administrations 2010

Glossary

Dealing	Any economic relationship between the permanent establishment and any other part of the enterprise
Free Capital	Funding that does not give rise to a tax deductible return in the nature of interest
KERT	The functions which needs active decision-making in regards to the creation and management of a loan
Significant people function	The key functions performed for a specific dealing or for the PE as a whole
Transaction	Any economic relationship between two independent or associated enterprises
Value	Value is in the context of arm's length distance referring to both the arm's length price provided by the transfer pricing methods and to the arm's length interest connected to the Free Capital approaches

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1 Introduction

1.1 Background

The subject of the attribution of profit to a Permanent Establishment (PE) has rarely been subject to any extensive national legislation and there is often no comprehensive legislation defining what a state should tax. Instead the answer is sought in bilateral tax agreements that usually are based on model conventions. The Organisation for Economic Co-operation and Development, (OECD) is one of the leading players with its Model Tax Convention on Income and on Capital (MC).¹

The MC divides taxing rights between countries in order to avoid any double taxation for the taxpayer, as well as providing the involved countries with a proper tax base. This is done through several different articles, where each article cares about one kind of income. General business profits are divided by article 7 MC. The notion is that the state of which a PE is situated, (Host State), may tax an enterprise of the profits generated in that state by the PE. Hence the state of the head office, (Head State), must, in the event of double taxation credit or exempt the enterprise of the profit attributed to the PE.² Article 7 MC draws the outline for taxing a PE. However much more guidance is needed to provide satisfactory means to avoid double taxation. Several attempts to clarify the subject have been made; but these have fallen short of fully avoiding double taxation.³

The latest attempt by the OECD to clarify the subject resulted in the “*2008 report on attributions of profits to permanent establishments*”, which entered into force 2008. This report was not based on the prevailing wording of article 7MC, which meant that at least extensive changes had to be made to the existing article. It was solved by changing the commentary to the existing article 7 MC in order to apply the 2008 Report on existing MC agreements. However, the OECD created a new article 7 MC in order to fully apply the new solution, which entered into force in

¹ IFA, *Attribution of Profits to Permanent Establishments* page 35 – 36, Owens J, Bennett M, *OECD Model Tax Convention – Why it works*.

² Dahlberg, M, *Internationell beskattning* page 147, Article 7.1 - 2 MC.

³ Jernkrok L, *Internprissättning och fasta driftsställen* page 676.

2010. This made it necessary to revise the Report in its reference and relation to article 7 MC. This revised version of the Report entered into force in 2010. Hence, guidance for pre-2010 treaties is sought in the 2008 version and guidance for the new article 7 MC is sought in the 2010 version (The Report).⁴

The solution brought forward by the Report, the so called Authorised OECD Approach (AOA), is the creation of a fiscal fiction, where the PE is considered as a separate entity. The AOA creates this fiction by attributing functions, assets, risks and Free Capital to the different parts of an enterprise. This approach has been acknowledged as better reflecting the economic reality than past solutions.⁵

Treating the PE as a separate entity as said means that it may be attributed transactions which the enterprise legally as a whole conducts with independent enterprises. It does also mean that dealings made within the enterprise have to be priced. The price is calculated by using an arm's length price, corresponding to a price paid by independent enterprises. This is done by using the principle of arm's length by analogy from the OECD Transfer Pricing Guidelines (TP Guidelines).⁶

All enterprises have the ability to create a PE, but one usually exists in the financial sector due to fiscal provisions, where Swedish banks operating by a PE abroad, and foreign banks operating by a PE in Sweden is a common sight.⁷ Loans stands for the predominant part of the dealings conducted within a traditional wholesale bank and the creation and management of a loan may result in several different dealings within an enterprise, for instance connected to any monitoring or managing risk function.

The Reports tries to solve the subject with a completely new approach attached with a completely new article. This raises questions whether the OECD has created new problems while trying to solve the old.

⁴ Commentary article 7 MC para 6- 9, Report on the Attribution of Profits to Permanent Establishments para 7 page 9, para 3 page 11 .

⁵ Burgers, I J.J, *Concluding remarks* chapter 7.

⁶ Report on the Attribution of Profits to Permanent Establishments para 10 page 8.

⁷ IFA, *Attribution of Profits to Permanent Establishments* page 630.

1.2 Purpose

The purpose of the thesis is to evaluate the approaches used for allocating Free Capital and the methods used for attributing profit to Permanent Banking Establishments, in accordance with the 2010 versions of article 7 MC and the Report.

- The evaluation of the approaches is based on finding the approach that will provide the most proper arm's length value of Free Capital for a Permanent Banking Establishment.
- The evaluation of the methods is based on finding the method that will provide the most proper arm's length price for any monitoring risk function service and any managing risk function service related to a loan. These services will be performed by one part of a bank to the PE which will have the economic ownership of the loan.
- The approaches and the methods ability to find a proper arm's length value will be evaluated in the context of avoiding double taxation according to article 7 MC.

1.3 Methodology

The thesis will initially use a clarifying descriptive method that presents the AOA on how to tax a PE. The relevant information will primarily be extracted from the Report, the MC articles, its commentaries and the TP guidelines; however other OECD materials will also be used. The text will gradually move from pure reviewing to pure analytical where the AOA is presented and simultaneously compared and analysed. This is done by combining the clarifying descriptive method with a comparative method. The comparison will be against other relevant literature and to the current practical situation, primarily from a Swedish perspective, which is explained later on in the methodology and in the delimitations.

The methods are traditional juridical methods, however there is a lack of national legislation which otherwise would have been the natural starting point. Instead the subject is as shown by the use of material highly intergovernmental, regulated by international associations such as the OECD.

Since a state when signing a MC, depending on its view on international law, either implement the MC into national legislation or regard it as having the same legal value as national law, the highest value would be attributed to the MC articles.⁸ The articles are from a Swedish perspective followed in legal value by the commentaries and the reports, where the latter two have the same legal value.⁹ This value is not defined, however countries usually declare their intent to either follow or reject a commentary or report. Much of the OECD materials do consequently have a larger legal source value than the material of comparison. This difference in legal source value should however not be overestimated or compared to the relationship between national legislation versus literature, which is much broader.

Allocation of Free Capital and profit to a PE is a global problem with global solutions. The methods and approaches used in the Report will thereby have the same general impact wherever they are applied. The idea of general methods and approaches would fail if there were too many country specific circumstances that could affect the arm's length price in such a way that double taxation would arise.

The thesis will therefore be written in a global perspective. However, irrespective of this fact, national legislation may have some impact on the preferred method or approach. Hence, Swedish legislation will be mentioned where it may have an impact on the global solution in order to demonstrate to the reader where difficulties may arise.

Combined with this semi global perspective is an intercompany view where focus is upon dealings within a wholesale banking enterprise. But information regarding retail banking will be used as far as it is generally applicable.

⁸ Dahlberg, M, *Internationell beskattning* page 158.

⁹ RÅ 1971 ref 50.

1.4 Delimitations

How to attribute profit to a PE is not where one starts off when venturing in to the field of international taxation. Consequently the thesis will start with the presumption that the reader already has an understanding of international tax law, international treaty law and transfer pricing. The thesis will therefore not explain the definition of a PE and the existence of it will be presumed. The same applies to the arm's length principle and the existence of a dealing.¹⁰

The thesis will only regard the 2010 versions of the MC, the TP Guidelines and the Report. Further, the second alternative of article 7.3 MC provided by the commentaries of that article will be disregarded. Countries may have different view on when a profit is realised and this may cause problems when adjusting profits by article 7 MC. The thesis however limits itself from such discussion.

The thesis is as said in the methodology written in a global perspective. This fact limits the thesis so as to not regard EU legislation. The regard taken to the Swedish situation and Swedish legislation is in no way exhaustive, as it only serves as exemplification. This Swedish perspective is chose by the simple reason of that the author is Swedish.

All enterprises have the ability to create a PE, but one usually exists in the financial sector and the AOA differ in application depending on the business conducted within this sector. Banking PE's are from a Swedish perspective largely used both abroad and within. The thesis is thus limited to only regard banking PE's.

A banking enterprise can be categorised as a retail or wholesale, where the different types of banking may have an impact on the AOA. The author has made the decision to focus on wholesale banking and loans, which stands for the predominant part of the dealings conducted within a traditional wholesale bank. No regard will hence be taken to other types of assets than financial.

The creation and management of a loan may result in several different dealings within an enterprise, where the thesis will focus on dealings connected to func-

¹⁰ See Glossary for the meaning of the word dealing.

tions monitoring and managing of the risks. However the general guidance and answers provided by the thesis will be applicable to all functions.

1.5 Disposition

The thesis is, as shown in the methodology, heavily dependent on the MC and the Report. These sources are so interconnected that the thesis is forced to, in order to fully describe article 7 MC, present some features in chapter two which then are fully described in the following chapters. The text will become more analytical as the thesis progresses from pure descriptive towards comparing as described in the methodology, which already will become apparent in chapter two.

Chapter two

The first waypoint in solving any international tax issue is the MC. Hereby this second chapter, the first one actually examining the subject, provides the thesis with a review and discussion on how to tax an enterprise through the use of the MC, with focus on article 7 MC.

Chapter three

The MC does not provide sufficient information to solve the purpose. The Thesis therefore follows by presenting the basics of the Report.

Chapter Four

The chapter begins with introducing the reader how to separate a PE into one entity by the first step of the AOA. It continues with exploring the questions regarding funding a PE, which arises when the PE is separated. The main focus is on the latter part.

Chapter Five

Before the analysis of the approaches and methods the thesis must present the comparability analysis which is the first step in providing an arm's length amount.

Chapter Six

The thesis continues on the subject of funding and capital, presenting the different approaches used to determine Free Capital. It is followed by an analysis evaluating the different approaches for allocating Free Capital.

Chapter Seven

The above chapters concluded the separation of the PE and its funding. This chapter follows with the basics on how profit is attributed to the PE in accordance with part two of the Report.

Chapter Eight

This Chapter could be seen as comparable to chapter six. The transfer pricing methods of the TP Guidelines are first presented and then analysed in accordance with the purpose.

Chapter Nine

This chapter combines the knowledge given by the preceding chapters and analyses the approaches and methods ability to avoid double taxation in accordance with article 7 MC.

Chapter Ten

This last chapter of the thesis provides the conclusion on the purpose.

2 The OECD MC

2.1 Introduction

This chapter provides the thesis with the basic waypoints in order to attribute taxing rights and begins with explaining the structure of the MC. It continues by exploring article 7 MC in order to give the reader the basic idea on how to attribute profits to a PE and what happens in case of double taxation.

2.2 Taxation according to the MC

The MC bilaterally, or multilaterally, divides taxing rights to countries by the use of different articles. These articles do not by themselves give a complete answer on how countries should compute the proper value to divide. More guidance is thereby received by commentaries attached to the articles, or by external reports such as the Report or the TP Guidelines.¹¹

Article 5 MC defines the PE. However, its taxing rights are not provided for here, but in article 7 MC, which is the main and general article regarding business profits. There are also special income articles regarding the allocation of dividends and interest which usually overrides article 7 MC. But they do not apply to dealings and transactions effectively connected to a PE.¹²

The main article regarding transfer pricing is article 9 MC, where transfer pricing is regulated in the form of transactions which takes place between associated enterprises.¹³ Article 9 MC provides a general tax concept that stipulates that a price between two related enterprises should be at arm's length. However, the article does not provide for the full answer how to accomplish this. The article is thereby connected with the TP guidelines that provide such in-depth guidance on how to calculate the transfer price. This general concept of an arm's length price is also

¹¹ Dahlberg, M, *Internationell beskattning* page 161.

