CHAPTER 16

Financial Industry Transfer Pricing Issues*

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SYNOPSIS

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§ 16.01 The Financial Industry


Most of the concepts that govern the U.S. transfer pricing regulations and the Organisation for Economic Co-operation and Development (“OECD”) Transfer Pricing Guidelines originally emerged in an industrial context. The first U.S. transfer pricing regulations were aimed at the pharmaceutical industry, and the traditional targets of transfer pricing investigation have been manufacturers and oil companies. Yet, today, some of the largest cross-border controlled transactions are those that occur among the member entities of multinational banks, securities firms, and insurance companies. Within those institutions, there is often found a conviction that traditional transfer pricing rules are not easily applied to their business. The conviction is sound, but only up to a point.

Many of the cross-border controlled transactions within the financial industry consist of rendering services or transferring tangible or intangible property. Applied to such transactions, the U.S. and OECD rules work as well (or as poorly) for financial institutions as they do for manufacturing and energy companies. For example, determining an arm’s length charge for the headquarters services rendered to foreign affiliates poses no greater challenge for banks than for manufacturers, because these services are, for the most part, the same in every global company (see Chapter 14 on services). Likewise, while financial institutions invest extraordinary sums of money in their proprietary databases and software, the decision regarding whether to enter into a cost sharing arrangement is governed by the same considerations that apply to the sharing of any production intangible (see Chapter 13 on cost sharing arrangements).

[2] Derivatives and Reinsurance

There are some transactions and arrangements that are unique to the financial industry and are not amenable to traditional transfer pricing analysis. Derivative financial instruments in the case of banking and securities firms, and reinsurance contracts in the case of insurance companies, are the principal examples. A derivative financial instrument, which is often also a “notional principal contract,” is a contract calling for payments between the parties based on specified market interest rates or currencies or the performance of a bond, a stock, or other financial instrument. Reinsurance is the assumption by one insurance company of all or part of the insurance risk of one or more insurance policies issued by the reinsured company.

Transfer pricing analysts have struggled to decide whether derivatives and reinsurance should be viewed as forms of property or as types of service in order to apply the appropriate rules. The best answer is probably that derivatives and reinsurance are so different from any of the property or services that the transfer pricing rule makers had in mind when they wrote the rules, that a set of special transfer pricing rules is...
warranted, just as special rules have been needed to determine the source and character of income from derivatives and insurance products.\(^1\)

The three factors that determine an arm’s length charge for a controlled transaction are (1) the functions performed, (2) the resources employed, and (3) the risks assumed by the parties to the transaction.\(^2\) What most distinguishes derivatives and reinsurance contracts from conventional transactions in property or services is the relatively greater importance of the risks assumed in the transaction. After all, the principal purpose and effect of these contracts is to require payments between the parties based on certain external events, thereby shifting between the parties the financial risk that such events will or will not happen.

The amount of resources employed and the value of functions performed in the consummation of a transaction can often be measured by reference to the costs incurred. As a result, transactions in which those factors predominate are amenable to transfer pricing methods that are tied to cost, such as the cost plus method,\(^3\) the resale price method,\(^4\) and some versions of the comparable profits method ("CPM").\(^5\) Because the assumption of risk in a particular transaction is less readily associated with specific production costs, cost-based methods are less useful in evaluating derivative and reinsurance contracts, and other transactions having the transfer of risk as their principal purpose.

### [3] The Role of Capital

Because financial institutions serve their customers by assuming risk, capital plays a somewhat different role in the financial sector than in the industrial sector. Much of an industrial company’s capital is “locked up” in production assets or inventory. The principal risks to which the capital is exposed are managerial incompetence or industry-wide decline. In contrast, the capital required to operate a financial institution is generally invested in liquid assets and is subject, in principle, to large and immediate customer claims based on external events. While, in that sense, financial capital is at greater risk than industrial capital, financial institutions are expert at evaluating and managing that risk, with the result that returns on financial capital may be less volatile and more predictable than returns on industrial capital.

Because so much of their capital is liquid, financial institutions ought, in principle, to enjoy greater flexibility than their industrial counterparts to locate their capital in low-tax jurisdictions while operating the business elsewhere. Whether this is true can be debated, but the Internal Revenue Service (hereinafter, the “IRS” or the “Service”) believes it to be, and this belief has strongly influenced their regulatory attitude toward transfer pricing of financial products and services.


\(^{2}\) Treas. Reg. § 1.482-1(d)(3).

