Capital Attribution under the Authorized OECD Approach

Institute of International Bankers Annual Seminar on International Bank Taxation

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Capital Attribution under the OECD Approach

- Authority for alternative use of OECD Approach in a U.S. PE
  - §1.882-5(a)(2) requires express adoption in Treaty Text or Accompanying Documents to depart from fungible formulary allocation rules
  - Final Reports on Attribution of Profits to Permanent Establishments
    - 1995 OECD Transfer Pricing Guidelines applied by analogy
  - U.S. implementation only in Bilateral Treaties and Protocols
    - 2003 U.S.-Japan Treaty
    - 2006 U.S.-Germany Protocol to 1989 Treaty
    - 2006 U.S.-Belgium Treaty
    - 2007 U.S.-Bulgaria Treaty
    - 2007 U.S.-Iceland Treaty
    - 2008 U.S.-Canada Protocol to 1980 Treaty
    - 2006 U.S. Model Treaty (Transfer Pricing Guidelines Text)
  - “Accompanying Documents” may include comprehensive MAP agreements under existing Article 7: None entered into to date
Authorized OECD Approach

- AOA determines the Limit to taxable Business Profits
  - Effectively Connected Income Rules remain available for limit of taxation

- Article 7(2) adoption of OECD Transfer Pricing Guidelines by Analogy
  - Takes into account economic differences of PEs and Associated Enterprises
  - “Functional Separate Enterprise Approach” adopted to value functions and resources employed by a PE
  - Pending amendments to OECD Model Article 7 and Commentaries to provide symmetrical treatment in home country for double tax purposes
    - U.S. opposes “symmetry” for outbound treatment under worldwide cross-crediting regime
    - Unclear whether foreign countries will grant symmetry for double tax relief based on reciprocity principle of treaties

- Consistency Principle applies - All Code vs. All Treaty
  - Rev. Rul. 84-17 (ECI rules only - apply to businesses within and without a PE)
  - Consistency principle expanded for Transfer Pricing of items partially within and without a PE compared to all ECI with a PE under the Code
Authorized OECD Approach

Authorized OECD Approach: Two Step Process

• **Step 1**- Hypothesize the PE as a Separate Enterprise
  
  – Attribute Assets and Risks to the PE based on Factual and Functional Analysis under Transfer Pricing Guidelines principles
    
    • Assets Used
    • Risks Assumed
    • Functions Performed (or resources employed)
  
  – Construct balance sheet of PE & allocate capital to attributed assets/risks

• **Step 2**- Test all “dealings” of the PE with other parts of the enterprise for recognition based on functions performed and attribute business profits under the arm’s length principle
Capital Attribution under the OECD Approach

• Capital Attribution Principles
  – Capital attributes to risk (and is not attributed by mere booking or “allotment” to the PE)
  – Debt/equity is characterized under host-PE country principles
  – Host-PE country has discretion (not the taxpayer) to adopt one of two Authorized Capital Attribution methods

• Authorized Capital Attribution Methods - Attribution of Profits Report, Part II (Banking) -
  – Capital Allocation (Internal Conditions: Risk-Weighted Asset Analysis)
  – Thin Capitalization (Comparable Bank Analysis - CPM Method)
  – Quasi-Thin Capitalization (Not an Authorized OECD Method: Safe-Harbor: Attributed Risk-Weighted Assets multiplied by Tier 1 minimum Ratio)
Capital Attribution under the OECD Approach

United States adopts the Capital Allocation Method - “Cleansed BIS Ratio Approach”

• Attribution Report recognizes two approaches to Capital Allocation-
  – “Pure BIS Ratio Approach” - Allocation of Capital (including Tier II Capital) followed by equity characterization in PE under host-PE country principles (“cleansing of capital”)
  – “Cleansed BIS Ratio Approach” - U.S. Method: Cleansing of Capital first and then allocating to PE - U.S. does not permit allocation of Tier II debt to U.S. PE unless functionally acquired for the purposes of the PE (would likely be evidenced by a related interbranch borrowing incident to the debt issuance)

  Attribution Report, Part II Annex - paragraphs 4 and 5

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

In particular, in determining the amount of attributable profits, the permanent establishment shall be treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities. With respect to financial institutions other than insurance companies, a Contracting State may determine the amount of capital to be attributed to a permanent establishment by allocating the institution's total equity between its various offices on the basis of the proportion of the financial institution's risk-weighted assets attributable to each of them.