¹² Commentary article 7 MC para 1-2, Article 10, 11 MC.

¹³ Article 9 MC.

used by article 7 MC and the Report, which have the same kind of relationships as article 9 MC and the TP Guidelines.¹⁴

A taxpayer may use two different articles, depending on the situation, if double taxation still would arise when dividing the profit by the MC. Either the taxpayer could use article 24 MC pleading that the taxpayer has been discriminated against. This article does not however have the broad scope that one could imagine. It only applies to direct discrimination, and it is in this context usually not applicable.¹⁵

Or, the taxpayer could invoke the Mutual Agreement Procedure, (MAP), contained in article 25 MC. The OECD states in the Report that this article sometimes will be necessary to use in order to avoid double taxation for the PE. But there has generally been a bad tendency that MAP cases stay pending, due to lack of interest from tax authorities to solve a case and thus possibly lose the right of taxation.¹⁶

The OECD has in recent years tried to solve this problem which has led to an amendment of article 25 MC in 2008. This amendment included an arbitration clause in article 25.5 MC. The Arbitration clause is however only seen as a complement to the MAP, where the MAP reactivates after the arbitration has settled any issue of where countries could not agree. It should be noted that the contracting states are the parts in the MAP and consequently also in arbitration. Though the taxpayer has the opportunity to reject the agreed price after the taxpayer may try to apply any domestic remedies available.¹⁷

Article 25 MC states that the arbitration clause becomes active if the countries are unable to come to an agreement within two years from the start of the negotiations. The countries already have three years to start negotiations from the time they have been notified of the double taxation, which gives a total of five years before any arbitration may become necessary. Article 25 MC does not provide any

¹⁴ Transfer Pricing Guidelines para 15 page 20.

¹⁵ Dahlberg M, *Förbud mot diskriminering i OECD:s modellavtal* page 43 – 44.

¹⁶ Report on the Attribution of Profits to Permanent Establishments Para 149 page 42, Report improving the resolution of tax treaty disputes para 10 – 11 page 4.

¹⁷ IBFD, *Bulletin for international taxation – 2008 OECD Model: The New Arbitration Provision* Page 210.

procedural requirements for the actual arbitration, but a sample is annexed that provides for a ruling within one year.¹⁸

The average time to conclude a MAP case involving Swedish tax authorities has declined notably in the recent years, from an average of nine years in 2003 to less than one year in 2009. By the same time Sweden went from solving two cases in 2003 to 38 in 2009 and the caseload rose from an open inventory of nine cases to 64. The shift to a larger caseload however more solved cases and less average time of completion seems to take place around 2006 – 2007. This shift relates to the fact that the Swedish tax authorities took over responsibility for MAP cases from the department of finance in 2006.¹⁹

2.3 Article 7 MC

2.3.1 Article 7.1 MC

This first paragraph of article 7 MC grants the taxing rights of income derived from an enterprise to the contracting states in order to avoid the MAP.²⁰ The notion is that the Head State has the primary right of taxation,²¹ where the Host State may only tax an enterprise for the profits which are attributable to the PE.²² Two important principles can be drawn out of this. First, a PE shall be taxed in the Host State. Second, there is no so called “force of attraction” which means that the Host State shall not tax more than what can be attributable to the PE.²³ Hence income derived from the Host State, however not connected to the PE should not be taxed in the Host State, just because of the presence of a PE.²⁴

¹⁸ Article 25 MC.

¹⁹ OECD, *MAP program statistics for the 2009 reporting period* Country: Sweden, SFS 2000:1077, *Om handläggning av ärenden enligt skatteavtal*.

²⁰ Article 7.1 MC.

²¹ Dahlberg M, *OECD:s nya tvåstegsmodell för att hänföra inkomster till fasta driftsställen – en kritisk analys* page 635.

²² Article 7.1 MC, Report on the Attribution of Profits to Permanent Establishments para 49 page 22.

²³ Report on the Attribution of Profits to Permanent Establishments para 50 page 22.

²⁴ Commentary article 7 MC para 11-12.

It should also be noted that the general result of the enterprise does not affect profits that could be allocated to the PE, and therefore the amount taxed in the Host State. The enterprise could as a whole make losses, however the PE could still be taxed as profitable. This originates from the functionally separate entity approach,²⁵ which is explained below.²⁶

2.3.2 Article 7.2 MC

The second paragraph of the article builds on the former, providing the prerequisite for how an enterprise would calculate an arm's length price on any dealing or transaction involving the PE. This is done by declaring that a PE should, in particular with dealings with other parts of the enterprise, be treated as a separate and independent enterprise.²⁷ The wording "*...in particular with dealings with other parts of the enterprise*"²⁸ is not intended to limit the application of the article only to dealings, it is applying to transactions as well. A transaction as covered by article 9 MC between an enterprise and its subsidiary could also be a dealing within the scope of article 7 MC, if the transaction is performed from the PE to the subsidiary.²⁹

Stating that the PE should be treated as a separate entity demands guidance on how to create such fiction. The approach provided for in the article is to separate the PE by regards to the functions performed, assets used and risks assumed by that PE.³⁰ However, the in-depth guidance is instead sought in the Report, which is the subject of the following chapters.³¹

Stated in this second part of the article is also that the Head State is obliged to make use of article 23 MC, crediting or exempting taxation of any profits attributed

²⁵ Commentary article 7 MC para 17, Hall M, *fördelning av vinster till fasta driftsställen* page 231.

²⁶ See chapter 3.2.

²⁷ Article 7.2 MC, Commentary article 7 MC para 16.

²⁸ Article 7.2 MC.

²⁹ Commentary article 7.2 MC para 24.

³⁰ Article 7.2 MC, Commentary article 7 MC para 19 – 20.

³¹ See chapters 3 and 4.

to the PE, in case of double taxation. This obligation derives from the wording “...in each contracting state”.³²

2.3.3 Article 7.3 MC

This third part of the article does not have the same connection to the Report as article 7.1 and 7.2 MC as they divide and limit a state's ability to tax. Article 7.3 MC stands alone, and it is enacted when any of the parties involved considers that an arm's length value has not been reached where double taxation cannot be avoided.³³

The solution provided by 7.3 MC is best presented by the following examples:

A bank has, by the same method in both countries calculated that a service provided by a part in the Head State to a PE has a price of 20. No state should make any alteration of this price if they accept that price as within arm's length. However, the article does not through the wording "should" stop another state from alternating the price to a price which in the eyes of that other state better corresponds with an arm's length price.³⁴

The same conditions apply, however the Head State does not accept the price of 20 as within arm's length while regarding 22 as within. (It is also allowed to adjust if 22 is viewed as better corresponding to the arm's length principle). The Head State will now alter the price to 22, where the price in the Host State still is 20. The Host state is now obliged to make a corresponding adjustment to 22, if the Host State accepts 22 as within arm's length. This is indifferent of the possible opinion of the Host State that the price of 20 correspond better to the arm's length.³⁵ It has been stated that this may create an incentive for tax authorities to adjust a price as fast as possible, in order to “lock” the price adjusted.³⁶

³² Article 7.2 MC, Commentary article 7 MC para 27.

³³ Article 7.3 MC.

³⁴ Commentary article 7 MC para 47 page 31.

³⁵ Commentary article 7.3 MC para 55.

³⁶ Treaty Policy Working Group, *RE: Revised Draft Article 7 and Commentary* Page 3.

Same fact as above, but the Host State does not accept the adjustment from 20 to 22 as within arm's length. Hereby article 7.2 MC is from the viewpoint of the Host State not fulfilled, consequently not obligating the Host State to make any corresponding adjustment. The double taxation may in this case be solved by the MAP.³⁷

Same conditions as above and both states make adjustments to 22 which by their view is within arm's length. The bank is however not considering 22 as within arm's length. Hereby the MAP becomes applicable if the bank can prove that the states in fact are out of arm's length range. The MAP is hence only applicable when a state has acted inconsistently with 7.2 MC.³⁸

A variation of this example is that the bank is obliged by national legislation to use different methods in each state calculating the price of the service. This may produce differences where the price calculated in the Head State is 22 and in the Host State 20. However, if both values are at arm's length, none of the states need adjust their prices.³⁹

Sweden has to the commentary of article 7 made an observation stating that it may not regard any price calculated through Free Capital approaches as falling within arm's length.⁴⁰ Hence the risk of double taxation becomes higher.

2.3.4 Article 7.4 MC

The last part of the article is a clarification that other articles relating to other income takes precedence over article 7 MC. However, article 7 MC applies nevertheless, if the transaction is efficiently connected to the PE.⁴¹ The Report did not require any changes of this part of the article and it should be seen as kept only to avoid any uncertainty on how to define the term "profits" within article 7 MC.⁴²

³⁷ Commentary article 7.3 MC para 56.

³⁸ Commentary article 7.3 MC para 52.

³⁹ Ernst & Young, *Comments on revised discussion draft of a new article 7 of the OECD Model Tax Convention* chapter 2:2.

⁴⁰ Commentary article 7.3 MC para 82.

⁴¹ Article 10.5, 11.4 MC.

⁴² Commentary article 7.4 MC para 71.

3 The Report and the AOA

3.1 Introduction

The reader has now been provided with the basics of how to tax an enterprise with a PE by the MC and its article 7. The previous chapter also stated that the wording of the MC does not provide enough guidance to be able to separate the PE from an enterprise. In order to achieve this one has to examine the guidance provided by the Report. This chapter explains the general concept behind the Report and its connection with the MC and the TP guidelines.

3.2 General

The Report is the latest contribution by the OECD in the attempt to find an approach to attribute profits to a PE that would solve the variation of interpretations of article 7 MC.⁴³ The main problem has been how to interpret “business income” from article 7.1 MC. There have been primarily two different approaches, namely the “relevant business activity approach” and “The functional separate entity approach”.⁴⁴

The first approach states that the profit or loss attributed to the PE is dependent on the result made by the enterprise. A potential profit made by the PE in one activity must therefore be adjusted if other parts of the enterprise also conduct business in the same activity, however making a loss.⁴⁵ The approach is further only allowing cost based calculations of price for dealings, disregarding any potential profit.⁴⁶

⁴³ Report on the Attribution of Profits to Permanent Establishments para 2 -3 page 11.

⁴⁴ Jernkrok L, *Internprissättning och fasta driftsställen* page 676.

⁴⁵ Jernkrok L, *Internprissättning och fasta driftsställen* page 676 - 677.

⁴⁶ IFA, *Attribution of Profits to Permanent Establishments* page 30.