\(^{3}\) Treas. Reg. § 1.482-3(d). \(\text{See Chapter 7.}\)

\(^{4}\) Treas. Reg. § 1.482-3(c). \(\text{See Chapter 6.}\)

\(^{5}\) Treas. Reg. § 1.482-5. \(\text{See Chapter 9.}\)
Global Trading

Multinational financial institutions have a unique means of conducting business that is referred to in the industry as “global trading,” and as “global dealing” in proposed IRS regulations issued in 1998. In a global trading operation, the company’s inventory of a particular security, or its position in a particular derivative instrument, resides in one legal entity, while the individuals responsible for managing the inventory or position and interacting with customers throughout the world reside in a variety of foreign entities (or branches) subject to foreign taxation.

Of course, multinational manufacturers also may spread their productive activities among several tax jurisdictions, with components manufactured in one country, assembled in a second, and marketed in a third. What distinguishes global trading in securities from multinational manufacturing of products is that the role of each entity in a manufacturing process is relatively discrete and normally results in an identifiable product or service that is often comparable to products sold between unrelated customers. In a global trading operation, employees in several jurisdictions are contributing to a single customer transaction, in effect providing services to the entity (or office) that owns the security being traded. Some of these services are not sold commercially, and an attempt to disentangle the contributions of the participating entities and to separately evaluate their contributions to the global trading profit or loss may be arbitrary or impractical.

From its experience scrutinizing the global trading operations of foreign banks with U.S. branches, the Service was sufficiently persuaded of the unique nature of the business and its products to propose special regulations for companies that engage in such operations. The regulations only apply to “global dealing” operations in which one of the related parties (or office) is a dealer in the security or financial instrument being traded. When the regulations become final, they will apply to taxable years beginning after the date on which the final regulations are published.

Industry Regulation

The financial industry is subject to extraordinary regulation, with banks being more regulated than securities firms, and insurance companies even more regulated than banks. Regulated status has a number of important implications for transfer pricing. For example, one reason for the growth in global trading is the desire to book transactions in the jurisdiction with the most reasonable regulations, even if that is not where the customers or employees are mainly located.

Bank and insurance regulators are especially concerned with maintaining the solvency of entities in their charge and may, therefore, impose capital requirements that exceed what the market might regard as adequate. This depresses earnings on capital and may itself motivate controlled transactions that have, as their primary

purpose, the satisfaction of capital adequacy requirements. The transfer pricing of any transaction not motivated by the inherent profitability of the transaction is always problematic.

Some regulations intended to promote solvency may preclude charging for more than the cost of providing an intercompany service or charging anything at all, making it difficult or impossible to satisfy the arm’s length standard imposed by tax law. Non-tax regulation is no defense in the eyes of the Internal Revenue Service, but the courts are more open-minded.\(^9\)

§ 16.02 Global Dealing Operations

[1] What is a Global Dealing Operation?

The Proposed Global Dealing Regulations determine an arm’s length allocation of income among “participants” in a “global dealing operation.”\(^11\) A global dealing operation consists of the execution of “financial product” transactions with customers by a “regular dealer in securities” whenever one or more “related activities” are being performed by an affiliate or foreign branch of the regular dealer.\(^12\) The proposed regulations exclude lending, proprietary trading, and commodities dealing from the definition of a global dealing operation,\(^13\) although the preamble indicates that the Service might reconsider its position on commodities and proprietary trading.\(^14\)


A regular dealer in securities is a taxpayer that “actively and regularly” deals in foreign currency or “securities” as defined by U.S. Internal Revenue Code (hereinafter “IRC”) Section 475(c).\(^15\) Although the requirement of “active” dealing might be construed as precluding a mere booking entity from qualifying as a “regular dealer,” it appears that such an entity, operating entirely through affiliated agents, was intended to qualify. The “related activities” that cause taxpayers other than the regular dealer to qualify as a “participant” are sales, marketing, pricing, risk management, and brokering.\(^16\)


In general, the United States taxes all U.S.-source income of a foreign corporation that is effectively connected with a U.S. trade or business, but only taxes certain

\(^9\) Treas. Reg. § 1.482-1(h)(2).
\(^12\) Prop. Treas. Reg. § 1.482-8(a)(2).
\(^17\) IRC§ 871(b), IRC § 882(a).
categories of effectively connected foreign-source income.\textsuperscript{18} The Proposed Global Dealing Regulations define the amount of income from a foreign corporation’s global dealing operations that will be taxed in the United States by treating, as income from U.S. sources, only that income that would be allocated to the U.S. trade or business if it were a separate participant in the global dealing operation.\textsuperscript{19} In determining that allocation, purported transactions between the U.S. trade or business and the head office or other branches of the foreign corporation, other than guarantee fees, may be taken into account.\textsuperscript{20}

