July 21, 1998

Commissioner Charles Rossotti,
Internal Revenue Service,
1111 Constitution Avenue, N.W.,
Washington, D.C. 20224,
CC:DOM:CORP:R (REG-208299-90).

Re: Proposed Regulations on
Global Dealing Operations

Dear Commissioner Rossotti:

On behalf of the Securities Industry Association ("SIA),* this letter responds to the request of the Internal Revenue Service and the Treasury Department for comments on the proposed Treasury Regulations addressing the allocation and sourcing of income and deductions among taxpayers engaged in a global dealing operation (herein the "Proposed Regulations").

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* SIA is the trade organization of the securities industry, representing more than 600 stock brokerage and investment banking firms in the United States and Canada. As a group, these firms account for more than 90 percent of the securities business in North America.

SIA commends the Treasury and the Service for their efforts in developing the Proposed Regulations, which represent a significant step towards rationalizing the tax treatment of global dealing operations. This is an area in which clear and comprehensive guidance is greatly needed. The allocation and sourcing rules contained in existing regulations cannot easily be applied to global dealing and, in some cases, simply do not make sense in that context. In contrast, the general approach of the Proposed Regulations — which allocate profits and losses among participants in a global dealing operation based on the arm’s length principles of Section 482 — is more consistent with the economics of the business and with the allocation of profits for non-tax purposes.

We are also pleased to see that the Proposed Regulations are in many respects consistent with the views expressed by the Organization for Economic Cooperation and Development (“OECD”) in its recent draft paper on The Taxation of Global Trading of Financial Instruments (herein, the “OECD Paper”) and with the rules of other jurisdictions that are major financial centers. In light of the significant potential for multiple and therefore prohibitive taxation, consistent international rules are critically important in the tax treatment of global dealing operations. We urge the Treasury Department, therefore, to continue its efforts to coordinate the Proposed Regulations with the tax treatment of global dealing operations in other OECD countries.

There are, however, certain aspects of the Proposed Regulations that we believe are in need of revision or clarification — in part to ensure that the Proposed Regulations reflect the economics of global dealing operations and in part to ensure that the Proposed Regulations are as consistent as possible with the OECD approach. We have summarized these points below and they are discussed in more detail in the remainder of this submission.

Summary of Comments

1. Capital. We believe that a capital provider that serves as a counterparty to global dealing transactions should be treated as a participant and should be allocated a share of global dealing profit or loss. Further, we believe that this share of profit or loss is most appropriately sourced to the residence of the capital provider, subject to an anti-abuse rule.

2. Deemed QBU. We recommend that the concept of a deemed QBU be removed from the Proposed Regulations on the basis that it has no relevance under our recommended approach to the treatment of capital that bears equity-type risk. If the deemed QBU concept is retained, we recommend that additional guidance be issued on the circumstances in which the activities of a U.S. participant in a global dealing operation will give rise to a deemed QBU of a foreign participant and that the Proposed Regulations include a safe harbor rule.

3. Profit Split Method. We recommend that the Proposed Regulations be revised to clarify that the profit split method may or may not be an appropriate method, depending on the facts and circumstances of a particular global dealing operation. Further, we strongly urge that the Treasury Department coordinate this and other aspects of the Proposed Regulations with the approach adopted by the OECD.

4. Interest Expense. We recommend that interest expense incurred in a global dealing operation be treated as an operating expense that reduces net profit or loss before that profit or loss is allocated under the Proposed Regulations.

5. Effective Date. We recommend that taxpayers be permitted to elect to apply the Proposed Regulations to taxable years beginning after the date of publication of the Proposed Regulations and, in appropriate circumstances, to prior open years.

6. Technical Comments. We have also provided comments on certain technical aspects of the Proposed Regulations.

Discussion

1. Treatment of Capital.

Under the Proposed Regulations, the provision of capital — in any form — to a global dealing operation is treated as a "routine" function and the capital provider is not treated as a participant (unless it otherwise qualifies as such by virtue of other activities).* The significance of this characterization is that capital must be compensated with an arm's length return before any remaining profit attributable to the global dealing operation is allocated among the participants. As a result, the Proposed Regulations appear to contemplate that capital will generally receive a positive return — even in situations where the global dealing operation generates an overall loss.**

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* We note, however, that the treatment of capital under the Proposed Regulations is not clear in certain respects, and certain substantive rules that are alluded to either in the preamble or in examples do not appear to have a corresponding provision in the text of the Proposed Regulations. Therefore, as noted above, we also suggest that the treatment of capital be clarified in a distinct set of rules that are set forth in the text of the Proposed Regulations.

** As a possible exception to this general rule, the Examples set forth in Proposed Regs. § 1.482-8(e)(8) seem to imply that capital could in effect be allocated a share of profit or loss under the total profit split method (though not under the residual profit split method).

