The Authorised OECD Approach and the Attribution of Profit to Banks´PEs

How far is the functionally separate entity approach fully achievable?

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### List of Abbreviations and Acronyms

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<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>ALP</td>
<td>Arm’s Length Principle</td>
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<td>AOA</td>
<td>Authorised OECD Approach</td>
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<td>Art.</td>
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<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
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<td>BIS</td>
<td>Bank for International Settlements</td>
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<td>CIT</td>
<td>Corporate Income Tax</td>
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<td>FSEA</td>
<td>Functionally Separate Entity Approach</td>
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<td>IAS</td>
<td>International Accounting Standards</td>
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<td>International Monetary Fund</td>
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<td>KERT</td>
<td>Key Entrepreneurial Risk- Taking</td>
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<td>MNE</td>
<td>Multinational Enterprise</td>
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<td>MTC</td>
<td>Model Tax Convention</td>
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<td>No</td>
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<td>OECD</td>
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<td>Para.</td>
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<td>PE</td>
<td>Permanent Establishment</td>
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<td>Report</td>
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Chapter I: Introduction

1.1 Premise

Art. 7 OECD Model Tax Convention (MTC) is entitled ‘Business profits’. This Article represents the distributive rule for business profit and the scope is to allocate the taxing rights between Contracting States. The modern version of Art. 7 has been reformulated in 2008 and adopted in the OECD MTC from version 2010. The first paragraph of aforementioned article attributes the taxing right to the host state in presence of a permanent establishment (PE). In order to do so, in the second paragraph it has been included the so-called functionally separate entity approach (FSEA), which has the scope to “provides the basic rule for the determination of the profits that are attributable to a permanent establishment”. This basic principle that tackles the FSEA as part of the Authorised OECD Approach (AOA) will lead to an attribution of profit as the PE would have been a separate entity from the head office.

In 2010 the OECD released also the ‘Report on the attribution of profit to permanent establishments’. This document has the scope to clarify the application of Art. 7 in PEs’ situations. Beside a first part that tackles general aspects of the attribution of profit to a PE, the following parts deal with financial sector’s enterprises. Despite the 2010’s and subsequent interventions, some issues regarding the attribution of profit to PE still remain.

1.2 Objective

This thesis’ aim is to analyse the extension of the FSEA used in order to attribute a proper amount of profit to banks’ PE and the related implication in the AOA. From a general perspective in fact, under the FSEA a PE is treated as being a separate entity from the head office. Functions, assets, risks and funding shall be attributed as it was a separate legal entity. However, beyond the previous

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1 Art. 7(1) OECD MTC: “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.”

statement some general limitation of the FSEA and the particular nature of bank (and in general financial institutions) require a further reflection. Practically speaking: how far is the extension of this functional separate entity approach? Is it treatable as a complete separate company by itself? If not, how far is from the economic reality of the company? Before answering to these questions, basics definitions will be included in the second chapter of this thesis. In particular the author will deal with concepts such as PE, FSEA, banks and traditional banking activities and an explanation of the AOA.

Despite time has been passed, some of rules created from the draft convention of the League of the Nations are still in force. In particular the AOA regards a complex analysis that has as a result “[…] to arrive to a profit that is sufficiently acceptable, but which is not scientifically verifiable”.

Although a ‘not scientifically verifiable’ discipline, the banking sector enjoys more detailed and specific legislation that have been included in the OECD’s ‘Report on the attribution of profit to permanent establishments’. Furthermore banks have a peculiar regulation that regards minimum capital requirement that has been established with the Basel agreements: they will concerns banks operating through subsidiaries while for PE no express reference is done. The third chapter will include a digression of the regulation for banks operating through companies.

In chapter four will be analysed several issues regarding the FSEA and the AOA and analysis different authors’ positions.

Although the FSEA represents a consolidated mechanism, it will be explained how this approach includes internal controversy and incongruences. Concerning banks it will be discussed the issue of the highly integrated nature of the banking sector, creditworthiness and the relation between free capital and minimum capital requirements. The final goal of this thesis is to seek to build up a constructive critic and to find out the extension, strength and limitation of the ‘functional separate entity approach’ included in the AOA with regard banks´ PE.

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3 Concepts such as the arm’s length principle and permanent establishment and separate accounting approach (a sort of predecessor of the separate entity approach) arise from the work done in the League of Nations between 1927 till 1933.

1.3 Delimitations

In order to complete this thesis, the following delimitations will be taken. Firstly: the main source of the materials derives from the OECD. In particular it will be analysed the OECD MTC version 2014, its commentary (version 2010), the ‘Report on the attribution of profit to permanent establishments’ and the `transfer pricing guidelines for multinational enterprises and tax administrations’. All the materials issued by the UN are out of the scope of this thesis so that are not included.

Secondly, the activity of banks involved in global trading of financial instruments and insurances companies will not be tackled in this thesis. The author’s analysis will focus on PEs of banks involved in the so-called traditional banking activity. For the definitions of ‘bank’ and what is meant by traditional banking activity please refer respectively to the sub-chapters 2.3 and 2.4.

Thirdly, possible approaches that could substitute the AOA will be not dealt in this thesis.

1.4 Legal method

The author will analyse the subject of this thesis following a traditional legal method and a comparative legal method. As primary issue, the present document’s core will regard the extension of the functionally separate entity approach utilised during the AOA. Beside this main aspect, several secondary are dealt. If on one hand studying banks has required several digressions in the field of political science, economy and tax policies, on the other hand the present document will not address technical issues deriving from the previous mentioned sciences. The focus will be on the legal implication arising for the AOA and from the OECD regulation as it is now (de lege lata approach).

The OECD materials represent the main source for this thesis. It would be important to discuss the legal value to assign to OECD’s materials. This legal sources used in fact have mainly supranational nature. In order to have full legal effect they must be implemented by national governments into their own legal system. However, the authority of the OECD documents is so high that it is also
followed by a great number of non-members countries. Issues such as international double taxation or tax distortions at macro-economy level can only be resolved through consensus and coordination's at international level.
2. Banks’ PE and the AOA

This chapter has the scope to introduce fundamental concepts with regard the subject of the thesis. In the first part, the author will focus on the OECD’s interpretation of key concepts such as permanent establishment, business profit, banks and traditional banking activity. After that more specific topics will follow: in particular the functionally separate entity approach (FSEA) and the authorized OECD approach (AOA).

2.1 Permanent establishment

In the area of international taxation one of the topics has been increasingly discussed is the proper taxation of PEs. Historically this form of taxable ‘entity’ has been created in order to tax the amount profit\(^5\) that has been arisen in the PE’s host country. In the OECD MTC Commentary stressed that: “the main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State”.\(^6\) States have always been reluctant to any kind of initiative or threat that may be at their tax base. The PE’s concept has the main function to allocate in the source Country income generate in its jurisdiction.