The latter approach, “The functional separate entity approach”, states that all transactions and dealings should be made according to the arm’s length principle, as if the PE were a separate entity. This approach does as a result not regard the profits or loss made by the enterprise as a whole.⁴⁷

This latter approach is the interpretation of article 7 MC used by the Swedish authorities. Though, it has been argued if Sweden applies the method to full extent. There is old case law where Swedish banks have not been able to allocate capital to their PE’s. Therefore profit calculated by the AOA may be contested by the tax authorities in order to clarify the legal position. However, there is almost non existing national legislation on the subject and Sweden tends to give great influence to OECD reports.⁴⁸

The OECD decided to use this latter approach which became the AOA of the Report. This is defined as:

“...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.”⁴⁹

This AOA enables a link between the Report and the MC and its article 7.2. The MC will work properly, avoiding any unnecessary double taxation as long as the AOA is applied in a correct way. However dependent if there is possibility to find an arm’s length value at all.

The choice of the separate entity approach as the AOA also enabled a link between the Report and the TP guidelines, where the latter in some aspects apply by analogy.⁵⁰ The differences between associated enterprises and PE’s make it impossible

⁴⁷ IFA, *Attribution of Profits to Permanent Establishments* page 30.

⁴⁸ RÅ 1971 ref 50, IFA, *Attribution of Profits to Permanent Establishments* page 631, 634.

⁴⁹ Report on the Attribution of Profits to Permanent Establishments para 8 page 12

⁵⁰ Jernkrok L, *Internprissättning och fasta driftsställen* page 678.

to apply the TP Guidelines directly, and there will never be a total equality between a profit made by an associated enterprise and a PE.⁵¹ This has however never been the goal; instead the notion has been that the same principles shall be applied to dealings between the enterprise and its subsidiary as between the enterprise and the PE.⁵²

The AOA is divided into two separate steps in order to achieve this goal properly. The second step attributes profits and losses to the PE and will be presented in chapter seven. The first step however separates the PE from the enterprise and how this is done is described in the following chapters.

⁵¹ Russo R, *The Attribution of Profits to PEs; The taxation of intra-company dealings* page 19.

⁵² Report on the Attribution of Profits to Permanent Establishments para 4 page 64.

4 Step one - the functional and factual analysis

4.1 Introduction

This chapter continues on the path taken by the previous chapter by presenting and discussing the first step of the AOA. This is done by first looking at the functional and factual analysis and the basic idea behind it. Followed by how functions assets and risk are attributed to a PE of a bank. This attribution is essential in order to create a separate entity were the attributing of functions especially affects all later parts of the analysis.

The creation of a fictional separate entity also creates the need to allocate funding to the PE. This is the topic of the latter parts of this chapter starting in subchapter 4.6. Funding is an essential part of banking in order to assume realised risk, and the capital used to fund the PE may come from various sources, where some of those will affect the taxation of the profits allocated.

4.2 General

The separation of a PE into a single entity is by the Report done by using a analysis which is based on the functional analysis found in the TP guidelines.⁵³

The aim of the two analyses however differs somewhat where the functional analysis has as its aim “...to identify and compare the economically significant activities and responsibilities undertaken.”⁵⁴ The aim of the analysis in the Report is however to fully create a fiction of a separate entity. It thus becomes apparent that the latter analysis needs to have further applications. This is reached by extending the functional analysis with a factual analysis that includes a thorough analysis of the assets used, the risk assumed and the funding needed by a PE. So, the functional and factual analysis is therefore analysing the functions performed, the assets used and the risk assumed.⁵⁵

⁵³ Report on the Attribution of Profits to Permanent Establishments para 62 page 78.

⁵⁴ Transfer Pricing Guidelines para 1.36 page 43.

⁵⁵ Report on the Attribution of Profits to Permanent Establishments para 13, 15 page 14 - 15.

This functional and factual analysis may start in the book accounts of the enterprise and the PE, which would be in an ideal world consistent with the analysis.⁵⁶ The OECD however requires the book entries of the PE and the enterprise to be symmetrical if used. Since state bookkeeping regulation often differs it has been expressed as a bit harsh.⁵⁷ The OECD also stresses that regard has to be taken on matters which are off balance sheet, especially concerning risks.⁵⁸ This has also been criticised as being all too ready to assume that internal dealings will be manipulated.⁵⁹ But there is no need to analyse every single activity, the analysis may be at portfolio or book level for instance for similar assets and risks.⁶⁰

4.3 Functions performed

Determining functions performed is the first part of the functional and factual analysis and it starts by determining the functions performed by the personnel for the enterprise as a whole. As for instance who is performing customer service, who is taking decisions and who is managing accounts. These “People functions” are subsequently assessed by their importance in the transactions and dealings of which the PE is a part of. This assessment provides for what the Report calls “significant people functions”, which are the key functions performed for a specific dealing or for the PE as a whole.⁶¹

What turns out to be the significant people functions vary from different sectors. A manufacturing enterprise does not have the same structure, and therefore not the same significant people functions as a financial institute. Neither is it certain that banks trading in the same field have the same business structure or business

⁵⁶ Report on the Attribution of Profits to Permanent Establishments para 62 page 78 – 79.

⁵⁷ Dahlberg M, *OECD:s nya tvåstegsmodell för att hänföra inkomster till fasta driftsställen – en kritisk analys* page 639.

⁵⁸ Report on the Attribution of Profits to Permanent Establishments para 19 page 68, para 35 page 72, para 51 page 75, para 89 page 84, para 130 page 92.

⁵⁹ IFA, *Attribution of Profits to Permanent Establishments* page 55.

⁶⁰ Report on the Attribution of Profits to Permanent Establishments para 76 page 82.

⁶¹ Report on the Attribution of Profits to Permanent Establishments para 62 page 25.

model. A Swedish bank with a centralised organisational structure would not be comparable to an enterprise established in a more hierarchical culture.⁶²

A bank's business activity primarily involves some forms of financial assets, many of which fundamentally connected to the risks they create.⁶³ It is therefore likely that the same person who is in control of the financial asset also handles the risk. The asset and the risk would also bein the same time. The assessment of special people functions is for banks therefore replaced by assessing the "Key Entrepreneurial Risk-Taking Functions", (KERT).⁶⁴ This is described as the functions that need active decision-making in regards to the creation and management of a financial asset.⁶⁵ An example is that a staff member could be dependent on predefined settings controlled by the Head Office, limiting his / hers ability to take an active decision and therefore placing the function at the Head Office instead of keeping it with the person who performs the function.

Traditional banking businesses are the borrowing and lending of money which is done by loans.⁶⁶ The creation and management of a loan is according to the Report divided into a number of specific functions which all needs to, at least initially, be performed by the enterprise as a whole.⁶⁷

These functions are, in the creation of a loan; sales/marketing, sales/trading, trading/treasury and sales/support. When the loan is created it has to fulfil other criteria to be seen as henceforth managed by the bank, these are; loan support, monitoring risk, managing risk, treasury function and the sales trading function.⁶⁸

⁶² Report on the Attribution of Profits to Permanent Establishments para 16 page 15.

⁶³ Report on the Attribution of Profits to Permanent Establishments para 21 page 69.

⁶⁴ Report on the Attribution of Profits to Permanent Establishments para 16 Page 15.

⁶⁵ Report on the Attribution of Profits to Permanent Establishments para 8 page 66.

⁶⁶ Report on the Attribution of Profits to Permanent Establishments Para 5 page 65.

⁶⁷ Report on the Attribution of Profits to Permanent Establishments para 6-7 page 65 - 66.

⁶⁸ Report on the Attribution of Profits to Permanent Establishments para 6-7 page 65 – 66, See the appendix for the full list with a brief explanation.

Several of these functions may be concluded as KERTs for the same dealing and there is no defined inner hierarchy.⁶⁹ However, the functions that usually are the most important KERTs are for the creation of the loan; the sales/trading function and for the management of the loan: the managing risk function.⁷⁰

A function such as the management risk has to be split, if it cannot be effectively attributed by the KERT to only one part of the bank. A situation could thus arise where two parts are deemed to share the function performed. The frequency of split functions seems to be relatively high between associated financial enterprises.⁷¹ One can consequently make the assumption that functions are even more intertwined within a bank.

The KERT approach has been criticised for being over-prescriptive. There have been concerns about the complexity of the system, which could look good in theory however hard to apply in practice. Thus leading to an even greater chance of that a function may not be fully attributed to only one part of the enterprise.⁷²

4.4 Assets used

When attributing assets to the different parts of a bank one has to bear in mind that the bank as a whole is always the legal owner of all assets. This fact is by the Report solved by stating that the bank has the legal ownership, while its parts have the “economic ownership”.⁷³ The thought is that a part will have the economic ownership of the assets it needs to support or perform the functions allocated to it.⁷⁴

⁶⁹ Report on the Attribution of Profits to Permanent Establishments para 16 page 15.

⁷⁰ Report on the Attribution of Profits to Permanent Establishments para 8 page 66.

⁷¹ The Taxation of Global Trading of Financial Instruments para 134 page 34.

⁷² IFA, *Attribution of Profits to Permanent Establishments* page 55, Jernkrok L, *Internprissättning och fasta driftsställen* page 684.

⁷³ Report on the Attribution of Profits to Permanent Establishments para 72 page 28.

⁷⁴ IFA, *Attribution of Profits to Permanent Establishments* page 103.

Simply leaving it up to a bank to nominate where its loans are owned could provide an incentive to allocate assets in a way that would lead to an inappropriate allocation of profit.⁷⁵ The functional and factual analysis thereby states that a loan is attributed based on where the KERT connected to that loan is based.⁷⁶

The KERT functions are divided into several functions that relates to either the initial creation or the subsequent management of a loan.⁷⁷ Hence, a PE would be defined as the initial economic owner, if the KERT comes to the conclusion that the KERT function(s) attached to that creation is / are solely performed by the PE. The subsequent economic ownership of the asset is then related to the part that performs the KERT attached to the management of the loan.

As functions may be split so can assets. Parts of the bank may thus be seen as jointly creating or managing a loan in the event where the KERT function(s) relating to the loan has/have been split when attributing functions.⁷⁸

4.5 Risks assumed

Attributing risk is done in the same manner as assets. Risks are legally borne, as assets are legally owned, by the bank as a whole. Hence the functional and factual analysis states that risk is attributed based on where the KERT connected to that risk is based.⁷⁹ This has the effect that the initial assumption and subsequent bearing of the risk relates to the functions in the same way as assets do explained above,⁸⁰ and the risk is split if the KERT function is.⁸¹

⁷⁵ Report on the Attribution of Profits to Permanent Establishments para 18 page 15.

⁷⁶ Report on the Attribution of Profits to Permanent Establishments para 59 page 24.

⁷⁷ See chapter 4.3.

⁷⁸ Report on the Attribution of Profits to Permanent Establishments para 74, 75, 77 page 81 - 82.

⁷⁹ Report on the Attribution of Profits to Permanent Establishments para 68 page 27 para 59 page 24.

⁸⁰ See chapter 4.4, Report on the Attribution of Profits to Permanent Establishments para 67 page 80.

⁸¹ Report on the Attribution of Profits to Permanent Establishments para 75 page 82.