(a) Treatment of Capital that Bears Equity-Type Risk. We agree with the general approach that capital furnished to a global dealing operation in the form of a loan or guarantee should not be treated as a participant* but should instead be allocated an appropriate return determined under the rules of the existing Section 482 regulations (e.g., the provisions of Regs. § 1.482-2(a) for determining an arm's length interest rate).** As discussed further below, however, we believe that this approach is inappropriate in the case of capital that bears equity-type risk (i.e., market and other business risks). An entity that serves as a counterparty, and whose capital is exposed directly to equity-type risks, should be treated as a full participant in the global dealing operation and allocated an appropriate portion of profit or loss.

The preamble to the Proposed Regulations recognizes that "an entity that directly bears the risk assumed by a global dealing operation should be compensated for that function." Yet, as noted above, the Proposed Regulations would treat a capital provider that bears equity-type risks in

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* Prop. Regs. § 1.482-8(a)(2)(ii)(B). The Proposed Regulations also provide explicitly that capital furnished in the form of a guarantee will be treated as a "routine" contribution for purposes of the profit split method. Prop. Regs. § 1.482-8(e)(6)(ii).

** The return for the loan or guarantee is sourced in accordance with the rules of existing law for the sourcing of interest and guarantee fees, and its status as effectively connected or non-effectively connected income (in the case of a foreign entity) is determined under the existing Section 864 regulations.

the same manner as a capital provider that bears only credit risk. This failure to distinguish between the two situations is inconsistent with economic reality. Capital that assumes market and business risks is necessarily exposed not only to the potential for profit but also to a risk of loss. It makes no sense, therefore, to provide that this type of capital cannot share in any losses generated by a global dealing operation and instead must always be compensated with a positive return. An entity that serves as a counterparty in global dealing transactions, and whose capital bears the risk of loss from those transactions, is as much a participant in the global dealing operation as an entity that contributes trading or marketing services. We recommend, therefore, that the Proposed Regulations be revised to provide that an entity whose capital directly bears the equity-type risks associated with the global dealing operation will be treated as a participant and should therefore be allocated a share of net profit or loss. The amount of this share would be determined under the general principles of the Proposed Regulations, e.g., based on comparable transactions, by treating capital as a factor in a profit split, or by any other economically sound standard.

Further, we disagree strongly with the approach adopted in the Proposed Regulations for determining the source and effectively connected status of the return that is allocated to capital that bears equity-type risk. Under the Proposed Regulations, the source of this return is determined based on where the capital is “employed”, and the principal factor in making this determination is where the traders are located.* The decision to expose an entity's capital to the equity-type risks of a global dealing operation is often made, however, by managers located in the home office of the entity in the entity's residence jurisdiction, rather than traders or marketers who may be located in other jurisdictions. Similarly, risk management and other capital-related functions may or may not be performed in the locations where traders or marketers are located. Given these variations among different firms' global dealing operations, we believe that it would be most appropriate to source the profit or loss allocated to capital to the residence jurisdiction of the capital provider. We note, moreover, that an approach that traces capital to trader locations seems inconsistent with the fungibility notion expressed in Prop. Regs. § 1.863-3(h)(3)(ii).

We recognize that a residence-based sourcing rule could, in certain circumstances, be subject to abuse — for example, if capital is placed in an entity that is located in a tax haven jurisdiction and that performs no other function besides serving as a booking location. We recommend, therefore, that this sourcing rule be coupled with an anti-abuse rule under which capital would not be sourced on a residence basis where the capital-providing entity performs only de minimis functions other than serving as a booking

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* This rule is not stated explicitly in the Proposed Regulations but can be derived from Prop. Regs. § 1.863-3(h)(v), Example (3)(vi). The Preamble to the Proposed Regulations states that this sourcing principle applies where a taxpayer directly bears risk arising from the conduct of a global dealing operation, such as when it acts as a counterparty without performing other global dealing functions.

location. We would like to discuss with you the appropriate features of such a rule but, as a preliminary matter, we suggest that this determination be made based upon all of the facts and circumstances, and that relevant factors include the extent to which certain functions related to capital management, such as risk management and credit analysis, are performed in that entity.

Finally, we note that the approach adopted in the Proposed Regulations for capital that bears equity-type risk departs significantly from the approach used by a number of other major countries for allocating the income generated by global dealing operations. Such a significant departure will almost certainly result in multiple taxation of this income in a substantial number of cases. For this reason, we believe that it is critical that the Proposed Regulations be revised to adopt the approach outlined above. Not only is this approach more consistent with the economics of the business, but it is also more consistent with the approach followed in other jurisdictions.

(b) <u>Other Comments on the Treatment of Capital</u>. Given the importance and the inherent complexity of this subject, we recommend that the rules relating to capital be stated more explicitly in the text of the Proposed Regulations in a set of provisions dealing directly with the treatment of capital. We suggest also that those provisions set forth a definition of the term “capital” and examples of different forms in which it may be provided to a global dealing operation.

