DRAFT

Changes to the Guidance on Capital Attribution to Banks

The following parts of the Guidance have been amended/ expanded :-

- **5 -** minor alteration in second paragraph
- **6.1 –** changes made to the second paragraph to reflect the publication of the new draft legislation incorporating OECD principles.
- **9.1 –** minor amendment to first paragraph to reflect the publication of further legislation as referred to above.
- **9.2.10-** correction of a typing error in the example.
- **9.2.12-** changes made to the second and third paragraphs to reflect the publication of the new draft legislation incorporating OECD principles.
- **9.3.2 -** a further paragraph has been added at the end.
- **9.3.4-** the second paragraph has been amended to remove a "ghost" of a previous version of the guidance. An example on the effect of profits and losses on capital ratios has been added, as has a paragraph on losses brought forward.
- **9.5.3-** the second and third paragraphs have been expanded slightly to clarify the position on "excess equity".
- **9.5.6** - a new section has been added to provide some guidance on allotments of capital.

Guidance on Capital Attribution to Banks

Index

1 What is capital for a bank? 5

2 What do banks do with capital? 6

3 Free Working Capital 6

4 The Purpose of the New Legislation 7

5 The Working Hypothesis 8

6 Overview of Approach to determining any Section 11AA Adjustment to Funding Costs 8

6.1 Step 1 - Attributing the assets 9

6.2 Step 2 - Risk weighting the assets 9

6.3 Step 3 – Determining the equity capital 9

6.4 Step 4 – Determine the loan capital 10

6.5 Step 5 – Determine the capital attribution tax adjustment 10

7 Alternative approaches to calculating the capital attribution tax adjustment 12

7.1 Use of comparables 12

7.2 Use of calculations based on funding of the company 12

8 Range of capital attribution tax adjustment 13

9 Detail on the 5 Steps 13

9.1 Step 1: Attribution of financial assets 13

9.1.1 Global Trading/Profit Splits 13

9.2 Step 2: Weighting of assets 14

9.2.1 Host v home state regulation 15

9.2.2 FSA regulatory rules 16

9.2.3 Risk weighting framework (banking book): on balance sheet items - chapter BC – IPRU(BANK) 17

9.2.4 Risk weighting framework (banking book): off balance sheet items - chapter BC in the IPRU(BANK) 19

9.2.5 Other off balance sheet items 19

9.2.6 OTC derivatives 20

9.2.7 Risk in the trading book 20

9.2.8 Counter party risk 21
9.2.9 Market risk 21
9.2.10 Large Exposures 22
9.2.11 Use of risk models 23
9.2.12 Intracompany transactions and assets 23
9.2.13 Intercompany transactions 24
9.2.14 Intracompany netting of third party items 24
9.2.15 Treasury functions 24
9.2.16 Off balance sheet assets 25
9.3 Step 3: Determining the amount of equity capital 25
9.3.1 Tier 1 capital 26
9.3.2 Tier 2 capital 26
9.3.3 Tier 3 26
9.3.4 Treatment of retained profits and losses 27
9.3.5 Permanent establishments 100 per cent funded by borrowing in the local markets. 28
9.3.6 Interest free loans 29
9.3.7 The arm's length amount 30
9.4 Step 4: Determining the amount of loan capital 31
9.4.1 Specific types of loan capital 31
9.4.1.1 Innovative or hybrid Tier 1 capital 31
9.4.1.2 Tier 2 subordinated debt in loan capital 32
9.4.2 Exceptional circumstances 33
9.5 Step 5: Disallowance of interest and other costs on funding equivalent to attributed equity 34
9.5.1 Allowance for potential additional interest cost and other costs on loan capital attributed to permanent establishment 35
9.5.2 Multi-currency books and the currency/interest rates to be used in arriving at the disallowances and allowances for equity and loan capital 38
9.5.3 Equity capital already allotted exceeding amount computed under legislation 39
9.5.4 Equity capital attributed but no funding costs in permanent establishment 40
9.5.4.1 Guarantee fees – no deduction available 40
9.5.5 Frequency of calculations 41
9.5.6 Allotments of capital 41
10 Outbound permanent establishments: the applicability of s.11AA(3) to outbound permanent establishment and DTR calculations 43

11 DTR problems: Mutual Agreement Procedure 43

12 Use of UK GAAP 44

13 BBA Examples 45

13.1 Example 1: branch which lends to corporate (retail customers) 45

13.2 Example 2: branch lends to customers and banks 46

13.3 Example 3: branch funded by third parties... 46

13.4 Example 4: branch which acts as deposit taker and lends to head office 47

13.5 Example 5: branch with assets not treated as UK assets for tax purposes 48

13.6 Example 6: branch where assets are booked outside the UK 48

13.7 Example 7: branch with surplus free capital.. 49

13.8 Example 8: branch expanding or contracting in size 50

13.9 Example 9: branch with only off balance sheet business and minimal funding costs 51

13.10 Example 10: branch with a trading book (minimal funding costs example required)52

Guidance on Capital Attribution for Banks

1 What is capital for a bank?

All companies require capital to support their activities, for example, to acquire premises and machinery so as to enable them to manufacture products. Such capital can be raised as equity by, for example, issuing ordinary shares or as loan capital by, for example, the issue of bonds.

Banks are exceptional because they trade in money, rather than goods in return for money. So as well as needing funds for capital purposes, they rely on access to funds in the form of money as an integral part of their trading activities. Banks do, of course, also offer fee earning services such as merger and acquisition services, but at its simplest they make a profit by borrowing money at interest from third parties and lending it to others at higher rates of interest. That money comes both from investors and customers who place funds with the banks.

To protect the interests of such customers, banks throughout the world are subject to regulatory standards designed to make sure they have a solid base of capital available at all times to meet their customers' demands. That capital requirement needs to be sufficient to act as a buffer against future, unidentified, even quite improbable losses, while still leaving the bank room to recover or organise an orderly winding down of its business.

The level and type of capital of banks (and certain other financial institutions) is, therefore, prescribed in a way that the capital of other concerns is not. For UK regulated banks this involves agreement, on an individual basis, between the bank and the Financial Services Authority (FSA), of a Capital Adequacy Requirement, which is the minimum level of capital they must hold. The Capital Adequacy Requirement is an appropriate ratio of capital to risk weighted assets, depending on the size of the bank, the nature of its activities and any other factors, which are considered relevant. It can be met by holding various types of capital, which are termed Tier 1, Tier 2 and Tier 3. How this equates to "equity capital" and "loan capital" is dealt with in sections 9.3 and 9.4, but generally Tier 1 capital is equity capital and Tier 2 and Tier 3 capital is loan capital.

In practice, banks normally hold capital in excess of that required by the regulator. They may exceed their Capital Adequacy Requirement to allow themselves a regulatory "cushion" or they may have other commercial reasons for choosing to hold more than the regulatory minimum. Under the FSA's regulations banks are allowed to hold an amount of Tier 2 capital up to but not exceeding their Tier 1 capital. However banks normally hold more Tier 1 and less Tier 2 than the FSA allows. Thus, even though the FSA will allow a bank's "loan capital" to comprise up to half of its total regulatory capital, in practice the proportion of loan to equity within the regulatory capital is usually much lower.

2 What do banks do with capital?

Banks aim to maximise their profits by conducting the maximum amount of lending and dealing business that is possible without infringing the capital adequacy requirement they have been set. This means that they cannot borrow every pound they use in their business; they must have a certain amount of regulatory capital. Part of that amount, which will be at least equal to and normally in excess of the minimum amount of equity capital required by the regulator, is “free” to the bank, since the bank is not paying interest to borrow it. The bank’s profit on this proportion of its capital will be much higher than its usual margin between the return on lending and its costs of borrowing. Therefore, the amount of the bank’s regulatory capital, particularly equity capital, has a direct effect on the profits it makes.

3 Free Working Capital

The position for UK permanent establishments of foreign banks until 31 December 2002 has, however, been very different from that described above. While the bank itself will be regulated in its home country, there is no FSA requirement for a permanent establishment to be regulated in the same way as an UK bank. What this means is that, if it chooses to do so, a permanent establishment in the UK, unlike a bank in the UK, is free to borrow the whole of the funds used in its business, without restriction. Therefore, the absence of any regulatory requirement for free capital can result in higher funding costs overall and lower profitability for permanent establishments. So, it is quite possible for a bank that is profitable overall to make a substantial loss in its UK permanent establishment, even if the terms on which the bank as a whole and the permanent establishment do business are broadly the same.

Prior to 1 January 2003 the only tax requirement for capital for UK permanent establishments was that described in the Appendix to Chapter 9 of the Banking Manual as free working capital. Free working capital adjustments, which in many cases would be based on the costs of fixed assets and the amount of capital required to cover other items such as losses, bear no resemblance to the regulatory capital that a permanent establishment would require if it were a separate entity regulated in the UK. In very broad terms these adjustments will comprise the higher of capital formally allotted to a permanent establishment by the company of which it is part, and the amount the permanent establishment would need to fund identifiable capital expenses, for example, buying premises or losses arising from start-up costs.

The existing free working capital adjustment is by its nature very arbitrary. If a bank allocates £50 million interest free to an UK permanent establishment by way of capital, then the commercial and tax profits will reflect the additional amounts earned on that free capital. If the bank does not allot any such capital and the permanent establishment has few physical assets in the UK, then the free working capital may be close to nil and the interest payable by the permanent establishment on the whole of the funds used in its UK business will be allowable for UK tax purposes, reducing the commercial profits and the UK tax payable.

4 The Purpose of the New Legislation

The new legislation at S11AA ICTA 88 aims to recognise for UK tax purposes the commercial reality that a bank's business must be supported by an appropriate amount of capital and that this has a direct effect on the overall profitability of the business. The new section sets out the basis on which the profits attributable to an UK permanent establishment of a non-resident company are to be determined. In particular, the section provides that the profits to be attributed are those that the permanent establishment would make if it were a separate entity in the UK engaged in the same or similar activities, under the same or similar conditions and dealing wholly independently of the non-resident company. In arriving at those profits certain assumptions are required to be made. Firstly, it is put beyond doubt that the permanent establishment is to be dealt with on the basis that it has same credit rating as the company as a whole. Secondly, the permanent establishment is also assumed to have the equity and loan capital that it would have if it were a separate entity carrying out those activities, under those conditions. The section goes on to prohibit deductions in arriving at profits chargeable to corporation tax in excess of those, which would have arisen on those assumptions.

For the reasons outlined in the sections above, there are regulatory requirements for banks as to the amount of capital required; they reflect the economic reality of the business. In general terms a UK bank engaged largely in "risky" lending to commercial concerns would be required to hold more capital than one which lends primarily to OECD governments. Its returns are likely to be correspondingly higher reflecting that additional risk and capital. The legislation recognises such economic reality and replaces the current arbitrary free working capital adjustment, which may bear no relation to the UK permanent establishment's business.