The Proposed Global Dealing Regulations assume that a financial institution that engages in global dealing has a trade or business and a permanent establishment in any country where marketers or traders trade as its dependent agent.\textsuperscript{21} The proposed regulations determine the source of the trading income by where the “capital is employed,” \textit{i.e.}, by the location of the dependent agent.\textsuperscript{22} This means that, if a foreign financial institution trades through a U.S. branch or subsidiary, all of the trading profits, including the share of profits allocable to the institution’s capital at risk, will be taxed by the United States. If the institution’s home-country tax authority does not accept the U.S. position that the income is sourced in the United States, the institution is exposed to double taxation absent a successful recourse to Competent Authority.

\section*{§ 16.03 Pricing Specific Transactions}

[1] Sales of Securities

Banks and securities firms may engage in controlled sales of stocks, bonds, and other securities. Normally this will happen when a customer in one country requires a security that is held in dealer inventory in another country or is more readily acquired on the other country’s exchange. In such cases the controlled entity that holds the inventory or acquires the security on the local exchange may sell the security to the controlled entity that serves the customer, which will resell the security to its customer.

For administrative convenience, the business transfer price for a controlled security sale may be the cost of the security—the purchase price if the security was purchased on the exchange or the inventory cost if taken from inventory. If the stock was sold to the customer for its cost, then the tax transfer pricing issue is how to divide the customer commission between the entity whose salespeople sold the stock and the entity whose brokers acquired it, since transferring the security at cost left the transferor with no compensation for the function it performed. Normally the entity that sells to the customer would earn the lion’s share of the commission, since the original purchase transaction may be a routine, ministerial act. However, if the stock is resold at a profit, especially if sold from inventory, there may then be “positioning gain” on

\begin{itemize}
\item \textsuperscript{18} IRC § 864(c)(4).
\item \textsuperscript{19} Prop. Treas. Reg. § 1.863-3(h)(3).
\item \textsuperscript{20} Prop. Treas. Reg. § 1.863-3(h)(3)(ii).
\item \textsuperscript{21} Prop. Treas. Reg. § 1.863-3(h)(3)(iv).
\item \textsuperscript{22} Prop. Treas. Reg. § 1.863-3(h)(3)(v).
\end{itemize}
the transaction. This gain clearly belongs to the entity that managed the position, but an allocation issue may arise if the entity that employs the managers and the entity that holds the inventory are not the same.

Controlled sales of securities are governed by the provisions of the transfer pricing regulations relating to sales of personal property. Under the transfer pricing regulations, the specified methods for controlled sales of personal property are the comparable uncontrolled price method ("CUP"), the resale price method, the cost plus method, the comparable profits method, and the profit split method.23 If a sale of the securities is undertaken pursuant to a global dealing operation, it will, instead, be governed by the Global Dealing Regulations, if and when those regulations become final. Under the Global Dealing Regulations, the specified methods are the comparable uncontrolled financial transaction ("CUFT") method, the gross margin method, the gross markup method, and the profit split method.24

[2] Derivatives
Multinational banks and securities firms enter into derivatives contracts with customers as a service to the customer. The entity that is the party to the customer contract may then enter into an offsetting contract with a controlled entity, whereby all of the risk of the contract, excepting perhaps customer credit risk, is transferred to the other entity, which will assume responsibility for managing the market risk. Alternatively, the entity that is the party to the customer contract may enter into a currency swap or other derivatives contract with a controlled entity to hedge a part of the market risk assumed in the customer contract. In either case, the controlled contract will allocate profit or loss from the customer contract between the controlled entities.

A derivatives contract does not entail a transfer of either tangible or intangible property. Nor is it considered a loan, even when the contract is cast in terms of offsetting loans, as in an interest rate swap. Arguably, each of the parties to the controlled contract could be considered as providing a risk assumption service to the other, but the better argument is that derivatives contracts should not be analyzed under the services provisions of the transfer pricing regulations (see Chapter 14). The services provisions are intended to deal with transactions in which the value added by the controlled entity is based, at least in part, on the amount and quality of individual employee effort that is expended, a factor that usually has a well-defined cost. In contrast, the value of a derivatives contract is entirely in its terms.

Assuming that derivatives contracts do not fall within any of the transactional categories described by the transfer pricing regulations, then there are no specified methods to be applied. If the contract is undertaken as part of a global dealing operation, then the methods specified in those regulations will apply, if and when the regulations become final.

