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FINANCIAL SERVICES

Branch Capital Attribution Tax Survey

A survey of international practice

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Contents

Introduction

There has been considerable variation across countries regarding the taxation of Permanent Establishments (PEs)

The financial crisis and subsequent economic downturn has led many financial institutions to re-evaluate their business models and activities to try to enhance the use of increasingly scarce resources. Many are currently analyzing their overall balance sheets, capital positions, liquidity, and funding sources. Meanwhile, the global regulatory environment for financial institutions is tending towards increased regulations and capital requirements.

Basel III rules for banks to set aside far more Tier 1 capital and hold a minimum level of liquid assets are set to come into force by the end of 2012, although banks will have until 2019 to comply fully. At the same time, for the insurance industry, Solvency II is bringing about greater harmonization of regulations and legislation in the European Union (EU). Capital requirements are to be tied to a comprehensive risk definition including underwriting and market risks. In response to Solvency II many insurance companies in the EU are using the 'passport' system i.e. branches (operating under Freedom of Establishment)[1].

In some instances, government bailout of the banks may have contributed to turning the financial crisis into a sovereign debt crisis. The G-20 set out a deadline for the advanced economies to halve deficits by 2013 and stabilize the ratio of debt to Gross Domestic Product (GDP). Countries with serious fiscal challenges may need to act faster. Fiscal tightening has become central to a variety of austerity measures. Tax authorities are working harder and smarter to protect their revenue bases. Not surprisingly, there is an increased focus on the issue of taxation of branches of overseas banking and insurance entities.

Continued

[1] The principle of freedom of establishment enables an economic operator (whether a person or a company) to carry on an economic activity in a stable and continuous way in one or more Member States.

There has been considerable variation across countries regarding the taxation of Permanent Establishments (PEs). The issue has featured prominently in Organisation for Economic Co-operation and Development (OECD) guidance and discussion. In its 2008 'Report on the Attribution of Profits to Permanent Establishments' (PE Report), the OECD's Committee on Fiscal Affairs (CFA) provided extensive guidance on how the profits should be attributed to a PE under tax treaties following Article 7 of the Model Convention. According to the PE Report, capital is attributed to support the assets and risks attributed to the branch. Assets and risks are attributed according to the location of Key Entrepreneurial Risk Taking (KERT) functions associated with not only the origin of the assets and risks but also with their on-going management.

The CFA intended the 2008 report to build on previous OECD discussion drafts in providing a better and broader consensus regarding the interpretation and practical application of Article 7. One of themes for the industry was to allow a bank or insurance entity to apply a single method of capital attribution across its branches globally while reducing the risk of mismatches that may result in double, or less than single, taxation (top-down approach).

In view of the 2008 OECD report, KPMG decided to update our previous survey of branch capital attribution produced in 2005. KPMG member firms in 33 countries provided information concerning the rules and approach adopted by the tax authorities in their country. Respondent countries were asked to provide details of domestic tax law and practice so as to help assess the degree of variation between the principles outlined in the OECD report and the current local position in the countries covered, while also seeking to identify what practical problems currently exist or may be anticipated. The survey was extended to cover branches of insurance companies in the participating countries, given the focus on branches following Solvency II.

Survey highlights

Key points:

1. General acceptance of the OECD's 'separate entity' and 'arm's length' principles
2. Resolution of profit/capital attribution mismatches
3. Increased awareness of PE profit attribution
4. Variance in PE capital attribution

1. Most countries surveyed generally accept the OECD's 'separate entity' and 'arm's length' principles and the guidance given in the PE Report. On PE profit (and capital) attribution, countries surveyed fall into the following three categories:

- Countries with no specific domestic rules for PE profit (and capital) attribution and/ or which closely follow the OECD guidelines (e.g. UK, Australia, Netherlands, and France), but which may apply the authorized OECD approach in different ways.
- Countries with some domestic provisions that may differ from the authorized OECD approach (e.g. Germany, Italy, and Korea).
- Countries that have detailed domestic rules that do not allow for the application of the authorized OECD approach (e.g. Argentina, Hong Kong, Brazil and Mexico).

2. For countries in the first two categories, mismatches in profit or capital attribution may be resolved by accessing the relevant Double Tax Treaty (DTT) or invoking the relevant Competent Authority procedure such as an Advance Pricing Agreement (APA), or Mutual Agreement Procedure (MAP). In Europe disputes may also be resolved through the EU Arbitration Convention. For countries in the third category, it may be difficult or potentially impossible to use the authorized OECD approach to resolve issues of double taxation.

3. PE profit attribution, itself, has not been an issue that has generally been raised by many tax authorities in the past. However, the OECD report has increased awareness of the issue. Capital attribution has been challenged more actively particularly around the issue of the deductibility of interest.