Regarding the specific definition included in the OECD MTC, Art. 5 (1) states that a PE is "[...] a fixed place of business through which the business of an enterprise is wholly or partly carry on.” This definition is quite broad and his followed by a “non-exhaustive list of examples”\(^7\) included in the second paragraph.

The fundamental requirements for the existing conditions for a PE are list below, and are in particular:

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\(^5\) Regarding the meaning of the word 'profits', the OECD MTC commentary on Art. 7, sub-para. 71 states that: “[...] It should nevertheless well understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD Member countries.”

\(^6\) OECD MTC Commentary on article 5, sub-para. 1.

• the existence of a “place of business”\textsuperscript{8},
• this place of business must be “fixed”\textsuperscript{10};
• the carrying on of the business of the enterprise through this fixed place of business.”

2.2 Article 7 OECD MTC and the FSEA

Art. 7 OECD MTC is entitled ‘business profit’ and includes the distributive rule for PE’s profit. It allocates the taxing right to the country in which the PE is located and in which the income taxed is sourced.\textsuperscript{11}

The second paragraph of Art. 7 contains the so called ‘functionally separate entity approach’ (FSEA). It states that:

the profits that are attributable in each Contracting State to the permanent establishment […] 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.\textsuperscript{12}

\textsuperscript{8} The term “place” is considered as the “cornerstone of the PE definition”. This place has the scope to run a business. It can include all the tangible assets necessary to run the function performed by the enterprise. Despite this, merely intangible assets cannot qualify as PE in any case. In the case of bank’s PEs, activities are usually performed through place of management, branch or office. For a further analysis see: VV. AA., Klaus Vogel on Double Taxation Conventions, 4th edition, Volume I, 2015.

\textsuperscript{9} The OECD MTC dedicates space at art. 3 to definitions regarding the word ‘business’. The OECD MTC commentary on art. 3 sub-para. 10.2 states that: "The convention does not contain an exhaustive definition of the term ‘business’ which, under paragraph 2, should generally have the meaning which it has under the domestic law of the State that applies the Convention. Sub-paragraph (h), however, provides expressly that the term includes the performance of professional services and of other activities of an independent character.”

\textsuperscript{10} The term fixed has the function to stress the link between the territory in which the PE is situated and the PE itself. It has mainly a space characteristic although includes a temporal elements, a certain degree of permanence. The OECD does not give a specific amount of time to establish a PE, however many Countries have established a six months period.

\textsuperscript{11} Art. 7(1) OECD MTC: "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.”

\textsuperscript{12} OECD MTC Art. 7 (2).
From a theoretical perspective the FSEA represents an optimal solution to attribute a proper amount of profit however, from practical perspective, this ‘fiction’ creates some difficulties. It particular the main critics regards the FSEA appears overly complex and ‘far reaching’ from the economic reality due to the fact the non- tax elements are taken in considerations. An in- depth analysis of the latter issue will be undertaken in the fourth chapter.

2.3 The concepts of enterprise and bank

For the purpose of this thesis it will be relevant to undertake an analysis of the concept of enterprise and business profits and see if there is any substantial implication with regard banks and banking activities.

Regarding the term 'enterprise', the OECD MTC is vague. It states in its commentary that: “no exhaustive definition of the term “enterprise” has therefore attempted in this Article [3]”. In this respect the author would like to mention Sasseville, that underlines the ambiguity of the term enterprise within the OECD MTC 2014. The OECD MTC Commentary on art. 3 para. 4 refers directly to the concept of enterprise in the respective domestic law. Furthermore the previous mentioned author writes: "that ambiguity, however, does not seems to have created significant practical difficulties".

The concept of bank is quite broad and can have different interpretation according with domestic law. Fundamental assumption for this thesis is that in the concept of enterprise is included the concept of bank. The OECD implicitly confirms this position: no contrary statement is found in its material.

In order to give a definition of the concept of ‘bank’, the author would like to mention the definitions included in the OECD ‘Glosarry of statistical term’ for the English word ‘bank’ and for the French one ‘banque’. In the former case:

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13 For a further analysis see Dziurdż K., Attribution of Functions and Profits to a Dependent Agent PE: Different Arm’s Length Principles under Articles 7(2) and 9?, World Tax Journal, Vol. 6, No. 2, 2014.
14 OECD MTC Commentary on Article 3,para. 1, sub-para. 4.
Banks are generally defined as institutions whose business is to receive deposits and/or close substitutes for deposits and grant credits or invest in securities on their own account.\textsuperscript{16}

The French definition that follows is wider than the English one, in fact:

Banks comprise all units that engage in financial intermediation as their principal activity and have liabilities in the form of deposits or financial instruments (such as short-term certificates of deposit) that are close substitutes for deposits.\textsuperscript{17}

As mentioned before the concept of ‘enterprise is quite vague’ and refers directly to the domestic law. For the purpose of this thesis, the concept of bank will regard closely the English interpretation that is near by the OECD’s concept of ‘traditional banking activity’.

2.4 Traditional banking activities

Nowadays Banks are generally involved in different kind of activities such as borrowing and lending money, providing insurances, financial instruments and so on. This thesis will deal with banks' PEs involved in the so-called ‘traditional banking activities’. According with the OECD’s ‘Report on attribution of profits to permanent establishments' for 'traditional banking activities' is meant the activities of “borrowing and on-lending money’.\textsuperscript{18}

2.5 The Authorised OECD Approach (AOA)

The Authorised OECD Approach consists in analysing the role that the PE and the head office play in a specific transaction following the FSEA. This means that a PE will be threat as a distinct entity from the company it belongs. In order to define the functions performed, assets used and risk assumed by the PE a 'functional and factual analysis' must be undertaken. In particular the OECD's

\textsuperscript{16} From the OECD Glossary of statistical term. https://stats.oecd.org/glossary/detail.asp?ID=177
\textsuperscript{17} From the OECD Glossary of statistical term. https://stats.oecd.org/glossary/detail.asp?ID=178
\textsuperscript{18} OECD, Report on the attribution of profit to permanent establishments, part II -A sub- para. 3.
approach is characterized on the significant people function approach performed into the PE. Nonetheless is important to clarify how: “the authorised OECD approach does not dictate the specifics of mechanism of domestic law, but only sets a limit on the amount of profit that may be taxed in the host country of the PE”. 19

2.6 AOA´s first step

The purpose of this chapter and the following sub-chapters is to give a descriptive overview on the AOA applied to banks. In general the AOA is composed by a two-steps process: the first step consists in running a functional analysis of the PE focusing on the:

- functions;
- risks;
- assets and
- funding.

The second step will focus on the remuneration for the dealings at arm’s length distance due to an application by analogy of the OECD ‘transfer pricing guidelines for multinational enterprises and tax administrations’.