Risks may not be visible in the same way as assets. It is therefore important to not only regard the balance sheet when analysing risks. Banks may also have risks that are not directly linked with the asset and the KERT, such as country risk which may relate to the inner stability of the state in question.⁸²

Other important risks connected to a loan which has to be monitored and managed are the credit risk, the market interest risk and the market foreign exchange risk. The first relates to the debtors ability to repay. The second becomes active when a loan has a fixed rate while the market rate fluctuates and the third applies when the loan is made in a foreign currency.⁸³

A risk may subsequently be borne by the same part which initially assumed the risk. However a risk may subsequently be transferred to another part of the enterprise without transferring the economic ownership of the asset. The Report states this as "*...Risk follows functions*".⁸⁴ The functional and factual analysis must hence consider whether a risk has effectively been obtained by another part of the bank or if that other part merely performs a service where the economic ownership still belongs to the initial owner. This have implications regarding the profit attributed to the PE and is dealt with below.⁸⁵ It is also, since the bank needs capital and funding in order to support any realisation of risks, of great importance where the risk is assumed and later on retained.⁸⁶

⁸² Report on the Attribution of Profits to Permanent Establishments para 18 page 68.

⁸³ Report on the Attribution of Profits to Permanent Establishments para 17 page 68.

⁸⁴ Report on the Attribution of Profits to Permanent Establishments para 44 page 73.

⁸⁵ See chapter 7.2.

⁸⁶ Report on the Attribution of Profits to Permanent Establishments para 17, 20 page 68 - 69, para 173 page 100.

4.6 Funding the PE

4.6.1 General

A bank needs to be funded for two reasons. Firstly, it has to, as said above,⁸⁷ have enough capital to be able to support any realisation of a risk connected to its assets, for instance to a loan that is not repaid. Secondly the bank has to have capital in order to support its business functions, i.e. lending money.⁸⁸

Capital is by the Report divided into three main sources: contributions from shareholders, retained profits and borrowings. The two first sources are equity capital and the last is labelled as debt. Debt capital can further be divided into several different kinds of debt, such as regular loans or long dated loans which are not subordinated. Subordinated loans qualify as either debt or equity capital depending on national legislation.⁸⁹

All kinds of equity capital and debt capital can be used to support the business functions of a bank.⁹⁰ However not all capital can be used to support the risks assumed. Payments and interest payments on debt capital is usually, depending on national legislation deductible. Then there is capital of an "*...investment that does not give rise to an investment return in the nature of interest that is deductible for tax purposes by the rules of the "Host State".*" This latter form of capital, usually equity capital, is the one used for supporting the risk assumed and the Report refers to this type of capital as Free Capital.⁹¹

Banks must also in contrast to most regular enterprises have regulatory capital, which is explained as the amount that a state see as enough to for a bank in order to assume risks. This regulatory capital is somewhat standardised since the Basel Committee on Banking Supervision of the Bank for International Settlement, (BIS)

⁸⁷ See chapter 4.5.

⁸⁸ Report on the Attribution of Profits to Permanent Establishments para 23, 26 page 69 – 70.

⁸⁹ Report on the Attribution of Profits to Permanent Establishments para 105 page 34.

⁹⁰ Report on the Attribution of Profits to Permanent Establishments para 26 page 70.

⁹¹ Report on the Attribution of Profits to Permanent Establishments para 105 page 34 - 35.

sets an internationally accepted standard of the minimum amount of regulated capital. Countries are however free to adopt a higher amount.⁹²

Regulatory capital is not equivalent to what the Report calls Free Capital, instead BIS divides regulatory capital into Tier 1 and Tier 2, where Tier 1 usually is Free Capital and Tier 2 is subordinated debts and long term loans. The long term loans may qualify as regulatory capital. the length of the loan allows that any losses can temporarily be funded from such loans until the bank is able to generate sufficient profits to offset those losses, enabling the bank to assume risk. "Usually" refers to that there could be national disparities where some forms of capital are listed as Tier 1 for accounting purposes qualify as debt capital for tax purposes.⁹³

The minimum requirements set by BIS are currently regulated by the BASEL 2 framework, where total capital has to be 8 % of the value on assets connected risks, out of which Tier 1 has to be a minimum of 4 %.⁹⁴ These percentages will rise as a consequence of the financial crisis, where the Tier 1 capital will be phased to a level of 6 % of the total capital by 2015.⁹⁵

Another important subject regarding the funding of a PE is its credit worthiness, which also is an important factor analysing the different approaches and methods below.⁹⁶ The functional and factual analysis is as explained dividing functions, assets and risks to the separate parts of an enterprise. A Head Office may have a fictional higher creditworthiness than the PE and it would therefore be reasonable to also provide different parts of the enterprise with different creditworthiness. It has however been seen as to difficult to attribute creditworthiness to separate parts of one single enterprise, which has led to that a PE has the same creditworthiness as the enterprise as a whole.⁹⁷

⁹² Report on the Attribution of Profits to Permanent Establishments para 32 - 33 page 71.

⁹³ Report on the Attribution of Profits to Permanent Establishments para 24, 34, 36, page 70 - 71.

⁹⁴ Report on the Attribution of Profits to Permanent Establishments para 33, 35 page 71 - 72.

⁹⁵ BIS, Group of Governors and Heads of Supervision announces higher global minimum capital standards page 6.

⁹⁶ Report on the Attribution of Profits to Permanent Establishments para 28 page 70.

⁹⁷ Report on the Attribution of Profits to Permanent Establishments para 100 - 102 page 33 - 34.

4.6.2 The importance of Free Capital

As said,⁹⁸ funding is important to a bank and the PE needs to be allocated with capital. Debt capital has a deductible interest and its presence will affect the profit set where more debts allocated to one part of a bank would mean less taxable profit for that part. It is therefore important to allocate a proper amount of Free Capital.⁹⁹

It has to be stated that this is only true in the fictional world where the Report operates. The Home State sets the regulatory capital amount for the entire enterprise making any Host State regulation superfluous. The PE could therefore, in reality, be completely debt financed.¹⁰⁰

The Report attributes Free Capital to a PE by yet another two step analysis. The aim is 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.”¹⁰¹ It starts with valuing the assets and risks and ends by determining the amount of Free Capital needed to support those assets and risks.¹⁰²

An asset is valued either by its book value, market value or purchase price where the Report seems to suggest the latter; though there is no inner hierarchy. However, the market value is usually used between independent enterprises and thus also the most used valuing the assets.¹⁰³

Measuring risks is harder and there are basically two alternatives available which may be combined. Either, one can make usage of the Basel framework, which earlier in the text was discussed in the context of regulatory capital.¹⁰⁴ The obvious

⁹⁸ See chapter 4.6.1

⁹⁹ Report on the Attribution of Profits to Permanent Establishments para 106 page 35, part two para 43 page 73.

¹⁰⁰ Report on the Attribution of Profits to Permanent Establishments para 86 – 87 page 83.

¹⁰¹ Report on the Attribution of Profits to Permanent Establishments para 85 page 83.

¹⁰² Report on the Attribution of Profits to Permanent Establishments para 107 page 35.

¹⁰³ Report on the Attribution of Profits to Permanent Establishments para 109 - 110 page 35 – 36.

¹⁰⁴ See chapter 4.6.1.

benefit of using the Basel framework is that the measurements are internationally consistent, where the same is applied both within the Home State as well as the Host State.¹⁰⁵ Or, the bank may also use its own risk models. These can provide for a more accurate arm's length price. However the Report states that these methods need to be further developed before they become fully reliable.¹⁰⁶

Measuring these risks and valuing the assets in this first step provides for the total funding needed for the PE.¹⁰⁷ Step two allocates the actual amount of Free Capital needed from that total amount. This is done by a number of different approaches in step two, described below in chapter six.¹⁰⁸

4.6.3 The cost of funding a PE

The difference, between the total funding of the PE provided in the first step and the Free Capital allocated may give rise to external and internal interest payments,¹⁰⁹ which shall be allocated to the PE by an arm's length amount.¹¹⁰

External interest, in contrast to internal interest, was deductible according to the OECD even prior to the Report. This is also the current position of most countries, including Sweden. However, some of these countries, not including Sweden, have an exemption where internal interest is allowed for banks.¹¹¹

¹⁰⁵ Report on the Attribution of Profits to Permanent Establishments para 91 page 85.

¹⁰⁶ Report on the Attribution of Profits to Permanent Establishments para 92 – 95, 106 page 85, 88.

¹⁰⁷ IFA, *Attribution of Profits to Permanent Establishments* page 103.

¹⁰⁸ Report on the Attribution of Profits to Permanent Establishments para 115 page 37, Para 97 page 86.

¹⁰⁹ IFA, *Attribution of Profits to Permanent Establishments* page 104.

¹¹⁰ Report on the Attribution of Profits to Permanent Establishments para 152 page 43.

¹¹¹ IFA, *Attribution of Profits to Permanent Establishments* page 47, 51, 628.

External interest is allocated by two main approaches, the tracing approach or the fungibility approach, where both can be altered from their pure form. The tracing approach states that funds borrowed are traced back within the enterprise to the actual third party that provided the loan. The PE will then be attributed the same rate as the rate of the loan from this third party. The fungibility approach does not trace the flow of money. The idea is that each third party loan contributes equally to all parts of the enterprise. Hence the PE will be attributed its share of the total external interest of the enterprise.¹¹²

Both methods have problems, and they can be modified or used side by side. For instance, a bank may apply the tracing approach to large loans while dividing smaller ones between the parts of an enterprise by the fungibility approach.¹¹³ There has not been any Swedish case brought to trial regarding this matter. It is therefore not possible for the author to predict which approach that would be preferred by the Swedish tax authorities.

There is one big difference when allocating external interest to a bank PE than to any other PE. Tier 2 subordinated debts and debts comparable to this can be, as stated above,¹¹⁴ included in the regulatory capital. Subordinated debts have a much higher interest rate than regular loans. It would therefore not be compatible with the arm's length principle if all such debt were allocated to one part of the enterprise.¹¹⁵

¹¹² Report on the Attribution of Profits to Permanent Establishments para 154 page 43.

¹¹³ Report on the Attribution of Profits to Permanent Establishments para 155 – 156 page 43.

¹¹⁴ See chapter 4.6.1.

¹¹⁵ Report on the Attribution of Profits to Permanent Establishments para 117 page 90.

There are two main ways to allocate this kind of debt. The first alternative is to allocate it together with the Free Capital by one of the approaches described below. This would mean that all capital (Tier 1 and 2) included in the BIS regulatory capital would be seen as Free Capital by the approaches.¹¹⁶

The second alternative is to "free" the regulatory capital from the interest bearing debt, and thus only allocate Free Capital as usually done. The higher interest on debts like subordinated debts may then be accounted for when allocating internal interest, which is described further down in this chapter. Care must however be taken to how the internal interest rate is set. If the rate for instance is set to a fair market wholesale interbank interest rate, it may not be able to reflect the actual mix of funding (equity capital, regular loans, subordinated debts exc.) of the bank.¹¹⁷

Internal dealings of interest can only exist if there is a significant people function in one part of the enterprise which could be seen as a treasury function. It is this treasury function that enters into loan agreements with third parties. The funds are then distributed to other parts of the enterprise, and this distribution enables an internal interest rate. It is important to note that the treasury function also has to become the economic owner of the funds to enable an internal interest. This is unlikely to happen if the treasury only borrows funds that it immediately lends on to other parts of the enterprise. This would however enable that the PE would have been required to pay a service fee. The Report establishes a proper internal interest rate by using the comparability analysis by analogy as described in chapter six below.¹¹⁸

¹¹⁶ Report on the Attribution of Profits to Permanent Establishments para 118 page 90.