4. There is some divergence with regard to PE capital attribution. While most countries have limited provisions in domestic tax legislation, there are differences in the minimum capital required for regulatory purposes. There is also divergence in the choice of OECD method countries have applied (thin capitalization vs. capital allocation approach). Countries are considering a more flexible approach to accommodate differences in the application of the OECD model.

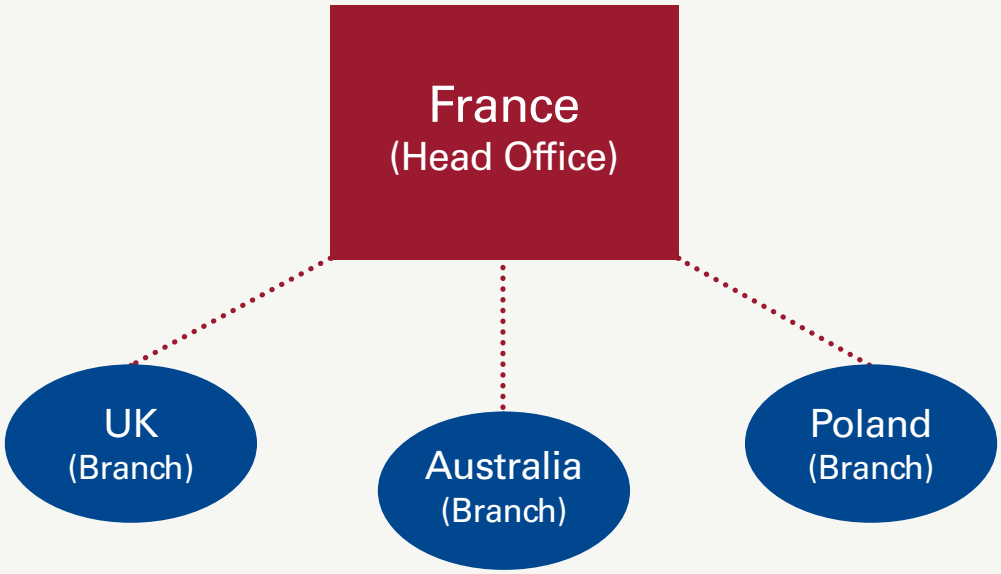
What does it mean for you?

The potential benefit to a bank or insurance entity can be measured by their ability to apply a top-down approach to the attribution of capital

One of the objectives of the PE Report was to set out a better and more consistent approach than had previously been available, providing tax administrations and taxpayers with a greater degree of certainty as to how profits (and capital) should be attributed to a PE under DTTs following the OECD Model. For taxpayers, greater awareness and certainty around tax liabilities that a common approach provides is crucial in managing their tax exposure.

The potential benefit to a bank or insurance entity can be measured by their ability to apply a top-down approach to the attribution of capital – i.e. a single method determined by head office with a goal of not incurring double taxation. From the results of the survey we can see the extent to which this may be achievable. Consider the case study shown in Figure 1 opposite.

Figure 1
French bank branching out



A bank with head office in France initially opens branches in the UK and Australia. It allocates total capital according to the capital allocation approach. It wishes to apply this approach across its branches. The UK, although favouring the thin capitalization rule, accepts other OECD methods such as the capital allocation approach. Australia too, allows for the use of this approach. In this case the French bank can consistently apply a single method of capital attribution. This is the 'first best' scenario.

Now consider the scenario where a branch in Poland is also opened. Poland applies a thin capitalization approach. As a result there is a potential mismatch in the capital attributed across branches.

The bank has two possible options:

- Apply the domestic rules and accept that they could result in double taxation; or
- If the double taxation impact is too large then decide whether to appeal and seek to apply the treaty position and if this fails then to invoke a Mutual Agreement Procedure (MAP) (if this is available). In this example the MAP is available and the company can also at the same time invoke the EU Arbitration Convention to help ensure that the issue is resolved – the results of the arbitration are binding on both tax authorities.

This is the 'second best' scenario. The bank may or may not be able to apply a single method (if the tax authority will not apply the treaty position without invoking the MAP or entering into an Advance Pricing Agreement (APA) across its branches, but, the MAP or APA procedures should at least resolve any mismatches in allocations and so help to eliminate double taxation.

Finally, suppose the bank opens a branch in Hong Kong. Given that this is a non-OECD country that does not apply the authorized OECD approach, it may not be possible to apply a top-down method as described above. Since there is not a comprehensive DTT between Hong Kong and France, there is a high risk of potential double taxation.

Source: KPMG, November 2010

Well actually it's a bit more complicated…

This year's survey also highlighted a number of countries for which the OECD report appears not to have much of an impact

The OECD report has succeeded in promoting a wider consensus regarding PE profit and capital attribution. Since our previous survey, most of the countries are now indicating, to varying degrees, an acceptance of OECD guidelines. This closer alignment of thinking has helped reduce the risk of double taxation.