[3] Reinsurance
Multinational insurance companies may enter into reinsurance contracts with

23 Treas. Reg. § 1.482-3(a). See Chapters 5, 6, 7, 9 and 10 for a discussion of these methods.
customers or with controlled affiliates. For example, an insurance affiliate may reinsure a portion of its customer policies with both affiliated and unaffiliated reinsurers, which may themselves reinsure (“retrocede”) part or all of the reinsurance they have written with yet other affiliated or unaffiliated reinsurers. Some insurance companies engage almost exclusively in the reinsurance business, the largest such companies being in Switzerland and Germany.

Reinsurance is written on a treaty or facultative basis. In a reinsurance treaty, the reinsurer agrees to insure all of the reinsured’s policies covering a defined category of risk. In facultative reinsurance, specific policies or a specific policy is reinsured. Reinsurance is also divided between proportional reinsurance and excess reinsurance. In proportional reinsurance, the reinsurer assumes a fixed portion or “quota share” of the entire risk covered by the reinsurance contract, normally paying to the reinsured a “ceding commission” based on the cost of selling and administering the original policy. In nonproportional reinsurance, the reinsurer assumes risks in excess of an agreed amount, for which reason it is also called “excess of loss” reinsurance. There are more likely to be comparable uncontrolled transactions for proportional than for nonproportional reinsurance because each reinsurer is accepting an identical slice of the underwriting risk.

Like derivatives contracts, contracts of reinsurance do not seem to fall within any of the categories of transaction described in the transfer pricing regulations; consequently, there are no specified methods for reinsurance. This will not change when the Global Dealing Regulations become final, because reinsurance is not covered by those regulations.

[4] Price Methods

Except for the profit split methods, all of the transfer pricing methods specified by the transfer pricing regulations and Proposed Global Dealing Regulations work by comparing the prices or profit results of controlled transactions to the prices or profit results of closely similar uncontrolled transactions. The methods that compare the actual prices of the controlled and uncontrolled transactions are the comparable uncontrolled price (“CUP”) method and the comparable uncontrolled transaction method in the transfer pricing regulations and the comparable uncontrolled financial transactions (“CUFT”) method in the Global Dealing Regulations. These methods are more dependent than any others on the comparability of the controlled transaction and the uncontrolled transaction being used as the transfer pricing benchmark.

Because many securities are publicly traded, they would seem to be good candidates for the CUP and CUFT methods. The CUP method expressly permits the use of information from public exchanges and quotation media to ascertain an arm’s length transfer price if certain criteria are satisfied. The CUFT method, specified in the Proposed Global Dealing Regulations, operates in essentially the same way as the CUP method, except that its rules and examples relate specifically to securities trading.

25 Treas. Reg. § 1.482-3(b)(5).
Like the CUP method, the CUFT method expressly permits the use of information from public exchanges and quotation media to ascertain an arm’s length transfer price. Examples given are registered national security exchanges, interbank markets, foreign securities exchanges subject to U.S.-type regulatory supervision, certain interdealer quotation systems, as well as some interdealer markets and debt markets.

The very feature that enables exchange trading of securities—the existence of numerous exact substitutes and relatively low transaction costs—leads to extreme price volatility, since the market can respond instantly to the slightest alteration of supply or demand. Thus, while the securities sold between controlled parties may be identical to those sold on a public exchange, the price reported by the exchange may not be a completely reliable benchmark since it may change during the course of the day when the controlled transaction occurred. This is especially important when the function of the transfer price is to divide customer commission revenue or other gross profit that is relatively small compared to the value of the security. Even a tiny variation in price can shift the entire profit from one entity to the other.

The Proposed Global Dealing Regulations recognize the importance of time “proximity” in establishing the comparability of controlled and uncontrolled securities transactions. In an example, the proposed regulations state that in appropriate circumstances public trades occurring shortly before and after a controlled trade may establish an arm’s length range of prices for the controlled trade.

The CUFT method, unlike the CUP method, is not limited in its application to the sale of property. It could, for example, be used to determine an arm’s length price for services rendered in a global dealing operation. Thus, if a participant in a global dealing operation is rendering a service, such as a selling service, for which an arm’s length compensation, such as a selling commission, can be determined from comparable uncontrolled transactions, then the CUFT method may be applied as a specified method.