2.6.1 Functions

Regarding the functions the OECD in the ‘Report on the attribution of profit to permanent establishments’ gives a high relevance to the:

The functional and factual analysis take account of the functions performed by the personnel of the enterprise as a whole including the PE - “people functions” - and assesses what significance if any they have in generating the profits of the business. 20

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The focus in this step is on the ‘people function’ performed in the PE in respect to the functions performed in the company as a whole. A potential issue arises from functions performed automatically and/or without human intervention.\textsuperscript{21} With regards specific banks’ PEs involved in traditional banking activities, the functions performed will be mainly two: firstly the function of creating a loan, secondly the activity of managing it during the length of the financial assets created.\textsuperscript{22} Furthermore the OECD highlights the functions performed in the traditional banking activity as the “key entrepreneurial risk-taking functions and […] generally attributed to the location performing those functions”.\textsuperscript{23} Due to the highly integrated nature of banks, there is not necessity that the two aforementioned steps take place in same company or part of the group. Neither that they both represent KERT functions.\textsuperscript{24} Furthermore after have issued a loan, the subsequently risk may be transferred to other parts of the company or even third parties.

\subsection*{2.6.2 Assets}

Once the functions of the PE have been analysed, the next step regards the assets used. The OECD applies an ‘economic ownership approach’: PE’s assets used will be considered as owned by the PE. Whid particular regards the assets used there is an important distinction between tangible and intangible assets:

\begin{flushleft}
\textsuperscript{21} In particular Monsenego J. in \textit{May a Server Create a Permanent Establishment? Reflections on Certain Questions of Principle in Light of a Swedish Case}, International Transfer Pricing Journal, Vol. 21, No. 4, 2014, analyses several aspect with regards PE requirements and serves. In particular he affirms that: \textit{“The authorized OECD approach does not recognize the possibility to attribute to a server the functions that are automatically performed by the server; however, as such functions are performed automatically, i.e. with no human intervention, a server will not be attributed any significant people functions.”}
\textsuperscript{22} See OECD, \textit{Report on the attribution of profit to permanent establishments}, part II, sub- para. 5.
\textsuperscript{24} Andresen U, Imhof M and Tao Y. \textit{Permanent Establishment Regulations for Banks and Insurers}, International Transfer Pricing Journal, Vol. 22, No. 3, 2015 explain the relation between KERT functions and the place where they are performed for banks according with German law: \textit{“Activities will qualify as KERT functions only if they are performed before the financial asset is created, i.e. up to the point in time the loan is granted. The consequence is that activities which are being performed in the ongoing management of an existing financial asset do not qualify as KERT functions for the purpose of the initial attribution of economic ownership of a loan under German law”}. (note omitted)
\end{flushleft}
tangible property should be attributed to the location where it is used rather than to the place from which it is acquired and subsequently managed, if differs. [...] Intangibles, on the other hand, having no physical location, are to be attributed to the business location where the work of developing, acquiring and management of them take place.  

2.6.3 Risks

As underlines in the OECD’s Report the range of possible risks is quite broad. In the specific case of PEs, is the whole enterprise that bears the risks. PE's risks in fact are difficult to allocate due to the fact that the PE has no separate legal entity from the company and for the highly integrated nature of its activities. However, under the AOA: “the PE should be considered as assuming any risks for which the significant people functions relevant to the assumption of risk are performed by the personnel of the PE's at the PE's location”.

The focus is again on the ‘people function’ performed in the PE in respect to the functions performed in the company as a whole. However the OECD’s Report clarifies the hierarchy between risk and functions. In fact it states that: “[…] the authorised OECD approach […] starts from the premise that assets and risks follow functions and capital follows risk”.

Regarding specifically traditional bank activities, the OECD's Report splits banks’ risks in several categories related on tax issues:

1. Credit Risk;
2. Market Interest Rate;
3. Market foreign exchange risk;
4. Country risk;
5. Legal risk
6. Unsettled foreign exchange position risk (knows as ‘Herstatt’ risk).

26 OECD, Report on the attribution of profit to permanent establishments, part I, sub-para. 68.
27 OECD, Report on the attribution of profit to permanent establishments, part III, sub-para. 80.
28 For a further analysis see: OECD, Report on the attribution of profit to permanent establishments, part II, sub-para. 90-105.
For the purpose of this thesis it is important to mention the role of credit risks.\textsuperscript{29} In fact:

In traditional banking activities, credit risk is generally the most important risk assumed as a result of the creation of the financial asset because the bank is potentially at risk for the whole of the principal sum advanced to a customer in the form of a loan, even though it may subsequently try to pass on that risk to an independent enterprise.\textsuperscript{30}

Despite a more detailed and specific regulation, the evaluation of risks for PE's banks appears much easier to identify than for other PE. The field of banking is based on strict requirements in order to have a correct identification of the risks undertaken by the bank recurrent over time. This is due firstly to protect the financing and global sector as a whole and secondly to protect investors.

2.6.4 Funding

In order to perform his function, a PE needs a minimum of capital with which it can carries out its own activities. This capital is called 'free capital' and it is characterized by “funding that does not give rise to a tax deductible return in the nature of interest”.\textsuperscript{31} Regarding the funding a proper amount of free capital shall be attributed to the PE: “under the AOA, PEs are required to have an arm’s length amount of free capital to support: the risk allocated to that PE, the functions it undertakes; and the assets it economically owns”.\textsuperscript{32}

The financing of a company can arise from two different sources: internal or external source. In the internal situation, the capital arise by the use or belonging of assets, while in the external case in can derived by external source such as in

\begin{footnotesize}
\begin{enumerate}
\item[29] The OECD, \textit{Report on the attribution of profit to permanent establishments}, part II, sub- para 17, where it defined credit risk as "the risk that the customer will be unable to pay the interest or to repay the principal of the loan in accordance with its term and conditions."
\item[31] OECD, \textit{Report on the attribution of profit to permanent establishments}, part I, sub-para. 15.
\end{enumerate}
\end{footnotesize}
the case of debt financing, equity financing or hybrid securities. The main
difference among them is related to the comparison between risk and return and
the relative tax treatment. Debt financing results in interest, and are usually tax
deductibles, while in the case of equity financing no deduction is allowed.
In the specific case of PEs, “[...] capital comes from three sources: 1) contribution
of equity by shareholders; 2) retained profits; 3) borrowing”. The first two
elements listed before represent equity financing whilst the third one debt
financing.
In the case of banks involved in traditional banking activities, the OECD´s Report
recommend the use of two official method plus a third one not recommended to
allocate a proper amount of capital to the PE, regarding both free and regulatory
capital.
The first method used is the so called ´capital allocation approaches´ and it
consists in allocating capital “[...] on the basis of the proportion that the risk-
weighted assets of the PE bear to the total risk-weighted assets of the entity as a
whole (the BIS ratio approach)”. This method is characterized by a ´formulary´
proportion between functions, assets and risks undertaken by the PE. The capital
approach method has created several issues: it has the limit “differences in the
definition of capital between home and host country can result in the attribution of
more or less than the total amount of capital of the enterprise”. The unclear
modality to manage the attribution of free capital beside the regulatory
requirements gives to this approach a grade of uncertainty in its application and in
a univocal implementation into domestic law for States. Furthermore the free
capital is allocated by proportion so that some authors retain that following this
method would be a sort of breach of the ALP: in particular the BIS ratio used
could assume the characteristics of formulary or quasi formulary approach.

