



Securities Industry Association

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Re: Proposed Regulations on Global Dealing

Dear Barbara and Tricia:

We would like to thank you for taking the time to meet with us on June 5 to discuss the proposed regulations on allocation and sourcing of income from global dealing operations (herein, the "Proposed Regulations"). This letter responds to your request that we provide you with additional information regarding the allocation methods commonly used by Securities Industry Association ("SIA") member firms to allocate profit and loss among participants in a global dealing operation and consider how these methods can be accommodated in the Proposed Regulations. You also asked that we consider whether the revised regulations, when issued, should reserve on the question of whether a global dealing participant in one country may be deemed to have a qualified business unit or permanent establishment in the country of another participant by virtue of the other participant's trading activities.

As set forth more fully below, we recommend that paragraph (e) of Prop. Regs. § 1.482-8 be revised and expanded to cover a wider range of "profit allocation" methods, including both the existing total and residual profit split methods and some additional profit-based service fee methods. Together these methods reflect the various ways in which securities firms allocate the profit or loss associated with global dealing operations that do not involve identifiable

transactions among the participants themselves. We have described these additional methods below and included a set of examples in Appendix B. With respect to the issue of the deemed qualified business unit, we agree with your suggestion that a reservation be included in the revised regulations as an interim solution. We would also like to work with you on a more permanent solution to this issue. Finally, because the changes that we recommend are substantial, and the issues presented so significant for the securities industry, we recommend that the Proposed Regulations be re-issued in proposed form before being issued in final form.

I. Allocation Methods

As we have discussed, we do not believe that the three “traditional” allocation methods set forth in the Proposed Regulations can be applied to allocate profit or loss from a global dealing operation that does not involve identifiable transactions between the participants (a “non-transactional model”). Further, we do not recommend that either the traditional methods or the profit split method be expanded beyond their original scope to address these situations. Rather, we recommend that a new category of “profit allocation” methods be added to the Proposed Regulations. The existing profit split methods (with certain modifications discussed below) would be included in this new category, but other profit-based service fee methods would also be included and illustrated in the regulations. Together, these profit allocation methods would address situations in which the participants combine their resources to create and sell a financial product to an unrelated customer and to manage the associated risk.

A. Comments on Allocation Methods Provided in the Proposed Regulations.

The Proposed Regulations provide four methods for allocating income or loss from a global dealing operation.¹ Three of these methods are analogous to the traditional methods provided in the existing Section 482 regulations for determining whether the pricing of a related party transaction in tangible or intangible property is arms’ length:

(1) the comparable uncontrolled financial transaction, or “CUFT”, method of Prop. Regs. § 1.482-8(b), which is similar to the comparable uncontrolled transaction method of Regs. § 1.482-4(c) for transfers of intangible property. The CUFT method evaluates whether the amount charged in a controlled financial transaction is arm’s length by reference to the amount charged in a comparable uncontrolled financial transaction. The Proposed Regulations contemplate that indirect evidence of the price of a CUFT may be derived from external data if the

¹ There is also provision in Prop. Regs. § 1.482-8(f) for the use of “unspecified methods”.

data is widely and routinely used in the ordinary course of the taxpayer's securities business to price uncontrolled transactions and certain other conditions are met;

(2) the gross markup method of Prop. Regs. § 1.482-8(d), which is similar to the cost plus method of Regs. § 1.482-3(d) for transfers of tangible property. The gross markup method evaluates the amount allocated to a global dealing participant by reference to the gross profit markup realized in comparable uncontrolled transactions. The gross markup method may be used where a participant purchases a financial product from an unrelated party and resells the product to a related party; and

(3) the gross margin method of Prop. Regs. § 1.482-8(c), which is similar to the resale price method of Regs. § 1.482-3(c) for transfers of tangible property. The gross margin method evaluates the amount allocated to a global dealing participant by reference to the gross profit margin realized in a comparable uncontrolled transaction. The gross margin method may be used where a participant purchases a financial product from a related party and resells the product to an unrelated party.

Each of these traditional pricing methods is premised on the existence of an identifiable transaction between two participants in a global dealing operation. For example, one or more of the traditional methods may apply where one participant sells an inventory security or foreign currency to another participant, who then resells the security or currency to an unrelated customer. Similarly, one of the methods may apply where one participant enters into a derivative transaction, such as a swap, with a customer and then transfers the risk associated with that derivative to another participant through a back-to-back derivative transaction. The traditional methods may also apply where one participant pays a sales commission to another participant that serves as a salesperson for a product that originates with the first participant.