- **U.S. - Germany Protocol adds**-

A financial institution may determine the amount of the capital attributed to its permanent establishment using its risk weighted assets only if it risk weights its assets in the ordinary course of its business.
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• Attribution of Assets to the U.S. PE under the Report on Attribution of Profits
  – Key Entrepreneurial Risk Taking Functions (“KERTs”)

  – Part II (Banking): KERT Functions for Commercial Banking
    • Negotiation, Solicitation and Credit Analysis for asset origination/acquisition
    • Risk Management for holding period, including risk transfer between PEs
    • Asset-splitting for Profit Split Methods contemplated (Paragraph 76)
      – Compare ECI Material Participation Test - “All or Nothing”
    • Risk Monitoring is not a KERT and \textit{does not} attribute an asset and capital allocation

  – Part III (Global Trading): KERT Functions
    • Marketing and Sales
    • Risk Management
    • Asset-Splitting for Profit Split Methods contemplated (Paragraph 263)
    • \textit{Parameter Setting and Risk Monitoring \textit{are not KERT Functions} and do not attribute capital, but are separately compensable services under the OECD Approach}
      – Compare ECI rules (including Global Dealing Regulations) which do not permit interbranch service mark-ups
Capital Attribution under the OECD Approach

General Steps for Cleansed BIS Ratio Capital Allocation

• Perform Factual and Functional Analysis

• Attribute Financial Assets (Banking and Global Trading) by reference to KERT Functions (including split-assets if applicable)

• Characterize (cleanse) the Bank’s equity capital under U.S. tax principles

• Determine ratio of attributed risk-weighted assets to worldwide risk-weighted assets

• Allocate cleansed capital to U.S. PE under the risk-weighted asset ratio

• Adjust interest expense in PE for “arm’s length” capital allocation conformity

• Note: Technical Explanations permit §1.882-5(c) principles (i.e. reciprocal 5% fixed ratios and actual ratio capital percentages) in lieu of risk-weighting
Capital Attribution under the OECD Approach

Adjusting Interest Expense in PE for Allocated Equity Capital

• Thinline capitalized PE’s may require some recharacterization of branch interest as equity under host-PE country’s rules - Part II, para. 128-134.

• Thickly capitalized PE’s may reduce book equity to allocated “arm’s length” amount - Part II, Paragraph 130.
  • Additional Interest Imputation to PE is implied by Attribution Report

• Attribution Report does not prescribe methods for determining the adjustment to branch interest expense. Possibilities-
  – Recharacterize interbranch borrowings first as a stacking/ordering rule
  – Disallow PE interbranch interest expense fungibly
  – Disallow PE interest expense fungibly, particularly if capital allocation exceeds interbranch balances
    • Spread excess equity capital allocation across all interest bearing book liabilities
    • Impute a loan from the PE to the Home Office - Paragraph 134.
  – Apply 882(c) fungibility principles for disallowance of amount and §1.884-4(b)(6) principles for specific liability determination giving remaining branch interest under §884(f)(1)(A)
Capital Attribution under the OECD Approach

Assume: Attributable Balance Sheet

- Risk-Weighted Asset Ratio
  - Gross Assets                  | Risk-Weighted
  - 20,000,000,000 x 0% = -0-
  - 25,000,000,000 x 0% = -0-
  - 15,000,000,000 x 100% = 15,000,000,000
  - 30,000,000,000 x 20% = 6,000,000,000
  - 10,000,000,000 x 50% = 5,000,000,000
  - 10,000,000,000 x 100% = 10,000,000,000
  - 40,000,000,000 x 50% = 20,000,000,000
  - 150,000,000,000