It is important to recognise that the new legislation does not require the actual allotment of capital to the UK permanent establishment. This remains, as now, a matter for the bank itself. But obviously where there has in fact been a capital allotment based on the economic and regulatory requirements of the permanent establishment's business, any tax adjustment under the new legislation is likely to be relatively minor.

Where, however, the UK permanent establishment's business is not supported, or is inadequately supported, by capital, the purpose of the legislation is to make an adjustment to the UK tax computation so that the taxable profits are more closely aligned with the taxable profits which would be achieved by similar banking activities carried out by a UK bank in the same or similar circumstances.

To avoid confusion this tax adjustment is referred to in this guidance as the capital attribution tax adjustment. The term free working capital adjustment refers only to adjustments made prior to the application of the new legislation.

5 The Working Hypothesis

Discussions continue within the OECD and the business community in OECD countries on the adoption of more detailed rules for attributing financial profits to the permanent establishments of multinational enterprises (the OECD Working Hypothesis). It is anticipated that these rules will, in recognition of the fact that capital requirements influence the level of profits, cover the attribution of capital to support financial businesses as well as fuller rules on the attribution of business and profits.

The OECD Working Hypothesis is a quite separate matter from the introduction of the draft UK legislation, which is concerned primarily with capital attribution in specified circumstances. The draft legislation is not, as some have mistakenly thought, a premature attempt to introduce the substance of the draft OECD Working Hypothesis into UK law. Whether or not the UK will agree to the more detailed provisions for the attribution of financial profits to the permanent establishments of multinational enterprises under discussion (and whether such agreement will be reflected in further UK legislation) is a matter for Ministers to decide in the future. The new legislation is not in any way linked to the progress of, or the conclusions reached by, the OECD discussions on the Working Hypothesis.

6 Overview of Approach to determining any Section 11AA Adjustment to Funding Costs

It is worth repeating at the outset that the adjustment required is purely a computational one for tax purposes and has no effect on the way in which the permanent establishment conducts or funds its actual business.

It may be helpful to consider the approach in terms of five distinct steps:

Step 1 determine the assets attributable to the permanent establishment.

Step 2 risk weight those assets.

Step 3 determine the equity capital that the permanent establishment would require if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions.

Step 4 determine the loan capital that such an enterprise would have had if it had the equity capital determined under step 3.

Step 5 determine the capital attribution tax adjustment to be made, based on the difference between the permanent establishment's actual funding costs on the combined amount representing the equity and loan capital determined under steps 3 and 4 and the notional funding costs (which will include a rate of nil in respect of the equity capital) to be taken into account under s11AA.

6.1 Step 1 - Attributing the assets

The amount of capital required by a permanent establishment will depend on the size and nature of its activities. Those activities are evidenced by the assets attributable to the permanent establishment from which it derives profits. These may not correspond to the assets shown on the permanent establishment's balance sheet (if such exists). For example, where the permanent establishment is responsible for business where assets are held off balance sheet, those assets must be attributed to the permanent establishment. Similarly business may be "booked" in another part of the company, while the economic reality is that the profit on the business is attributable to the UK permanent establishment's efforts. Again the underlying assets must be attributed to the permanent establishment.

The new legislation incorporates into UK domestic legislation the relevant principles in the Commentary on the Business Profits Article of the OECD Model Tax Convention and in the OECD publication "Transfer Pricing and Multinational Enterprises: Three Taxation Issues". As a result the current position on issues such as booking and on intra company royalties etc. is maintained. In addition the OECD principles are explicitly applied by UK law to the taxation of all permanent establishments in the UK not just those where the non-resident entity is based in a country with which the UK has a treaty.

6.2 Step 2 - Risk weighting the assets

Banks do not require the same amount of capital in relation to each of their assets. The regulatory rules recognise that the capital requirement varies according to the risk implicit in the business – from 100 per cent of an asset to 0 per cent. The next step in attributing capital is therefore to apply the appropriate risk-weighting ratio to all the different classes of assets attributable to the permanent establishment.

This will already be a requirement of the company's regulator in relation to the whole of its business, including that of the permanent establishment. There are details in section 9.2.1 on the extent to which it is possible to base the risk weighting of assets for the permanent establishment on the existing regulatory requirements of the company's home state.

6.3 Step 3 – Determining the equity capital

There is an inevitable tension between the hypothesis of a permanent establishment being a distinct and separate enterprise and the fact that it is in practice part of a larger entity. The requirement of the legislation that the attribution should be based on the hypothesis that the permanent establishment is a distinct and separate enterprise, *engaged in the same or similar activities under the same or similar conditions* goes some way to resolving this tension. It recognises the need to look at the economic reality of the permanent establishment's activities, which may in practice go beyond those, which would be possible for a small independent bank. In line with this, and making it clear that the legislation is not simply seeking to treat the permanent establishment for tax purposes as if it were a free standing subsidiary of

similar size, section 11AA(3)(a) states, for the avoidance of doubt, that among the same or similar conditions are included the fact that the permanent establishment has the same credit rating as the non-resident bank. That reflects the economic and legal reality i.e. that it is able to obtain funds at a cost below that of an independent entity of the same size.

The amount of equity capital to be attributed to the permanent establishment will therefore be that appropriate to the level of the permanent establishment's risk weighted assets, any exceptional factors and the likely UK equity capital requirement for a UK banking business of similar size and business activities. That level of attributed capital is likely to exceed the FSA minimum regulatory requirement which would be appropriate for a UK banking business of similar size and activities, reflecting the difference between FSA requirements for UK banks and actual level of capital used in the UK banking business.

6.4 Step 4 – Determine the loan capital

Loan capital in this context is the amount of interest bearing capital within Tiers 1, 2 and 3 of a bank's regulatory capital. Innovative Tier 1 capital, which is interest bearing debt, will be included here while preference shares, which are equity, will be excluded.

The amount of attributable loan capital will clearly be dependent on the overall regulatory capital required and reflect the fact that in practice the Tier 2 capital of UK banks is normally well below the maximum 50 per cent of total regulatory capital permitted by the FSA. As an example, if the permanent establishment's equity capital was determined under step 3 as 8 per cent of its risk weighted assets, then its loan capital may be in the region of 2 per cent or 3 per cent depending on the facts and circumstances rather than the maximum permitted 8 per cent.

6.5 Step 5 – Determine the capital attribution tax adjustment

Having established the equity and loan capital, which the permanent establishment would require under the new measure, it is necessary to arrive at the hypothetical cost of such capital for the purposes of the capital attribution tax adjustment.

So far as the equity capital is concerned this will be nil. To the extent that there is deductible Tier 1 capital to be taken into consideration this will form part of the loan capital (see section 9.4). The rate of interest to be applied to the total amount of loan capital will depend on a number of factors including the functional currency of the permanent establishment, the likely hypothetical mix of loan capital and to some extent the actual nature of, and rate of interest on, loan capital held by the permanent establishment and bank.

It is important to be clear that the mix of, and cost of, loan capital actually held by the permanent establishment will not necessarily determine the hypothetical cost of loan capital. Nor will that cost be based on the most tax effective capital cost, i.e., the

maximum possible amount of tax deductible Tier 1 and Tier 2 subordinated debt. The aim is to arrive at an amount, which reflects the requirements of the legislation.

The hypothetical funding cost reached as described above must then be compared with the actual funding costs of an equivalent amount of funding in the permanent establishment. Clearly any interest free funds provided by the company will be deducted from this total figure first. An appropriate mix of interest bearing funds held by the permanent establishment will then have to be determined and the actual interest costs of those funds identified.

The difference between the hypothetical funding costs for the appropriate mix of equity and loan capital and the actual funding costs of an equivalent amount of funding is the capital attribution tax adjustment required by section 11AA. This will of course be carried to the permanent establishment's tax computation. An example of how this might look is as follows.

A branch is funded by its head office with:

- short terms loans of £800m at an interest cost of 5 per cent;
- a ten year loan of £25m at an interest cost of 7 per cent; and
- an interest free allotment of capital of £75m.

Assume in the facts and circumstances of the branch that:

- the analysis under s.11AA requires the branch to have equity capital of £150m and loan capital of £50m. Therefore, £200m of the actual funding is to be treated as displaced by the attributed equity and loan capital for the purposes of computing the costs to be disallowed under s.11AA.
- the appropriate interest rate for attributed loan capital is agreed at 6 per cent, and
- the funding to be displaced by the attributed equity and loan capital is agreed as the £75m allotted equity, £25m ten-year loan and £100m of the short-term loans.

The attributed capital and its cost will be:

Type of Capital	Amount of Capital	Interest Rate	Cost
Equity capital	£150m	0 per cent	£0
Loan capital	£50m	6 per cent	£3.0m
		Total	£3.0m

The funding that will be displaced by the capital will be

Type of Funding	Amount of Funding	Interest Rate	Cost
Allotted capital	£75m	0 per cent	£0
10 Year loan	£25m	7 per cent	£1.75m
Short term loan	£100m	5 per cent	£5.0m
		Total	£6.75m

Therefore the costs to be disallowed under s.11AA as the capital attribution tax adjustment are £6.75m - £3.0m = £3.75m

7 Alternative approaches to calculating the capital attribution tax adjustment

7.1 Use of comparables

The new legislation in S11AA requires the permanent establishment to be regarded as a separate and distinct enterprise carrying on the same or similar activities under the same or similar conditions. There are a number of reasons why the activities of the permanent establishment might differ from those generally carried on by a separate entity of the same size as the permanent establishment, trading in the UK. It may therefore be difficult to find UK banks that are true comparables to the permanent establishment in terms of both size and level or type of activities. If appropriate comparables can be found then these can be used as an indicator of the amount of equity and loan capital that the permanent establishment would have at arm's length.

If comparables are used then Steps 1 and 2 would need to be carried out in broadly the same way and should demonstrate that there is indeed a high degree of comparability between the business of the permanent establishment and the UK comparable.

The use of comparables might prove to be most helpful as a check where capital has been attributed to the permanent establishment based on the capital mix of the company as a whole, as discussed below.

7.2 Use of calculations based on funding of the company

In most cases the way the bank, of which the permanent establishment is part, funds itself in the market will be the most obvious measure of an arm's length mix of funding for that company. Where this is so, there is clearly scope for considering the extent to which the funding of the permanent establishment would replicate the funding of the whole company. Generally, unless the activities carried on by the permanent establishment are sufficiently different (that is, either inherently more or less risky) from those carried on by the bank as a whole, it may be possible to apply the capital ratios of the bank to the UK permanent establishment. Even where the activities of the permanent establishment are sufficiently different from those of the rest of the bank to warrant an argument that the permanent establishment would have a somewhat different capital structure, the capital structure of the whole company could still be used as a starting point with appropriate adjustments being made.