Further, while we agree that it is appropriate to apply the rules of existing law in determining the source and effectively connected status of compensation received for a loan or guarantee, we note that existing law is not entirely clear — particularly with respect to the treatment of guarantee fees. While Bank of America* provides some guidance with respect to the treatment for sourcing purposes, the existing rules for determining effectively connected income and subpart F income do not clearly address guarantee fees. We recommend, therefore, that additional guidance on these subjects be provided in regulations under the appropriate Code sections.

Finally, the Proposed Regulations contemplate that capital is to be treated as fungible within a single legal entity, i.e., as supporting all of the entity's transactions regardless of where those transactions are booked.** Thus, the Proposed Regulations provide that the payment of a guarantee fee by one branch of a legal entity to another branch would be inappropriate and will be disregarded.*** We agree that this rule makes sense in relation to capital provided in the form of credit support. We also believe that the residence-based sourcing approach that we recommend above with respect to capital that bears equity-type risk is consistent with this fungibility principle.

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* Bank of America v. United States, 680 F.2d 142 (Ct. Cl. 1982)

** Prop. Regs. § 1.863-3(h)(3)(ii).

*** Id.

2. Deemed Qualified Business Unit.

Proposed Regulations Section 1.863-3(h)(3)(iv) provides that, for purposes of the rules governing the source and effectively connected status of global dealing profits, a qualified business unit shall include a U.S. trade or business that is deemed to exist because of the activities of a dependent agent in the United States (a "deemed QBU").*

Although the Proposed Regulations do not state this explicitly, it appears that the principal significance of a deemed QBU relates to the treatment of capital. As discussed above, we believe that the rules relating to capital that bears equity-type risk should be revised and, under the approach that we recommend, the concept of a deemed QBU would be unnecessary. Accordingly, we recommend that the provisions of the Proposed Regulations relating to deemed QBUs be eliminated and that the allocation and sourcing rules of the Proposed Regulations apply solely with respect to legal entities and actual branches. If the deemed QBU concept is not eliminated, then we strongly urge that the circumstances in which a deemed QBU will arise be clarified and that a safe harbor rule be added to the Proposed Regulations.

(a) Relationship to Treatment of Capital. Example (3) of Prop. Regs. § 1.863-3(h)(3)(v) provides the only illustration in the Proposed Regulations of the function of a deemed QBU. Based on that Example, it appears that the

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* A deemed QBU may exist without regard to the books and records requirement of Regs. § 1.989(a)-1(b).

principal relevance of the existence of a deemed QBU arises in connection with the sourcing of a return on capital that bears equity-type risk. Thus, where an entity that provides risk-bearing capital to a global dealing operation has a deemed QBU outside its residence country, the Example requires that a portion of the return that is attributed to the capital be allocated to the deemed QBU. Where the capital provider is foreign and the deemed QBU is in the United States, this allocation results in treatment of a portion of the capital return as U.S. source effectively connected income.

Example (3) illustrates this approach in the context of the profit split method. In the Example, a U.K. company (P) and its U.S. and Japanese subsidiaries (USsub and Jsub) conduct a global dealing operation, and P is deemed to have a U.S. QBU by virtue of the activities of USsub on its behalf. The Example sets forth a three-step allocation procedure:

(i) In Step One, routine functions — including for this purpose P’s assumption of risk as a counterparty — must be identified and compensated with an arm’s length return. The Example allocates $40 to P in Step One.

(ii) In Step Two, the residual profit from the global dealing operation is allocated among the three participants using a multi-factor formula that reflects the relative values of their non-routine contributions. P is allocated $48 of the residual profit in this Step.

(iii) Finally, in Step Three, the return allocated to P in Step One for the provision of capital is reallocated to the locations where the capital is considered to be employed. The Example indicates that this determination is made based on where the traders are located, with the result that a portion of P's $40 return on capital is re-allocated to P's deemed U.S. QBU.

As noted above, Example (3) represents the only guidance included in the Proposed Regulations regarding the function of a deemed QBU. In the Example, the only relevance that P's deemed U.S. QBU appears to have relates to the requirement that P's return on capital be reallocated in Step Three among P's trading locations — one of which is the deemed QBU that exists by virtue of USsub's trading activities. The deemed QBU appears to be irrelevant in Step Two, in which the residual profit (i.e., after reduction by the return on capital) is allocated among the various U.S. and foreign participants. In particular, the deemed QBU is not treated as a separate participant for this purpose (although presumably an actual QBU could be treated as a participant in Step Two). Moreover, the residual profit that is allocated to P in Step Two ($48) is not reallocated in Step Three to P's deemed QBU. Thus, it would appear that the only function of the deemed QBU is to attract a share of the $40 return on capital that is allocated to P in Step One.

As discussed above, we believe that capital that bears equity-type risk should be treated as located in the residence country of the capital provider. Under this approach, there would be no need for the reallocation contemplated by Step Three of Example (3) and thus no role for the deemed QBU. Further, it is not entirely clear under the Proposed Regulations what other function the deemed QBU might serve. We recommend, therefore, that the Proposed Regulations be revised to eliminate the references to a deemed QBU and that Example (3) be revised accordingly.