¹¹⁷ Report on the Attribution of Profits to Permanent Establishments para 121 page 90.

¹¹⁸ Report on the Attribution of Profits to Permanent Establishments para 157, 159 page 44. IFA, *Attribution of Profits to Permanent Establishments* page 104.

5 The comparability analysis

5.1 Introduction

Chapter two and three provided the general concept of attributing profits by the MC and the Report. Chapter four went further into the Report and begun by exploring the solution on how to create the separate entity. It progressed by explaining the importance of funding and its impact on the PE's profits. Before the thesis may analyse and evaluate the approaches it is needed to present the comparability analysis used to find the comparability needed for the approaches and methods.

5.2 General

The first step to compute an arm's length amount is by an analogical use of the comparability analysis in TP guidelines.¹¹⁹ This analysis compares five different factors which are: characteristics of property or services, functional analysis, contractual terms, economic circumstances, and business strategies,¹²⁰ none of which may have any material effect on the measured price or margin which cannot be adjusted.¹²¹

It is relatively easy to find good comparables for the first factor for loans. At least as long as the loan has a fairly usual composition. Important factors may however be the interest rate, the principal, the currency and the terms. The credit worthiness is the same throughout the enterprise. Hence a comparable transaction cannot have credit differentials, or the effect of such credit differentials has to be removed.¹²²

As explained above, functions are allocated using special people functions and KERT.¹²³ All the functions for creating a loan may not always be performed by a single part of the bank, and a single function may also be split if it cannot be effec-

¹¹⁹ Report on the Attribution of Profits to Permanent Establishments para 40 page 20.

¹²⁰ Report on the Attribution of Profits to Permanent Establishments para 190 page 51.

¹²¹ Transfer Pricing Guidelines para 1.33 page 41 -42, Jernkrok L, *Internprissättning och fasta driftsställen* page 679.

¹²² Report on the Attribution of Profits to Permanent Establishments para 147, 167 page 96, 99.

¹²³ See chapter 3.

tively attributed to one part of the enterprise. This is obviously not the case for the independent enterprise of comparison, which by definition performs all functions alone. So the complexity of the second factor depends on how well the functions were divided, and how easy it is to extract a dealing and its functions by the first step of the AOA.¹²⁴

The third factors, contractual terms, are easy to compare between independent or associated enterprises. However such contract does not exist for dealings within an bank. Instead, the Report requires that fictional contractual terms are to be determined.¹²⁵ There is also, due to this lack of any contract, a greater burden of proof on the enterprise.¹²⁶

Banks operate in a regulatory environment, where some countries may have less regulated markets than others and the fourth factor has to take this in consideration. The last factor does not include any particular problems, and the business strategy has already been analysed in the first step of the AOA.¹²⁷

¹²⁴ Report on the Attribution of Profits to Permanent Establishments para 148 page 96.

¹²⁵ Report on the Attribution of Profits to Permanent Establishments para 190 page 51. Russo R, *The Attribution of Profits to PEs; The taxation of intra-company dealings* page 20.

¹²⁶ IFA, *Attribution of Profits to Permanent Establishments* page 105.

¹²⁷ Report on the Attribution of Profits to Permanent Establishments para 152, 154 page 97.

6 Allocation of Free Capital

6.1 Introduction

Chapter two and three provided the general concept of attributing profits by the MC and the Report. Chapter four went further into the Report and begun by exploring the solution on how to create the separate entity. It progressed by explaining the importance of funding and its impact on the PE's profits. Chapter five presented the comparability analysis which is the first step in determining an arm's length value. Lastly chapter six provided the thesis with the comparability analysis needed for the approaches and methods.

This chapter will combine that knowledge in order to analyse and evaluate the approaches in order to find the approach that will generally provide the most proper arm's length value of Free Capital for a bank PE. The chapter starts with a general presentation and discussion of the approaches.

6.2 The different approaches

6.2.1 General

The desire when creating the Report was to agree on a single approach to allocate Free Capital. However, from the text of the Report it is apparent that any consensus could not be reached by the member states.¹²⁸ This has led to the creation of several different approaches with individual strengths and weaknesses and in order to counter this fact the Report suggests that one could test more than one approach.¹²⁹

¹²⁸ Report on the Attribution of Profits to Permanent Establishments para 147 page 42, IFA, *Attribution of Profits to Permanent Establishments* page 55.

¹²⁹ Report on the Attribution of Profits to Permanent Establishments para 53 page 76.

It should be mentioned that the scope of arm's length Free Capital is narrower for banks compared to non-financial enterprises. This is triggered by the fact that there is somewhat an idea, based on market forces and regulated capital, regarding how much capital that a bank actually needs.¹³⁰

6.2.2 The capital allocation approach

The Free Capital required by the capital allocation approach is calculated from the total Free Capital of the bank as a whole. This is done by first checking how the assets and risks have been attributed by the functional and factual analysis. The approach then looks at how the asset has been risk-weighted by any regulatory measuring standard in step one, for instance the Basel Framework, mentioned above.¹³¹ If the risk analysis states that the PE has 10 % of all the bank's risk-weighted assets the PE should be allocated 10 % of the bank's Free Capital. It should be noted that the approach requires all Free Capital to be attributed to the entity, not only the regulatory minimum capital requirements. Consequently the functions assets and risk attribution, and the subsequent risk-weighting have to be done for the whole enterprise.¹³²

This simplicity is however connected to several potential problems. For instance, a bank may have a temporary surplus of capital if it has sold off a business sector or stockpiling capital in preparation of buying other enterprises. On the other hand it may be thinly capitalised, where much of the capital is at its subsidiaries. There could also be differences in the way the different parts of the bank conducts business, for instance by either private and retail banking. All of these variations have to be considered when applying the approach and states may thus differ in their application.¹³³

¹³⁰ Report on the Attribution of Profits to Permanent Establishments para 118, 120 page 37.

¹³¹ See chapter 4.6.2.

¹³² Report on the Attribution of Profits to Permanent Establishments para 98 - 99 page 86 - 87.

¹³³ Report on the Attribution of Profits to Permanent Establishments para 100 – 104 page 87 – 88.

States on the other hand may have different definitions of capital, which means that the bank may have a different total amount of Free Capital, depending on which state you ask. Other areas that also may alter are market conditions, period of computing etc. These problems may have been accounted for in the risk analysis performed in part one. However, some of them may not be appropriately reflected in that analysis.¹³⁴

6.2.3 Economic capital allocation approach

This approach is actually only just a variation of the capital allocation approach. The difference is that the bank's own the economic capital used instead of the regulatory capital. The idea is that the bank's own risk model would better relate to factual circumstances and therefore provide with a better arm's length price. Tough there is as said,¹³⁵ doubtfulness if any present risk model used by banks could be a reliable option. The OECD acknowledges however that this approach has a future potential.¹³⁶

6.2.4 Thin capitalisation approach

An approach that has some potential in the current time is the thin capitalisation approach. By means of this approach a PE should have as much Free Capital as an independent bank carrying on the same or similar activities under the same or similar conditions in the Host State.¹³⁷ These similar independent banks are found by using the comparability analysis from the TP guidelines.¹³⁸

¹³⁴ Report on the Attribution of Profits to Permanent Establishments para 102, 105 page 87 - 88.

¹³⁵ See chapter 4.5.2.

¹³⁶ Report on the Attribution of Profits to Permanent Establishments para 96, 106 page 86, 88, Russo R, *The Attribution of Profits to PEs; The taxation of intra-company dealings* page 24.

¹³⁷ Report on the Attribution of Profits to Permanent Establishments para 107 page 88.

¹³⁸ Report on the Attribution of Profits to Permanent Establishments para 129 page 39.

Finding a comparable bank may sound easier than it actually is. The Report states as mentioned that it is an independent bank which has to be compared with the permanent establishment to which the Free Capital has to be allocated. Hence the comparability analysis cannot compare the PE to another fictitious legal entity, i.e. another PE.

The independent bank also has to be similar to the PE. This may create difficulties when smaller banks do not conduct the same type of business as a PE of a larger enterprise, or are able to have the same risk profile. Also, the PE as always, has the same creditworthiness as the bank it belongs to.¹³⁹

The thin capitalisation approach does not relate to the Free Capital of the enterprise as the above mentioned approaches do.¹⁴⁰ Hence differences between the parts of an enterprise do not cause any problems. One side effect of this is however, that the PE may be allocated more Free Capital than what the enterprise possesses.¹⁴¹

Other problems may however arise as a consequence to that the Free Capital is calculated in relation to external enterprises. So there has to be an attention to key variables when performing the functional and factual analysis, such as quality and nature of the assets, cash flows, business sector, strategies etc,¹⁴² and any difference which has a material effect has to be adjusted in order to fulfil the comparability requirements.¹⁴³

¹³⁹ Report on the Attribution of Profits to Permanent Establishments para 108 page 88.

¹⁴⁰ See chapter 6.2.2, and 6,2,3.

¹⁴¹ Report on the Attribution of Profits to Permanent Establishments para 111 page 89.

¹⁴² Report on the Attribution of Profits to Permanent Establishments para 133 page 40.

¹⁴³ Report on the Attribution of Profits to Permanent Establishments para 109 page 89.

6.2.5 Quasi thin capitalisation approach - Safe harbour approach

Not relating to any need for finding comparability is the quasi thin capitalisation approach, though it is not an authorised approach by the Report.¹⁴⁴ Instead it is, as the headline says, a safe harbour approach. The concept of safe harbour is directly provided by the TP guidelines and the objective is to provide a simple alternative where the allocation would be accepted by the tax authorities.¹⁴⁵

The notion is that it would be enough to only allocate the regulatory amount of Free Capital needed in the Host State for an independent bank by the rules set by that Host State.¹⁴⁶ The amount is however only acceptable as long as it is lower than the amount which would be allocated by the other approaches. The regulatory minimum is on the other hand usually below what can be allocated by other methods. The demand therefore does not mean so much in fact.¹⁴⁷

¹⁴⁴ Report on the Attribution of Profits to Permanent Establishments para 135 page 40.

¹⁴⁵ Transfer Pricing Guidelines para 4.94 page 159 - 160.

¹⁴⁶ Report on the Attribution of Profits to Permanent Establishments para 135 page 40.

¹⁴⁷ Report on the Attribution of Profits to Permanent Establishments para 113, 115 page 89 - 90.

6.3 Analysis - generally the most appropriate Free Capital allocation approach

6.3.1 General considerations

The ongoing increase of the required level of regulatory capital needed for a bank has the effect that larger amounts of Free Capital needs to be allocated to the PE. These requirements also affect the arm's length amount of Free Capital, which becomes somewhat narrower for banks than for non financial enterprises, making it less difficult to find a proper arm's length result.

The way in which the KERT has been applied is vastly important for the performance of the approaches. Any problems in the KERT assessment would impact the applicability and increase the risk of different opinions and double taxation. The author shares the view that the KERT may in some cases be over-prescriptive. It looks good in theory to micro-divide split functions within the enterprise. However it may turn out hard to do in practice.