While this is only one possible way of arriving at an arm's length range of capital, for the purposes of calculating the tax adjustment, permanent establishments may see it as the most straightforward method. The Inland Revenue will be very happy to consider this approach in suitable cases, including those where the nature of the

businesses of the company and the UK permanent establishment differ significantly but where it is possible to adjust for these differences.

8 Range of capital attribution tax adjustment

UK based banks, even banks carrying on broadly the same business activities, have a range of regulatory capital ratios. To some extent this reflects the individual requirements imposed on banks by the FSA. But this is not the whole story since banks normally carry capital above that demanded by the FSA. This is one of the reasons why it is inappropriate to produce a safe harbour capital ratio for UK banks, which permanent establishments could use in preference to carrying out the calculations described above.

But this also means that there is no “right answer” when arriving at the equity and loan capital amounts required by section 11AA. The answer is likely to be within a range of figures rather than set ratios such as 9 per cent equity capital and 3 per cent loan capital**.**

9 Detail on the 5 Steps

9.1 Step 1: Attribution of financial assets

In arriving at the profits attributable to a permanent establishment the Inland Revenue currently follows the guidance set out in the OECD Commentary on Article 7 of the Model Tax Convention and in the publication Transfer Pricing and Multinational Enterprises: Three Taxation Issues. This position will not be changed by the new legislation. Where the permanent establishment is responsible for the creation of a financial asset then both the asset and the related income should be attributed to that permanent establishment.

9.1.1 Global Trading/Profit Splits

Where a permanent establishment either has:

- assets that arise from activities conducted as a global trading arrangement; and/or

- profits from assets, which are dealt with as part of a profit split for profit attribution purposes (which may or may not be covered by an advance pricing agreement).

Then the proportion of those assets which should be treated as assets of the permanent establishment for the purpose of attributing capital to it under s.11AA (3) should be consistent with the logic of the business and the profit split. For example, if the London permanent establishment of a bank is the booking centre for a global FX options book, the profits of which are split between permanent establishments in London, New York and Tokyo, the assets should not be treated as wholly those of

the London permanent establishment since they derive in part from the activities of New York and Tokyo.

Implicit in such arrangements is that the assets belong not to the location in which they have been booked, the choice of which is usually a matter of operational and administrative convenience, but to all locations involved in the global trade. However, simply splitting the assets in proportion to the profits attributed to each centre in the profit split may not be an appropriate way of determining what capital should be attributed to the booking location permanent establishment, as that permanent establishment may be receiving part of its share of the profits in respect of its routine back office functions.

In the above example London may receive 40 per cent of the overall profits and New York and Tokyo 30 per cent each. However, if the additional 10 per cent of profits allocated to London arise from its reward for the back office functions associated with the administration of booking (which may well be rewarded on a cost plus basis) then it would not be appropriate to attribute 40 per cent of the assets to London. Assuming all three centres have an equal trading/risk management role, and this is properly reflected in the one-third share each of profits (after excluding the back office reward), then it would be appropriate to attribute one third of the assets to the London permanent establishment. A corollary to this is, of course, that the costs of funding the trading book are split between the centres on the same basis where the profit of the book is split before funding costs.

If the global trading operations are not in fact fully integrated, such that London and Tokyo have only a basic marketing role with all traders and risk management operations being based in New York, then it is most likely that all assets should be treated as New York assets regardless of where they are booked with no capital being attributed to London in respect of those assets. In practice, London would not usually be the booking centre in such circumstances. Nor, in such a case, would a profit split necessarily be the appropriate methodology for the attribution of profits between the permanent establishments.

9.2 Step 2: Weighting of assets

Banks (and other financial institutions) are regulated entities and as such are required by their regulator to maintain a certain level of capital to support their financial assets. From a supervisory perspective capital provides a buffer that enables a bank to absorb losses without the interests of the depositors being adversely affected. And in general terms the more risky the asset the more capital that is required to support it. So capital follows risk and regulatory capital is determined in a banking context by attributing a risk weighting to the financial assets.

Because there is a regulatory framework that banks adhere to, this framework can be used to help calculate the capital that a permanent establishment would have if it were a separate enterprise. Once assets have been correctly attributed to the permanent establishment these can be risk weighted to establish the amount of capital that is required to support them.

To provide a very simple example of how the risk weighting of assets works, assume that Bank X is required by its regulator to maintain a minimum capital ratio of say 11 per cent. This will mean that the minimum amount of capital that it is required to hold for regulatory purposes will be 11 per cent of its risk weighted assets. If we assume that X has assets of £1000m, all of which are risk weighted at 100 per cent then Bank X will be required to hold a minimum of £110m capital i.e. £1000m x 100 per cent x 11 per cent. If Bank Y is also required to maintain regulatory capital of 11 per cent and also has assets of £1000m but they are all risk weighted at 50 per cent then its minimum capital requirement will be correspondingly lower i.e. £1000m x 50 per cent x 11 per cent, so its capital requirement will be at least £55m. Of course the bank may well hold a higher ratio of capital than its regulator requires for its own capital management purposes.

What the legislation, in the new section 11AA ICTA 1988, aims to achieve here is an attribution of capital, primarily equity capital, to the permanent establishment for tax purposes. If less capital has actually been allotted to the permanent establishment this will give rise to an interest disallowance and lead to a tax adjustment. The Inland Revenue are effectively looking at a percentage of capital, on which funding costs will be disallowed, giving rise to a higher profit/lower loss and ultimately an adjustment to tax. The Inland Revenue will be looking for a degree of pragmatism and are not expecting permanent establishments to apply the precise and detailed requirements of the capital adequacy regulatory regime, especially if there would be very little change in the end result if they were to do so.

The formulation of rules on bank capital is the domain of the Basel Committee on Banking Supervision. The 1988 Capital Accord set a minimum capital standard of 8 per cent (of risk weighted assets) for banks in the industrialised world. Most industrialised and emerging market countries are signed up to the Basel Accord but in practice there is some variation in the way in which the different regulatory regimes apply the rules. The rules applied by the FSA are derived from EU directives which themselves are derived from the Basel Accord. The 1988 accord dealt primarily with credit risk and it has since been recognised that credit risk alone is not always a good indicator of a bank's financial condition. Therefore, a new framework is being designed to improve the way in which regulatory capital reflects credit risks and, also, operational risk. The new Capital Accord is expected to be finalised in the fourth quarter of 2003, allowing for implementation of the new framework in each country at year-end 2006.

Whilst the current regulatory regime deals primarily with credit risk, market risk is also taken into account and market risk in the trading book is referred to in more detail in 10.2.7 and 10.2.9 below.

9.2.1 Host v home state regulation

Where a bank carries on a banking business through permanent establishments in a number of different countries rather than through subsidiaries, then the primary responsibility for regulating the banking business of that bank (including its permanent establishments) will lie with the home state regulator. The host state regulator, that is the regulator in the country in which the permanent establishment

carries on its activities, will have some oversight function, but this will be limited and will not extend to setting the capital requirements of the permanent establishment. The FSA has various oversight functions of permanent establishments in the UK including liquidity, systems and controls, money laundering and business plans.

Where a group carries on banking activities through subsidiary companies then each company will be regulated by the regulator of the country in which it resides. If we assume that we have a US banking group, the US parent bank will be regulated by the US regulator and any UK banking subsidiaries will be regulated by the UK regulator, the FSA.

Whilst a permanent establishment carrying on a banking business in the UK would in fact continue to be regulated primarily by its home state regulator, it would, if it were a separate enterprise trading in the UK, be regulated by the FSA. The new legislation aims to create a more level playing field between companies carrying on a banking business in the UK and permanent establishments. In order to achieve this, the regulatory rules that should be applied to the permanent establishment are those that would apply to UK corporates - that is the FSA regulatory regime. It should be stressed that this regime is only being applied for the purposes of attributing capital to the permanent establishment to arrive at a capital attribution tax adjustment. The regulation of the bank, including its permanent establishments, remains a matter for the home state regulator.

During consultation, representations were made about the difficulty in applying host state regulatory rules where assets were in actual fact weighted according to the rules of the home state regulator. In order to address some of the concerns it was accepted that, where the regulatory regime of the home state is not materially different to that operated by the FSA, the permanent establishment’s assets may initially be risk weighted according to the home state's rules. However, any major differences between the home state’s rules and those operated by the UK will need to be adjusted for. For example, some regulators allow transactions between separate legal entities in their jurisdiction to be risk weighted at 0 per cent in instances where this would not be permitted by the FSA. If assets of the permanent establishment are initially risk weighted on the basis of the home state’s rules then an adjustment would need to be made to reflect the fact that those assets would require a higher risk weighting under UK rules. Whether the outcome of the home state regulation is materially different depends not just on the regulatory rules but on the nature of the permanent establishment’s activities. There may be significant differences in the rules for specific types of customers but if the permanent establishment does very little business with such groups the outcome may be broadly the same as if it were UK regulated.

9.2.2 FSA regulatory rules

There are numerous regulatory rules and requirements but those that are of particular significance here are the rules pertaining to a bank’s capital. In particular there are capital adequacy requirements (generally referred to in these notes as “CAD” as they are based on a number of EU directives) and there are large exposure

limits. The relevance of the large exposure limits is dealt with in section 9.2.10 and the rest of this section will focus on CAD requirements and in particular the FSA's regulations for the risk weighting of assets.

For most banks carrying on a traditional loan business, credit risk, the risk of loss as a result of the failure of their borrower to meet its obligations, is one of the principal risks they face. It is therefore principally credit risk which is taken into account when risk weighting assets on the banking book. Credit risk can arise in respect of both on and off balance sheet assets and international agreement has established a way of weighting both the on balance sheet and off balance sheet items to reflect this risk.

Credit risk may also arise in connection with the CAD trading book requirements although these primarily deal with market risk. Market risk is the risk that the market price will move against the bank so that when the position matures it will make a loss (see 9.2.9)

Whilst the risk-weighting framework for both the banking book and the trading book is briefly referred to below the examples given are illustrative and not exhaustive. Precise details of the FSA regulatory regime can be found via the FSA's website (www.fsa.gov.co.uk) and the rules on the risk weighting of assets are in the Interim Prudential Source Book for banks (IPRU (BANK)) (www.fsa.gov.uk/handbook/ipru_bank).

The information given below is intended to provide some background on the risk weighting of on and off balance sheet assets, and on the treatment of credit risk and market risk in the trading book. Some of these issues, and the calculations involved, are complex and, as the Inland Revenue is adopting a pragmatic approach, the fine detail of the FSA regime will not be appropriate in all cases. That is, as already mentioned above, the Inland Revenue is attempting to attribute a percentage of capital, on which funding costs will be disallowed, giving rise to a higher profit or lower loss and ultimately an adjustment to tax where less capital has in fact been attributed. Therefore, permanent establishments are not expected to apply the precise and detailed requirements of the FSA's capital adequacy regime where application of the detailed rules would produce very little change to the practical outcome.