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33 From Petruzzi R., *Transfer pricing aspects of Intra-group Financing*, Ecotax, Wolters Kluwer, 2016, p. 20: “Hybrid securities are instruments that share a number of characteristics of debt and equity, e.g., convertible debts, preferred stocks, and option-linked bonds”.
37 In particular see the Australian Bankers´ Association in *Public Comments received on the Discussion draft on the Attribution of Profits to Permanent Establishments – Part II (Special Considerations for Applying the Working Hypothesis to permanent Establishments of Banks)*. For a further analysis see also Mascarello S., *Attribution of Profits to Permanent Establishment of Banks*, IBFD ITPJ, 2006.
The ´economic capital allocation approach´ can be considered a variation of the first mentioned method. It concentrates the attention on the attribution of capital based on the internal bank’s model for the measurement of the risk. It focuses in particular on “credit and market risks […] although it entails a higher risk of double taxation”.  

The second approach is called ´thin capitalization approach´. The core of this method is to attribute the same amount of free capital as the PE was a completely separate entity. It implies for banks treating a PE as it was an independent bank, subject for this reason to regulatory requirement. The limitation of this approach is underlined in the OECD’s ´Report on the attribution of profit to permanent establishments´ when it states that:

The PE when hypothesised as a separate enterprise would be smaller than the bank as a whole and so might be compared with similarly smaller independent banking enterprises. However, small independent banks are unlikely to be comparable to a PE that is part of a large banking enterprise. They are likely to carry on different types of business, to have different risk profiles and to have different types of customers than the PE to which they are being compared. In short, small independent banks may not be a reliable benchmark to use for attributing capital to such a PE.

Furthermore the aforementioned system has another constraint that the amount of free capital of the PEs could be higher than the amount of capital of the entire bank. After the two authorised methods the OECD deals with a third one not recommended called ´quasi thin capitalisation/regulatory minimum capital approach´ also known as safe harbour approach. This approach consists in attributing an amount of capital as the PE was a separate entity following the host

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40 For a further analysis see VV, AA., Status of Implementation of the Authorized OECD Approach into Domestic Tax Law and Tax Treaties – Part 2, European Taxation, Vol. 55, No. 9, 2015, p. 9.
41 The OECD´s Report on the attribution of profit to permanent establishments, part II, sub-para. 114 clarifies: “it may be acceptable as a safe harbour as long as it does not result in the attribution of profits to the PE that are beyond the range of profits that would result if one of the authorised OECD approaches to capital attribution had been applied”. (note omitted)
country rules. The limitation of this method is that in certain circumstances a double non-taxation could arise.\(^\text{42}\)

To conclude it is important to remark how the issue of the funding is fundamental for bank involved in the activity of lending and borrowing money. Beside the tax aspect of attributing proper amount of free capital, the PE’s head office shall also focus on maintaining a proper amount of minimum capital due to regulatory purposes. Keeping it is essential for the survival of the bank as a whole. Nowadays in fact for a bank “crossing the minimum capital threshold, would for all intents and purposes, be regarded as the kiss of death”.\(^\text{43}\)

### 2.7 AOA’s second step

After have performed the first step of the AOA and having a picture of the PE and of the head office, the second step regards the allocation of profit to the PE. In this phase in fact will be undertaken a ‘comparable analysis’. During this second step in fact: “the profits of the hypothesized separate and independent enterprise must be determined by applying, by analogy, the OECD Transfer Pricing Guidelines”.\(^\text{44}\)

The dealing between PE and the head office shall be priced at arm’s length remuneration and in order to do so, we shall have a look into the OECD Transfer Pricing Guidelines to determine which method it will be the most appropriated.

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\(^{42}\) From the OECD’s Report on the attribution of profit to permanent establishments, part II, sub-para. 115: “the effect of attributing only the regulatory minimum for each of the countries where the bank has PEs is that any free capital in excess of that amount is effectively allocated to the head office. However, the effect of such an approach is that the host country is exercising less than its potential taxing rights under Article 7 and so there are unlikely to be problems of double taxation. Problems of less than single taxation would arise if the home country were to relieve double taxation by reference to the full arm’s length amount of profit even though the host country has taxed less than that amount, as frequently occurs in the case of certain exemption systems”.

\(^{43}\) Borio C. and Zhu H., BIS Working Papers n° 268, Capital regulation, risk-taking and monetary policy: a missing link in the transmission mechanism?, 2008, p. 4. In particular the working paper regards the ’kiss of death’ to two main risks: reputational cost and adverse market reactions.

3. Banks operating through subsidiaries

3.1 Premise

In the international scenario several are the organizations whose object is the law-making inherent banks. The author will mention in particular three of them: the Organization for Economic Co-operation and Development (OECD), the International Monetary Fund (IMF) and Basel Committee on Banking Supervision (BCBS). The work done by the OECD has had a particular focus on the international tax aspects whilst organizations as IMF and BCBS have had more regard to the stability of the global financial sector, focusing on mainly in tax policies in the case of IMF\(^45\) and minimum regulatory capital requirements in the case of the BCBS.

However in recent years each of the aforementioned organizations has undertaken initiatives with different intentions that have led a sophisticated regulation with regards bank and their particular function in the economy. Furthermore these initiatives created somewhat conflicting rules regarding the taxation of financial institutions: in this respect one of the main conflicts arises on nowadays rules that allow tax deductions only for interest arising from debt financing while for equity financing not.

Basel Accords is related more closely to the problems inherent in the capital structure of banks, with an eye to the minimum capital requirement and the allocation between Tier 1 and Tier 2. There are expressly references of these agreements in the OECD's 'Report on the attribution of profit to permanent establishments' albeit rather vague.\(^46\)

3.2 Capital requirements: the Basel agreements

In order to fulfil their own scope firms must have an enough amount of capital to be able to pursue functions performed. This amount of capital can arise from two

\(^{45}\) With regard the IMF its work has analyzed taxation from a macroeconomic and financial policies point of view, with a particular emphasis on the 'tax distortion effect' arising from the allowances of tax deductions only for debt financing.