(b) Safe Harbor Rule. If the deemed QBU concept is not eliminated, as we recommend, then (i) clarification is needed regarding the circumstances in which a deemed QBU will be considered to arise and (ii) a safe harbor rule is clearly warranted.

Application of the deemed QBU rules will be quite difficult as a practical matter and may have punitive and unintended results. This is because the circumstances in which a foreign participant in a global dealing operation will be deemed to have a U.S. QBU are for the most part unclear. Moreover, the consequences to a foreign participant of being deemed to have a QBU are quite significant and are likely to be unexpected — particularly where the foreign participant does not have an actual branch in the United States. Not only will any income that is attributed to the deemed U.S. QBU be subject to net basis U.S. taxation, but the branch profits and excess interest taxes of Section 884 may also apply and the foreign participant will be required to file its own U.S. income tax returns. Failure to file a tax return may lead to the disallowance of deductions in computing taxable income and potential exposure to penalties under Section 6114. Further, to the extent that other jurisdictions do not follow this approach, U.S. tax imposed on income attributed to a deemed QBU may be ineligible for credit or other relief in the participant's residence jurisdiction (e.g., because the residence jurisdiction treats the income on which U.S. tax is imposed as domestic source). At the same time, the fact that the income is treated as U.S. source under the Proposed Regulations would similarly limit the participant’s ability to credit residence country tax against its U.S. tax liability, with the result that the income is subject to multiple taxation.

Yet, it will be difficult in most cases for a foreign participant in a global dealing operation to determine whether it has a deemed U.S. QBU and thus whether it is required to file a return. The Proposed Regulations appear to indicate that U.S. marketing activities undertaken by a U.S. participant on behalf of a foreign participant can result in the existence of a deemed QBU where those activities are “non-routine”. The circumstances in which marketing will be considered non-routine are not entirely clear, however, under the Proposed Regulations. Moreover, the treatment of non-routine marketing activities is beyond the scope of the existing rules under Regs. § 1.864-7(d) and the Permanent Establishment article of most income tax treaties. The application of the existing rules is likewise unclear with respect to other aspects of a global dealing operation, and there is little authority generally in the context of financial businesses.

For example, the Proposed Regulations indicate that a U.S. participant that has (and presumably “habitually exercises”) the authority to enter into contracts in the name of a foreign participant will be treated as a deemed QBU of the foreign participant.* In the context of a global dealing operation, however, a U.S. participant may have varying degrees of authority to contract on behalf of an affiliate. While a U.S. participant with unlimited contractual authority may clearly constitute a QBU, it is not obvious that a U.S. participant with more limited authority — for example, the authority to execute contracts during certain time periods (e.g., when the markets are closed in the foreign participant's jurisdictions) or within certain limited pricing parameters — would qualify as a deemed QBU under the existing rules. In fact, similar questions can be asked about nearly any function that is part of a global dealing operation, depending on its importance to the operation and the manner in which it is conducted.

It is important, therefore, that clearer guidance be published on the circumstances in which functions performed by a U.S. participant in a global dealing operation will result in a deemed QBU for one or more foreign participants. As a procedural matter, it would seem most appropriate to address this subject in regulations that would be issued under Section 864. Further, while we recognize that resolving these issues will require a considerable effort on the part of Treasury and Service personnel, we believe that this guidance should be made a high priority so that it can be implemented as soon as possible in conjunction with final global dealing Regulations.

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* Prop. Regs. § 1.863-3(h)(3)(vi), Example (3)(ii). This conclusion is presumably based on Regs. § 1.864-7(d) and Article 5, paragraph (4) of the U.S.-U.K. income tax treaty.

As a substantive matter, we strongly recommend that the Proposed Regulations be revised in two respects. First, the Proposed Regulations should clarify that the existence of a deemed QBU will be determined based on all of the relevant facts and circumstances, including in circumstances where a U.S. participant has the authority to execute contracts on behalf of a foreign participant. Second, the Proposed Regulations should include a safe harbor rule under which a deemed QBU would not be considered to exist where either (i) a U.S. participant performs only a limited range of activities on behalf of foreign participants (such as de minimis routine or non-routine marketing activities), or executes contracts only in limited circumstances,* and receives adequate compensation in either case in the form of a fee for such services or (ii) the portion of the total profit from the global dealing operation that would otherwise be allocated to the deemed QBU for the taxable year is lower than 20%. A safe harbor rule of this type would greatly facilitate both taxpayer compliance with the Proposed Regulations and their administration by the Service. Particularly in the case where multiple foreign jurisdictions are involved in a global dealing operation, the possibility that a single U.S. participant may constitute multiple deemed QBUs, with each being allocated a relatively minor portion of the global

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* This should not be limited to circumstances in which the U.S. participant has authority while the foreign participant is closed for business, but should also include cases where the U.S. participant can execute contracts within certain clearly defined risk or credit limits.

dealing profits yet being required to file a separate tax return, represents a significant and unnecessary administrative burden.