  WW Risk-Weighted Assets 560,000,000,000

  Risk-Weighted Asset Ratio 10%

  Worldwide Equity 60,000,000,000

  Attributable Equity 6,000,000,000
Capital Attribution under the OECD Approach

Compare PE Attributable Assets with §1.882-5 Code Rules

- Starting Point for Treaty-Based Attribution - Line 2 + Lines 5(b) & (c)
  - KERT Function Analysis may split-assets away from PE
  - Line 5(c) may attribute part or whole to PE under treaty

- U.S. Assets on Line 5(d) enable approximate maximum ratio of ECI to Treaty-based attributable assets

- All of Page 1, lines 1-9 must be filed if treaty method is adopted
Capital Attribution under the OECD Approach

Compare PE Total Booked Liabilities to §1.882-5 Liabilities
### Capital Attribution under the OECD Approach

#### Interbranch Allocation Method: Reclass Interbranch Liabilities First

<table>
<thead>
<tr>
<th>Assets</th>
<th>Before the year</th>
<th>After the year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Cash</td>
<td>25,000,000,000</td>
<td>25,000,000,000</td>
</tr>
<tr>
<td>2a. Trade receivables</td>
<td>20,000,000,000</td>
<td>20,000,000,000</td>
</tr>
<tr>
<td>2b. Loans to banks</td>
<td>15,000,000,000</td>
<td>15,000,000,000</td>
</tr>
<tr>
<td>3. Premises</td>
<td>30,000,000,000</td>
<td>30,000,000,000</td>
</tr>
<tr>
<td>4. Securities</td>
<td>56,000,000,000</td>
<td>56,000,000,000</td>
</tr>
<tr>
<td>5. Loans to shareholders</td>
<td>10,000,000,000</td>
<td>10,000,000,000</td>
</tr>
<tr>
<td>6a. Interbranch liabilities</td>
<td>20,000,000,000</td>
<td>20,000,000,000</td>
</tr>
<tr>
<td>6b. Other liabilities</td>
<td>70,000,000,000</td>
<td>70,000,000,000</td>
</tr>
<tr>
<td>7. Total liabilities</td>
<td>160,000,000,000</td>
<td>160,000,000,000</td>
</tr>
</tbody>
</table>

#### Risk-Weighted Asset Ratio

<table>
<thead>
<tr>
<th>Gross Assets</th>
<th>Risk-Weighted</th>
</tr>
</thead>
<tbody>
<tr>
<td>20,000,000,000 x 0% = 0</td>
<td>-0-</td>
</tr>
<tr>
<td>25,000,000,000 x 0% = 0</td>
<td>-0-</td>
</tr>
<tr>
<td>15,000,000,000 x 100% = 15,000,000,000</td>
<td>15,000,000,000</td>
</tr>
<tr>
<td>30,000,000,000 x 20% = 6,000,000,000</td>
<td>6,000,000,000</td>
</tr>
<tr>
<td>10,000,000,000 x 50% = 5,000,000,000</td>
<td>5,000,000,000</td>
</tr>
<tr>
<td>10,000,000,000 x 100% = 10,000,000,000</td>
<td>10,000,000,000</td>
</tr>
<tr>
<td>40,000,000,000 x 50% = 20,000,000,000</td>
<td>20,000,000,000</td>
</tr>
<tr>
<td>150,000,000,000</td>
<td>56,000,000,000</td>
</tr>
</tbody>
</table>

#### Worldwide Equity Attribution

<table>
<thead>
<tr>
<th>Attribution</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Worldwide Equity</td>
<td>60,000,000,000</td>
</tr>
<tr>
<td>Attributable Equity</td>
<td>6,000,000,000</td>
</tr>
</tbody>
</table>
Capital Attribution under the OECD Approach