\(^{46}\) See OECD, *Report on the attribution of profit to permanent establishments*, part II sub-para. 36.
different sources: equity capital and debt capital.\textsuperscript{47} For banks the situation is even more peculiar. Beside the issue of obtaining a proper amount of capital in order to fulfil their functions, a minimum of mandatory capital is required. The international organization that has had the main function of establish minimum requirement for bank's capital structure has been the BCBS with three different agreements, called Basel agreements. Basel I was concluded in 1988. It rules for the first time the minimum capital structure requirement. In 2004 Basel II was published: this new agreement divides the capital in two main categories (called 'Tiers'). The main distinctions between Tier 1 and Tier 2 regard the capital investment's permanency length and the subsequent treatment of interests. In the latest update of the Basil III, it has been established that:

\begin{quote}
Common Equity Tier 1 must be at least 4.5\% of risk-weighted assets at all times. Tier 1 Capital must be at least 6.0\% of risk-weighted assets at all times. Total Capital (Tier 1 Capital plus Tier 2 Capital) must be at least 8.0\% of riskweighted.\textsuperscript{48}
\end{quote}

Basel III includes also liquidity requirements. Despite this there is no direct implication for liquidity to assign to a bank's PE both a BCBS level\textsuperscript{49} and at OECD level.\textsuperscript{50} The distinction between Tiers should be done only at the level of parent company or subsidiary. PE's capital structure is not dealt in the Basel agreements, but only at OECD level. Regarding banks' PEs the OECD’s ‘Report on the attribution of profit to permanent establishments’, listed two authorised method (plus a third one not recommended) to allows an integration of the Basel agreements with the OECD’s Report. Despite this, the results arising from the use of these three methods could lead to results different form one to other and further

\textsuperscript{47} From the relationship between the two previous sources of capital, it is to get a picture of the financial situation of a company: in fact, the relation of the two funding sources is utilized to have an overall idea on the risks undertaken and his exposure to a possible insolvency or bankruptcy of a company: this ratio is called debt-to-equity ratio.
\textsuperscript{48} BCBS, \textit{Basel III: a global regulatory framework for more resilient banks and banking systems}, 2011, para. 50.
\textsuperscript{49} In the specific, the 'liquidity coverage ratio' and 'net stable funding ratio'. For a further analysis see: BCBS, \textit{Basel III: a global regulatory framework for more resilient banks and banking systems}, 2011.
\textsuperscript{50} From OECD, \textit{Report on the attribution of profit to permanent establishments}, part II sub-para. 88.: "an arm’s length attribution of —free capital to the PE may have to be made to ensure an arm’s length attribution of taxable profit to the PE, even though no —free capital has actually been allotted to the PE for regulatory or other purposes.”
difficulties arise depending on the type of method used in the domestic law: double taxation issue could arise in cases of application of two different methods by the Contracting States.\footnote{For a further analysis see Gazzo M., Attribution of Free Capital to Permanent Establishment of a Bank: A Vexed Issue, A general Overview and the Italian ‘State of Art’, Intertax, Vol. 37, issue 11, 2009.}

\section*{3.3 Tax considerations for debt funding and equity funding}

In order to maximize the profit, banks need to fulfil minimum regulatory capital requirements. Numerous are the incentives to fund themselves through debt capital, such as granting tax deductions exclusively for debt funding’s interests. Author as De Mooji retains that from an economic perspective the distinction between deductions within debt and equity return make “no sense”.\footnote{See De Mooij R.A., Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions, IMF Staff Discussion Notes, 2011, p. 10.} Furthermore it has been at tendency of the last year to have an extensive use of debt financing. Author as Allen for example suggests the possibility to allow tax deductions extended to equity capital. The previous mentioned author thinks that the decision for bank management to finance them through debt arises from tax incentives. Change the tax discipline could help the whole global system to be more stable, and also be incentives for virtues bank, and in general virtues companies. She also underlined the “policy paradox”\footnote{Allen H.J., Let's talk about tax: fixing bank incentives to sabotage stability, HeinOnline, 18 Fordham J. Corp & Fin., 2012-2013, p. 824.} existing nowadays: “financial regulation forces banks to fund themselves with more equity, while tax rules simultaneously punish equity funding”.\footnote{Allen H.J., Let's talk about tax: fixing bank incentives to sabotage stability, HeinOnline, 18 Fordham J. Corp & Fin., 2012-2013, p. 824.} Allen’s considerations could have a direct effect also for PE, granting tax deduction also for the amount of free capital. The author’s position on this issue is that neutralizing the differences in tax treatment between debt and equity capital would allow the concept of free capital, understood as “funding that does not give rise to a tax deductible return in the nature of interest”\footnote{OECD, Report on the attribution of profit to permanent establishments, part I, sub- para. 15.}, be meaningless. The issue of attributing regulatory minimum capital requirement between head office and the PE will remain the sole to solve.
3.4 Tax distortions

The IMF has analysed the problem from a tax policy's point of view. In the report 'Debt bias and other distortions: crisis related issues in tax policy' is written that: “[...] tax distortions are likely to have contributed to the crisis by leading to levels of debt higher than otherwise would have been the case”. In particular the bias between debt and equity financing with regards banks is on one hand less responsive to tax due to regulatory capital requirement but on the other hand more benefiting from the possibility of using hybrid financial instruments.

Tax distortion can be contrasted, according with Page with a “cost-of-equity tax deduction [that] would reduce undesirable behaviour”. Another distortion is caused by the different corporate income tax rate that is applied in different jurisdiction, in fact:

there are a potential tax advantages to borrowing in countries with relatively high statutory CIT rates. Lending from subsidiaries in low tax jurisdictions to other located in high tax ones is advantageous, for instance, since then interest is taxed at a lower rate than it is deducted.

There may even be circumstances in which by borrowing, preferably in relatively high-tax jurisdictions, companies can double-dip, taking multiple interest deductions. (note omitted)

To counter this type of problem, greater coordination between international organizations is needed, and OECD's attention should be drawn to the possible effects of so-called tax distortions.

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56 From IMF, Debt bias and other distortions: crisis related issues in tax policy, 2009, p.11: “Banks face both an explicit tax advantage of debt and, through regulatory requirements, an implicit penalty— with evident risk of policy incoherence. Tax incentives towards high leverage may have undercut the effectiveness of regulatory requirements.”


59 IMF, Debt bias and other distortions: crisis related issues in tax policy, 2009, pag. 35.
4. How far is the separate entity approach fully achievable?