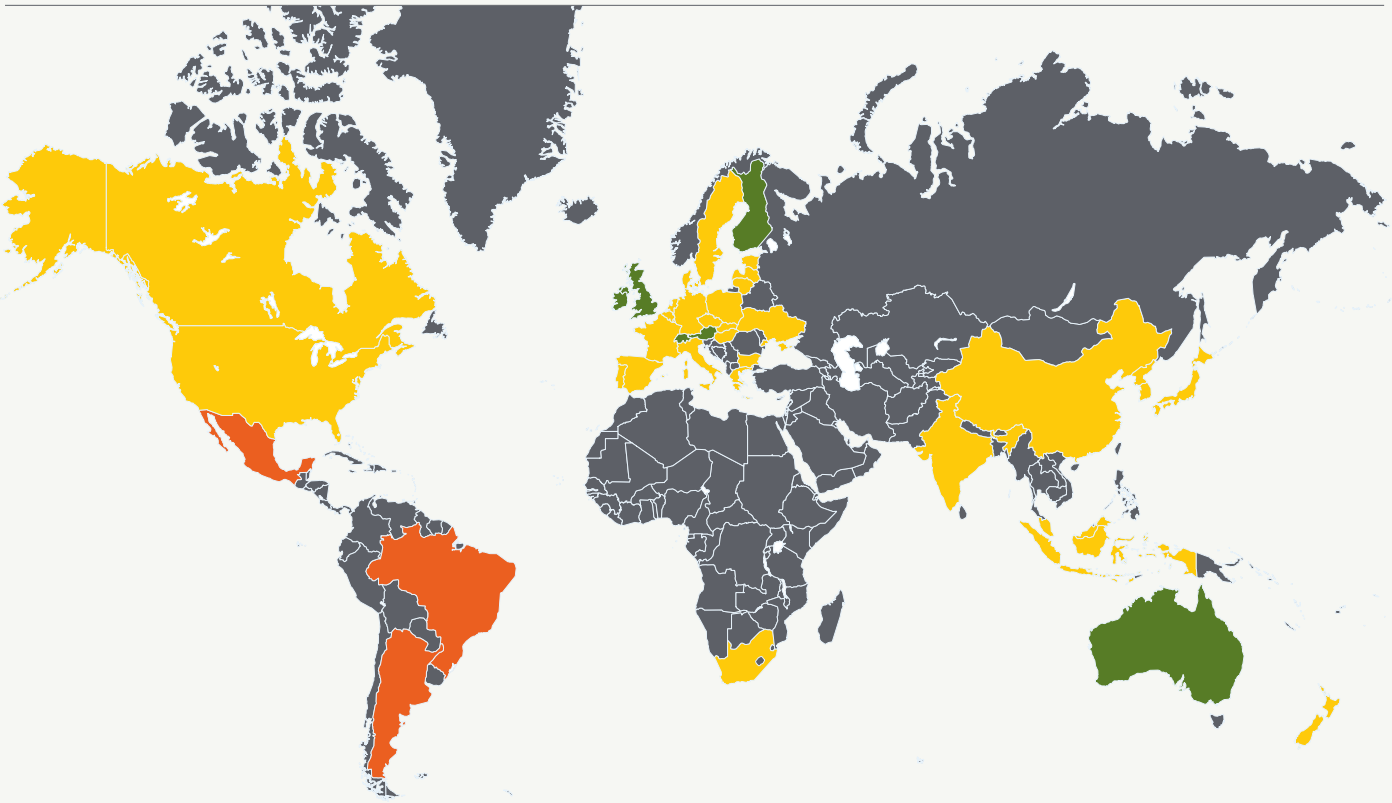
However, in practice the picture is complicated by the fact that only a few countries allow for a flexible application of the OECD approach that would facilitate the 'first best' scenario for the taxpayer described above. Consulting the relevant treaty position and/or invoking a Competent Authority procedure may help achieve this outcome, or at least the 'second best' outcome.

This year's survey also highlighted a number of countries for which the OECD report appears not to have much of an impact. Domestic legislation in such jurisdictions takes precedence with varying results. This makes it difficult for a bank or insurance entity to apply a top-down method due to the uncertainty of double taxation should one of these jurisdictions be involved. This may result in the 'least favoured' outcome.

Figure 2 summarizes the present environment facing a bank or insurer looking to branch out in the modern world, on the basis of the results of the survey, and country responses to Article 7 of the Model Tax Convention (Model Tax Convention on Income and Capital Condensed Version).