None of the traditional methods work, however, in the case of a global dealing operation that follows a "non-transactional" model, *i.e.*, an operation in which two or more participants combine their resources to create and sell a financial product to an unrelated customer and to hedge any risks associated with the product. In this situation, there are no separately identifiable transactions between the participants. The product in question is not sold from one participant to another and then resold to the customer. Rather, the participants contribute various elements – such as capital, trading, product design, and marketing -- to the creation and sale of the product and to the management of associated risks, and the resulting profit or loss is then allocated

among them. This type of joint effort is characteristic of the global dealing operations conducted by many SIA members in a variety of financial products.²

Profit and loss from this type of global dealing operation typically is not allocated on a transaction-by-transaction basis with reference to particular customer transactions. Rather, profit or loss derived by the operation as a whole over some period of time is typically allocated among the participants based on their contributions to the joint effort over that period of time. The traditional methods, with their focus on comparing specific controlled transactions with specific uncontrolled transactions, simply do not apply where the amounts being allocated arise from a grouping of customer transactions entered into over a period of time.

The Proposed Regulations provide only one alternative method – the profit split method -- for the allocation of profit or loss from global dealing operations that do not fit the intra-group transactional model underlying the three traditional methods. The profit split method, however, is inadequate in several respects.

First, the Proposed Regulations appear to require that taxpayers using the profit split method allocate both profits and losses among all participants. While some securities firms do choose to share profits and losses among all participants, not all firms choose to do this. Regulatory constraints in particular countries often prevent a regulated participant from sharing in losses booked in a related participant. Alternatively, the business arrangement among the participants may be that one participant bears all residual loss (and receives all residual profit) from the operation, while the other participants receive only a share of positive profit, if any. By requiring the sharing of losses in all circumstances, the Proposed Regulations effectively impose a partnership arrangement on the participants. In fact, the business arrangement among them may be very different.

We recognize that there is one reference in Prop. Regs. § 1.482-8(e)(2) to the possibility that one participant might earn a profit while another participant incurs a loss.³ It is not entirely clear, however, that this statement permits the allocation of a net loss to a single participant. For example, one might interpret the statement to contemplate the allocation of a relatively small amount of

² Also common are hybrid operations that combine a transactional model for some functions with a non-transactional model for other functions. The traditional methods likewise do not work for these hybrid operations.

³ Prop. Regs. § 1.482-8(e)(2) provides as follows: “The profit allocated to any particular participant using a profit split method is not necessarily limited to the total operating profit from the global dealing operation. For example, in a given year, one participant may earn a profit while another participant incurs a loss, so long as the arrangement is comparable to an arrangement to which two uncontrolled parties would agree.”

operating profit to a participant that happened to have incurred substantial local costs - - with the result that the participant would incur an overall loss by virtue of having insufficient income to cover its costs. Moreover, the remaining language of paragraph (e) and the preamble to the Proposed Regulations refer repeatedly to the allocation of both profit and loss. In that context, we respectfully suggest that the implication of the Proposed Regulations, as currently drafted, is that losses must always be shared.

In addition, the profit split method as set out in the Proposed Regulations appears to preclude the allocation of losses to the function of providing capital. This is because the Proposed Regulations appear to treat capital as a “routine” contribution (rather than as a participant) and require that it receive a market rate of return. Although we have discussed with you the possibility that a market rate of return might include a profit-based return (rather than, for example, an interest rate), it is not clear from the Proposed Regulations that such a return could include an allocation of losses. It is quite common, however, among securities firms for the capital provider to receive all residual profits and losses from a global dealing operation (as its return for bearing the risk of the operation) while other participants receive a fee or some type of profit-based compensation. The revised regulations need to accommodate this type of arrangement.

To address the problems outlined above, we recommend that paragraph (e) of Prop. Regs. § 1.482-8 be revised and expanded to cover a wider range of “profit allocation” methods. The profit split methods – with certain modifications described below -- would be one type of profit allocation method. In addition, various profit-based service fee methods would be included, and provision would be made for other unspecified allocation methods. This approach is described more fully in Part B. below.