Finally, we recommend that the Treasury and the Service also consider in this context a provision that a foreign participant will not be deemed to have a U.S. QBU in circumstances where the existence of an actual branch would be unlawful. For both U.S. and foreign regulatory reasons, U.S.-based securities firms generally separate their U.S. and foreign operations in different U.S. and foreign legal entities. In practice it is rare that a foreign subsidiary would have an actual U.S. branch, and in certain cases foreign subsidiaries of a U.S. securities firm may not be permitted to conduct business in the United States. In this situation, it would seem particularly inappropriate to treat a foreign subsidiary as though it were conducting a U.S. business through a deemed U.S. branch. In a number of analogous situations, the courts have recognized that it is inappropriate to allocate income under Section 482 to an entity that could not lawfully earn that income itself.* It would be consistent with this line of authority to conclude that a foreign participant in a global dealing operation that could not legally establish an actual branch in the United States will not be deemed to have a U.S. QBU by virtue of the activities of a U.S. participant.

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* See, e.g., Commissioner v. First Security Bank of Utah, N.A., 405 U.S. 394 (1972); Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996); The Procter & Gamble Company v. Commissioner, 961 F.2d 1255 (6th Cir. 1992).

3. Profit Split Method.

(a) Application of Best Method Rule. The Proposed Regulations require that taxpayers apply the “best method” rule of Regs. § 1.482-1(c) in determining the most appropriate pricing methodology for a global dealing operation, taking into account all of the facts and circumstances of the taxpayer's particular situation. Consistent with the “best method” rule, the Proposed Regulations do not establish an explicit priority of pricing methods. In addition, the Proposed Regulations do not require that any specific pricing method be applied in connection with a particular trading structure, such as those commonly referred to as the “separate enterprise”, “natural home”, “centralized product management” or “integrated trading” models. The Proposed Regulations do, however, identify certain types of transactions that may be priced in accordance with a particular method.*

We are concerned that the Proposed Regulations at least appear to imply that the circumstances in which transactional pricing methods — specifically, the comparable uncontrolled financial transaction (CUFT) method and the gross margin and gross markup methods — are appropriate are relatively limited and that the profit split method will be the “best method” in a fairly broad range of circumstances. To the contrary , we believe that the profit split method will often be the least appropriate method, particularly in the

* For example, Prop. Regs. § 1.482-8(d)(1) provides that the gross markup method may be used to establish an arm's length price for a transaction in which a participant purchases a debt or equity instrument from an unrelated party and sells the instrument to a related party.

context of a global dealing operation that follows the "centralized product management" or "separate enterprise" structural models.* These structural models typically involve readily identifiable transactions between related entities or business units that resemble common transactions and relationships among unaffiliated parties. Accordingly, trading operations that are conducted in this manner may not be likely candidates for profit split pricing as such transactions can more properly be handled through fee arrangements that generally fall within the scope of other sections of the Section 482 regulations.

Therefore, we urge that the Proposed Regulations be revised to state explicitly that the profit split method may or may not be the "best method" for any type of global dealing operation, depending upon the facts and circumstances. Although the preamble to the Proposed Regulations does note that the profit split method is expected to apply in cases where the structure of a global dealing operation "may make it difficult to apply a traditional transactional method", we are concerned that this statement is not sufficiently clear to ensure that taxpayers will not be inappropriately forced to apply the profit split method on audit. Moreover, a statement contained only in the preamble to the Proposed Regulations clearly lacks the legal effect of a textual provision.

We note, moreover, that such a statement would be consistent with the conclusions set forth in the OECD Paper, which emphasizes repeatedly a strong preference for

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* These models are described in the OECD Paper at ¶¶ 54 through 61.

transactional pricing methods and characterizes the profit split method as a method of "last resort".* An explicit statement in the Proposed Regulations acknowledging that the applicability of the profit split method depends on a taxpayer's particular facts and circumstances would thus enhance to a meaningful degree the coordination of the U.S. rules with international rules governing the taxation of global dealing operations. Although such a statement may depart to some extent from the general approach of the Section 482 Regulations, we believe that it is warranted in this context by the especially high likelihood of multiple taxation in the absence of coordinated international rules.

(b) <u>Technical Comments</u>. We have several technical comments on the description of the profit split method provided in the Proposed Regulations. First, we recommend that the Proposed Regulations provide additional guidance on the various factors that may be acceptable for inclusion in a profit split formula. The Proposed Regulations mention only the use of trader compensation and, in this respect, are much more limited than Notice 94-40. In view of the critical role that selection of appropriate factors plays in the proper application of this method, it would be very useful for the Proposed Regulations to provide additional examples of factors that may be appropriate in various circumstances.