4.1 Bank’s PE and subsidiaries: a breach of the principle of neutrality?

From a comparative reading of chapter II (for bank’s PE) and chapter III (for bank’s subsidiaries) the regulations regarding the two legal forms analysed appear difficult to integrate each other. If on one hand the principle of neutrality represents a pillar of tax law, on the other hand the differences of treatment between PEs and subsidiaries can be seen as a breach of the principle of neutrality of legal forms. It is on the OECD’s purpose to maintain a different treatment within subsidiaries and PEs: as underlined in the ‘Report on the attribution of profit to permanent establishments’, the two different solutions have different economic output. It is not one of the OECD goals to achieve equality between them. The Report states that:

The legal form chosen, PE or subsidiary, may have some economic effects that should be reflected in the determination of taxable profits. In many cases, business operated through permanent establishments rather than separate entities precisely because the PE structure provides for efficient capital utilisation, risk diversification, economies of scale, etc., making the structure more profitable.\textsuperscript{60}

The difference in treatment can represent for banks an opportunity to operate abroad. However an author such as Panayi retains that: “If PEs are taxed differently from subsidiaries, this could create an incentive through one vehicle rather than another”\textsuperscript{61}. The difference in treatment if unbalanced can represent an incentive (or disincentive) for a legal form over the other. A PE is basically a simplified choice that must be treated through a ‘fiction’ as it was a separate and independent bank.

Despite the OECD does not appear to be interested in achieving the neutralization of legal forms, neutrality is somehow achieved with the affinity of neutrality inherent the arm’s length principle, which will: “[…] ensures that similar

\footnotesize{\textsuperscript{60} OECD, \textit{Report on the attribution of profit to permanent establishments}, part II, sub-para. 4.}
\footnotesize{\textsuperscript{61} Panayi C., \textit{The Taxation of Permanent Establishments: Selected Issues}, Bulletin for International Taxation, Vol. 67, No. 4/5, 2013.}
economic transactions are similarly taxed, irrespective of the form used in carrying on the business”.

4.2 PE’s treatment as a fiction

In the OECD` Report on the attribution of profit to permanent establishments´ the word ´fiction´ is used in different situation to express the approach to take to deal with PE. In particular: “The PE must be view as a functionally separate entity. As a single legal entity cannot trade with itself, this is a fiction”. Fiction in fact means treating a PE as it was a separate legal entity, although in reality is not. It is the OECD that expressively states that:

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

If on one hand the purpose is to treat a PE as a separate entity in order to attribute the correct amount of business profit, on the other hand this simulation as some limitation. Firstly: a fiction cannot substitute background the non-tax differences existing between the two legal forms, such as “[…] the availability of limited liability, separate legal entity, different accounting obligations or other regulatory differences […].” In the case of banks in fact, non-tax elements could lead to a completely different attribution of capital, both concerning the total amount and for how it is composed and allotted. Treat a PE as separate entity for tax purpose

64 OECD, Report on the attribution of profit to permanent establishments, part II, sub-para. 11.
66 With specific regard the issue of free capital, is the OECD itself in the Report on the attribution of profit to permanent establishments, part II, sub-para. 52 defined it as “not an exact science […]
without including the economic implication can let the previous mentioned fiction to be far away from the substance of the transactions.

The author agrees with Panayi when affirms that “it arguably questionable whether or not confining the comparability exercise to the tax factors (always) yields an accurate and fair result”.\textsuperscript{67} Initiating an assessment by isolating tax factors from other factors such as structure and capital composition for businesses highly integrated as banks, appears to be difficult and to lead to a result (or range of results) that could be considered approximately ‘accurate and fair’ by the contracting parties. However the result is susceptible to certain degree of discretion.

Schoueri is also on a similar position: he underlines how the ALP included in the FSEA, lead subsequently to a fiction that cannot reflect the economic reality. Furthermore according with his view a PE will be considered more as an integrated entity than a separate entity due to the control that the head office has on it. He affirms that:

\begin{quote}
The ALS would not reflect reality, as MNEs do not treat each subsidiary as a separate entity but rather as integrated entities, whose prices can be controlled by an MNE, considering the respective tax implications.\textsuperscript{68} (note omitted)
\end{quote}

In the author’s understanding, the economic reality of a bank’s PE is closer to be in substance considered as an integrated entity with the head office. The unclear nature of the FSEA plus the lack of consideration for non-tax elements lead to an approximate result, although roughly correct. The authors agrees with the view that more than talking about a functional and separate entity approach, the issue goes around an FSEA hybridized with ‘single’ entity approach. Although a PE could be seen as separate entity, the head office has still the power to dictate strategies that has direct effect on the whole structure. The position is shared also by Kobetsky that points out how:

\begin{quote}
[that] can give raise to a range of arm’s length results for the capital attributable to a PE, not a single figure”.
\end{quote}


[...] a permanent establishment is one part of a whole enterprise with a unitary profit motive and common control. For highly integrated international enterprises, such as bank, the use of the separate entity fiction is inappropriate from both a normative and practical perspective.\textsuperscript{69}

As mentioned before, the position taken by the OECD seems not to be clear: it states that the FSEA principle to be followed, but on the other hand traces of the single entity approach are still followed and included the guidelines. In support of the above-mentioned thesis, we can take in consideration the greater ease and feasibility of the documentation produced to conclude internal transaction with respect to external ones. Practice has shown how: “[...] the supporting documentation available to evidence the pricing policies between PE and head office/other parts of the enterprise will be less formal than that needed for transactions between separate legal entities (eg fellow subsidiaries)”\textsuperscript{70}

4.3 Critics to the AOA

In this chapter the author will be analysidethe main critics with regard the AOA. For a practical reason the author decides to deal with the different issues in the subparagraphs listed below:

1. Complexity;
2. Risk of erosion tax base and/or no practical benefits;
3. Heterogeneous accounting system issue;
4. Creditworthiness issue;
5. Funding issue.

In the first two situations listed upon, the analysis and the critics will regard mainly the AOA as a whole. No. 3) will regard accounting difficulties. In 4) and 5) the focus is on the FSEA applied in the AOA.

4.3.1 Complexity

The introduction of the AOA has generated perplexity in the field of the international tax law. This was due for a certain degree of complexity that has led to several Countries to do not apply the approach created by the OECD. Authors as Miller and Oats point out that:

[...] the OECD’s method (AOA) has been heavily criticized during the course of the BEPS Project work on PEs. The AOA is felt to be difficult to apply. There is a lack of detailed guidance on how to apply it, except for companies in the financial sector.\textsuperscript{71}

The AOA scepticism arises from the dawn of the modern version of article 7 OECD MTC, incorporate for the first time in the 2010 version of the MTC. Nouel underlines how: "Six out of the thirty-one OECD Member countries that approved the 2010 OECD Model made a reservation indicating that they intend to use the previous version of Art. 7 (Chile, Greece, Mexico, New Zealand, Portugal and Turkey)". \textsuperscript{72} Furthermore: “the UN Committee of Experts on International Cooperation in Tax Matters [...] also agreed not to include the AOA in the future version of the UN Model Tax Convention”. \textsuperscript{73} A further problem that arises in this respect regards the application of the AOA between OECD member countries and OECD non-members countries: as mentioned before the AOA is included only in the OECD MTC so that in cases of unclear determination in tax treaty between a OECD member and a non-member countries, it shall not be retained as applicable.\textsuperscript{74}