As shown in Figure 2 the majority of countries surveyed are yellow, indicating that the 'second best' scenario (previously described) is generally the likely outcome. Some countries are still considering which OECD method to apply. It is hoped that dispute resolution mechanisms in place such as the MAP and the EU Arbitration Convention will help provide greater understanding and flexibility, allowing for countries to progress from yellow to green in Figure 2.

Figure 2
Branching out in the modern world



- Applies the OECD Model and allows flexibility in choice of method.
- Applies the OECD Model (less flexibly) or only through DTT/MAP/APA.
- The OECD Model cannot be applied.

Source: KPMG, November 2010

Insights and concluding thoughts

The survey highlighted generally wider acceptance by tax authorities of OECD guidelines for PE profit and capital attribution

The survey highlighted generally wider acceptance by tax authorities of OECD guidelines for PE profit and capital attribution.

It is an issue that is being raised more actively by tax authorities following the OECD report, while in the past this was generally not the case in most countries. As a result, there is a greater need for branches of banks and insurance entities to thoroughly review their business models and capital structure. Evidence from respondents suggests that many have yet to do so. The OECD's concept of KERTs will likely have some bearing on where assets and capital are attributed for tax purposes.

While our survey has captured the issues facing the direct taxation of branches, there are significant headwinds on the indirect tax side. In April 2010 the International Monetary Fund (IMF) proposed two types of global levies on bank branches. The simple version is a straight tax on a bank's gross profits, before deducting compensation. A 'financial stability contribution', would initially be at a flat rate; this would eventually be refined so that riskier businesses paid more. The second version, a more complex tax, aims directly at excess bank profit and pay. These are being applied unilaterally by certain countries, which will add further complications for branches.

Against this background, tax directors of banks and insurance entities need to consider undertaking detailed functional analysis to identify the KERTs and thus appropriately attribute assets and capital to their branches. As well as reducing the risk of double taxation, such an exercise often helps to identify opportunities for tax planning. A combination of KPMG member firms' global and local knowledge in financial service (FS) tax and our FS transfer pricing networks can provide taxpayers with a broad-ranging risk review and essential tax planning advice. Our firms' have successfully helped taxpayers negotiate APAs and MAPs with tax authorities to offer our clients improved certainty amidst a challenging business environment.

Detailed results by country


Argentina


Denmark


India


Netherlands


Spain


Australia


Finland


Ireland


New Zealand


Sweden


Austria


France


Italy


Poland


Switzerland


Belgium


Germany


Japan


Portugal


UK


Brazil


Greece


Korea


Singapore


US


Canada


Hong Kong


Luxembourg


Slovakia


China


Hungary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Argentina

As a non-OECD member there is limited impact of the OECD report thus far. Branches of foreign-owned entities must keep their accounting records separate from their parent companies. Thin capitalization rules apply to determine the deductibility of interest (based on a fixed debt-equity ratio). Some of the tax treaties signed by Argentina establish a MAP. In practice, there were very few cases that applied this procedure which tends to be a lengthy process.

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Australia

Australia complies to a large extent with OECD principles. Detailed legislation deals with profit attribution to PEs. The 'separate enterprise' principle is recognized for the sourcing of income and allocation of deductions to a PE. Capital is attributed according to the quasi-thin capitalization approach. Foreign banks conducting business in Australia at or through a branch are required to hold a fixed percentage of risk-weighted assets. Australia accepts the 'symmetry' principle. Australia will respect the capital attribution rules of the host country for Australian entities with overseas branches. For countries with which Australia has a double tax agreement, a MAP article will apply.

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No detailed guidance on PE profit attribution, but usually follows OECD guidelines. Recent draft guidelines on capital attribution also conform to the 'BIS ratio approach' (a capital allocation approach based on risk-weighted assets). This is likely to lead to an increased compliance burden. Austrian tax authorities have generally tried to avoid differences in the method of allocating capital by accepting the foreign jurisdictions' application of rules if the outcome seemed to be reasonable. Austria allows for application of MAP. EU Arbitration Convention is also applicable.

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Belgium

The separate enterprise principle is applied with regard to PE profit attribution. Belgian legislation only provides for a limited number of provisions with regard to capital attribution Adoption of OECD's proposals is likely to have implications on compliance as well as tax liabilities. The focus of insurance branch enquiries has primarily been the allocations keys used in order to attribute investment income and premiums to the branch and capital structure (given the notional interest deduction). A MAP can be applied in case of double taxation. Furthermore, the EU Arbitration Convention can also be applied.

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Brazil

No specific rules regarding PE profit or capital attribution. General rule allowing for the deductibility of certain expenses provided that these are necessary for maintaining the source of income and are consistent with the activities of the company. Interest expense of a loan from a foreign related party is deductible up to the rate of LIBOR plus a 3 percent spread. As OECD rules are not applied, the report has not been seen as an immediate concern. Under Brazilian legislation, insurance companies should be incorporated in Brazil. Thus, it is not possible to open a branch of a foreign insurance company.