9.2.3 Risk weighting framework (banking book): on balance sheet items - chapter BC – IPRU(BANK)

Counter parties are given risk weightings that reflect their relative riskiness. Unless an exposure merits a reduced risk weighting under the weighting bands it should receive a 100 per cent risk weighting. Instances where there are variations from the normal weighting and full details of Zone A and B countries are set out in the FSA's Interim Prudential Source Book for banks (IPRU (Bank)). Countries included in the term "Zone A" include full members of the Organisation for Economic Co-operation and Development (OECD). At the time of writing the Zone A countries comprise Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, South Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Saudi

Arabia, Spain, Sweden, Switzerland, Turkey, UK and USA. “Zone B” comprises all countries not within Zone A.

The risk weighting bands are as follows:

0 per cent risk weighting
This applies to a number of asset types including:

- certain cash and claims collateralised by cash deposits placed with the lending institution;
- certain claims on Zone A central governments or central banks;
- claims carrying the explicit guarantees of such Zone A central governments or banks;
- certain claims or claims guaranteed by Zone B central governments and central banks where these are denominated in local currency and funded by liabilities in the same currency; and
- certificates of tax deposit.

10 per cent risk weighting
Certain holdings of government securities attract a 10 per cent weighting, in this instance as a proxy for market risk rather than as a measurement of credit risk.

20 per cent weighting
This applies to a number of asset types including:

- claims on or guaranteed by certain listed multilateral development banks;
- claims on or guaranteed by credit institutions in Zone A countries;
- claims on or guaranteed by credit institutions in Zone B countries where the claim has a residual maturity of 1 year or less;
- claims on or guaranteed by Zone A public sector entities (for instance in the UK these comprise local authorities and certain other non – commercial public bodies); and
- certain claims on investment firms, exchanges and clearing houses.

Certain government securities attract a 20 per cent weighting, again as a proxy for market risk.

50 per cent weighting
Asset types coming under this category include:

- loans to individuals fully and completely secured by a first charge on a residential property;
- loans to certain housing associations;
- certain mortgage sub-participations and mortgage–backed securities issued by certain SPVs; and
- loans to public universities fully secured by a mortgage on residential property.

100 per cent weighting
This applies to a number of asset types including:

- claims on the non bank private sector;

- claims on banks in Zone B countries with a residual maturity of over 1 year;
- claims on or guaranteed by Zone B central governments and banks (unless denominated in the national currency and funded by liabilities in the same currency);
- claims on zone B regional governments or local authorities; claims on Zone B public sector entities;
- claims on commercial entities owned by the public sector; and
- premises, plant equipment, other fixed assets, real estate, trade investments and other assets not otherwise specified.

9.2.4 Risk weighting framework (banking book): off balance sheet items - chapter BC in the IPRU(BANK)

When looking at off balance sheet items, a distinction is made between Over The Counter (OTC) derivative contracts and other off balance sheet items.

9.2.5 Other off balance sheet items

The off balance sheet credit risk in the case of non-OTC items is measured by multiplying the notional principal amount by a credit conversion factor (CCF) of either 0 per cent, 20 per cent, 50 per cent or 100 per cent and weighting the resultant figure by the counter party risk weight.

The same counter party risk weight is used as for on balance sheet assets.

The following non-exhaustive list provides some details of the different CCFs:

100 per cent credit conversion factor
This applies to items such as:

- direct credit substitutes, including general guarantees of indebtedness and standby letters of credit; sales and repurchase agreements;
- asset sales with recourse where the credit risk remains with the bank;
- forward asset purchases;
- forward deposits placed; and
- the unpaid part of partly paid shares and securities.

50 per cent credit conversion factor
This applies to items such as:

- transaction related contingent items not having the character of direct credit substitutes i.e. warranties and standby letters of credit related to particular transactions;
- note issuance and revolving underwriting facilities; and
- other commitments (i.e. formal standby facilities and credit lines) with an original maturity of over 1 year.

20 per cent credit conversion factor
This applies to items such as documentary credits collateralised by the underlying shipments.

0 per cent credit conversion factor
Includes items such as other commitments (i.e. formal standby facilities and credit lines) with an original maturity of up to a year or which can be unconditionally cancelled at any time.

Two examples of how the calculation might look are as follows:

Example 1

If a bank extends a 5 year revolving credit facility to a company of say £500,000 then the calculation would be £500,000 x 50 per cent (CCF) x 100 per cent (counter party credit risk weighting) which results in a risk weighted amount of £250,000.

Example 2

If a bank provides a guarantee in respect of a debt of £100,000 owed by a company then the risk weighted amount would be £100,000 x 100 per cent (CCF) x 100 per cent (counter party credit risk weighting) so £100,000.

Again full details on risk weighting off balance sheet items can be found in the IPRU (BANK).

9.2.6 OTC derivatives

The risk here lies in having to replace any positive cash flows following the failure of a counter party. The exposure from OTC derivatives is dealt with under the same broad framework as other off balance sheet contracts with the contract's Cash Equivalent Amount (CEA) being multiplied by the risk weight appropriate to the counter party to determine the risk weighted amount for the contract. The difference with the treatment of other derivatives lies in the way in which the CEA is calculated and whilst this is dealt with in the derivatives chapter in the IPRU (BANK), it is not covered here.

9.2.7 Risk in the trading book

Where a bank has a trading book over a certain size it needs to meet the trading book capital requirements of the Capital Adequacy Directive (and its subsequent amendment). Essentially the framework, which applies to the trading book, takes into account market risk and counter party risk (additional capital can also be required for large exposures as in the banking book). The definition of a bank's trading book and the threshold for applying the CAD trading book requirements are covered in chapter

CB in IPRU (BANK). Where the CAD trading book requirements do apply a bank should split its business between trading and banking books.

9.2.8 Counter party risk

In general, counter party risk is only present in the trading book on deals that are not finally settled. By their nature, derivative contracts involve a delay between the transaction date and some future maturity date. The time delay creates two types of risk for a bank:

a) market risk - the risk that the market price will move against the bank so that when the position matures it will make a loss; and

b) counter party risk - the risk that the price will move in the bank's favour, so that it makes a book profit, but that at maturity it cannot realise that profit because the other party defaults.

Details of when capital should be assigned to counter party risk are set out in IPRU (BANK).

9.2.9 Market risk

Whilst credit risk or counter party risk can feature in the CAD trading book requirements these requirements focus primarily on market risk. The standard treatment of trading book capital requirements for market risk can include calculations under five separate headings:

1. Foreign exchange position risk
2. Commodity position risk
3. Equity position risk
4. Interest rate position risk
5. Large exposure risk

Further details of these calculations can be found in the relevant chapters of IPRU (BANK).

A bank can calculate the amount of capital that it needs to cover market risk using different models. These may be based on the standard approach set out in the FSA source book or can be based on internal models, which produce a measure of the value at risk (VaR). A VaR measure provides an estimate of the worst expected loss on a portfolio resulting from market movements over a period of time. UK regulated banks can use internal models in the calculation of market risk where they have been approved/recognised by the FSA. Further guidance on the use of such models in the calculation of the capital attribution tax adjustment is at section 9.2.11.

9.2.10 Large Exposures

The Large Exposures regime is separate from the CAD regime (referred to in the section above) and is covered by The Banking Consolidation Directive. This regime limits the amount of exposure that a bank can have to an individual counter party to a percentage of the bank's capital (generally limited to 25 per cent of the bank's capital base, although there are exceptions to this and there are some other large exposure limits that apply). The details of the Large Exposures regime are contained in the IPRU (Bank) at Chapter LE. In practical terms the Large Exposure limits often hit a bank harder, in terms of capital required, than the CAD requirements.

The large exposure capital base will generally be the sum of allowable Tier 1 and Tier 2 capital less any deductions. To show how the two regimes can interact it is perhaps useful to look at a very much simplified and hypothetical example.

- A bank has WRAs of £10m and is required to have a minimum capital ratio of 10 per cent for CAD purposes.
- It will, therefore, need to have a combined total of Tier 1 and Tier 2 capital of at least £1m.
- The bank now wants to lend £350,000 to a company.
- Assume that this will be risk weighted at 50 per cent.

For CAD purposes, the bank would need a further £350,000 x 50 per cent x 10 per cent = £17,500 capital.

For Large Exposure limit purposes the bank would need a capital base of £350,000/25 per cent = £1,400,000.

Therefore, if it were to make this loan, the capital held by the bank would be determined by the Large Exposure limits rather than the CAD requirements.

The FSA's Large Exposures policy does not apply to UK permanent establishments of banks incorporated overseas, but UK permanent establishments of banks incorporated outside the European Economic Area (EEA) do have some reporting requirements for Large Exposures and are required to report their 20 largest exposures.

Although the FSA Large Exposures regime does not apply to permanent establishments it can be seen that at arm's length it will influence the amount of capital that a bank holds. Therefore, to the extent that the permanent establishment is to be regarded as a separate entity trading in the UK in the same or similar activities, in the same or similar circumstances the Large Exposure regime, as applied by the FSA, would have an effect on the amount of capital to be attributed to the permanent establishment.

However, during consultation, it was agreed that the Large Exposure regime would not be taken into account in calculating the amount of capital to be attributed to a permanent establishment unless the company as a whole has to carry extra capital, for large exposure purposes, against that financial asset. This means that, if applying

the above example to a permanent establishment, the Revenue would not attribute extra capital of £382,500 to the permanent establishment (£400,000 - £17,500) in order to satisfy Large Exposure requirements unless as a matter of fact the company as a whole has to carry extra capital, for Large Exposure purposes, against that asset. If extra capital was required at the company level and that asset is correctly attributed to the permanent establishment, then the capital related to that asset should also be attributed to the permanent establishment.

9.2.11 Use of risk models

During the consultation process the Inland Revenue was asked if it would accept the use of banks' internal risk models in order to calculate the capital required to support the trading book of a permanent establishment. It was agreed that such risk models can be used to the extent that they would be acceptable to the FSA and are in fact used by the bank in calculating the capital required to support its trading book.

If an internal risk model is accepted by a home state regulator and there are no significant differences between the home regulatory requirements and those of the FSA, then that model can be used for the purposes of calculating the capital requirements for the permanent establishment's trading book. Where there are significant differences between the two regimes then adjustments should be made to take these into account and to reflect any specific requirements of the UK regulatory regime. (Recognition requirements are covered in chapters TS and TV of IPRU (BANK).)

9.2.12 Intracompany transactions and assets

Transactions entered into between different parts of the same company will not be taken into account for the purposes of attributing capital to a permanent establishment. However, intracompany transactions will still be relevant for the purposes of attributing profits and income to the permanent establishment.