The CUP and CUFT methods may not be reliable methods for lines of business in which the profit earned is very small compared to the price of the security. Even a tiny variation from arm’s length pricing of the security itself could dramatically skew the allocation of profit among controlled entities that contributed to earning it. In such cases, examination of the margin or gross margin earned by the entity that purchased the security for resale to customers may be a more reliable approach to arriving at an arm’s length result. Under the transfer pricing regulations, the methods that compare gross margins on controlled transactions to gross profits on uncontrolled transactions...
are the resale price and cost plus methods. Since securities are not produced by the banks and securities firms that sell them, there is little difference between the resale price and cost plus methods. Technically, the resale price method applies when the controlled transaction is the original purchase, and the cost plus method applies when the controlled transaction is the sale. In the Global Dealing Regulations, the resale price method is called the “gross margin method,” while the cost plus method is called the “gross markup method.” According to the regulations, both methods can be used even when the controlled purchaser or seller does not take title to the security, although that factor would be taken into account in assessing the comparability of any uncontrolled transaction.


The determination of transfer prices by reference to gross margins is disfavored by the Service when a determination based on operating margins is feasible. The CPM is a specified method for, among other transactions, sales of personal property and can, therefore, be used to determine the allocation of profits arising in connection with controlled sales of securities.

CPM is not a specified method under the Proposed Global Dealing Regulations. The reason given for this variation from what is otherwise a distinct Service preference for CPM is that the profitability of a participant in a global dealing operation is based on unique intangibles and specific risk-assumption terms and that it would be difficult to make comparability adjustments in a profit-based analysis. In particular, it seems that the Service was concerned that CPM would be used to allocate a relatively small but stable profit to the participants that employed the producers (and therefore had less flexibility over the location of their activities), leaving a possibly very large residual profit in the company that employed the capital (and therefore might readily be located in a tax haven).

[7] Profit Splits

The two profit split methods specified by the transfer pricing regulations, the comparable profit split and the residual profit split, are both available for controlled sales of property, such as a sale of securities between controlled members of a banking or securities group. The Proposed Global Dealing Regulations also specify

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31 Treas. Reg. § 1.482-3(c).
32 Treas. Reg. § 1.482-3(d).
33 Prop. Treas. Reg. § 1.482-8(c).
34 Prop. Treas. Reg. § 1.482-8(d).
35 Prop. Treas. Reg. §§ 1.482-8(c)(1) and(d)(1).
36 Treas. Reg. § 1.482-3(a)(4).
two profit split methods, the total profit split and the residual profit split.\textsuperscript{40}

The total profit split is not a complete analog to the comparable profit split. The latter requires the taxpayer to allocate profits in the same proportion as they are allocated in comparable uncontrolled business arrangements,\textsuperscript{41} which rarely can be identified in the real world. The total profit split is preferably, but not necessarily, based on uncontrolled comparables.\textsuperscript{42} The total profit split can be applied purely on the basis of internal data, permitting, for example, an allocation of global operating profit or loss in proportion to producers’ compensation.\textsuperscript{43} Another difference is that the total profit split is ordinarily applied only when all participants in the global dealing operation perform all of the functions,\textsuperscript{44} a restriction not applicable in the comparable profit split.

One of the greatest transfer pricing challenges facing the financial industry is the allocation of profits between entities that hold the capital at risk in a global trading or other financial business and permanent establishments or related entities that employ the traders and other professionals who manage the capital at risk. Some industry experts and transfer pricing specialists have recommended the use of hedge fund data to determine an appropriate profit split between the owners and managers of financial capital. Hedge funds involve investors who contribute large sums of money into a fund that is managed by an expert trader. The allocation of trading profits between the investors and the hedge fund manager is fairly standard, with the manager receiving a fee equal to 1%-2% of the amount under management plus 20%-30% of any profits. While the manager is not required to absorb losses directly, he typically must offset losses in one year against his share of profits in subsequent years. There are many hedge funds, the profit split data is publicly available through various sources, and there are funds specializing in almost every category of trading in which the related parties might be involved. In other words, hedge funds are in several respects the perfect “comparable,” at least for the proprietary trading businesses of a global bank or securities firm. Comparability adjustments may be needed to account for the marketing costs that must be carried by global banks and securities firms in their dealing operations.