The commentary to article 7 MC explains that countries should refrain from altering the computation of interest if the same approach is used in both states. The author is of the opinion that a bank, or any other enterprise for that matter, would like to use the same approach to as many parts of the enterprise as possible. The obvious gain is that it would be much easier, demanding less administration and being more cost-effective. What may become a real problem is national legislation demanding the usage of one approach. This is analysed by chapter nine but should be borne in mind here as well.

There is a real concern whether the approaches are capable of providing an arm's length price at all. This is not least shown by Sweden's observation in article 7 MC, where there is expressed a concern if any of the approaches available would find an arm's length interest rate. Sweden is actually expressing that it would in many cases consider solving the differences by the use of MAP.

6.3.2 The different approaches

In the author's view, the appropriateness and usability of the approved approaches is mainly dependent on the bank's geographical area of business and the bank's business model. The geographical area of business is in this context referring to similarities in national legislation, language and market conditions. The bank's business model is referring to an integrated business model applied worldwide.

The first mentioned approach, the capital allocation approach, is dependent on how the geographical area of business and the bank's business model differentiate the PE and the Bank as a whole. As regards the geographical area of business, this would mean that comparable legal systems would increase the probability for similarities in terms of capital definition and deductibility. Such similar legal systems combined with also the same or similar language would definitely improve the chances of avoiding misunderstandings, especially if the Host State modifies or has its own regulatory risk measurement standard. It would also be easier to gain information, for both the taxpayer and the tax authorities. Similar market conditions would enhance this effect. Examples where countries have similarities in both the general legal system and language are the Scandinavian countries or to some extent commonwealth countries. The author is however leaving it unsaid whether those general similarities are shown in for this case relevant legislation.

The capital allocation approach also demands that all of the Free Capital has to be allocated to the different part of the bank, which requires an assessment of the bank as a whole. Hence, a bank with a PE's geographically dispersed would experience more or less difficulty in applying the approach even in a Host State geographically close to the Head State.

A bank's business model may stipulate that the bank provides similar services and performs similar functions in all parts of the enterprise. However the case may also be that functions and services are highly specialised and divided between the different parts. Because the capital allocation approach divides the total amount of Free Capital within the bank, the latter alternative may pose a problem; if it has not been appropriately reflected in the risk analysis performed in part one.

The approach would neither prove to be a good alternative when the bank is in a reorganising or expansive phase for instance selling or buying other enterprises. The value would fluctuate and attract attention from the tax authorities. This attention may well lead to disagreements between the bank and the involved tax authorities, or between the latter.

The economic capital allocation approach is as said only a variation of the capital allocation approach and applies in the same way. There is no reason to think otherwise than the OECD, that bank's internal risk models are not ready to be applied so as to determine the allocation of Free Capital. Nevertheless, it could be a favourable alternative in the future. The economic capital allocation approach may in the author's opinion itself create an incentive for banks to evolve their internal risk models to take benefit of the tax favourable schemes which may be developed. Such initiatives may however be interpreted by the tax authorities as implementing tax avoidance schemes, banks should thereby act with care.

From a theoretical point of view it could be discussed if the thin capitalisation approach would guarantee the highest degree of consistency with the AOA and the fiction of a separate entity, as the capital and economic capital allocation approaches seem to have more in common with the old ways of treating the enterprise and its PE as one entity for tax as well as for legal purposes.

The bank's geographical area of business is not relevant for the thin capitalisation approach. This is due to the fact that the latter approach compares the PE as a separate entity towards an independent bank. The bank as a whole that owns the PE is not connected to the evaluation. In fact, no problems relating to any internal or external differences between the PE and the bank as a whole relates to the thin capitalisation approach.

Nevertheless, the geographical area of business is relevant between the PE and the independent bank of comparison. The author is of the opinion that it would be hard to find comparable independent banks. Particularly in countries where the majority of banks are PE's or subsidiaries, and banks are due to regulatory provisions to operate with branches i.e. PEs for tax purposes. If a comparable bank cannot be found in the state of the PE one has to look elsewhere. However, since a

similar geographical area of business probably would have PE's yet lacking comparable independent banks it may consequently make the geographical area of business substantially differ before finding a comparable bank and such difference has to be adjusted for by the comparability analysis.

The bank's business model is also still relevant, although not in the same way as for the above mentioned methods. The PE need to provide similar services and perform similar functions as the independent bank used as comparable. This may as stated by the OECD not always be the case. The PE may be a part of a larger multinational enterprise and therefore have products that a comparable bank of the same size as the PE would never be able to have. Any potential difference in the business model is not reflected in any prior calculation as it were for the capital allocation approach. As a consequence the thin capitalisation approach needs to adjust any difference that materially affects the comparison. This is done in the same way as for regular TP methods by the use of the TP guidelines.

The thin capitalisation approach has no limit on how much Free Capital that may be allocated to the PE. This could be favourable if the PE is situated in a low taxed Host State. Allocating non deductible Free Capital to a PE in a low taxing Host state will raise the profit taxed for the PE in that low tax Host State. Consequently more deductible debt capital may be allocated to a high tax Head State hence lowering the profit in that state. A high profit in a low taxing state and a low profit in a high taxing state equal lower general tax paid.

The quasi thin allocation approach is as mentioned a safe harbour approach. It is not recognised by the Report and the approach only relates to the Host State's national regulation for capital demands. There is therefore no need for any comparison. The geographical area of business is only relating to the chance of Head State bank or authorities will misinterpret the Host State national legislation, for instance due to language barriers. This problem would however be easy to correct once noticed. The bank's business model is for the quasi thin capitalisation approach irrelevant.

The quasi thin capitalisation approach has one big advantage even though it is not recognised by the Report and that is simplicity. Thus the author believes that the approach may play a part at least in the first years following the implementation of the Report. It will depend on the states and enterprises willingness to explore this unknown territory of taxation.

The quasi thin allocation approach cannot be used when the amount of Free Capital allocated to the PE is higher than it would be using any other approach. This will consequently have the effect that more interest-bearing debt is allocated to the PE than by other approach. Hence taxpayers would likely be more prone to use this approach when the tax rate is higher in the Host State than in the Head State. Consequently high taxing states would probably look less favourably on this approach.

7 Step two - determining the profits

7.1 Introduction

Step one of the AOA presented in the preceding chapters created the separate entity and allocated funding to it. Step two of the AOA determines what profits should be attributed to the PE, and how it is done. This chapter starts off in part two of the AOA and provides the thesis with the basics about attributing profits and what is needed to know before using the methods in chapter eight.

7.2 General

Since the PE by the first part of the AOA is considered an independent entity it should also be provided with a proper share of the bank's profit. This is easily done if the PE performs all general services needed and all the functions connected to any loan it may be the economic owner of. There would simply be no internal dealings and all profit connected to economic owned products would be attributed to the PE.¹⁴⁸ However, the PE may use general services or support functions provided by other parts of the bank,¹⁴⁹ such as the treasury function explained above.¹⁵⁰ Any other part of the bank may also perform a function, or even split a function relating to the creation or management of a loan, presented above.¹⁵¹ Both these kinds of dealings need to be remunerated by an arm's length profit in accordance with article 7.2 MC.¹⁵²

General support services do not affect any specific function or asset directly and will therefore decrease the general profit. But functions relating to the creation or management of a loan are linked directly to that loan and its potential profit.¹⁵³ It may however not be enough with only a service fee regarding functions connected

¹⁴⁸ Report on the Attribution of Profits to Permanent Establishments para 157 page 97 – 98.

¹⁴⁹ Report on the Attribution of Profits to Permanent Establishments para 216 page 56.

¹⁵⁰ See chapter 4.6.3

¹⁵¹ See chapter 4.3 and 4.5

¹⁵² IFA, *Attribution of Profits to Permanent Establishments* page 104.

¹⁵³ Report on the Attribution of Profits to Permanent Establishments para 159 page 98.

to risks performed by another part than the initial economic owner. As said earlier, risks follow functions,¹⁵⁴ and not necessarily the economic ownership. Due to this fact a risk function would either result in that: a service is provided within the enterprise, that some sort of risk is effectively transferred or that the economic ownership is transferred, i.e. that the loan is sold within the bank.¹⁵⁵

Functions commonly relating to risk in the creation and management of a loan are monitoring risk functions and management risk functions mentioned above and explained in the appendix.¹⁵⁶

Monitoring risk functions are for instance functions that monitor the overall credit exposure of the bank's clients or analyses credit exposure.¹⁵⁷ These can either be very simple or rather complex, where a simple function may be relatively easy to price using a traditional transaction method. Even though such functions turns out to be complex they still only monitor the risk, and do not require any decision making per se. This implies that any monitoring risk function will be of such importance that it would transfer the risk by being a KERT function. Any monitoring risk functions should consequently be regarded as services provided to the economic owner.¹⁵⁸

Management risk functions on the other hand make decisions per definition and are as said usually one of the KERT functions in the creation and management of a loan.¹⁵⁹ This fact could very well lead to that the risk is effectively transferred. It depends on the managing function. However, this is evaluated by the functional and factual analysis.

¹⁵⁴ See chapter 4.5.

¹⁵⁵ Report on the Attribution of Profits to Permanent Establishments para 159, 173 page 98, 100.

¹⁵⁶ See chapter 4.3 and appendix

¹⁵⁷ Report on the Attribution of Profits to Permanent Establishments para 7 page 65.

¹⁵⁸ Report on the Attribution of Profits to Permanent Establishments para 175 - 176 page 101.

¹⁵⁹ See chapter 4.3.

It is needed to state that regard has to be taken to that a bank may have different risk management functions. The relevant functions would be those of active management, in contrast to more strategic risk management functions.¹⁶⁰ It is also usual that banks set general guidance on how much risk they may allow; these general standards do however not affect the attribution of risks.¹⁶¹

Internal services, general or directly connected to an asset, are usually highly customised and have as their primary goal to apply only to one bank's specific need. This may make it hard to find a comparable external service, which will have implications regarding the use of the methods presented below.¹⁶²

As stated above,¹⁶³ the bookkeeping can be a starting point of the analysis. This is also the practice followed by many countries, including Sweden.¹⁶⁴ Hence it is essential to have a sound and comprehensive bookkeeping within the bank. It has to be determined whether a cost occurred in the Head Office but for the benefit of the PE is included in a dealing, or if that cost has been allocated to the PE by the functional and factual analysis. Costs already claimed for one dealing can for obvious reasons not be included in the analysis for another. Regard is also needed to be taken to functions performed by other parts of the bank. Their expenses and how these have been booked have to be accounted for when setting the price of the dealing.¹⁶⁵ Symmetry of bookkeeping is required here as for the first step of the AOA.¹⁶⁶ This for instance requires a profit adjustment at the "selling" part if a deduction is made at the receiving part of the enterprise.¹⁶⁷

¹⁶⁰ Report on the Attribution of Profits to Permanent Establishments para 179 - 180 page 101 - 102.

¹⁶¹ Report on the Attribution of Profits to Permanent Establishments para 25 Page 17.

¹⁶² IFA, *Permanent Establishments of Banks, Insurance Companies and other Financial Institutions* page 87, See chapter 8.

¹⁶³ See chapter 4.2.

¹⁶⁴ IFA, *Attribution of Profits to Permanent Establishments* page 41, 618.

¹⁶⁵ Report on the Attribution of Profits to Permanent Establishments para 187 - 188 page 50.