Similarly, we recommend that the Proposed Regulations provide additional examples of the types of

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* <u>See</u>, <u>e</u>.<u>g</u>., OECD Paper at ¶¶ 128, 132-134, 165, 172.

functions that will be considered “routine” and therefore excluded when applying the residual profit split method. In particular, it is not clear under the Proposed Regulations what types of marketing activities might cause a salesperson to cross the line from routine to non-routine. Presumably, a marketer that works closely with a trader to develop a unique product for a particular customer should be treated as performing a non-routine function. Where the marketer works with the trader to customize a common type of transaction, however, the characterization of the marketing function is not clear. Given the importance of the distinction, it would be useful for the Proposed Regulations to provide additional guidance on this point.

Finally, we suggest that the Proposed Regulations provide further guidance on the types of expenses that should be treated as “operating expenses” which are subtracted from gross profit in computing operating profit and loss. As a starting point, we recommend that expenses which are treated as attributable to the global dealing operation for financial reporting purposes generally be so treated under the profit split method.

4. Allocation of Interest Expense.

The Proposed Regulations do not apply to the allocation of interest expense. Rather, interest expense incurred in a global dealing operation is allocated exclusively under the rules provided in Regs. § 1.882-5 (in the case of interest expense incurred by a foreign corporation) or Regs. § 1.861 -9T through - 12T (in the case of interest expense incurred by a U.S. corporation).

We are concerned that, particularly in the case of a U.S. corporation, the lack of coordination between the interest allocation rules and the Proposed Regulations is almost certain to result in a determination of net profit for a global dealing operation that bears little resemblance to economic reality. This is because the Proposed Regulations may require that profits from global dealing (determined before the allocation of interest expense) be allocated either from a U.S. participant to a foreign participant, or vice versa - without regard to the location in which the profit is otherwise booked - while the regulations under Section 864(e) do not permit a corresponding allocation of the related interest expense from one participant to another. Interest expense, and expenses that are treated as equivalent to interest and are thus also subject to allocation under Section 861, are so significant a component of the net profit of any global dealing operation that the inability to allocate these expenses in a manner that matches the allocation of the related income will in many cases result in serious distortions. For example, where a global dealing operation involves both U.S. and foreign corporations, but all transactions — including borrowings — are booked in a single foreign corporation, profits attributable to the operation will be allocated among the various U.S. and foreign corporations but all interest expense will remain in the foreign corporation that is the booking location. Clearly, the amount of net profit, after interest expense, that is allocated to each of the participants will be either too high (in the case of the non-booking locations) or too low (in the case of the booking location).*

The Preamble to the Proposed Regulations states that the Internal Revenue Service anticipates issuing proposed regulations under Section 861 that provide rules adopting the significant principles of the proposed regulations under Sections 882 and 884. These proposed regulations provide for the determination of U.S. assets and liabilities, and the allocation of interest expense to a U.S. branch of a foreign corporation, in cases where a foreign corporation that is a dealer under Section 475 has assets that produce both effectively connected and non-effectively connected income. As we understand it, analogous rules in the context of Section 864(e) would provide for the treatment of assets attributable to the global dealing operation of a U.S. corporation as partially U.S. source and partially foreign source by

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* For example, suppose that a global dealing operation conducted by a U.S. participant and a foreign participant earns $200 of gross profit and incurs $100 of interest expense, all of which is booked in the foreign participant. Suppose also that the profit split method is applied and that the relevant factors indicate a 50-50 split between the participants. If interest expense is taken into account for purposes of the profit split, then $100 of net profit will be allocated $50 to the U.S. participant and $50 to the U.K. participant. Under the Proposed Regulations, however, the U.S. participant would effectively be allocated $100 of profit ($100 of gross profit minus $0 of interest expense), and the U.K. participant would be allocated $0 ($100 of gross profit minus $100 of interest expense).

reference to the allocation of global dealing profit to U.S. and foreign QBUs of the U.S. corporation.

While we believe that regulations of this type would certainly be useful, they will only partially eliminate the potential for distortion because they will not permit the allocation of interest expense to an entity other than the entity in which the interest expense is booked. In order to eliminate fully the potential for distortion, interest expense incurred in a global dealing operation must be taken into account as an operating expense that reduces the net profit or loss to be allocated under the Proposed Regulations.

We recognize that the Section 864(e) regulations generally follow a “water's edge fungibility” approach that distinguishes between interest expense booked in domestic and foreign entities. We urge the Treasury and the Service to consider, however, whether a limited exception to that approach in relation to global dealing operations would fall within the scope of the Treasury's regulatory authority under Section 864(e)(7), Section 482 and subpart F. In this regard, we note that the Treasury’s regulatory authority under these Code provisions is quite broad and generally extends to the development of rules that are necessary or appropriate to carry out the purposes of the statutory provisions. Section 482 in particular grants the Treasury regulatory authority to allocate gross income and deductions as necessary in order to reflect clearly the income of related organizations, trades or businesses. We believe that the inclusion of interest expense within the scope of the Proposed Regulations would fall within the scope of this authority, and we respectfully submit that regulations which do not appropriately take into account the interest expense incurred in global dealing operations do not “clearly reflect income” within the meaning of Section 482.