\section*{§ 16.04 Global Dealing Profit Splits}

\subsection*{[1] Notice 94-40}

Under the so-called “all or nothing” rule of the U.S. income tax regulations, a foreign corporation with a U.S. trade or business that materially participates in an international business transaction must treat the entire income from the transaction as being attributable to the U.S. business, even if foreign affiliates also materially

\begin{flushright}
\textsuperscript{40} Treas. Reg. § 1.482-6(c).
\textsuperscript{41} Treas. Reg. § 1.482-6(c)(2)(i).
\textsuperscript{43} Prop. Treas. Reg. § 1.482-8(e)(2)(ii).
\textsuperscript{44} 63 Fed. Reg. 11,182 (Mar. 6, 1998).
\end{flushright}
The income, in most instances, would not be taxable unless it was from sources within the United States, but the U.S. regulations on foreign currency transactions and notional principal contracts overcome that requirement by determining the source of income by reference to the location to which the income is attributed.

The U.S. position was problematic for foreign banks with U.S. branches that participated in international derivatives transactions, as was the U.S. refusal to recognize transactions between the U.S. branch and the headquarters company or between the U.S. branch and foreign branches, notwithstanding tax treaty provisions that appeared to permit the income of a permanent establishment to be based on what it would have earned as a separate entity.

For a time, the only solution afforded the foreign banks was to secure an advance pricing agreement ("APA") whereby the income of the U.S. branch would be determined as if the branch were a separate entity pursuant to methodologies that the Service accepted as being reliable measures of an arm’s length result. In a number of cases the methodology was a profit split method, and, in Notice 94-40, the Service disclosed to the general public the generic terms of that method. Trading profit or loss was defined as revenues less directly related expenses such as “compensation of certain personnel, trading computer systems, and broker commissions.” Other expenses were allocated to the locations that incurred them, while interest expense was allocated under applicable IRS regulations.

Trading profit or loss was allocated among locations that contributed to the trading activity based on the value of the location (often measured by traders’ compensation), the risk associated with the location (sometimes measured by the volume of transactions), and the extent of activity of the location (measured by the compensation of key support people). The factors were weighted, but not always the same way. Ordinarily, the value factor was weighted more heavily, although sometimes the risk factor was given greater weight.

Notice 94-40 was never regarded as binding in any way on the Service or on taxpayers, although many multinational banks and securities firms have followed it in at least some respects. In fact, the method described in Notice 94-40 was not much used in subsequently issued APAs, as both taxpayers and the Service came to view the 94-40 method as inadequate. Because the Proposed Global Dealing Regulations reflect the positions now being taken by the Service in APA negotiations, they are a far better guide than Notice 94-40 for future transactions.

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45 Treas. Reg. § 1.864-6(c).
47 1994-1 CB 351.
48 Id. at 352.
49 Id.
50 Id.
51 Id.
**[2] Proposed Global Dealing Regulations**

The Proposed Global Dealing Regulations split operating profit or loss among the participants in a global dealing operation. Operating profit or loss is calculated by subtracting from dealing revenue all expenses other than interest and income taxes.\(^\text{52}\)

The total profit split may be used when all functions are performed by all participants. The total profit split allocates operating profit or loss among all participants in proportion to some measure of their respective contributions, such as the compensation paid to traders, risk managers, and marketers.\(^\text{53}\) The residual profit split, which is to be used when some functions are performed by only some participants, requires a distinction between routine and non-routine contributions.\(^\text{54}\)

Non-routine contributions are those that are so integral to the operation that they cannot be reliably evaluated and, ordinarily, will be compensated through a profit split method.\(^\text{55}\) Participants that employ marketers, traders, and risk managers are regarded as performing non-routine functions.\(^\text{56}\) In the residual profit split, entities that perform routine functions are compensated based on the application of other methods, including in appropriate cases CPM, while the residual profit or loss is then allocated among entities performing non-routine contributions in what amounts to a total profit split.\(^\text{57}\)

A very controversial feature of the Proposed Global Dealing Regulations is their treatment of capital as a routine contribution\(^\text{58}\) without providing any guidance as to what methods other than profit split might be employed to determine the arm’s length share of global dealing profits.

\section*{§ 16.05 Advance Pricing Agreements (APAs)}

As discussed in Chapter 19, under its Advance Pricing Agreement Program, instituted in 1991, the IRS may agree with a taxpayer on the appropriate transfer pricing method for a specific transaction or transaction prior to the filing of the taxpayer’s return, although many APAs include years for which the substantive APA request is filed after the date the return was filed so that one or more APA years deal with filed years.\(^\text{59}\) APAs that exclusively bind the IRS and a taxpayer are referred to as “unilateral” APAs, while APAs that also bind the tax authority of another country, ordinarily pursuant to the mutual agreement procedures in a tax treaty, are referred to as “bilateral” APAs. APAs are often negotiated pursuant to the settlement of transfer pricing issues on previously filed returns, with the taxpayer and IRS agreeing for a