As well as dealing with the attribution of capital to a permanent establishment the new legislation incorporates into UK domestic legislation the relevant principles from the Commentary on Article 7 in the OECD Model Tax Convention on Income and on Capital and in the publication "Transfer Pricing and Multinational Enterprises: Three Taxation Issues". As mentioned in 6.1 above this means the existing rules on, for example, booking are unchanged and applied to all permanent establishments in the UK. Therefore income booked in another location but proper to the PE will need to be included in the attribution of profit to that PE (not the booking location – see the comments at section 6.1).

Following the approach in the publication "Transfer Pricing and Multinational Enterprises: Three Taxation Issues" the new legislation makes it clear that where the permanent establishment is raising funds as an agent or conduit for other parts of the same company it will still need to be rewarded by an appropriate fee or turn but the permanent establishment will not be expected to have capital to support these transactions if it would not have such capital at arm's length. However, the Inland

Revenue will need to be satisfied that the permanent establishment is in fact raising funds as an agent or conduit and that the funds so raised are for non UK business i.e. that the raising or finding of money in the domestic market for lending elsewhere is an activity commonly carried on by independent banks in the UK market and that the permanent establishment has not sacrificed a profit (and forgone a third party asset) which it could have made in the normal course by lending the money to a third party itself.

So, to the extent that intracompany transactions can be respected for tax purposes the attribution of income will need to be taken into account, but there will be no requirement to attribute capital. Where intracompany transactions cannot be respected, because the third party asset properly resides with the UK permanent establishment and not say with a booking location, then not only should the branch be attributed the income from that asset but the amount of capital required to support that asset must also be considered.

9.2.13 Intercompany transactions

The FSA generally requires transactions between two separate corporate entities, whether in the UK, or elsewhere, to be risk weighted using the appropriate risk weights. This approach should be followed when calculating the amount of capital to be attributed to a permanent establishment. So, where a permanent establishment enters into a transaction with another company, whether connected or not and whether in the UK or abroad, any financial asset arising from that transaction should be assigned the appropriate risk weight under the FSA rules (but see the comments in 9.2.15 regarding treasury functions).

Where the home state regulatory rules are used as a starting point and the home state treatment of inter company transactions differs from that of the FSA, this will need to be adjusted for and taken into account in arriving at a figure for the attribution of capital (and thus profit) to the permanent establishment for tax purposes.

9.2.14 Intracompany netting of third party items

Netting agreements are one of the tools used by banks to manage credit risk and to reduce their capital requirements. To the extent that the FSA would allow netting of assets and liabilities, and provided that the FSA's requirements for netting between different parts of a company, such as an acceptable netting agreement, are met then the Inland Revenue will allow the netting of intracompany assets and liabilities when calculating the amount of capital to be attributed to the permanent establishment for tax purposes.

9.2.15 Treasury functions

Transactions with a separate company should be risk weighted in accordance with the FSA's rules as above but specific concerns have been raised over treasury

operations carried out by a UK permanent establishment. Generally where funds are raised by a permanent establishment and passed onto a separate entity, as part of a treasury activity carried on by that permanent establishment, the financial asset arising from that transaction should be risk weighted in the normal way. However there are situations where this treatment could give rise to anomalous results as the same funds could effectively be risk weighted twice within the UK . Therefore, the Inland Revenue will accept that where funds are raised by the permanent establishment in the following circumstances then that treasury transaction will not be risk weighted for the purposes of calculating the amount of capital attributable to the permanent establishment:

- the funds are raised by the permanent establishment as part of a treasury activity undertaken by that permanent establishment
- they are passed on to another company which carries on a banking business and is regulated by the FSA on a solo basis or as parent of a solo consolidated group
- the funds are used by the company carrying on the banking business to create a financial asset which will be subject to the risk weighting rules

9.2.16 Off balance sheet assets

Off balance sheet items may not actually require funds to create them, i.e. if a bank guarantees a debt of £1m then it may not need £1m on day one, but it will need to have funds if and when the guarantee is exercised. Notwithstanding this, off balance sheet assets can still carry risk and, if so, banking regulators do require banks to hold capital to support that risk. Therefore in order to calculate the capital to be attributed to the permanent establishment for tax purposes, off balance sheet assets will need to be risk weighted. The FSA's rules on the risk weighting of off balance sheet items are dealt with in sections 9.2.4-9.2.6.

Where the amount of the off balance sheet assets is negligible then there may be cases where these can be left out of account i.e. cases where the numbers are so small that they cannot possibly materially affect the arm's length range of capital that would be attributed to the permanent establishment.

9.3 Step 3: Determining the amount of equity capital

The new S11AA(3)(b) ICTA 1988 states that it shall be assumed that the permanent establishment has the equity capital, which it would have if it were a distinct and separate enterprise, engaged in the same, or similar activities under the same or similar circumstances.

The term equity capital has not been defined in the legislation as this term is generally well understood. In the banking sector the capital supporting a bank's activities and risks is split into three categories – Tiers 1, 2 and 3. While Tier 1 will consist largely of equity capital and Tiers 2 and 3 largely of loan capital the extent to which items in these tiers will be regarded as equity or loan capital for the purposes of s11AA is set out below.

9.3.1 Tier 1 capital

This takes two forms, issued capital, and internally generated capital. The majority of the issued capital will be issued share capital. This share capital can either be allotted, called up and fully paid ordinary share capital, or perpetual non-cumulative preferred (or preference) shares, which are not redeemable at the option of the holder. This issued capital will be "equity capital".

However in certain circumstances a bank may also be able to issue "innovative " or "hybrid" Tier 1 capital, i.e. interest bearing debt instruments. These instruments can only be issued in certain circumstances and must have certain characteristics in order to qualify as Tier 1 capital for the FSA's capital adequacy requirements. For the purposes of S11AA ICTA 1988 this hybrid or innovative Tier 1 is loan capital and **not** equity capital.

The second form of capital falling within Tier 1 is internally generated capital. This can include general and other reserves created by appropriations of retained earnings, share premium and other surpluses as well as retained profits and losses arising during the course of the current year. The FSA provides for certain items to be taken into account and/or deducted from these reserves or profits/losses in order to arrive at a figure of Tier 1 capital, but to the extent that the net result would qualify for Tier 1 for FSA CAD requirements then this internally generated capital will equate to "equity capital" and not "loan capital" for the purposes of S11AA.

9.3.2 Tier 2 capital

A number of items fall within this category of capital including subordinated term debt and convertible subordinated bonds. Both of these will be regarded as "loan capital" for the purposes of S11AA. However dated preferred shares or perpetual cumulative preferred shares falling within Tier 2 will be regarded as "equity capital".

Tier 2 capital also includes reserves arising from the revaluation of tangible fixed assets and fixed asset investments as well as general provisions. Whilst general provisions are not normally considered to be equity they will not be loan capital. So, to the extent that such reserves or provisions could fall to be included in the Tier 2 capital of a bank under the FSA's CAD rules then they may effectively be treated as equity when looking at the capital structure of the permanent establishment (see the example at 9.4.1.2.).

In some cases the amount of reserves or provisions included within Tier 2 can be substantial and as these are effectively "equity" rather than "debt" for the purposes of the legislation these should not be overlooked.

9.3.3 Tier 3

Tier 3 capital is used to support trading book activities and essentially consists of short-term subordinated debt. Very little Tier 3 capital appears to be issued in practice, but any such debt will be "loan capital".

9.3.4 Treatment of retained profits and losses

The FSA allows current year profits, net of any tax, anticipated dividends and other appropriations to be included in the Tier 1 capital of a bank where the amount of those profits has been verified by the bank's external auditors. Current year losses are to be recognised without an audit. This applies to companies carrying on a banking business in the UK and not to permanent establishments of foreign banks. There are clearly difficulties in replicating the audit requirement in the permanent establishment scenario. Therefore, it is accepted that post tax profits can be counted as equity capital to the extent that these funds have been kept in the UK and not remitted to head office.

To the extent that profits have not been remitted to head office they can be taken into account as they accrue over the year on an averaged basis consistent with the basis and frequency with which the risk-weighted assets are calculated. The same principle applies to losses. Where a bank has losses these should also be taken into account (the regulator requires losses to be deducted from a bank's Tier 1 capital) and they will effectively increase the amount of capital that needs to be attributed to the permanent establishment.

There should be consistent treatment for both profits and losses with the same basis being applied to both.

The simple example set out below shows how retained profits, or losses, can effect the capital ratios of a permanent establishment independently of any movement in the WRA's. There are obviously other factors which can effect the capital ratios such as changes in the levels of provisions :-

- The permanent establishment starts with assets of £1000m all risk weighted at 100%.
- It is agreed that at arm's length the permanent establishment would have a total capital ratio of 12 per cent of which 8 per cent will be equity capital (for ease loan capital is not covered in this example but see 9.5.6).
- It is assumed that profits or losses have accrued evenly over the year (although this is unlikely to happen in reality).
- It has been agreed that in reaching the capital attribution tax adjustment regard will be had to the average capital ratios based on the figures shown at the beginning and end of the year (unless there is a dramatic change in the assets levels, and profit / loss accruing over the year).

Year 1

Non interest bearing capital or " equity" capital of £80m is allotted to the permanent establishment at the beginning of the year. By the end of the year the WRA's are still £1000m but losses for the year are £10m. The "equity" type capital is therefore reduced by these losses and is now £70m with the "equity" capital ratio becoming 7% of the WRA's.

If the loss of £10m accrues evenly over the year then the average loss will be £5m and the average figure of “equity” capital is therefore £75m. The capital attribution tax adjustment should therefore reflect an interest disallowance in respect of £5m “equity” which the Permanent establishment would have been required to find if it were a separate entity.

The same principles will apply equally in an attribution case as losses will increase the amount of capital that the permanent establishment would require at arm’s length.

Year 2

WRA’s remain £1000m but the permanent establishment has profits of £5m, which accrued evenly over the year and which have been retained at the year end.

At the end of the previous year the permanent establishment effectively had allotted capital of £70m (£80m less the £10m loss of the previous year). At the end of year 2 it has retained the profits of £5m so has allotted capital of £75m. The average “equity” over the year is £72.5m and the average capital ratio will be 7.25%.

Again there will be a restriction of the interest deduction to reflect the fact that the permanent establishment would have required a further £7.5m “equity” type capital at arm’s length.

In some cases a permanent establishment may have losses brought forward from a period before the commencement of the new legislation. These losses will not effect the amount of capital to be attributed to the branch or the way in which the capital attribution tax adjustment is calculated. That is, ultimately a comparison will still need to be made between the amount of equity and loan capital that the permanent establishment would have at arm’s length and the amount that it actually has.

However, losses brought forward will have an effect where capital has previously been allotted to the permanent establishment for the purpose of making good those losses. If the permanent establishment were a separate entity then losses would erode the capital base as they arise. Similarly, where capital has been allotted to a permanent establishment to cover losses then that capital must have been absorbed and therefore it cannot be regarded as still available when considering the amount of capital that the permanent establishment actually has.