We believe that this approach is preferable to an attempt to expand the existing methods. In particular, you had suggested that the CUFT method of the Proposed Regulations might be revised to address global dealing operations that do not involve intra-participant financial transactions.⁴ We do not recommend this approach. As we understand your suggestion, the CUFT method might be applied in these circumstances by treating the allocation of profit or loss agreed upon by the participants as a controlled financial transaction and comparing the terms of that allocation to similar arrangements between uncontrolled parties - - using, where necessary, indirect evidence derived from a proprietary pricing model. This interpretation would be a significant departure from the common

⁴ You also suggested that the CUFT method, as described in the Proposed Regulations, already encompasses these situations. If so, we do not think that this is clear from the language of the Proposed Regulations, which contemplates a “controlled financial transaction” with an identifiable “price”. In any event, as discussed in the text above, we do not recommend that the Proposed Regulations be revised to clarify this point.

understanding of the CUFT method (and its analog, the CUT method for transfers of intangible property). As set out in the Proposed Regulations, the CUFT method is easily understood by taxpayers and auditors who are already familiar with the basic transfer pricing methods for tangible and intangible property, and it is easily applied where financial products are actually sold or resold among participants. Expanding the method to encompass arrangements that do not involve intra-participant financial transactions would be more confusing than beneficial.

Moreover, there are likely to be very few, if any, comparable uncontrolled global dealing arrangements that follow a non-transactional model, because securities firms normally do not enter into joint venture-type arrangements with unrelated traders, marketers or capital providers. In addition, the restrictions placed by the Proposed Regulations on the use of proprietary pricing models make it unlikely that securities firms would have an appropriate internal model for use in this context. Thus, as a practical matter, we believe that it would be difficult or impossible to apply the CUFT method to global dealing operations that follow a non-transactional model.

Adapting the CUFT method, however, is unnecessary. Instead, the CUFT method can be retained in its proposed form for application to global dealing operations that involve identifiable financial transactions among participants. Global dealing operations that follow a non-transactional model can be addressed instead in a new section of the regulations as described below.

B. Recommended Approach.

Specifically, we recommend that paragraph (e) of Prop. Regs. § 1.482-8 be expanded to encompass a wider range of “profit allocation” methods. The existing total and residual profit split methods would be one category of profit allocation method. Other profit allocation methods would include profit-based service fee methods such as a profit-based trader compensation method, a hedge fund method and a bid/ask spread method. The regulations would also provide for the use of additional, unspecified profit allocation methods if more appropriate under the circumstances.

We have outlined below some general points with respect to the profit allocation methods that should be addressed in the introductory language of revised paragraph (e) of the regulation. We have then described each of the profit allocation methods (including the modifications that we recommend for the profit split method), and we have attached as Appendix B a set of examples illustrating these methods.

1. General Points with Respect to Profit Allocation Methods.

Each of the following points should be addressed in the introductory language of revised paragraph –8(e):

a. Availability of Methods. Each of the profit allocation methods should be available in circumstances where the arrangement between the global dealing participants is designed to compensate each participant for its contribution to a joint effort leading to the creation and sale of third-party customer transactions and the management of associated risks. In that context, the methods should be available for the allocation of profit or loss derived from reasonable groupings of customer transactions, determined along product lines and occurring over reasonable periods of time. Arrangements involving intra-participant sales of financial products, or the execution of other identifiable financial transactions such as back-to-back swaps between participants, could continue to be addressed by the CUFT, gross markup and gross margin methods.

b. Choice of Method. The choice of a particular method (whether a profit allocation method or a traditional method) would be made in accordance with the provisions of Regs. § 1.482-1, including the “best method” rule of Regs. § 1.482-1(c). Thus, the determination of the most appropriate method would depend upon the particular facts and circumstances, including the structure of the operation, the existence of identifiable transactions among the participants or the lack thereof, the manner in which the participants allocated the risks of the global dealing operation among themselves, and the relative values of their contributions to the overall profitability of the joint operation. The method chosen should ensure that each participant receives appropriate compensation based upon the taxpayer’s particular facts and circumstances.

c. Treatment of Losses. The regulation should state clearly that the profit allocation methods do not require the sharing of losses among all participants, although sharing of losses may be appropriate depending upon the circumstances.

d. Cost of Carry. The regulation should provide for “operating profit or loss” (as defined in the Proposed Regulation) to be reduced by the cost of carry prior to allocation under one of the profit allocation methods. The “cost of carry” is an amount charged by the firm’s internal treasury function to the global dealing participant that provides the capital and serves as the booking location. The effect of reducing operating profit or loss by the cost of carry is that gross revenues in an amount equal to the cost of carry remain with the capital provider (rather than being allocated away to another participant).