\begin{footnotes}
\footnotetext[52]{Prop. Treas. Reg. § 1.482-8(e)(3).}
\footnotetext[53]{Prop. Treas. Reg. § 1.482-8(e)(5)(iii).}
\footnotetext[54]{Prop. Treas. Reg. § 1.482-8(e)(6)(ii).}
\footnotetext[55]{Id.}
\footnotetext[56]{Prop. Treas. Reg. § 1.482-8(e)(6)(iii).}
\footnotetext[57]{Prop. Treas. Reg. § 1.482-8(e)(6).}
\footnotetext[58]{Prop. Treas. Reg. § 1.482-8(e)(8), Ex. 5.}
\end{footnotes}
given number of future years to apply the transfer pricing method on which the settlement was based. The reverse also occurs, with the APA methodology or a variation thereof “rolled back” to pre-APA open years.

Financial companies were initially among the heaviest users of the APA program, reflecting the development of global trading in foreign exchange and securities during the 1990s and the need to achieve some certainty about transfer pricing results in the absence of clearly applicable transfer pricing methods. Since banks operate overseas mainly through branches, the risks of double taxation of income from trades in which the home office and one or more branches participated were especially severe, and global trading by foreign banks with U.S. branches constituted the bulk of financial product APAs.

As shown in the table below, derived from statutorily required annual reports by the IRS for APAs issued through 2007, APAs with foreign financial companies greatly outweigh those entered into with US financial companies, while the total number of financial product APAs declined significantly after the global dealing regulations were proposed in 1998.

<table>
<thead>
<tr>
<th>Year APA Executed</th>
<th>Foreign Company (US Branch)</th>
<th>Foreign Parent</th>
<th>US Company (Foreign Branch)</th>
<th>US Parent</th>
<th>Total</th>
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<td>5</td>
<td>9</td>
<td>2</td>
<td>40</td>
</tr>
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<td>0</td>
<td>≤3</td>
<td>≤3</td>
<td>0</td>
<td>≤6</td>
</tr>
<tr>
<td>2006</td>
<td>0</td>
<td>0</td>
<td>≤3</td>
<td>≤3</td>
<td>≤3</td>
</tr>
<tr>
<td>2007</td>
<td>≤3</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>≤3</td>
</tr>
<tr>
<td>Total</td>
<td>43</td>
<td>17</td>
<td>11</td>
<td>8</td>
<td>79</td>
</tr>
</tbody>
</table>

The table below breaks down the transfer pricing methods (“TPMs”) that were employed during the initial wave of financial product APAs (1991-1999).  

<table>
<thead>
<tr>
<th>Financial Product TPMs</th>
<th>Year APA Executed</th>
<th>Profit Split (Notice 94-40)</th>
<th>Residual Profit Split</th>
<th>Inter-branch Allocation</th>
<th>Market-Based Commission</th>
<th>Taxpayer’s Internal Allocation System</th>
</tr>
</thead>
</table>

According to the IRS reports for the period 2000-2005, there were at least 15

60 Ann. 2000-35, 2000-1 CB 922 (Table 12).
financial product APAs that involved financial transactions (generally foreign currency exchanges) in which autonomous branches of a single taxpayer were engaged. These APAs determined the appropriate profits attributable to each branch by reference to the internal accounting methods of the branch, with statistical tests being used to verify that the results (combining for each branch all the trades of that branch) were priced the same as uncontrolled trades. During the same period there were 11 financial product APAs for which the TPM was profit split.\textsuperscript{61}

§ 16.06 Organization for Economic Cooperation and Development

[1] Transfer Pricing Guidelines

The OECD has published and periodically updated transfer pricing guidance to the taxpayers and tax administrations of the United States and other OECD member countries ("Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations," hereinafter, "the Guidelines"). The Guidelines are important because they may serve as \textit{de facto} transfer pricing regulations for those countries that do not have their own, more specific rules, and because they will be the starting point for arriving at agreement in Competent Authority proceedings between OECD member countries.

The Guidelines call for adherence to the arm’s length standard and express a preference for “traditional” transfer pricing methods (the comparable uncontrolled price method, the resale price method, and the cost plus method) over “transactional profit methods” (such as profit split methods and the transactional net margin method). The Guidelines contain specialized guidance on transfer pricing of services and intangible property, but as yet provide no such guidance on transfer pricing of reinsurance and other transactions peculiar to financial institutions. Moreover, the Guidelines deal with transactions between separate legal entities that are related and do not deal with dealings within a single legal entity.