¹⁶⁶ See chapter 3.2.

¹⁶⁷ Russo R, *The Attribution of Profits to PEs; The taxation of intra-company dealings* page 31.

In this regard, It is important to note, that the accounting framework in the financial sector differs from that in the industry or commerce sectors. The latter tends to have more of a product and process oriented cost accounting.¹⁶⁸ There is also a difference in e.g. organisational structure, product catalogue and functions performed where a bank may be much more diverse than a regular industry enterprise, especially when it is involved in global trading, however generally applicable.¹⁶⁹

¹⁶⁸ IFA, *Permanent Establishments of banks, insurance companies and other financial institutions* page 87.

¹⁶⁹ The Taxation of Global Trading of Financial Instruments para 136 page 34 - 35, Report on the Attribution of Profits to Permanent Establishments para 173 page 43.

8 Attributing the profits to the PE

8.1 Introduction

The two steps of the AOA have now been discussed and it is time to gather the information provided by the previous chapters, in order to evaluate the methods. The purpose is to find the method that will provide the most proper arm's length price, for any monitoring risk function service and any managing risk function service related to a loan.

This chapter has the same structure as chapter six starting with a general presentation and discussion of the methods.

8.2 The different methods

8.2.1 General

The notion by the TP guidelines is that the most appropriate method should apply to any given case. All methods below are therefore potentially usable in the services provided for in this case. Their appropriateness relies on the available information and the comparability of the controlled and uncontrolled transactions. Any material difference between those transactions has to be adjusted for if any method could become applicable. What counts as a material difference depends on the method and what it analyses, and information relevant to the material differences may be difficult to extract.¹⁷⁰

The methods are separated between traditional transaction methods and transactional profit methods. Where the former were until recently required to be implemented before the latter. This hierarchy has been removed; however, the OECD still prefers the traditional methods when applicable.¹⁷¹ This is since the OECD regards them to be more closely connected to the actual price of the product, which usually can be directly related to the relationship between the buyer and seller.¹⁷²

¹⁷⁰ Report on the Attribution of Profits to Permanent Establishments para 146 page 96, Transfer Pricing Guidelines para 2.2 page 59.

¹⁷¹ Transfer Pricing Guidelines para 2.1, 2.3 page 59 - 60.

¹⁷² Transfer Pricing Guidelines para 2.3 page 60.

The methods may however be used together when calculating a dealing, if none of them by themselves are able to provide for a conclusive answer.¹⁷³

8.2.2 The Comparable Uncontrolled Price method

The Comparable Uncontrolled Price method (CUP) compares the price paid for a dealing between the parts of the bank with the price of a comparable transaction. This transaction can either be provided internally given that similar asset are also sold by the bank to independent parties. The transaction can also be provided externally, by comparing the price paid between independent enterprises.¹⁷⁴

It is hard to remove any material differences concerning the price of the asset, and this is the basic problem for the CUP making it hard to find a comparable transaction.¹⁷⁵

8.2.3 The Resale Price Method and the Cost Plus method

The Resale Price Method (RPM) does not measure the price of the product. Instead it requires that the asset, after it has been sold within the bank is sold or provided again to an independent party. The RPM is used when the comparability analysis concludes that the reseller is the least complex entity who is provided with a gross margin of the price. This gross margin consists of that reseller's expenses regarding the sale and a profit mark-up.¹⁷⁶

In contrast, the Cost Plus applies if it is determined that the supplier is the least complex entity which will be provided with a gross margin of the cost incurred by the supplier, therefore disregarding any resale price. The margin consists of the price to produce the service and a profit mark-up. Since the Cost Plus does not relate to the resale price it is therefore not dependent on an independent buyer as the RPM; hence it applies more efficiently to services.¹⁷⁷

¹⁷³ Transfer Pricing Guidelines para 2.11 page 62.

¹⁷⁴ Transfer Pricing Guidelines para 2.18, 2.20 page 64 – 65.

¹⁷⁵ Jernkrok L, *Internprissättning och fasta driftsställen* page 680.

¹⁷⁶ Transfer Pricing Guidelines para 2.21 page 65, para 2.29 page 67 – 68.

¹⁷⁷ Transfer Pricing Guidelines para 2.39 page 70 -71.

Needed to be stated here is that there always has to be a least complex entity in order to apply the RPM or the Cost Plus.¹⁷⁸

Once evaluated the gross margin is compared to what would be an expected margin of a comparable transaction. The comparable could as in the same way as for CUP be provided either internally or externally and the price left after the gross margin is removed will be the transfer price.¹⁷⁹

These methods set focus on the functions assets and risks attributed to the parts involved. This means that the service or product could differ somewhat. The TP Guidelines makes a comparison of a supplier that in some cases should have the same margin independent if it were to make toasters or blenders. However the greater difference in product the greater possibility of difference in functions assets or risks.¹⁸⁰

8.2.4 The Transactional net margin method

The Transactional Net Margin Method (TNMM) is applied in the same manner as the RPM and the Cost Plus and it is generally the most used for transactions between associated enterprises.¹⁸¹ The difference is that the TNMM compares the result of a transaction at a net margin level, including operating expenses,¹⁸² in contrast to the RPM and Cost Plus that uses the gross margin.¹⁸³ This makes the method even less sensitive of service, product and function differences than the above explained methods, and it is practical to use when one party performs complex functions.¹⁸⁴

¹⁷⁸ Transfer Pricing Guidelines para 2.59 page 78.

¹⁷⁹ Transfer Pricing Guidelines para 2.22 page 65 – 66, para 2.40 page 71, Jernkrok L, *Internprissättning och fasta driftsställen* page 681.

¹⁸⁰ Transfer Pricing Guidelines para 2.24 page 66, Jernkrok L, *Internprissättning och fasta driftsställen* page 681.

¹⁸¹ Jernkrok L, *Internprissättning och fasta driftsställen* page 682.

¹⁸² Transfer Pricing Guidelines para 2.48 page 74.

¹⁸³ Transfer Pricing Guidelines para 2.58 page 77 - 78.

¹⁸⁴ Transfer Pricing Guidelines para 2.63 page 79.

The TNMM may however be more sensitive regarding capital utilisation as differences of the level of funding (equity vs. debt capital). The banks may also differ in business strategy where one of the banks for instance mainly targets wealthy clients.¹⁸⁵

8.2.5 The Transactional profit split method

The transactional Profit Split method (Profit Split) does not need to compare the dealing with a transaction and therefore differs from the methods described above.¹⁸⁶ Instead, the profit generated from a loan is divided between the parts performing the functions, regarding the assets used and risks assumed, relevant to it as it would have been between independent parties. This method's strength is that it can be used when all parts involved makes valuable contributions to the product and where the functions are highly integrated.¹⁸⁷

The profit which will be attributed by the Profit Split is calculated either by the gross margin or the net margin.¹⁸⁸ The net margin is generally used; however the gross margin may be a better alternative when the PE has a lot of different functions and products.¹⁸⁹

There are two general approaches to calculate the division of profits; the contribution analysis and the residual analysis.¹⁹⁰ The contribution analysis divides the whole profit for an asset to the different part of the enterprise. This is always based on an approximation of how a division would be made by independent enterprises. Data from independent enterprises may not always be available. The analysis is then based on the relative value of the functions performed by the parts, accounting for the assets used and risks assumed.¹⁹¹

¹⁸⁵ Transfer Pricing Guidelines para 2.69 - 2.72 page 81 - 82.

¹⁸⁶ See chapter 8.2.2, 8.2.3 and 8.2.4.

¹⁸⁷ Transfer Pricing Guidelines para 2.4 page 60, para 2.109 page 93, Para 2.116 page 95.

¹⁸⁸ Transfer Pricing Guidelines para 1.43 page 68.

¹⁸⁹ Transfer Pricing Guidelines para 2.131 page 100.

¹⁹⁰ Transfer Pricing Guidelines para 2.118 page 96.

¹⁹¹ Transfer Pricing Guidelines para 2.119 page 96 - 97.

The residual analysis has two steps. It starts by attributing profit to any routine function for which the traditional methods or the TNMM can be used. The remaining (Residual) profit is then divided on the remaining functions in the same order as for the contribution analysis.¹⁹²

The residual Profit Split is hence applying better to dealings where the asset is connected to several different functions of varying importance. It may, however, in some situations underestimate the value of the functions which are not included in the residual profit. If so, the Contribution analysis may be more applicable.¹⁹³

¹⁹² Transfer Pricing Guidelines para 2.121 page 97.

¹⁹³ Report on the Attribution of Profits to Permanent Establishments para 170, 172 page 143.

8.3 Analysis – The most appropriate transfer pricing method

8.3.1 General considerations

The discussion regarding how the KERT is applied discussed in the analyses of the approaches is also valid for the methods who all has to be evaluated in this analysis, because all have the potential to be the most appropriate in the specific cases. This potential lies in their general applicability, the ability to gain information and the chance of finding a comparable transaction with no or adjustable material differences. These three areas will hereby be the basis of evaluation.

Monitoring risk functions can according to the OECD be either simple functions or rather complex, where traditional transaction methods may be used for the simpler functions. However, the OECD states that there could be difficulties to apply these methods if the service function is so integrated with other functions that it is not possible to separate them. There is also a general view expressed at the IFA congress in 1996 that internal banking services usually are highly customised to only match one bank's internal requirement.

The above statements by the OECD and the IFA congress also applies regarding management risk functions. The OECD is however of the opinion that management risk functions usually are more complex than any monitoring risk function.

All of the methods except the Profit Split either compare an internal or external transaction with the dealing. To the author's knowledge, the only possible buyers which would provide an internal comparison of any monitoring or management risk service would either be another independent bank, i.e. a competitor to the bank performing such services or a to the bank, associated enterprise. The first possible transaction would never take place, and the latter may not be used as a comparison. This leads to the author's conclusion that an internal comparison would be nearly impossible to find. An external CUP may exist, if the services provided are of a basic level and not too customised to the bank's own needs.

Important to note while reading the text is that a dealing is always compared to a transaction by independent enterprises and the arm's length price computed for a transaction between associated enterprises will not be the same as the arm's length price for a dealing between parts of the same enterprise.

8.3.2 The monitoring risk and management risk services

The CUP method compares the price paid for the service with the price paid for a comparable transaction and has because of this a high general applicability.

The ability to gain information relevant for the CUP is relatively easy. The method relies on the price paid and the composition of the service of comparison. That information should be accessible through the open market. This requires, however, that it is possible to find a comparable transaction.

Any internal banking services are as said often highly customised to a bank's own needs, so the price paid on a comparable transaction will therefore probably differ from the arm's length price which should be paid for the compared service. That difference must be adjusted in order to use the external comparable transaction. The author however believes that no proper adjustments could be made unless the services would be of a very simple nature. The author is by this concluding that the CUP will rarely be applicable regarding any monitoring risk function. This applies to an even greater extent to any management risk function due to the above mentioned complexity of such services.

Since the RPM is dependent on a resale price it demands that the receiver is reselling the service to an external part. This is not the case for any monitoring or management risk functions. A fundamental variable in its comparison cannot therefore be used and the RPM is hereby lacking the general applicability.