Cost of carry may be determined by a firm’s treasury department in a variety of ways. For example, some firms may base the cost of carry on the

actual cost of the firm's external financing, while other firms may charge a rate based on the opportunity cost of the capital provided or a rate comparable to the return that an external bank or equity investor would have required from the operation. However determined, the cost of carry is applied against the income of the global dealing operation in order to measure profitability for management reporting purposes. A global dealing operation cannot be conducted without capital, and the global dealing operation does not have "free" access to the firm's capital. Rather, the cost of carry represents the effective cost to the firm of utilizing its capital in the global dealing operation. Although it is not an actual external expense, it is similar in the sense that the capital provider cannot obtain and furnish its capital unless it earns that minimum amount.

Therefore, it is appropriate that the capital provider retain an amount of gross revenue equal to the cost of carry and that this amount reduce the operating profit or loss that is subsequently allocated under a profit allocation method. Mechanically, the profit allocation methods would be applied as the second stage of a two-stage process. In the first stage, any function that is to receive a return not based on profits would be allocated that return. For example, if the taxpayer had determined that it was appropriate for the back office function to receive a "cost-plus" return, that return would be calculated and allocated to the participant providing the back office function. In the second stage, after all non-profit-based returns have been calculated and allocated, operating profit would be determined. For this purpose, the cost of carry would be applied to reduce operating profit. As noted above, the effect of this reduction is that an amount of gross revenue equal to the carry amount will remain with the capital provider/booking entity. Once operating profit has been computed, it would be allocated, in accordance with one of the profit allocation methods, among the participants that are to receive profit-based returns. As discussed below, those participants could include the capital provider, in which case the capital provider would retain both the cost of carry amount and an additional profit-based amount.⁵

Failure to address cost of carry in this manner produces distortive results, because the return allocated to the capital provider is then too low in relation to the value of its contribution while the return allocated to other global dealing participants is artificially high.⁶ We have included an example illustrating this point in Appendix A to this submission.

⁵ We note that where no other participant receives a profit-based return, and all residual profit or loss remains with the booking entity/capital provider, cost of carry is effectively irrelevant because operating profit does not need to be computed for allocation to other participants. Cost of carry is included by default in the amount retained by the capital provider.

⁶ The cost of carry that is taken into account for tax purposes should be the same amount that is used for management reporting purposes. In other words, a firm would not be permitted to apply a cost of carry computed solely for tax

Finally, it is important to understand that cost of carry is not an external expense, and reducing operating profit or loss by the cost of carry amount does not mean that external interest expense is being allocated under the global dealing regulations. Rather, the firm's actual external borrowing cost, and other external costs associated with raising capital, would continue to be allocated separately. Cost of carry is a purely internal measurement that should be used as a proxy for allocating a portion of the global dealing income to the function of providing capital. Once this allocation is made, it becomes necessary to "back out" the cost of carry from the operating profit that is allocated to participants receiving a profit-based return.

e. Treatment of Capital. Finally, the provision of capital should not be treated as a "routine" function. Rather, the return allocated to capital should in all cases be dependent upon the type and degree of risk borne by the capital provider (e.g., market risk, credit risk, legal risk, operational risk), taking into account any contractual arrangement among the participants designed to shift risk away from the capital provider (and the fact that the capital provider will retain the cost of carry amount, as discussed above). Thus, for example, if the capital provider bears all of the market and credit risk associated with a global dealing operation, then it would typically be allocated all residual operating profit or loss from the operation after compensation of the other participants. On the other hand, if the capital provider had arranged with the other participants to bear none of the market risk but only credit risk (like a lender), then capital could be allocated a market-based interest-rate type of return. Numerous other variations are possible between these two extremes. Therefore, we do not believe that the use of the term "routine" is appropriate with respect to capital. Designating all capital as "routine" implies a standardization that simply does not exist, and we see no point in attempting to designate particular capital providers as performing either "routine" or "non-routine" functions. Rather, we recommend that capital providers should be treated in all cases as participants in the global dealing operation. The return allocated to capital should vary, however, as in the case of other participants, according to the risks assumed by the capital provider and the value of its contribution to the overall operation (and taking into account the fact that the cost of carry amount has already been allocated to the capital provider).