Recognizing that the Member states were not consistent on attributing income to permanent establishments and the special issues raised by global trading of financial instruments carried out by branch operations of multinational banks, several years ago the OECD undertook a project to achieve consistency under an “authorized OECD approach.” This work led to the publication of a “Report on the Attribution of Profits to Permanent Establishments” in four parts, each of which had been updated from time to time and released in final form on July 17, 2008. Part I sets forth the basic concepts, Part II applies to branches of foreign banks engaged in traditional banking activities, Part III deals with global trading of financial instruments and Part IV deals with insurance activities.

As set forth in the Report, the OECD has adopted an “authorized OECD approach” that treats a permanent establishment as if it were a separate entity and then applies transfer pricing principles to determine the profits that it would have earned. The

authorized OECD approach permits “dealings” between the permanent establishment and other parts of the enterprise to be taken into account in the calculation of attributable profits, even though such dealings have no legal significance.

Part I describes the authorized OECD approach as having two steps. The first step requires the identification of the activities carried on through the permanent establishment. This is done through a functional and factual analysis that identifies the economically significant activities and responsibilities undertaken through the permanent establishment. Under the second step, the remuneration for any dealings is determined by applying the arm’s length transfer pricing principles articulated in the Guidelines by reference to the allocation of functions performed, assets used, and risks between the permanent establishment and the rest of the enterprise.

Part II of the Report applies the authorized OECD approach of Part I to branches of foreign banks engaged in traditional banking activities, i.e., the borrowing and on-lending of money. Because banks are highly leveraged, the attribution of capital to their permanent establishments will limit local interest deductions and have a significant impact on their local effective tax rates. The most significant and controversial provision of Part II was the proposed allocation of capital to the locations where “key entrepreneurial risk-taking functions” are performed. The key entrepreneurial risk-taking functions are those which require active decision making with regard to the acceptance and/or management of individual risks and portfolios of risks. For a bank, the creation of a financial asset and its subsequent management are likely to be the key entrepreneurial risk-taking functions and so, economic ownership of the financial asset and its income and expenses are generally attributed to the location performing those functions. This approach is consistent with, and presumably influenced by, the U.S. proposed global dealing regulations, which also imply that profits attributable to risk capital should be allocated among the business locations of a taxable entity in proportion to the compensation and location of personnel who managed the risk.

Part III of the Report is devoted to global trading of financial instruments. Part III applies the authorized OECD approach of Part I and reiterates the central role of “key entrepreneurial risk-taking functions” featured in Part II. In particular, the Report notes that the function of market risk management is likely to be of particular importance. Part III catalogues the many functions performed in global trading operations as well as the different sorts of risk, including credit risk, to which the trader’s capital is exposed. While recognizing the preference of the Guidelines for transactional transfer pricing methods, Part III acknowledges that global trading functions may be so integrated in the “integrated trading model” that profit split methods may have to be applied.

Part IV applies the authorized OECD approach of Part I to the operation of property and casualty insurance, life insurance, and reinsurance activities. It restates the importance of the “key entrepreneurial risk-taking functions” that were featured in Parts II and III and identifies the assumption of insurance risk as the key entrepreneurial risk-taking function for an insurance enterprise. This approach attributes the economic ownership of investment assets of an insurance enterprise to the parts of the

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enterprise that perform the function of assuming insurance risk.

On July 17, 2008, the OECD Council approved release of the final Report and on the same day approved the 2008 update of the OECD Model Tax Convention (including a Revised Commentary) reflecting the conclusions of the Report that did not conflict with the then existing Commentary. The Revised Commentary on Article 7 adopted the two-step approach of Part I of the Report. Following Part I, the Revised Commentary also stressed the importance of attributing free capital in determining the capital structure of a permanent establishment. The Revised Commentary acknowledges that different approaches to attributing free capital may all yield an arm’s length result. In this respect, OECD member countries have agreed to accept, in computing double taxation relief, the quantum of interest deduction allowed in the State where the permanent establishment is located, if the difference in capital attribution between the taxing States results from conflicting domestic law choices of authorized capital attribution methods producing results consistent with the arm’s length principle. It is important to note that the Revised Commentary is less detailed than the Report and in some cases refers to the Report.

As part of the same project, on June 24, 2008, the OECD released for public comment a proposed new version of Article 7 and its Commentary which would fully implement the conclusions of the Report on a “clean slate” basis. This proposal spells out in detail steps required to implement the authorized OECD approach.