Fungible Allocation Method: Reclass PE Liabilities Pro-Rata

- Risk-Weighted Asset Ratio

Gross Assets

Risk-Weighted

<table>
<thead>
<tr>
<th>Asset Description</th>
<th>Beginning of the year</th>
<th>Ending of the year</th>
<th>Calculations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>10,000,000,000</td>
<td>10,000,000,000</td>
<td></td>
</tr>
<tr>
<td>Trade notes and accounts receivable</td>
<td>20,000,000,000</td>
<td>20,000,000,000</td>
<td>20,000,000,000 x 0% = 0</td>
</tr>
<tr>
<td>Cash less for bad debts</td>
<td>10,000,000,000</td>
<td>10,000,000,000</td>
<td>10,000,000,000 x 0% = 0</td>
</tr>
<tr>
<td>Inventories</td>
<td>18,000,000,000</td>
<td>18,000,000,000</td>
<td>18,000,000,000 x 0% = 0</td>
</tr>
<tr>
<td>U.S. government obligations</td>
<td>15,000,000,000</td>
<td>15,000,000,000</td>
<td>15,000,000,000 x 0% = 0</td>
</tr>
<tr>
<td>Less accrued (tax) accruals</td>
<td>10,000,000,000</td>
<td>10,000,000,000</td>
<td>10,000,000,000 x 0% = 0</td>
</tr>
<tr>
<td>Other current non-U.S. assets</td>
<td>10,000,000,000</td>
<td>10,000,000,000</td>
<td>10,000,000,000 x 0% = 0</td>
</tr>
<tr>
<td>Other current U.S. assets</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Derivative assets</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Less accumulated depreciation</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Land (at fair value)</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Less accumulated amortization</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Assets held in trust</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Other non-current non-U.S. assets</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Other non-current U.S. assets</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Total assets</td>
<td>110,000,000,000</td>
<td>115,000,000,000</td>
<td>115,000,000,000 x 10% = 11,500,000,000</td>
</tr>
</tbody>
</table>

Liabilities

<table>
<thead>
<tr>
<th>Liability Description</th>
<th>Beginning of the year</th>
<th>Ending of the year</th>
<th>Calculations</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>18,000,000,000</td>
<td>18,000,000,000</td>
<td>18,000,000,000 x 0% = 0</td>
</tr>
<tr>
<td>Mortgages, notes, bonds payable in less than 1 year</td>
<td>20,000,000,000</td>
<td>20,000,000,000</td>
<td>20,000,000,000 x 0% = 0</td>
</tr>
<tr>
<td>Mortgages, Notes, bonds payable in over 1 year or more</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Other current liabilities</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Loan from shareholders</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Mortgages, Notes, bonds payable in over 1 year or more</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Other current liabilities</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Liabilities held in trust</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Other miscellaneous liabilities</td>
<td>0</td>
<td>0</td>
<td>0 x 100% = 0</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>40,000,000,000</td>
<td>45,000,000,000</td>
<td>45,000,000,000 x 10% = 4,500,000,000</td>
</tr>
</tbody>
</table>

Net assets (value of identity) | 110,000,000,000 | 115,000,000,000 | 115,000,000,000 x 10% = 11,500,000,000 |

Worldwide Equity | 60,000,000,000 | 60,000,000,000 | 0% |

Attributable Equity | 6,000,000,000 | 6,000,000,000 | 0% |
Capital Attribution under the OECD Approach

- Fungible Allocation Method

Sum of:

3rd Party Adjustment

\[
115,200,000,000 \times 5,000,000,000 = 120,000,000,000 = 96.0\% = 4,800,000,000
\]

Interbranch Adjustment

\[
28,800,000,000 \times \text{Interbranch Exp.} = 30,000,000,000 = 96.0\%
\]
Capital Attribution under the OECD Approach

Fungible Allocation Approach: $4,800,000,000 compare to $1.882-5: $3,958,333,000
Code v. Treaty Approach Considerations

• Conditions that give rise to lower profits in PE under the OECD Attribution of Profits approach:

  – U.S. Assets (3rd Party ECI) approximate or are greater than OECD attributable assets
    • U.S. assets are often 100% ECI but may be partially attributable under OECD Transfer Pricing
      – Loan Asset – Credit Functions/Risk Management in H/O

  – Capital Allocation under OECD Risk-Weighting is less than under the fixed 5% §1.882-5 allocation approach

  – Taxpayer has losses on Non-ECI assets that are attributable
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