9.3.5 Permanent establishments 100 per cent funded by borrowing in the local markets.

Under the new legislation the permanent establishment will be treated as having the equity capital that it would have if it were a separate enterprise engaged in the same

or similar activities under the same or similar circumstances. This applies equally whether funding for the permanent establishment is obtained directly from third parties or from head office.

Where all of the funding for the permanent establishment is from external sources, then any equity capital, which would be required by the permanent establishment at arm's length, will be treated displacing an equal amount of third party debt. The surplus third party funds will then be regarded as money raised by the permanent establishment for other parts of the company. This can be illustrated by a simple example:

- The PE has loans to customers of £100m, which are fully funded by monies that it raises in the London market;
- It receives interest income on the loans at 6 per cent;
- It pays interest to third parties at 5 per cent;
- Before the attribution of capital to the PE it has the following profit and loss account:

Income £100m @ 6 per cent £6m
Interest expense £100m @ 5 per cent (£5m)
Pre-tax profit £1m

For illustrative purposes only, it is being assumed that:

- all of the loans are risk weighted at 100 per cent giving WRAs of £100m; and
- the PE would require 11 per cent capital to support those assets (8 per cent equity and 3 per cent loan capital).

Therefore, the PE will be treated as having equity capital of £8m.

This £8m equity will effectively displace £8m of the funds that the PE has raised in the market along with the associated interest cost. This displaced £8m of third party loans will be regarded as raised by the PE for other parts of the same company and the profit and loss account will be as follows:

Income £100m @ 6 per cent £6m
Interest expense £92m @ 5 per cent (£4.6m)
Profit before tax £1.4m

The displacement of third party funds will lead to a disallowance of interest costs. In this situation the Revenue will not expect an attribution of income to the PE on the £8m in addition to the interest disallowance.

9.3.6 Interest free loans

Interest free loans received by the permanent establishment from other parts of the same company will be treated as if they were equity capital but interest free loans

from a separate legal entity, i.e. from another company, will not be regarded as equity capital.

9.3.7 The arm's length amount

The new legislation at S11AA(3)(b) ICTA 1988 assumes that the permanent establishment has the equity capital that it could reasonably be expected to have if it were a distinct and separate enterprise, engaged in the same or similar activities under the same or similar circumstances. The question therefore arises as to what this amount of equity capital should be.

If the permanent establishment were a separate enterprise trading in the UK then it would be set a minimum level of regulatory capital by the FSA. Whilst this minimum would not be less than 8 per cent of the total risk weighted assets, capital levels set by the FSA may range from between 9 per cent to 15 per cent, with some exceptional cases where the ratio is much higher. In addition most banks actually operate with levels of capital in excess of the level set by the FSA and the amount of this "excess" varies depending on the needs, activities and the attitude of that particular bank. Therefore, as a starting point the amount of capital that the permanent establishment would have at arm's length would be over and above the regulatory minimum, but the questions still arise as to what that regulatory minimum would be and how much more capital the permanent establishment would actually have? In forming a view on this there are a number of factors that could be taken into account:

- The level of capital that the bank has as a whole;
- The level of capital held by other banks of the same size, trading in the UK;
- The level of capital held by banks undertaking the same type of activities in the UK; and
- The level of capital held by a bank, trading in the UK, that is comparable, in both size and in terms of its activities, to the permanent establishment.

In practice it may be difficult to find companies that are true comparables in both terms of size and level or type of activities, so as a practical starting point regard can be had to the capital levels of the company of which the permanent establishment is a part. So if the bank as a whole has a capital ratio of say 11 per cent then as a starting point it might be assumed that the permanent establishment would have a similar capital ratio.

There may be instances where such an approach would not produce a level of capital that would be in an arm's length range. For instance, where the bank itself is based in a country where banks' capital falls very close to the regulatory minimum (where the figure might be too low for a permanent establishment in a country where banks were generally much more generously capitalised). In such a case using the capital ratio figure of the bank as a whole might produce a figure that would be less than the minimum level of capital that would be required by the FSA. Or, more critically, it might give a figure, which is significantly out of line with the known level of capital for companies carrying out a banking business in the UK.

Additionally the activities of the permanent establishment may not be a microcosm of the activities of the bank as a whole, with the permanent establishment undertaking activities, which are either more, or less risky than those undertaken by other parts of the same company. However, in this situation it is envisaged that, if necessary, adjustments could be made. So if the permanent establishment carries on a relatively greater proportion of more risky activities than the bank as a whole, it might be reasonable to assume that as a stand alone it would have a slightly higher capital ratio and vice versa.

9.4 Step 4: Determining the amount of loan capital

S11AA(3)(b) ICTA 88 says that the permanent establishment shall be assumed to have such equity and loan capital as it could reasonably be expected to have in the circumstances specified in S11AA(2), that is, if it were a distinct and separate enterprise, engaged in the same or similar activities under the same or similar conditions. This means looking not just at the amount of equity capital that the permanent establishment would have at arm's length (as determined under Step 3 above), but also looking at the mix of equity and loan capital that it would have if it were a separate enterprise trading in the UK in the same or similar conditions.

The Revenue does **not** accept that a permanent establishment would have the most tax efficient mix of capital that is theoretically possible, i.e. comprising the minimum amount of equity capital and the maximum amount of loan capital, because such capital structures are not in fact seen at arm's length.

As mentioned above in the equity capital section there are a number of factors that could be taken into account in reaching a view on the amount of loan capital:

- The capital structure of the bank as a whole;
- The capital structure of other banks of the same size, trading in the UK;
- The capital structure of other banks undertaking the same type of activities in the UK ;
- The capital structure of another bank, trading in the UK, that is comparable, in both size and in terms of its activities, to the permanent establishment.

9.4.1 Specific types of loan capital

9.4.1.1 Innovative or hybrid Tier 1 capital

As we are looking at the mix of equity and loan capital that the permanent establishment would have at arm's length, it is possible that in certain circumstances this hypothesised mix could include interest bearing Tier 1 instruments**.** Where it is accepted that a permanent establishment can be hypothesised as having innovative or hybrid Tier 1, then the amount of any such issue cannot exceed the amount that the company would be able to issue if it were a separate enterprise trading in the UK. That will reflect both the fact that the FSA will not permit the hybrid or innovative Tier 1 to exceed 15 per cent of the total Tier 1 capital, and that the level of innovative or hybrid Tier 1 actually held by banks is less than the 15 per cent limit.

A. Where the company has issued hybrid and/or innovative Tier 1
If the company itself has issued innovative or hybrid Tier 1 capital, then an appropriate proportion of this may be attributed to the permanent establishment if the permanent establishment would meet the FSA requirements for such an issue, assuming it were a separate enterprise. At present the FSA requires a bank to have 6 per cent Tier 1 capital before it can issue innovative or hybrid Tier 1 and, as already mentioned, this innovative or hybrid Tier 1 cannot exceed 15 per cent of the total Tier 1 capital.

Provided that the conditions mentioned above are met, the Inland Revenue would be prepared to accept that an appropriate proportion of the actual innovative or hybrid Tier 1 issued by the company could be hypothesised as attributable to the permanent establishment even if the branch was not itself of a size (in terms of assets etc.) to make such an issue likely.

B. Where the company has not issued hybrid or innovative Tier 1
There may be cases where the home state regulator does not allow the issue of innovative or hybrid Tier 1 instruments - so there is none in the company - but the UK permanent establishment as a stand alone company in the UK would both satisfy the FSA requirements for an issue of such Tier 1 and would be of a sufficient size to make such a Tier 1 issue. If this is the case then the Revenue will accept in principle that the UK permanent establishment may include an appropriate proportion of innovative or hybrid Tier 1 in its loan capital.

However, where there is no innovative or hybrid Tier 1 in the company as a whole and the home state regulator **does** allow such issues, it is extremely unlikely that the Inland Revenue would accept that the permanent establishment would have such Tier 1 instruments, even if the permanent establishment were of a size etc. to make such an issue. That is, the fact that the company as a whole has chosen not to issue such instruments would be taken as a strong indication that the permanent establishment would similarly have chosen not to issue such instruments if it were a separate enterprise.

9.4.1.2 Tier 2 subordinated debt in loan capital

As we are looking at a mix of capital then it is also possible that the hypothesised permanent establishment would have a mix of equity and loan capital that would include a proportion of Tier 2 subordinated debt.

However, the Inland Revenue does **not** accept that the permanent establishment will have the most tax efficient mix of capital that is theoretically possible i.e. the maximum amount of subordinated debt possible under the FSA’s CAD rules. This is because it is highly unlikely that a separate stand-alone entity would have such high levels of costly subordinated debt. Research into the published accounts for banks trading in the UK and internationally has shown that they do not carry high levels of subordinated debt. A number of UK and major international banks have Tier 2 capital that is less than maximum they could hold and that Tier 2 capital will often contain

significant levels of general provisions and reserves, rather than substantial amounts of subordinated debt.

As with innovative or hybrid Tier 1 debt it may be difficult to find companies that are true comparables. A practical starting point will therefore be the capital structure of the bank as a whole. So, if a bank has a Tier 1 capital ratio of say 7 per cent with 1 per cent being innovative or hybrid Tier 1 and Tier 2 capital of say 4 per cent of which 2 per cent is subordinated debt and the balance is provisions and reserves then it may be appropriate to hypothesise that the permanent establishment would have a similar capital structure. These ratios could then be applied to the permanent establishment's WRAs taking into account the actual reserves and provisions of that permanent establishment. Assuming for simplicity that the permanent establishment does have the same level of reserves and provisions as the company as a whole, this would effectively mean that the permanent establishment would have equity capital of 6 per cent in Tier 1 with a further 2 per cent of capital, in the form of reserves and provisions, in Tier 2. It would also have loan capital of 3 per cent (1 per cent in Tier 1 and 2 per cent in Tier 2). If the permanent establishment has different figures of reserves and provisions then the mix of capital included in Tier 2 may be different to that held by the company as a whole.

There may be instances where such an approach would not produce an attribution of capital to the permanent establishment that would fall within an arm's length range. For instance, the company as a whole may have been building up a "war chest" to make further acquisitions so it may not be reasonable to simply use the capital structure of the company as a whole as a blueprint for the capital structure of the permanent establishment. Additionally the activities of the permanent establishment may be sufficiently different from the activities of the company as a whole that the permanent establishment would have had a somewhat different capital structure at arm's length as an independent entity. However, even in these two situations it is envisaged that the capital structure of the company could still be used as a starting point and adjustments could then be made where these could be justified.

Generally, where the capital structure and ratios of the company as a whole are applied to the WRAs of the permanent establishment, adjustments would not be required unless the resulting ratios clearly gave rise to a figure of capital that fell outside an arm's length range. That is, where the results would be inconsistent with the range generally seen for companies carrying on a banking business in the UK or would be below or out of line with the FSA's CAD requirements.