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Canada endorses the OECD's separate enterprise principle, but as of yet has no specific rules for profit attribution. There is a specific rule regarding attribution of capital to a foreign bank branch (based on a fixed debt/equity ratio), but this is only implicit in the determination of tax deductible interest. Tax authorities seem to primarily focus on PE profit allocation issues relating to foreign branches of Canadian insurers, and thus there is potential issue of double taxation. Should the enterprise be challenged by the Canadian tax authorities the enterprise could file an objection to the assessment with the Canadian tax authorities. Should the objection to the assessment not be successful, an enterprise resident in a country with which Canada has a tax convention in force could seek a ruling from the Competent Authority.

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China

No legislation on PE profit attribution for tax purposes exists. There are no specific rules to allocate a minimum amount of capital to branches of a foreign banking operating in China. Branches of foreign insurance companies are required to hold a minimum amount of operating capital, attributed to them free of any interest charge. Previously, tax authorities did not actively question the capital structure of branches of foreign banking/insurance entities, or the allocation of profit to a branch. The OECD report is not considered to be a significant issue at this point in time, although tax authorities refer to the OECD guidelines where necessary.

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No detailed rules or proposed legislation regarding PE profit attribution exist. The arm's length principle is endorsed. Capital attribution is determined by Danish thin capitalization rules based on a fixed debt-equity ratio. Danish tax authorities have yet to decide on which method to apply from the OECD report. Generally the OECD rules are followed, without specifying whether thin capitalization or quasi-thin capitalization approach should be adopted. One possibility to avoid double taxation with respect to capital attribution is for the bank or insurance company to obtain an APA. A MAP can be applied in case of double taxation. The EU Arbitration Convention can also be applied.

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PE profit attribution does not appear to be a major issue at present and the absence of specific rules is not causing concern locally. Following the OECD report however, Finish tax authorities have started to raise issues concerning the capital allocation to Finnish branches of banking entities. No specific rules for PE profit attribution and for the attribution of investment income. Tax authorities have limited experience in the issue and seem to be flexible with the approaches adopted in the OECD report. Some Finnish branches of insurance entities have experienced an increased tax burden due to the attribution of investment assets.

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No detailed rules on profit attribution exist in France, but the tax authorities do take an interest in the capital attribution issue and their approach bears a strong resemblance to the OECD's capital allocation (BIS ratio) approach. Many banks have faced effective double taxation due to the mismatch between the capital allocation required by the French Tax Authority and head office country rules. Some of them have obtained an adjustment in the home country of the head office; others have invoked the EU Arbitration Convention to try to resolve the situation. Branches of insurance entities are not allowed to deduct interest charged by their head offices or PEs. A tax treaty procedure is in place (for elimination of double imposition) for insurers/reinsurers in France but there is no difference in managing the procedure between the insurance and banking industries.

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Specific administrative guidelines on PE profit attribution, in particular capital attribution, exist. Tax authorities accept the BIS ratio and the quasi-thin capitalization approaches. The determination of the risk-weighted assets (including off-balance sheet positions) and market-risk position are becoming increasingly scrutinized. These are likely to increase the compliance burden. For insurance branches, the attribution of investment assets and equity capital are based on the level of technical reserves including unearned premiums and deposits retained. Further equity capital needs to be attributed to the branch, amounting at least to the pro rata minimum capital according to the supervisory law of the country the head office is located in.

From a German perspective there is a potential risk of double taxation when applying a single method for profit allocation between head office and its branches even if this allocation is perfectly in line with the OECD. The actual double tax treaties may conflict with the recent OECD interpretation. Germany, for many years, has adopted specific guidelines regarding how to calculate the appropriate profit share of an insurance branch located in the country. Tax authorities are assumed to continue to apply this approach. Taxpayers may appeal to the EU Arbitration Convention to resolve double taxation issues.

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No detailed rules or practice for PE capital and profit attribution exist. There is no obligation to attribute free capital to Greek branches of EU credit entities. Greek tax authorities have yet to focus on the implementation of the OECD report and as such foreign banks operating in Greece have not experienced an increased compliance burden. Greek branches of insurance entities are not allowed to deduct interest charged from their head office or other PEs of their head office. Tax authorities are likely start to focus on the attribution of capital and investment assets to Greek branches.

For the application of a single method of capital attribution/attribution of assets across branches, a bank or insurance entity in Greece would need to obtain an OECD treaty position then the procedure that would be used would be either the EU Arbitration Convention or the MAP.