The difficulty of the application of the AOA arises from a high complexity. In the case of banks despite the existence of specific guidelines\textsuperscript{75}, the AOA can assume

\begin{flushright}
\textsuperscript{74} See Monsenego J., \textit{Introduction to Transfer Pricing}, Student litteratur, 2013, p.121.
\textsuperscript{75} for the financial sector the OECD dedicated two sections of the ‘Report on the attribution of profit to permanent establishments’ to banks (part II) and to ‘enterprises carrying on global trading
an even higher grade of difficulty due to the peculiar international regulation. The area where the discipline is particularly specific with respect to banks regards minimum capital requirements, a more detailed evaluation of the risks assumed and creditworthiness. Furthermore the AOA entails banks to a greater administrative burden: it requires an adjustment or addition of the documentation that banks produce for regulatory, managing and financial purposes, so that beside a greater complexity emerges a greater burdensome.\(^\text{76 77}\)

### 4.3.2 Risk of erosion tax base and/or no practical benefits

Another reason that explains why States are so sceptic about the AOA is due to the risk to see erode their tax base.

The main argument against the AOA is that, in certain circumstances, it may transfer profits from the PE state to the residence state of the enterprise. This is a product of the unlimited recognition of “deductible” notional expenses in case in which the domestic law of the PE state would otherwise disallow such deductions.\(^\text{78}\)

Moreover there is no empirical evidence that the AOA will be really useful to deal with the issue of double taxation. Although no practical benefits can arises from the AOA, author as Schnitger retains that at least no risk of double taxation as well double non-taxation should arise in case of a ´unanimously´ application of the AOA.\(^\text{79}\) The author also agrees that it is better to have a homogeneous interpretation of the rules imposed by the OECD. The number of reservations included in the OECD Commentary shows reluctance of States to a uniform

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\(^{76}\) With the release by the OECD publication Transfer Pricing Documentation and Country-by-Country Reporting ACTION 13: 2015 Final Report, companies have the burden to produce a further three-tiered documentation to the tax administrations. These documentations will be composed by a ´Master file´, a ´local file´ and a ´Country by Country´ report.

\(^{77}\) Despite the OECD’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations Guidelines, 2010. sub-para. 5.28 states that: “documentation requirements should not impose on taxpayers costs and burdens disproportionate to the circumstances.”


application. However it is also important to remark the OECD´s work concerned creating a framework of space in which States have margin to move rather than dictating specific and tightly binding guidelines. A greater homogeneity will arrives with time.

4.3.3 Heterogeneous accounting system issue

Art. 7 OECD MTC includes the distributive rule regarding business profits. A potential issue arising regards the different accounting system used by States: “profits and losses cannot be determined without clear accounting standards. Usually, such standards are established by domestic laws of the contracting States, and they may deviate from one another”. In addition sensible differences between common law country and civil law country still exist. However, in the international scenario has been a very relevant role the activities done by the International Accounting Standards (IAS) especially for the financial sector: since the 90´ it has been working to create accounting principles common to all nations. The implementation into the domestic law has not been uniformly done, however the work done so far makes the author retaining that we are on the right track to solve issues arising from different accounting systems.

4.3.4 The creditworthiness issue

In the specific case of banks, the author would like focus the attention on two different aspects of the FSEA: on the issue around the creditworthiness and capital requirement. One of the main factors to take into account is the creditworthiness of the bank. Creditworthiness is described as:

[...] the perception by an independent party, e.g. a credit rating agency, of the likelihood that a company (e.g. a bank) will meet its commitments in respect of any borrowing it has made and investments it has received.

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81 OECD, Report on the attribution of profit to permanent establishments, part II, sub-para. 29.
The creditworthiness is in fact a crucial factor for a bank because “[…] is inversely related to the interest rate it pays to its investors (its depositors and holders of its debt instruments). The lower the creditworthiness of the bank the higher the interest rate it pays to its investors.”

According with the OECD Report, at the presence of bank's PE, the creditworthiness is “usually undertaken by reference to the bank as a whole or to specific financial instruments and not to individual branches”. The aforementioned sentence shows up an ambiguity in the AOA that regards the FSEA. How is possible treat a bank branch as a separate entity if the creditworthiness shall be considered as a single entity with the head office? The OECD justify this position saying that for the creditworthiness and the capital “[…] reflects the fact that generally the whole of the bank’s assets and capital are potentially available to meet any claims on the bank regardless of where the liability leading to the claim is located”. A possible alternative would be attributing a specific creditworthiness to the PE. However in this case other side-effects arise. Author as Mascarello for example, explains that attributing a lower creditworthiness to the PE in respect to the head office’s creditworthiness in situation of internal dealings could lead to aggressive tax planning strategies. The OECD FSEA ‘exemption’ is justified by the risk of tax avoidance that prevails over the possibility of fully extending the FSEA in the attribution of profit to a bank’s PE. In this particular issue the author shares the view of the OECD: at the presence of MNEs which exploit legislative gaps to implement aggressive tax planning strategies, attributing the same creditworthiness of the head office represents a right choice especially for highly integrated enterprise such as banks.

4.3.5 PE’s funding issue

The AOA includes treating a PE as a separate legal entity: it should have a proper amount of free capital based on the functions, assets and risks performed. For Banks’ PE however, beside the issue of the attribution of free capital more

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82 OECD, Report on the attribution of profit to permanent establishments, part II, sub-para. 28.
84 OECD, Report on the attribution of profit to permanent establishments, part II, sub-para. 30.
85 For a further analysis see Mascarello S., Attribution of Profits to Permanent Establishment of Banks, IBFD ITPJ, 2006, p. 63.
complexity arises from the combined fulfilment of tax capital requirement and minimum regulatory capital regulated by the BCBS.

The OECD in the ‘Report on the attribution of profit to permanent establishments’ deals between the relations between the OECD Report and the Basel agreements. The report states that:

In general, for financial accounting purposes Tier 1 capital does not result in any interest cost, whilst Tier 2 capital does. Consequently, in computing the bank’s profit for accounting purposes it is usually only the return on Tier 2 capital that will be deducted. The treatment for tax purposes may not follow the accounting treatment. Although the return on Tier 1 capital does not result generally in any tax deduction in the nature of interest (it is free capital for tax as well as accounting purposes), there may be some instruments that qualify as Tier 1 capital for regulatory purposes but are treated as debt for tax purposes in some jurisdictions. […] Further, in a number of jurisdictions, some Tier 2 capital such as subordinated debt may be treated as free capital for tax purposes.86