9.4.2 Exceptional circumstances

As mentioned above, there are situations where applying the capital structure of the company as a whole to the permanent establishment will not give rise to an arm's length result. One such situation, which was raised during the consultation process, was the unusual position of banks, which do not, and have no need to, issue tax-deductible capital in their home territory. It is accepted that if such a bank were to set up a subsidiary company in another territory it would in all likelihood issue tax-deductible capital (if such capital were a common feature of banks trading in that other territory). Therefore, applying the capital structure of the company as a whole to

the permanent establishment trading in the UK is unlikely to give an arm's length result. Instead, regard should be had to the other factors mentioned in the sections on equity and loan capital.

If banks resident in other countries feel that exceptional circumstances apply in their case then they should discuss these circumstances with their Inspector at the earliest opportunity.

9.5 Step 5: Disallowance of interest and other costs on funding equivalent to attributed equity

The legislation specifies that no deduction may be made for any costs in excess of those that would have been incurred if the permanent establishment had the equity and loan capital assumed by s.11AA(3). The term "cost" is intentionally not limited in the legislation, except by its context, to give it a broader meaning than simply interest. Its context will restrict it to funding, funding related costs and costs incidental to funding. It will certainly include fees and incidental costs associated with loans, such as those described in s.77(6) ICTA 1988. It is also broad enough and intended to catch non-interest funding and funding related costs such as swap payments and premiums, whether related to hedging or used as the primary method of funding by, for example, embedded loans in swap arrangements. It will also include foreign exchange losses determined in accordance with normal rules, though it must be stressed that all these costs are limited to those part of the costs that relate to funding that is displaced from the permanent establishment by the assumptions on equity and loan capital.

For example, a permanent establishment of which the functional currency is sterling has:

- assets of CHF 1000m which are 100 per cent funded by a loan from head office of CHF1000m at an interest rate of 4 per cent;
- been charged set up fees of CHF 15m as an arm's length arrangement fee; and
- on translating for tax purposes, a currency loss against sterling of CHF10m has been incurred on those costs.

If the analysis determined that the permanent establishment should be holding equity capital of CHF 100m*, then no deduction may be made for the following:

Interest	CHF 40m x 10 per cent	=	CHF 4,000,000
Arrangement fee	CHF 15m x 10 per cent	=	CHF 1,500,000
Foreign exchange loss	CHF 10m x 10 per cent	=	CHF 1,000,000
Costs to be disallowed			**CHF 6,500,000**

*NB this equates to 10 per cent of the funding requirement and is used purely for arithmetic simplicity, it is **not** indicative of the level of capital likely to be held. See sections 9.3 and 9.4 on how to arrive at figures for equity and loan capital for a particular permanent establishment.

Although the legislation does not require equity capital to be physically held by a permanent establishment, in practice the majority of permanent establishments are likely to have some equity capital already providing interest free funds. For example, they may have retained profits, provisions, as described above, or their head office may have actually made physical allotments of capital to the permanent establishment. In such cases the costs for which no deduction may be made should be limited to those that relate to funding that is displaced by the additional amounts of equity capital assumed by s.11AA(3).

Thus in the above example, if the permanent establishment already had CHF 50m equity capital allotted to it, the position would be that the permanent establishment is:

- 5 per cent funded by its allotted (equity) capital;
- 95 per cent funded by a loan from head office of CHF 950m at an interest rate of 4 per cent;
- charged set up fees of CHF 14.25m as an arm's length arrangement fee (assuming the fees are directly related to the amount of the loan); and
- on translating for tax purposes, a currency loss against sterling of CHF 9.5m has been incurred.

If the analysis determined that the permanent establishment should be holding equity capital of CHF100m then no deduction may be made for the following (NB: 5.26 per cent = 50/950):

Interest	CHF 38m x 5.26 per cent	=	CHF 2,000,000
Arrangement fee	CHF 14.25m x 5.26 per cent	=	CHF 750,000
Foreign exchange loss	CHF 9.5m x 5.26 per cent	=	CHF 500,000
Costs to be disallowed			**CHF 3,250,000**

In some cases, permanent establishments in the UK may have made adjustments in their tax computations to disallow interest in respect of free working capital adjustments agreed previously with the Inland Revenue. Such adjustments should be discontinued for accounting periods beginning on or after 1 January 2003 and replaced by capital attribution tax adjustments on the lines described above.

9.5.1 Allowance for potential additional interest cost and other costs on loan capital attributed to permanent establishment

The legislation specifies that no deduction may be made for costs in excess of those that would have been incurred if the permanent establishment had the equity and loan capital assumed by s.11AA(3). This requires a composite adjustment to be made to interest and other funding costs in the tax computation (the capital attribution tax adjustment).

One of the assumptions in s.11AA (3) is that the permanent establishment has loan capital, determined as described in section 9.4. It is possible that attributed loan capital which could be subordinated debt or innovative Tier 1 may carry a higher interest rate (a premium to the lender for accepting the subordinated terms of the

loan) than the actual funding of the permanent establishment if, for example, the permanent establishment were funded entirely at lower short term interest rates. Therefore, it is possible that additional interest costs may need to be taken into account when considering the interest element. The following extension of the first example above illustrates this point.

A permanent establishment is:

- 100 per cent funded by a loan from head office of CHF 1000m at an interest rate of 4 per cent;
- charged set up fees of CHF 15m as an arm's length arrangement fee; and
- on translating for tax purposes, a currency loss against sterling of CHF 10m has been incurred.

If the analysis determined that the permanent establishment should be holding equity capital of CHF 100m and loan capital of CHF 40m as subordinated debt at 6 per cent then:

Additional interest to be *allowed* on the subordinated debt will be:

Interest on the subordinated debt	CHF 40m x 6 per cent	=	CHF 2,400,000
Less			
Interest on existing funding of same amount	CHF 40m x 4 per cent	=	CHF 1,600,000
Additional interest to be allowed		=	CHF 800,000

Therefore, the costs for which no deduction may be made become:

Interest	CHF 40m x 10 per cent	=	CHF 4,000,000
Arrangement fee	CHF 15m x 10 per cent	=	CHF 1,500,000
Foreign exchange loss	CHF 10m x 10 per cent	=	CHF 1,000,000
Less			
Additional interest on subordinated debt		=	(CHF 800,000)
Costs to be disallowed			**CHF 5,700,000**

The question arises as to what the additional interest rate and other terms should be for the attributed loan capital. The obvious comparable is the actual rate on the bank's loan capital, but this will not always be the case. If the bank has not issued loan capital to third parties then comparables may still be available from market data for issues of subordinated and other types of debt for banks across the range of credit ratings.

Another circumstance in which the bank's own loan capital may not be a suitable comparable would be if it was issued before the permanent establishment was brought into existence. The terms prevailing at the time the subordinated debt was issued may not be arm's length at the time the permanent establishment was created. Here it will be necessary to fall back on third party comparables. It should be

stressed that the legislation is not treating permanent establishments as created on 1 January 2003, so this should be a comparatively rare occurrence.

It will be necessary to review the interest rates and the premiums used on loan capital from time to time as they will change for new issues with changes in the market. It would not be an arm's length assumption that loan capital once issued is permanent. Even perpetual debt issued as innovative Tier 1 is commonly created to be repayable after a period of time (usually around 5-10 years) through, for example, the use of interest payment step-ups that make it uneconomic to continue the loan after they apply.

The above would be a very simple situation. Complexities likely to be encountered are that the permanent establishment may be funded on a composite rate that already takes account of the additional interest and other funding related costs of issuing subordinated debt or innovative Tier 1, or the permanent establishment is funded (whether from head office, associates or third parties) by various loans of different durations, carrying a variety of interest rates, in different currencies, etc.

Where a simple weighted average of the company's funding costs is used as the rate on head office loans then, if the capital structure agreed is broadly equivalent to that of the company as a whole, an adjustment for the attributed loan capital is unlikely to be necessary as the additional costs on the attributed loan capital will already have been taken into account. Where the capital structure agreed for the permanent establishment is different from that of the whole bank and the amounts are likely to be significant, an adjustment may need to be calculated. This could be positive or negative depending on whether the permanent establishment was assumed by s.11AA to hold proportionately less or more loan capital than the bank.

Where the permanent establishment is funded by loans at different rates of interest and on different terms, or where an adjustment must be made on a composite rate, there is no automatic presumption that the loan capital assumed by s.11AA(3) should displace, or be replaced with, cheaper overnight funding. The loan capital should be treated as displacing or being replaced by longer term funding which is fulfilling a similar role in the funding structure of the permanent establishment. However, there may exceptionally be circumstances where the permanent establishment can show that a different answer is appropriate. For example, it may be that a particular issue of long terms bonds may be specifically linked to an identified structured transaction with a third party and, as such, it may not be appropriate to treat it as being displaced by attributed loan capital. Instead the loan capital should be treated as displacing other debt funding.

If subordinated debt or innovative Tier 1 has been issued through and used to fund the permanent establishment, then the interest rate on that debt should be used to calculate the costs of the permanent establishment's loan capital. However, to the extent that the amount of such loan capital issued exceeds the amount assumed by s.11AA(3) then a disallowance will still arise. The disallowance to be taken into account in the capital attribution tax adjustment will not be the whole of the interest on the excess loan capital, only the additional costs associated with the form of the loan capital compared to ordinary funding. In the same way that, when attributing additional loan capital, there should not be an automatic presumption that the

additional loan capital displaces the cheapest funding, neither should it be presumed that excess loan capital should be replaced by the cheapest overnight funding. A similar principle to the above applies, namely that the replacement debt will most likely be longer term funding which is fulfilling a similar role in the funding structure of the permanent establishment, albeit not subordinated.

How this might work in practice is illustrated by the following example.

A permanent establishment is:

- 100 per cent funded by a loan from head office of CHF 900m at an interest rate of 4 per cent and a subordinated loan of CHF 100m from an associate at an interest rate of 6 per cent;
- charged set up fees of CHF 15m as an arm's length arrangement fee; and
- on translating for tax purposes, has a currency loss against sterling of CHF10m.

If the analysis determined that the permanent establishment should be holding equity capital of CHF 100m and CHF 40m of loan capital as subordinated debt at 6 per cent then no deduction may be made for the following:

There will be no additional interest to be allowed on the subordinated debt as it is assumed by s.11AA(3) that this will be reduced to CHF40m from the CHF100m actually held. However, a further disallowance will arise in respect of the premium on the CHF 60m excess loan capital:

Interest on the existing subordinated debt	CHF 60m x 6 per cent =	CHF 3,600,000
Interest on attributed funding of same amount	CHF 60m x 4 per cent =	CHF 2,400,000
Additional interest to be disallowed	=	CHF 1,200,000

Therefore, the costs for which no deduction may be made become:

Interest	CHF 40m x 10 per cent =	CHF 4,000,000
Arrangement fee	CHF 15m x 10 per cent =	CHF 1,500,000
Foreign exchange loss	CHF 10m x 10 per cent =	CHF 1,000,000
Plus		
Additional interest on excess subordinated debt	=	CHF 1,200,000
Costs to be disallowed		**CHF 7,700,000**

9.5.2 Multi-currency books and the currency/interest rates to be used in arriving at the disallowances and allowances for equity and loan capital

The calculations should be performed in the functional currency, which the permanent establishment uses to calculate its taxable profits. Therefore, if the actual funding of the branch is in a mix of currencies then these will need to be translated to the functional currency of the permanent establishment. The funding costs used in

the capital attribution tax adjustment calculations should be the actual funding costs of the permanent establishment and not the costs of an equivalent amount and type of funding in the functional currency. For example, if the permanent establishment is funded at short-term US dollar rates of say 2.0 per cent, then the sterling equivalent of that amount of interest should be used in the calculations.