2. Description of the Profit Allocation Methods.

a. Profit Split Methods. The existing total and residual profit split methods should be retained as one category of the specified profit allocation

purposes. Further, we believe that the cost of carry amount used for management reporting purposes should be presumed to be an arm's length amount, in view of the fact that the global dealing operation is only one of many business lines competing for the firm's capital.

methods. However, Example (5), illustrating the residual profit split method, should be revised with respect to its treatment of capital.⁷

Specifically, the discussion of P's compensation for acting as counterparty should be removed from subparagraph (iv) of Example (5), which addresses compensation for routine contributions (such as back office services). P's role as counterparty could then be addressed in either of two ways. First, P could be allocated a flat \$40 (rather than a profit percentage), as in the existing example, but on the grounds that the participants had agreed among themselves to limit the risk to which P's capital was exposed – for example, by shifting risk to UKSub or JSub through a derivative transaction – and that the \$40 represented the agreed return on P's capital under these circumstances. P would also receive a percentage of the operating profit, as in the current example, to compensate P for its traders' contributions.

Alternatively, P could be allocated a larger percentage of the operating profit (rather than a flat \$40) on the grounds that P had agreed to bear all or a substantial portion of the risk associated with the global dealing operation. P's larger percentage would take into account its contributions of both traders and capital. If possible, we would recommend including both of these alternatives as examples of the residual profit split method, because this would be a useful way of illustrating the variety possible in the treatment of capital.

b. Profit-Based Compensation Method. This method is intended to address the situation in which the capital provider bears all or substantially all of the risk associated with the global dealing operation and the other participants receive profit-based compensation for providing trading and possibly marketing functions. This situation often arises when the other participants are regulated entities that are not permitted to share in losses realized by the capital provider. The trading function would typically receive profit-based compensation, which might be determined as a percentage of positive profit (if any), as a dollar amount determined by reference to the traders' bonus compensation or in some other manner. If the trading function were located in more than one participant, the total amount allocated to the trading function would be divided among those participants using a factor such as headcount (appropriately weighted) or trader compensation.

The marketing function could be compensated either with a sales commission or in a manner similar to the trading function. The appropriate type of compensation would depend upon the degree to which the marketers were involved in designing and tailoring the financial product. A marketer who had

⁷ Much of the introductory language in Prop. Regs. § 1.482-8(e)(1) – (3) could be retained in the introduction to the revised paragraph (e) and given broader application to all of the profit allocation methods (with the modifications described on pages 6-9 of the text).

little or no input in product design would normally be compensated with an arm's length commission, while a marketer who was integrally involved in tailoring a product to the needs of particular customers might receive a profit-based compensation. We have included an example of the profit-based compensation method in Appendix B.

c. Hedge Fund Method. The hedge fund method is patterned after the arrangements typically used in the hedge fund context, wherein the traders who actively manage the fund are compensated in two components – one intended to cover their costs and the other designed to reward them for profitability. The investors, who provide the capital, receive all residual profit or loss. As applied to a global dealing operation, the trading function might receive a fee computed as a percentage of net asset value under management as a proxy for the costs that it incurs. Alternatively, the trading function could be allocated a specific percentage of gross revenues or positive profit as cost compensation.⁸ In addition, the trading function would receive an agreed percentage of net operating profit as compensation for its trading contribution. That percentage might be a flat percentage regardless of profitability, or it might start out at a relatively low level but then increase once a “hurdle” rate of return was reached. As in the case of the trader compensation method, marketers would be compensated in a manner appropriate to the particular role that they play, whether as salespeople or as participants in product design. An example illustrating this method is also included in Appendix B.

Although this method relies on a framework similar to that employed by the hedge fund industry, we do not believe that the hedge fund industry represents an appropriate comparable for a global dealing operation. Therefore, we believe that the hedge fund method should be included as one of the profit-based service fee methods in revised paragraph (e) of the regulation, rather than as an example of the CUFT methodology. The typical hedge fund involves a group of traders who invest and manage capital of unrelated investors. While there may be certain rates of return that are generally accepted by traders in the hedge fund industry, these rates are reflective of the risk allocations typical in the industry and the types of investments typically made by the funds. In the global dealing context, the participants have much greater flexibility in terms of functional and risk allocation and the types of product that are traded. As a result, the typical hedge fund is unlikely to be an appropriate comparable for a global dealing operation, even though the participants in the global dealing operation may decide to use a methodology based on the hedge fund construct in order to determine the compensation of each participant.