If the Proposed Regulations are revised to take into account interest expense, it will be necessary to take into account the fact that prevailing interest rates may vary across trading locations and in different currencies. For that reason, we do not believe that it would be appropriate to treat all of the interest expense incurred in a global dealing operation as fungible within the global book. A complete fungibility approach could have the effect in many circumstances of allocating either more or less interest expense to a particular trading location than is necessary to fund that location’s activities.

The best approach, we believe, would be to apply a “matched funding” methodology under which interest expense would be allocated to the portfolio of transactions within the global book that is funded with the associated debt obligations. Securities dealers that engage in global dealing activities generally maintain their books and records on a matched funding basis in order to determine profit and loss for management accounting and other non-tax purposes. We believe, therefore, that it would not be difficult to match items of interest expense to particular trading locations and transactions in particular currencies. After interest expense was matched to the appropriate portfolio, the net profit or loss from that portfolio would be allocated under the Proposed Regulations.

As an alternative, all of the interest expense incurred in the global dealing operation could be applied against the gross profit from the global book. If this approach were adopted, however, we believe that it would be necessary for the allocation methodology to take into account interest rate differentials across currencies. For example, under a "separate currency pools"* type of approach, interest expense denominated in a particular currency could be allocated to the gross profit from transactions denominated in that same currency. Only the net profit in each currency would be translated into dollars (or other relevant functional currency) and allocated under the Proposed Regulations among the appropriate participants, i.e., the participants that engaged in the transactions in that currency pool.

Finally, we urge that any regulations issued under Section 861 with application to global dealing operations be issued in proposed form to allow sufficient opportunity for public comment. Recognizing that this may mean that the Proposed Regulations are made effective in advance of the Section 861 regulations, we suggest that consideration be given to permitting elective application of any proposed Section 861 regulations during the period prior to their finalization.

5. Effective Date.

As noted above, the tax treatment of global dealing operations is quite uncertain in many respects under the

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* See Regs. § 1.882-5(e).

existing Regulations. Although some taxpayers may be able to achieve greater certainty by entering into an advance pricing agreement (APA), the APA process was never intended as a general solution and has not served that function. The Proposed Regulations are thus a welcome step towards resolving the existing uncertainties.

The Proposed Regulations are proposed to be effective, however, only for taxable years beginning after the date on which they are published in final form. Given the inherent complexity of these regulations and their importance to the financial community, we expect that the Treasury and the Service will receive a substantial number of comments on the Proposed Regulations and that finalization will require a considerable period of time. As a result, final Regulations may not be effective until the year 2000 for calendar year taxpayers (assuming final Regulations are not published until sometime during 1999).

We understand that, in light of these circumstances, Treasury and the Service are considering whether to permit retroactive or temporary application of the Proposed Regulations. In our view, it would be appropriate for Treasury and the Service to permit taxpayers to elect to apply the Proposed Regulations, in their current form, for taxable years beginning after the date on which the Proposed Regulations were published. Consideration should also be given to permitting retroactive application to prior taxable years that have not been closed. Elective application would bring welcome relief to taxpayers that may otherwise be forced to live through two more years of uncertainty and exposure to multiple taxation.

We note that others have suggested that the Treasury and Service consider the re-issuance of the Proposed Regulations as Temporary Regulations that would be applicable to all taxpayers, without exception, for taxable years beginning after the date of re-issuance. While we understand the arguments in favor of this approach, we are concerned that it would have disparate effects on different classes of taxpayers that are affected disproportionately by various aspects of the Proposed Regulations. For example, banks and other institutions that conduct business in branch form will clearly benefit from the treatment of inter-branch transactions under the Proposed Regulations. This aspect of the Proposed Regulations is of lesser practical significance, however, to securities firms that conduct business in subsidiary form. On the other hand, securities firms and other U.S. financial institutions that conduct foreign business through foreign subsidiaries are particularly affected by the uncertainties that remain in the Proposed Regulations with regard to the circumstances in which a foreign subsidiary may be deemed to have a U.S. branch or permanent establishment.

In light of this potential for disparate effects, we believe that elective application is the better approach. To guard against the possibility of “cherrypicking”, the ability to elect to apply the Proposed Regulations could be conditioned on their application to all of a taxpayer's global dealing operations, i.e., a taxpayer (determined on an affiliated group basis) would not be able to apply the Proposed Regulations to its global dealings in one type of financial product, but not to its dealings in other financial products. In addition, the election could be conditioned upon reasonable substantiation of the taxpayer's results, taking into account the absence of guidance at present regarding documentation requirements.