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Hong Kong

As a non-member, the OECD report has, to date, only had a limited impact. Generally PE profit attribution is required to be consistent with the operations of the branch as reflected in the accounts. Hong Kong operates specific provisions in calculating taxable profits from insurance operations. There are no specific rules regarding capital attribution. The Hong Kong tax authority would generally seek to apply the principles in the OECD Transfer Pricing Guidelines except where they are incompatible with specific local provisions. Hong Kong has only a limited double taxation agreement network, which it is actively seeking to expand.

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Hungary

OECD transfer pricing guidelines and methods are generally accepted in Hungary. The country endorses the 'separate entity approach'. There are no restrictions on the capital requirements for bank branches of EU entities, but non-EU entities are obliged to hold at least a fixed amount of capital. The current approach of the Hungarian Tax Authorities is quite formalistic (focusing on the accounting documentation and calculation of profits) and so the OECD report has had a limited impact on compliance and tax burdens so far.

The Hungarian tax authorities are challenging the capital structure of Hungarian branches of foreign insurance companies. Recent legislation allows branches to obtain an APA with the Hungarian tax authority. In principle, given the fairly simple Hungarian approach to capital attribution, a procedure under the EU Arbitration Convention or a DTT/MAP should be accessible.

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General rules allow PE profit attribution to be based on an accounting formula (turnover/receipts). India does not have any formal thin capitalization rules in place; however these are expected to be introduced in April 2011. Tax authorities have not challenged the capital structure of Indian branches of foreign banks in the past. The OECD report has not been seen as an immediate concern. Foreign insurance companies are not permitted to independently carry on business in India. They typically set up joint ventures with Indian insurance companies where they are allowed to hold up to a maximum of 26 percent.

Tax authorities have, on a limited basis, referred to OECD guidelines. A bank or insurance entity can apply for a MAP to address the issue of double taxation with respect to capital attribution/attribution of investments. However, the tax authorities have, so far, not challenged the capital structure of foreign banks in India.

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No specific rules regarding PE profit or capital attribution exist. In the past, Irish tax authorities have challenged the capital structure of Irish branches of foreign banks based on the separate entity approach. However, these were unsuccessful in the absence of any domestic provisions that denied relief for interest expense incurred by the branch. The question of PE profit allocation is not one which has been actively raised by Irish tax authorities. Ireland's low corporation tax rates relative to other countries mean that Ireland is more likely to be a head office location rather than a branch location.

In the case of an Irish branch, PE profit attribution is an issue more likely to be raised by the taxing authorities of head offices located in higher taxed countries. The introduction of a formal transfer pricing regime in Ireland is likely to see more focus on the issue. Ireland broadly adopts the OECD approach and allows for MAPs and the EU Arbitration Convention to resolve double taxation issues.

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Italy

There is no specific legislation on PE profit attribution in Italy. The quasi-thin capitalization approach has been used by the Italian tax authorities when assessing the adequacy of Italian branches' capital. In the past there was no minimum capital requirement applicable for the Italian branches of foreign banking entities. The Italian branch of an EU insurance company is not required to have a minimum statutory capital but may be supplied with an 'endowment fund' large enough to carry out its business. Following the OECD report, tax authorities are referring to OECD guidelines to assess the adequacy of endowment funds. As a result Italian branches of insurance entities are likely to face an increased tax burden.

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No specific legislation or other rules regarding PE profit to PEs exist in Japan, but the issue is regularly examined at tax audits from the viewpoint of functions and risks, and whether the return is commensurate with these. Thin capitalization rules apply to bank branches in Japan but rarely present a problem in practice for most banks. There is a restriction on interest paid to a head office by Japanese branches (payments up to LIBOR are allowed). Japanese tax authorities, although rarely referring to OECD reports in the past, are becoming more flexible in their approach, especially around the issue of double taxation. Japan allows for APAs to resolve issues of double taxation.

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Korea

PE profit attribution rules in Korea closely follow OECD guidelines (the 'separate entity' principle, 'arm's length' principle). With regard to the attribution of capital, the thin capitalization rule and the quasi-thin capitalization rules apply. PE profit attribution is an issue that is actively considered and challenged by the Korean tax authorities. In cases where there are differences between the OECD report and the Korean tax law regarding the allocation of capital or free capital, the tax authorities might not allow the taxpayer to refer to the OECD report in the tax audit or in APA/MAP. However, Korean tax law allows a taxpayer to eliminate the double taxation through the tax credit method.

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Luxembourg

Luxembourg accepts the 'separate entity' principle with regard to PE profit attribution. No specific rules for capital attribution exist. Generally, Luxembourg tax authorities refer to the OECD report especially concerning transfer pricing policy. Luxembourg applies a thin capitalization approach to the application of capital allocation to PEs (a debt/equity ratio based on the relevant insurance regulations). Luxembourg has a DTT with most of EU countries, which allows for the use of Article 25 MAP to resolve mismatches.