The previous mentioned paragraph gives a general overview of the ‘funding issue’ and help us to understand how the issue of regulatory capital and capital allotted for tax purposes are somehow distinguished and how with nowadays ‘rules no clear overlay is possible between the concept of Tier 1 and free capital. Beside this, the BCBS regulation is very specific with regards the composition of the Tiers88, whilst regarding the composition of free capital the paragraph quoted before is quite vague. In order to deal the issue the relation between free capital and minimum capital requirement more precisely, the OECD included in the ‘Report on the attribution of profit to permanent establishments’ two official

86 OECD, Report on the attribution of profit to permanent establishments, part II sub-para. 36.
87 Regarding the capital allotted the OECD’s Report on the attribution of profit to permanent establishments, part II, sub-para. 87- 88 underlines that: “for regulatory purposes in both home and host countries, there is no need for any free capital to be formally allotted to the PE […]This should not however affect the attribution of —free capital for tax purposes. Consequently, an arm’s length attribution of —free capital to the PE may have to be made to ensure an arm’s length attribution of taxable profit to the PE, even though no —free capital has actually been allotted to the PE for regulatory or other purposes”
88 For example the Basil Agreements allow including up to 15 percent of hybrid instruments in Tier 1, so that partially tax deductions are allowed for this part of capital.
methods (capital allocation approaches and the thin capitalisation approaches) plus a third one “not recommended”. The existence of two authorised approaches plus a further not recommended gives rise to some degree of uncertainty, especially in the modality in which have been implemented into the domestic law. Moreover “the use of different approaches to attribute capital by the host country and the home country may give raise to double taxation”. The author shares Mascarelló’s position when she retains the need “to find consensus on the adoption of one single method”. In the author´s view in fact the choice of a possible unified method should fall between a method between the two authorised: the capital allocation approach and thin capitalization approach. The former method would implies a sort of restriction of the FSEA in favour on greater extension of the single entity approach: the comparison between “the risk-weighted assets of the PE [and] the total risk-weighted assets of the entity as a whole” lead to a ‘formulary’ approach that result in treating a PE a part of the whole company instead a separate entity. On the other hand the ‘thin capitalization approach’ could lead to achieve neutrality of treatment ‘between banks´ PEs and banks´ subsidiaries. However “under a thin capitalisation approach, it is possible for either more or less capital than the enterprise as a whole possesses to be attributed amongst its various parts”. For now it is important to emphasize how to restrict only to three methods within more than 30 different nations is already an excellent result. Nevertheless the author recommendation for the future is to focus on a homogenous implementation into the domestic law by States in order to avoid the uncertainty, complexity and confusions that exist with the nowadays’ rules, and working at OECD level to reduce the number of method authorised.

90 The author would like to underline how during the 2003 Discussion Draft has been proposed to establish a hierarchy between the approaches. The proposal was not followed and it was preferred to give discretionary choices to States within the recommend method of use.  
93 OECD, Report on the attribution of profit to permanent establishments; part II, sub-para. 98.  
94 OECD, Report on the attribution of profit to permanent establishments; part II sub-para. 111.
5. Conclusion

As final remarks, the author would like to underline the extension, strength and limitation of the FSEA included in the AOA. As a general overview the FSEA in fact appears to be not fully achievable: in the OECD’s Report in fact it is not applied consistently. The FSEA still includes traces of the single entity approach in certain situations that leads to a certain degree of uncertainty and approximation, although the final result would be roughly correct and generally accepted.95

In the author’s view the hybrid nature of the FSEA is not per se a limitation but shall be considered as strength: the OECD’s approach grants a certain degree of flexibility and ability to adapt based on the context that on the other hand would have let the FSEA and the AOA be even more complicate. In the case of creditworthiness in fact to utilize the same creditworthiness as the head office represents both theoretically and practically best solution. Theoretically, the highly integrate nature of banks allows the whole group to potential cover the risks assumed by a part of that, whilst practically speaking it is reduced the complexity on attributing a specific creditworthiness to the bank’s PE. With regards capital requirement and capital allotted the regulation appears quite complex: in the specific case of the attribution of free capital the method recommend by the OECD are too different and also the way they can be implemented is not clear. In this respected the author retains that the OECD should works more on reducing the number of method applied to at least a sole approach. In particular a possible choice would be within the one of the two methods authorised: the ´capital allocation approach´ and the ´thin capitalization approach´. The sole method that will be chosen in the future will help us to understand the extension of the FSEA: lower in the former case due to the ´formulary´ or ´quasi-formulary´ nature of this approach, wider in the latter case due to the application of regulatory requirement to the PE as it was a separate bank.

95 There are currently progressive currents that would go to re-evaluate existing rules: some of them would want to change or replace FSEA and the AOA. Others would like to contend with the previous version of Art. 7 OECD MTC. With regard this latter issue Reimer in Klaus Vogel on Double Taxation Conventions, 4th edition, Volume I, 2015, p.477, states that: “Practical experience has shown, however, that there was considerable variation in the interpretation of these general principles [separate entity and arm’s length principle] and of other provisions of earlier versions of Article 7.”
Having a unique approach will also allow for an international discussion on possible re-evaluation of the principle of neutrality applied to legal forms. If the subsidiaries and the PEs would have had a homogeneous treatment, FSEA would therefore be more effective and the AOA easier to apply.

However, it is important to stress how the work done until this point has been long and steady, and above all, driven by different needs, such as creating a set of logical rules that were welcomed by at least the OECD State members, and in the meanwhile following and integrating other international initiatives (such as in the case of the IMF and BCBS). In addition to this, we shall also include the tendency by States to protect their own tax base and how they are afraid to come up with OECD’s rules on more binding rules whose practical effect may not be awarded.

The final result obtained by the mixture of the above mentioned forces is the AOA. The author retains that the AOA is not necessarily a perfect mechanism, and in the previous sub-chapters he has explained the main issues: complexity in dividing functions, assets and risk in highly integrated enterprises such as banks, uncertainty in capital structure of banks PE and around the creditworthiness. The AOA despite certain difficulties of application has nevertheless continued to generate outcomes that although not scientifically verifiable and/or univocal result lead to a generally accepted outcome. The author agrees with Carveth Read that in certain cases “[…] it is better to be vaguely right than exactly wrong”.

What the OECD did was creating rules generally accepted and that could lead to a “profit [that] is sufficiently acceptable, but which is not scientifically verifiable”. A not full or hybrid interpretation as it occurs now with single entity traces in the FSEA represents a proper solution and of course the strength of this system is that provides results generally accepted. In long term run, the author recommends also to open an international discussion on the tax distortions effect existing on the tax treatment of interest within equity and debt financing. It could have a direct effect on the issue of attributing a proper amount of free capital to PEs. Working on it could lead to a simplification of the existing regulation plus it could induce to a more fair tax treatment and a greater extension of the neutrality principle.

96 Read C., Logic, deductive and inductive, 1898, p. 351. The similar quote “It is better to be roughly right than precisely wrong.” is usually misattributed to John Maynard Keynes.

Literature, cases and similar material referred to


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