⁸ Another alternative is that actual trading costs may be reimbursed and traders receive just an agreed percentage of net operating profit as a return for their trading contribution; this situation, however, is quite similar to the profit-based compensation method.

d. Bid/Ask Spread Method. We have also included in Appendix B an example illustrating a bid/ask spread method for compensating sales personnel and/or product designers who are not participants in the global dealing operation with a portion of the bid/ask spread on transactions that the salespeople or designers introduce to the global dealing operation. Although this method is not typically used to allocate profit among the global dealing participants, we believe that it would be useful to incorporate a specific reference to this method or an example in order to illustrate that this is a permissible way for the global dealing operation to compensate related parties that play a significant role in generating revenues for the global dealing operation (but are not dedicated solely to the operation). The example provided in Appendix B illustrates the bid/ask method in combination with the residual profit split method, but the bid/ask spread method could also be used in conjunction with any of the other profit allocation methods.

e. Unspecified Methods. The regulations should make clear that alternative methods for allocating operating profit or loss are possible and may be more appropriate than the specified methods, depending upon the business arrangement among the participants.

C. Re-Issuance of the Regulations in Proposed Form.

Finally, we believe that the foregoing modifications are so significant a change to the Proposed Regulations that the revised regulations should be reissued in proposed form. We recognize that other groups of foreign financial institutions have urged you to finalize the Proposed Regulations as quickly as possible, and we do not intend to minimize the difficulties that these other taxpayers may face in the absence of final regulations. We believe, however, that this problem could be addressed by permitting elective reliance on the re-proposed regulations during the period between re-issuance and finalization of the regulations (and possibly for earlier periods), subject to appropriate conditions to prevent manipulation. This regulations project is too significant for the financial industry, and the revisions needed are too fundamental, to risk the adoption of final regulations that do not adequately address the issues faced by both U.S. and foreign financial institutions.

II. Deemed Qualified Business Unit or Permanent Establishment

As we have discussed, we recommend elimination of the portions of Proposed Regulations Section 1.863-3 that would attribute income allocated to a participant in one country to a deemed qualified business unit (“QBU”) or permanent establishment (“PE”) in a second country when traders are located in a participant in that second country. Instead, the global dealing regulations should provide for a “one-step” allocation of profit or loss among the participants under the Section 482 regulations and should affirmatively state that profit appropriately allocated to a participant under the Section 482 regulations

normally would not be reallocated to a deemed QBU or deemed PE in another jurisdiction.

We recognize that there is a potential for abuse under this approach. Removing the deemed QBU/PE rules could, in the absence of anti-abuse rules, facilitate the allocation of inappropriate amounts of global dealing profit to booking entities located in tax haven jurisdictions. Nonetheless, we do not believe that this possibility should preclude elimination of the rules in non-abusive cases. The bulk of our global dealing business is conducted in the major trading jurisdictions (such as the U.K. and Japan), and regulatory and business (rather than tax) considerations generally drive the location of booking entities. Therefore, we believe that the potential for abuse is limited and could be addressed with a more targeted approach than the deemed QBU/PE rules. We would like to discuss this point further with you and to work with you in devising an appropriate solution.

Further, we recognize that the question of attribution to a deemed branch arises under other provisions of existing law and income tax treaties, when a participant in one country has the right to execute contracts on behalf of a second-country participant in a global dealing operation. However, we strongly believe that existing law in this regard should be modified with respect to global dealing operations.