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Mexico

The OECD report will have no impact in Mexico because branches of foreign banks are not permitted under local laws. Only subsidiaries regulated by the National Banking Commission and the Ministry of Finance are permitted. In some cases the foreign banks establish Representative Offices but do not create a PE for the foreign bank. For insurance branches, the revenues obtained by the home office or any of its branches abroad are attributable to the PE, in the proportion in which the PE contributed to the expenses incurred for obtaining such income. Foreign resident PEs in Mexico must comply with basically the same obligations as any Mexican legal entity for accounting and tax purposes. Tax authorities often refer to the OECD report to support their technical position.

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Netherlands

No detailed rules covering profits or capital attribution exist, but Dutch tax authorities have generally adopted an approach very similar to the OECD's BIS ratio approach for both inbound and outbound PEs. For insurance branches, investment assets and thus the investment income are attributed to the branch where the insurance activity was concluded. A number of banks have experienced effective double taxation due to a mismatch between the capital allocated under Dutch and head office country rules. All Dutch tax treaties contain a MAP. Some tax treaties allow for the possibility of arbitration (e.g. EU Arbitration Convention).

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New Zealand

General PE profit attribution rules exist in New Zealand and the country endorses the 'arm's length' principle. Thin capitalization rules apply, and provide a 'safe harbour' based on a percentage of risk weighted assets. The OECD report has not been a cause for concern thus far. There is a potential problem for double taxation due to the mismatch between different jurisdictions' application of the rules as the New Zealand tax authorities do not allow notional internal charges.

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Poland

No specific tax rules regarding PE profit attribution in banking institutions exist. OECD guidelines are generally referred to in Poland. Likewise, there are no specific rules in place that make it mandatory to allocate a minimum amount of capital to branches of foreign banking or credit entities. Thin capitalization rules are generally applicable regarding the deductibility of interest expense. Poland is generally compliant with OECD transfer pricing guidelines and the EU Arbitration Convention. MAP is generally implemented in most of double tax treaties concluded by Poland.

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Portugal

No specific rules regarding PE profit and capital attribution for EU banking or credit entities exist. However, Portuguese branches of non-EU banking or credit entities are required to hold a minimum amount of capital. Tax authorities have not previously questioned the capital structure of Portuguese branches of foreign insurance entities. As a result, Portuguese branches of EU insurance entities have typically been debt-funded. Since the publication of the OECD report, tax authorities have been more focused on challenging the capital structure of Portuguese branches of foreign banks, applying the economic capital allocation approach to determine the minimum capital requirements for branches. Other OECD methods may eventually be applied.

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Singapore

No specific provisions for PE profit or capital attribution exist. Although not an OECD member, Singapore endorses the arm's length principle. Tax authorities have referred to the OECD guidelines, in the absence of legislation and have increased their scrutiny with regards to transfer pricing requirements and documentary evidence. Branches of foreign insurance entities must satisfy minimum capital and fund solvency requirements. There are no thin capitalization rules. Interest expenses are deductible from income provided that they were incurred in the production of income.

To address the issue of elimination of double taxation, the taxpayer can generally look at the framework of co-operation under a Double Taxation Agreement (DTA) whereby a credit or exemption may be granted subject to meeting the conditions. In addition, there is also a special provision within the framework of co-operation under a DTA via the MAP Article whereby it provides a mechanism for resolving difficulties arising from the application of the provisions of a DTA. The taxpayer may use his or her right under this Article, to address him or herself to the taxation authority of the state in which he or she is a resident to resolve issues relating to the application of the DTA.

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Slovakia

No detailed rules on PE profit attribution exist in Slovakia. There are no thin capitalization rules or minimum capital requirements, although OECD methods could be applied in the future. Tax authorities, although yet to challenge the capital structure of branches, are becoming increasingly interested in the issue. OECD principles have been accepted, and therefore a more strict approach is likely leading to an increased compliance burden. The general treaty protection against double taxation applies automatically, providing the conditions stipulated by the treaty are met.

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South Africa

No specific regulations regarding PE profit or capital attribution exist, therefore South Africa generally follows OECD guidelines. As with foreign-owned subsidiaries, financial assistance to non-resident PEs is to be subject to thin capitalization rules. Following the OECD report, tax authorities are likely to place a greater scrutiny on the issues of profit and capital attribution. The only procedure available would be the MAP for countries which South Africa has DTAs with.

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Spain

No detailed rules and practices for PE profit or capital attribution exist. Spanish branches of EU banks and insurance entities have typically been mainly debt-funded. Spanish tax authorities have already focused on the implementation of the OECD report. In certain cases they have applied the BIS solvency ratio to determine the minimum capital requirements for branches, but in theory the other OECD methods could also be applied in future. It should be noted that this new approach is not fully consolidated and it is currently under discussion. Unlike banks, branches of insurance entities are not allowed to deduct interest charged by their head offices to other PEs.