Finally, we note that any such election would presumably be available just for a short period of time, i.e., until the Proposed Regulations are finalized, so that the revenue impact of the election, if any, would be limited. In this regard, we believe that the decision to elect the Proposed Regulations would be driven in most cases by the desire for greater certainty and the taxpayer's ability to meet substantiation requirements — and not by any desire to achieve more favorable tax results. We note, moreover, that the Service itself will benefit in the audit context from a taxpayer's election to apply the Proposed Regulations, because the applicable rules will be clearer and the results will be more consistent with the government's views regarding the appropriate treatment of global dealing operations.

6. Other Comments.

We also have the following technical comments on certain aspects of the Proposed Regulations.

(a) Commodities futures and options. We believe that it would be appropriate for the Proposed Regulations to be extended to global dealing operations in commodities futures and options. We are not aware of any particular distinctions between dealing operations in these instruments and dealing operations in other types of financial instruments that would warrant different treatment under Section 482.

(b) Treatment of proprietary activities. Under Prop. Reg. § 1.482-8(a)(2)(i), the taking of proprietary positions is not included within the definition of a global dealing operation unless those positions are entered into by a regular dealer in securities in its capacity as such. While we agree that it would be inappropriate to include taxpayers (such as hedge funds) that do not engage in customer transactions within the scope of the Proposed Regulations, we are concerned that the exclusion of non-customer proprietary positions taken by securities dealers may raise difficult compliance issues because it is often the case that securities positions are sold from a dealer's inventory book to its proprietary book, or vice versa. Under these circumstances, it will be difficult to determine whether a particular position is appropriately treated as a customer or non-customer transaction for purposes of the Proposed Regulations. Further, to the extent that a securities dealer is conducting proprietary trading through multiple trading locations, the income allocation principles set forth in the Proposed Regulations will often be more appropriate than the rules of existing law or other possible alternatives.* We recommend,

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* In the absence of the Proposed Regulations, it is not (continued...)

therefore, that a taxpayer that is otherwise a regular dealer in securities be permitted to elect to include all of its proprietary trading activities within the scope of the Proposed Regulations. This election would be applied on an affiliated group basis.

(c) Risk transfer agreements. We request that the Proposed Regulations be clarified to state that a risk transfer agreement entered into between two branches of the same legal entity will be respected for Federal income tax purposes, even if the transaction does not involve different functional currencies or the allocation of income to more than one jurisdiction. The Proposed Regulations define a "risk transfer agreement" to mean a transfer of risk "between two qualified business units ... of the same taxpayer" that meets certain conditions. Under current law, the concept of a QBU generally refers only to a branch or division that has a distinct functional currency or location. The provisions of the Proposed Regulations relating to risk transfer agreements presumably are also intended to apply, however, in situations where such an agreement is entered into between two divisions that are located within the same branch of a participant, or between two branches that use the same functional currency.

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*(...continued)
entirely clear how proprietary trading activities would be treated under the existing Section 482 regulations. Further, the "all or nothing" material participation rules of the existing Section 864 regulations would seem as inappropriate in this context as in the context of dealing operations.

We recommend, therefore, that this point be clarified to preclude the possibility that any negative inference might be drawn from the contexts in which the QBU concept is used under current law.

(d) Statistical methods. Prop. Regs. § 1.482-8(a)(4)(iii) provides that the district director may adjust a taxpayer's results under a pricing method applied on a transaction-by-transaction basis if a “valid statistical analysis” demonstrates that the taxpayer's controlled prices, when analyzed on an aggregate basis, provide results that are not arm's length. We recommend that the Service provide additional guidance - perhaps in the form of a notice or revenue procedure - regarding the statistical methods that it intends to apply for these purposes. In any given situation, more than one methodology may be viewed by qualified statisticians as a “valid” statistical analysis. Thus, we believe it would be appropriate for the Service to provide more guidance on the intended meaning of this term, so that taxpayers can anticipate the approach that will be followed by the Service on audit. Further, where a taxpayer has employed a methodology that would reasonably be considered as “valid” in its particular circumstances, we do not believe that an auditor should be authorized to apply a different methodology in order to adjust the taxpayer's results merely because that other method would also be considered a “valid” statistical analysis.

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Please do not hesitate to contact the undersigned with any questions regarding the foregoing. SIA would welcome the opportunity to work with the staff of the Treasury Department and Internal Revenue Service on finalization of the Proposed Regulations.

Sincerely yours,

Anthony J. Cetta
Chairman, Committee on
Federal Taxation

cc: Donald C. Lubick, Assistant Secretary (Tax Policy)
Joseph H. Guttentag, Deputy Assistant Secretary
(International Tax Affairs)
Philip R. West, International Tax Counsel
Patricia A. Brown, Deputy International Tax Counsel

(Department of the Treasury)

Stuart L. Brown, Chief Counsel
Michael Danilack, Associate Chief Counsel (International)
Paul S. Epstein, Senior Technical Reviewer, Branch 5, Office of Associate Chief Counsel (International)
Ginny Chung, Attorney Advisor, Branch 5, Office of Associate Chief Counsel (International)

(Internal Revenue Service)