Importantly, the other major countries in which U.S. securities firms conduct global dealing operations – such as Japan, the U.K. and other European countries - - have not taken this approach.⁹ In our experience, other taxing authorities seek to achieve an appropriate allocation of profit or loss among the entities involved in the global dealing operation. Once a profit allocation has been made to an entity located in their jurisdiction, they do not seek to reattribute that profit to a deemed branch in another country (and vice versa). This means that when a U.S. firm allocates a portion of its global dealing profits to, for example, a Japanese subsidiary, Japan will tax that profit. Japan will not consider whether a portion of that profit should be reallocated to the United States on the grounds that a U.S. affiliate is acting as the agent of the Japanese subsidiary. If the United States insists on such a reallocation, the result will be double taxation.¹⁰

⁹ We recognize that the U.K. Inland Revenue, in an article on “Financial Global Trading” in its December 1998 Tax Bulletin, has acknowledged that it may be necessary to consider whether a trader should be considered a permanent establishment of a capital provider. In our experience, however, the Inland Revenue has not adopted this approach in auditing the global dealing operations of U.S. securities firms.

¹⁰ Other problems raised by the deemed QBU/PE provisions include: (a) it is often unclear under existing law whether a U.S. participant should be treated as a dependent agent of a foreign participant, or vice versa, in a global dealing

The global dealing regulations were intended to minimize, and where possible eliminate, double taxation. They were also intended to reduce the need for taxpayers to rely on the Advance Pricing Agreement and competent authority programs to resolve double taxation issues in the global dealing context. The provisions of the Proposed Regulations that require allocation to a deemed QBU or deemed PE undermine these objectives. If the Proposed Regulations are finalized with the deemed QBU/PE provisions, U.S. securities firms will have no choice but to seek the assistance of the APA and competent authority programs to avoid substantial overtaxation of their global dealing operations. Clearly, this is not the result intended by the Treasury Department and the Internal Revenue Service.

When we discussed this issue in June, you suggested that the revised global dealing regulations, when issued, could simply reserve on the issue of the deemed QBU or deemed PE. We understand your proposal to be that the text of Prop. Regs. § 1.863-3(h)(iv) and the text of Example 3 in Prop. Regs. § 1.863-3(h)(v) would be replaced in each case with the word “Reserved”. In addition, the preamble to the revised regulations would affirmatively state that the Treasury and Service were reserving on the question of whether a global dealing participant in one country may be deemed to have a QBU or PE in the country of another participant by virtue of the other participant’s trading activities.

We agree that this is a good interim solution that will facilitate reissuance of the regulations, and we agree that you should proceed to revise the regulations on this basis. In this regard, however, we have two additional recommendations.

First, as you suggested, the reservation should be accompanied by preamble language that clearly explains the reason for the reservation - - specifically, that there is no international consensus on whether the attribution of global dealing income to a deemed QBU or deemed PE is appropriate and, in that context, adoption of the deemed QBU and deemed PE rules may result in double taxation and an increased burden on the APA and competent authority programs. It is important to establish in the preamble that the question under consideration is whether a global dealing participant in one country will be deemed to have a QBU or PE in the country of another participant, and not merely how to attribute income to such a deemed QBU or PE. Unless this is

operation, (b) foreign subsidiaries of U.S. firms would be required to file U.S. tax returns, and U.S. subsidiaries of foreign firms would be required to file foreign tax returns, solely for this purpose, adding substantially to the complexity already faced by multinational firms in preparing U.S. and foreign tax filings, and (c) related to the foregoing, foreign subsidiaries of U.S. firms would be forced to deal with the branch profits tax, Regs. § 1.882-5 and other tax provisions aimed at inbound investors – areas of the tax law that U.S. firms normally do not confront.

made clear in the preamble, we are concerned that an auditor examining a U.S. taxpayer with a global dealing operation might still seek to attribute profit to a deemed QBU or deemed PE on the theory that the regulations explicitly contemplate the possibility of a deemed QBU or PE but are merely silent on how to determine the amount of profit to attribute. Obviously, this situation should be avoided.

Further, the reservation is clearly just an interim solution. Therefore, we would like to work with you in seeking a more permanent resolution to the problem. As we discussed, this might come in the form of amendments to the regulations under Section 864, a statutory amendment or more targeted agreements with particular treaty partners. We would like to discuss these alternatives with you in more detail at your convenience. In that context, we would also like to discuss certain practical issues presented by the sourcing rules of the Proposed Regulations with respect to dividends, interest and substitute payments.

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We would appreciate the opportunity to meet with you again when you have had the chance to review this submission. In the meantime, please contact Patricia McClanahan at (202) 326-5324 if you have any questions about the foregoing or we can provide you with any other assistance.

Sincerely yours,

Saul M. Rosen
Chair, SIA's Committee on the Federal
Taxation of the Securities Industry