Spain has DTTs with most OECD countries which allow the use of the MAP (Article. 25). EU Arbitration Convention could be also invoked. Finally, the Spanish domestic law allows for unilateral or multilateral APAs to address transfer pricing issues and policies on a future position.

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Sweden

There is no specific legislation on PE profit attribution or the attribution of financial assets or capital to branches of banks in Sweden. Foreign enterprises not otherwise liable to tax in Sweden are liable to tax for income arising from a PE in Sweden. New legislation is currently not anticipated. The Swedish Tax Agency generally seeks transfer pricing guidance from OECD reports. This is likely to result in an increase in tax audits focused on the issue.

The standpoint of the Swedish Tax Agency (STA) is that Swedish tax residents should not be subject to double taxation. The STA may therefore, upon request from the taxpayer, apply the EU Arbitration Convention or MAP, in accordance with the applicable double taxation treaty, to try to avoid double taxation.

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Switzerland

PE profit attribution is not a major issue in Switzerland. OECD guidelines are generally followed and the 'separate entity' approach is adopted. There is no specific legislation for attributing profits to PEs. The general rule for capital attribution follows regulatory requirements (in general at least 8 percent of the value of the assets should be allocated to the PE for tax purposes). However tax authorities accept other approaches if applied to the insurance entity as a whole. Swiss tax authorities do not require transfer pricing documentation or analyses to be filed with the tax return and appear to be pragmatic in their approach in dealing with mismatches of different jurisdictions' application of OECD rules. Under existing Swiss double tax treaties there are normally provisions for a MAP but they do not allow for the possibility of arbitration where agreement is not reached.

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UK

The UK introduced legislation in 2003 with regard to PE profit attribution, enshrining the separate entity principle. UK rules closely follow the OECD report with respect to the allocation of capital. The tax authority (HMRC) applies a thin capitalization approach, benchmarking capital allocations against the capital structure of comparable UK banks (where these exist), however it will accept the capital allocation approach in most cases. The issue of PE profit allocation is actively raised by HMRC, and in particular the concept of KERTs is invoked to help sustain its technical position. Tax authorities apply the OECD report when dealing with individual enquiries or under a MAP. The EU Arbitration Convention can also be applied.

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US

PE profit and capital attribution rules differ significantly from OECD guidelines in the US Internal laws do not recognize the branch operations of a foreign corporation as separate entities for income tax purposes. However, the OECD report can be more applicable under the treaty method for settling double taxation issues. Certain tax treaties (e.g. UK – US) closely follow the OECD Transfer Pricing Guidelines in determining the profits and capital attributable to a PE, for instance, allowing for the use of risk-weighted assets to determine branch capital. Although the US taxing authorities might not specifically refer to or invoke the OECD report, it is generally taken into consideration where the treaty specifically mentions the OECD report.

International Comparison

	Extent of current rules/ practice A=highly developed	**Approximation to OECD authorized approach**	**Current issue?**	**Anticipated impact of OECD report**
Australia	A	High	Yes	Low (existing rules)
Germany	A	Medium	Yes	Increased tax
UK	A	High	Yes	Low (existing rules)
US	A	Medium	Yes	Low (existing rules)
France	B	High	Yes	Increased documentation
Ireland	B	High	No	Uncertain
Netherlands	B	High	Yes	Increased tax
Canada	C	Medium	No	Increased tax
Denmark	C	High	No	Documentation increase
Luxembourg	C	High	No	Low
New Zealand	C	Medium	No	Increased tax
South Africa	C	High	No	Low
Spain	C	Medium	Yes	Compliance
Belgium	D	Medium	Yes	Increased tax / compliance
Portugal	D	Medium	Yes	Uncertain
Switzerland	D	Medium	No	Uncertain
Austria	E	Medium	Yes	Compliance
Hong Kong	E	Low	No	Low (non-OECD member)
India	E	Low	No	Low
Italy	E	Low	Yes	Increased tax
Japan	E	Low	No	Low
Korea	E	Medium	No	Low
Slovakia	E	Medium	Yes	Increased tax / compliance
Sweden	E	Medium	Yes	Increased tax
Argentina	F	Low	No	Low (non-OECD member)
China	F	Low	No	Low
Finland	F	Medium	Yes	Increased tax
Poland	F	High	No	Low
Brazil	G	Low	No	Uncertain
Greece	G	Low	Yes	Increased tax
Hungary	G	Low	Yes	Compliance
Mexico	G	Low	No	Low
Singapore	G	Low	No	Low (non-OECD member)

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