The Cost Plus is generally applicable when the service provider is the least complex entity, providing for a gross margin to the supplier consisting of the price to produce the service and a profit mark-up. If the Cost Plus could be seen as generally applicable is therefore dependent on whether the provider of the service could be seen as the least complex entity. The calculated gross margin would otherwise be too low. The applicability is determined by examining the type of service, and

how the function providing the service was allocated in the functional and factual analysis. A service function may be seen as having a large impact on a loan and can be regarded as a KERT function, making the least complex entity the receiver. This would to a larger extent be true regarding management risk functions than monitoring risk functions.

Regarding the ability to find relevant information one has to consider the differences in accounting between the industrial / commercial sectors and the bank sector. The industrial / commercial sectors have an accounting framework based on product and process cost, where a cost can be precisely attributed to a service or asset. This is however not the case for the banking sector, and definitely not for dealings within a bank. The Cost Plus advantage of being less dependent on the similarity of the service by using the cost may therefore prove to be a disadvantage in relation to a banking PE, where it could be hard to find the cost related to the services (the dealing) provided for within the bank. This disadvantage may be less prominent depending on the structure of the bank, where the service function may be based in one part of the bank with separate bookkeeping.

Another problem regarding the ability to find information is that the information regarding the profit mark-up from the compared transaction, if extractable, has to be accessible. The author believes that competing banks would not tend to give that sort of information to anyone who asks.

The chance of finding a comparable transaction for the Cost Plus is not that dependent on variations in the complexity and nature of the service provided as the CUP. However it may have an impact on the structure of the functions providing that service, as well as the attribution of assets and risks. An increased chance of such impact will increase the chance of non-removable material differences between the services compared. As said; services provided within banks are generally highly customised and that applies to any monitoring risk function or management risk function, however to a greater extent for the latter. The author's opinion is therefore that the Cost Plus, may prove as hard to apply as the CUP.

The TNMM is in many ways similar to the Cost Plus and has the same general applicability as the dealing needs to have a least complex entity. It differs as it uses the net margin in calculating the cost related to the service and the profit attached to the service, making it possible to apply a more general profit indicator than the Cost Plus.

The ability to gain information would likewise be similar to what has been said regarding the Cost Plus. However, the implications of the non cost based accounting standard regarding banks, and the additional problem of the dealing taking place within one single entity will make it even harder to find the net margin expenses related to the service provided, without having any non-adjustable material differences.

The opposite is on the other hand true regarding the ability to gain information regarding the profit. The TNMM may use a more general profit indicator than the Cost Plus that will be easier to extract from the enterprise of comparison without any non-adjustable material differences.

This also relates to the chance of finding a comparable transaction. The TNMM is even less dependent than the Cost Plus of any variation in the complexity and nature of the service provided. The OECD is even stating that this method is practical to use when one party of the dealing performs complex and intertwined functions which may be hard to extract. Un-adjustable differences may however be connected to other parts not directly connected to the service. The OECD mentions differences in the level of funding, which may as shown earlier in the thesis be difficult to allocate.

The TNMM is in the author's point of view less applicable than the Cost Plus regarding the ability to extract information concerning the relevant costs for any monitoring risk function or management risk function, but it is more appropriate than the CUP and the Cost Plus regarding the ability to find an arm's length profit. A possible solution if the Cost Plus is able to extract the cost of the service is to combine the Cost Plus method with a profit indicator from the TNMM.

The main difference between any monitoring risk function and any management risk functions is that the latter usually is more complex. However, important management risk functions may be so important to a loan that a least complex entity will be hard to find.

The Profit Split is generally applicable when the least complex entity cannot be found and / or where the functions related to the dealing are complex.

Since the needed information is provided within the bank itself the Profit Split does not rely on an external comparable. The OECD states that the profit should be divided, if no external data is to be found, by the functions performed, regarding the asset used and risks assumed. This information is already provided for in step one of the AOA and is therefore making the Profit Split easier to apply.

The method provides for two alternatives when calculating the profit that will be split, either on gross margin or net margin. The easiest and most reliable margin would depend on what kind of business is conducted by the PE. The net margin would be an easy alternative if the PE only dealt with one or similar kinds of financial products. If the PE has other functions and products there may be a need for applying a gross margin.

The creation of a loan and the following management is split by the functional and factual analysis. This analysis will in most cases find that the functions are divided and even split within several parts of the enterprise. These functions will also vary in importance where the risk management is likely to be a KERT while monitoring risk may stay as a routine function. This would suggest that the Residual Profit Split would apply more frequently than the Contribution Profit Split.

9 Analysis – Avoiding double taxation according to article 7 MC

9.1 Introduction

The Previous chapters have concluded how to separate the PE into a legal entity and how to attribute funding and profit, all in accordance with article 7 MC and the Report. In chapter two it was explained how article 7 MC deals with the situation where double taxation still would arise. This chapter continues with analysing this situation in the context of the information about the approaches and methods primary presented.

9.2 The issue of double taxation

Article 7 MC's solution to prevent double taxation is to avoid any unnecessary alternation of the value once set by the taxpayer, and the article urges the state to not make any adjustment if the value could be seen as within arm's length. If an adjustment is made even so, the other state will be obliged to make a corresponding adjustment if the new price or interest is within arm's length.

A state may therefore alter the value set by two reasons. Either a state regards it as outside the scope of arm's length, or that there is a value which better corresponds to the arm's length. The probability of such behaviour will be closely linked to the actual scope of the arm's length. The range of this scope is dependent of how well the methods and approaches of the Report performs. They are in turn dependent on how well the functional and factual analysis is performed when, creating an independent entity.

As shown, there could be considerable difficulties to find a proper arm's length value, especially regarding the level of interest of Free Capital. This uncertainty may in the author's opinion well be countered by national legislation, at least applying to what type of Free Capital approach to use.

A turnout where states start to legislate is not preferable; it would in the author's opinion not clarify the subject. Instead it would be likely that a state not only chooses the "easiest" and most applicable approach or method but also the one that suit that states conditions the most. Why would a high tax state not consider that the thin capitalisation approach may allocate more Free Capital to the PE than the capitalisation approach, hence lowering the taxable amount in the Head State? The author would guess that once one state starts to legislate other states may follow in order to protect their national interests.

National legislation would also create major difficulties for the enterprises where they may have to use different methods in the Head and Host State for the same service. The wording of "should refrain" may be of little help in order to stop a state from making adjustments while it sees its tax base disappear.

National legislation creates another problem as well. The last example in chapter 2.2.4 demonstrate how double taxation may arise when there is a difference in national legislation of what type of method or approach to apply. There are two possible ways out of that problem if the methods or approaches show a different value.

First, since it is the bank that actually calculates these values it would probably try to "find" a value between these two methods. As an example; a correct calculation by method 1 would provide a value of 20 and method 2 of 22. The bank would now try to recalculate the methods and find the value to be 21 for both methods. This value is consequently within arm's length range, where the states should refrain from making an adjustment.

Second, the bank could tax for a value of 20 in the first state and 22 in the other state in line with national legislation. The bank needs to then show that either of the values calculated would be outside the scope of arm's length, and by this enabling MAP.

The most important factor in both cases is the scope of arm's length. A state would be more reluctant to accept 21 instead of 22 if the difference would mean millions more or less in tax revenue. The same argument applies towards the taxpayer. A bank would not like the idea to be forced to tax millions more in the anticipation of any result from the MAP.

In absence of any national legislation the double taxation problem is much easier to handle. However, since a state is demanded to make a corresponding adjustment if the other states first adjustment is within arm's length it may be that, as stated by the Treaty Policy Trading Group, states may rush to adjust a value in order to lock the value adjusted.

The OECD considers that it is sometimes necessary to resolve a double taxation issue by the usage of MAP. The author believes, since an enterprise will have to be double taxed until the states have agreed using the MAP, that the goal of article 7 MC and the Report by some meaning fails.

The author does however not see any better alternative solution. An alternative where the enterprise is only taxed by the initial value until the states have agreed would potentially provide an incentive for the states to come to a fast conclusion, and the enterprise would not be double taxed. On the other hand, it would also be an incentive for the enterprise to set an initial value which would best correspond to its interest.

The potential time an enterprise would be affected by double taxation before the involved states come to an agreement will vary. But, as presented in chapter two, the total time can be as much as over 6 years from the time of double taxation.

Sweden has in recent years lowered its average time of completing a MAP to below one year. The double taxation impact of Sweden's commentary to potentially not regard any value arising from the Free Capital approaches as within arm's length range and by that applying the MAP more frequently it thereby reduced. This easy and effective management of MAP cases is however not the general situation.

10 Conclusion

10.1 What can be the most appropriate Free Capital allocation approach

The OECD is right when stating that no one method suits every situation. Attributing Free Capital is a new concept and it will probably take some time both for the banks and the tax authorities to adjust to the new situation. The author's opinion is however that the capital allocation approach would generally provide for the most proper arm's length value of Free Capital for a banking PE. A variation of this approach, using banks own risk models by an economic capital allocation approach may become more used in the future.

The author believes that it will in most cases be hard to find any proper independent bank of comparison thus making the capitalisation approach not generally able to provide for a proper arm's length price. The quasi thin capitalisation method will since it is not recognised generally have a small impact.

10.2 The most appropriate transfer pricing method

Which method that would be the best method applicable to a dealing is not just reliant on the method itself. It is essential to have a good foundation. This should be based on a graspable structure of functions assets and risk provided by the functional and factual analysis.

The author believes that a variation of the Cost Plus and the TNMM may apply, if the costs for the service are extractable and there is a least complex entity. Here the Cost Plus would provide for the cost and the TNMM would add a proper profit. The Profit Split would otherwise apply if the cost was not to be found, or if there is no least complex entity. The ability to find the proper cost would not depend on the service provided. However, any monitoring risk function would not make the service provider a complex entity. This may on the other hand be true regarding any management risk function.

The above argumentation and the purpose has had its starting point in that any functions of monitoring and managing risk are fully divided to one part of the en-

terprise. The author will by that remind the reader that it would be even harder to find a comparable transaction for the CUP Cost Plus and TNMM if the functions themselves were split. This could make the Residual Profit split the only reasonable method left.

10.3 Avoiding double taxation according to article 7 MC

Article 7 MC is the best alternative available to solve any double taxation. However there is a flaw where differences in national legislation could turn out to be counterproductive by creating situations of double taxation. Those cases and the cases where the states cannot agree on a price within arm's length range are only solvable by the MAP. This solution may place a bank in the situation where it has to be double taxed for as long as six years. This period of time is decreasing in Sweden; however, the author does not believe that this is generally applicable to all countries.

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Article 7 OECD 2010 model tax convention on income and capital

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.

Functions involved in creating a new financial asset - a loan

(The Report part 2 paragraph 6 page 65.)

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):

- Sales/Marketing - *e.g.* cultivating potential clients, creating client relationships and inducing clients to start negotiating offers of business;
- 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.;
- Trading/Treasury - *e.g.* raising funds and capital, taking deposits, raising funds on the most advantageous terms, making the funds available; and
- 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.

Functions involved in managing an existing financial asset - a loan

(The Report part 2 paragraph 7 page 65 - 66.)

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):

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

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duration of borrowing with lending, and maximising efficiency of employment of regulatory capital and return on capital employed;

- 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.