It would not be appropriate to translate the amount of the funding into sterling and then apply short-term sterling rates of say 4 per cent to that amount for the purposes of the calculation. Similarly when determining the interest rate on attributed loan capital, the interest rates to be applied should be related to the currency of the loan capital not those applicable to the functional currency of the permanent establishment.

However, where the funding has been hedged or converted into the equivalent of another currency by, for example, raising funds in one currency and using swaps into another currency, then the costs of the hedge must also be taken into account. For example, a permanent establishment with a functional currency of sterling that is normally funded in sterling, raises funds more cheaply by borrowing in US dollars and swapping the US dollars into sterling. The calculation of the capital attribution tax adjustment should take into account both the US dollar costs translated into sterling and the swap costs.

9.5.3 Equity capital already allotted exceeding amount computed under legislation

Where equity capital is already allotted to the permanent establishment in an amount that exceeds the amount attributed by s.11AA(3) then, in the first instance, the reasons for the excess should be established and further consideration given to whether the amount attributed to the permanent establishment is correct, (as it is possible that some factors may have been missed when considering the amount of equity capital to be attributed). Where a higher allotment of capital has been made to the permanent establishment then there are likely to be commercial reasons for the permanent establishment having that level of equity capital. These could well make the allotted level of equity capital the appropriate level of capital to attribute under s.11AA(3).

Where the allotment is not for commercial reasons, but is, say, wholly tax driven and is in excess of an arm’s length range then the Inland Revenue may have to accept that the capital allotted exceeds that required by s.11AA(3). Where it is accepted that this is so then the “excess” of capital needs to be redesignated as either as loan capital or as general funding, for which an adjustment will need to be made. Whether the excess equity should be treated as loan capital, general funding or a mixture of the two will depend on the facts of the particular case.

If an adjustment is made to the allotted equity capital and a tax treaty containing an Exchange of Information Article exists, Inspectors should submit details to Competent Authority at Inland Revenue Policy International so that the relevant fiscal authorities can be advised of the position.

9.5.4 Equity capital attributed but no funding costs in permanent establishment

Although no example has been seen in practice, it is theoretically possible that equity capital could be attributed to a permanent establishment under section 11AA(3) that has no debt funding for the equity capital to displace, for example, a permanent establishment that provided only guarantees. The FSA will (as do other banking regulators) require capital to be held against such obligations because, although contingent, the bank is exposed to risk and the possibility of loss. Therefore, regulatory capital is required even though there are no actual assets for which funding is required.

In the case of there being no funding requirement it is necessary to consider what would be done with the equity capital the regulator would require to be held. The most likely answer is that the capital would effectively be loaned to head office or another permanent establishment of the company at interbank rates and income of that amount should be imputed. It would be exceptional for the permanent establishment to be treated as providing more than general funding and so be entitled to a share of any profit or loss on a specific asset as the permanent establishment is unlikely to have had any role in the creation of the assets.

9.5.4.1 Guarantee fees – no deduction available

No deduction should be given in respect of guarantee fees paid or claimed to be paid by the permanent establishment to the head office or to another permanent establishment of the same company.

The legislation specifies that the permanent establishment should be treated as having the same credit rating as the rest of the bank of which it is a part. This was done to put the matter beyond doubt in the context of determining the amount of capital the permanent establishment would have if it were a separate enterprise carrying on the same or similar activities under the same or similar conditions.

The permanent establishment of a bank will, as a matter of fact, have the credit rating of the bank as a whole. When dealing with the permanent establishment, the credit rating that third parties will take into account will be that of the bank.

Claims made for the deduction of guarantee fees between a permanent establishment and its head office or another permanent establishment fail because it is not possible for a company to guarantee parts of itself. Therefore, there is no transaction to recognise for tax purposes. This is part of the existing OECD principles on the taxation of permanent establishments, which do not recognise such a guarantee as a transaction that can be taken into account when determining the profits attributable to a permanent establishment for tax purposes. To recognise such a guarantee fee, contrary to the international consensus, would be likely to lead to less than single taxation where the fiscal authority of the home country of the permanent establishment did not recognise the receipt of the putative guarantee fee.

It would also be likely to lead to double taxation where such fees were imputed to the permanent establishments of UK companies and the fiscal authority of the host country did not recognise the payments of the putative guarantee fee and so gave no relief.

Any guarantees provided to the permanent establishment by associates should be considered on normal transfer pricing lines, both as to the amount of the fees and whether the associates are capable of providing the guarantees claimed.

9.5.5 Frequency of calculations

Although a banking regulator may require daily reports of a bank's capital for monitoring purposes, what we are attempting to arrive at is a pragmatic basis of calculation, which reflects the facts of a particular case, not a replication of the reporting requirements of the FSA. Therefore, the legislation sets no rule about how frequently calculations should be performed, beyond the general need to have taken the attribution of capital into account when filing the tax return for the permanent establishment in order to have submitted a correct self assessment.

The frequency of the capital attribution calculations will depend on the facts in a particular case, but in the vast majority of cases we are not expecting this to be calculated on a daily, weekly or even monthly basis. The frequency should be governed by what is reasonably required to ensure an accurate self-assessment.

At one end of the spectrum there may be a permanent establishment with relatively little movement in the level of assets in the year and, therefore, relatively little movement in the amount of capital that would be required to support those assets. In such a case it would be appropriate to calculate the level of capital and any associated interest disallowance by reference to the level of assets at the end of the year.

Further along the spectrum, where there has been a reasonably steady rise or fall in assets then a simply arithmetic average of the opening and closing levels of assets will be sufficient.

At the opposite end of the spectrum, in cases where there are large one off spikes or dips in the level of assets then it might be necessary to calculate the level of capital required to and from the dates of those events. For instance, if the level of assets in a permanent establishment doubled in a particular period and then stayed more or less constant until the end of the year it might be appropriate to look at the level of capital required from the beginning of the year until the change in asset levels took place and then from that date until the end of the year.

9.5.6 Allotments of capital

In addition to the issue of "excess" equity addressed at 9.5.4 above there are other issues that could arise where capital is actually allotted to a permanent establishment.

To illustrate these a simple example is set out below :-

Year 1 .

- A PE estimates that it will have WRA's of £1000m at the year end.
- Its capital requirement is agreed to be 11per cent split 8 per cent Tier 1 and 3 per cent Tier 2 (for simplicity only it is assumed that Tier 1 is all "equity" and that Tier 2 is subordinated debt).
- The PE is therefore allotted non interest bearing capital of £80m at the start of the year.
- At the end of the year the WRA's are still £1000m.
- The accounts for the branch do not include interest at subordinated debt rates.

If the hypothetical arm's length funding costs of the PE are compared to the actual funding costs then the only adjustment to be made in the computations for the year will be a negative one to reflect the interest rate that would be payable on an arm's length amount of subordinated debt, in this case interest on £30m.

Overall there is of course a positive adjustment as the permanent establishment will have “equity” capital that it did not previously have.

Year 2.

- There is a fall in WRA's to £900m.
- The permanent establishment still has allotted capital of £80m.

8 per cent of £900m is £72m. Whilst there may appear to be “excess” equity it is likely that the £80m is still within the arm's length range and at arm's length a bank is unlikely to repay equity in the short term simply as a result of a small step up in its Tier 1 ratio.

But what about the subordinated debt ? Should it be assumed that the permanent establishment still carries an amount of £30m or should it be assumed that in view of the “excess” equity the permanent establishment would have reduced the level of subordinated debt?

At arm’s length a bank is unlikely to maintain exactly the same capital ratio year on year and so either of the above could be realistic assumptions. One solution could be to have regard to what has happened at the entity level, how have the ratios changed, has subordinated debt been repaid? However a more practical solution may be to reach agreements which build in “tolerances” within which the capital ratios can move.

In this example it has been assumed that at arm’s length the permanent establishment would have equity capital of 8 per cent and loan capital of 3 per cent. This could be regarded as the “minimum” that the permanent establishment would require at arm’s length (this is **not** a reference to the regulatory minimum). Thus where say the amount of equity capital dropped below this level an adjustment would

be required in the computations to take account of the difference between the amount of equity capital that the permanent establishment would have at arm's length and the amount that it actually has.

If 8 per cent and 3 per cent are regarded as "minimum's" then some kind of upwards movement or tolerance could be agreed and this could be based on the movements that occur in the whole entity's capital ratios over a period of time.

Where equity appears to be "excess" then consideration will need to be given to whether or not the amount of equity capital has in fact moved outside an arm's length range and this is dealt with at 9.3.4 above.

10 Outbound permanent establishments: the applicability of s.11AA(3) to outbound permanent establishment and DTR calculations

The new s.11AA will apply for the purposes of computing the profits of an overseas permanent establishment of a UK company in determining the amount of the UK corporation tax attributable to those profits for the relief of foreign tax under s.797 ICTA 1988. As in the case of UK permanent establishments of foreign companies, the regulatory rules to be used for the purpose of this capital attribution tax adjustment will be those of the country in which the permanent establishment is situated.

In practice many UK banks have in the past formally allotted capital to their overseas permanent establishments to ensure maximum relief for foreign taxes. It is unlikely that the new approach will make a significant difference to the amounts of foreign tax that are relievable in the UK. However, it will provide UK banks with a basis that should be easier to apply than the making and monitoring of formal allotments of capital to their permanent establishments.

11 DTR problems: Mutual Agreement Procedure

Where double taxation problems arise, because for example the foreign fiscal authority disputes the amount of capital attributed to a permanent establishment, then the Mutual Agreement Procedure (MAP) Article of the relevant tax treaty can be invoked by the taxpayer to require the foreign fiscal authority and the UK Revenue to use best endeavours to resolve the dispute by mutual agreement. This can apply to the permanent establishments of non-resident banks and to UK banks. If any MAP claim is made it should be referred immediately to a Competent Authority at Revenue Policy International in accordance with the general instructions on such claims at DT232.

12 Use of UK GAAP

Questions have been raised as to whether in computing the profits of UK permanent establishments of overseas banks for UK tax purposes, the use of UK GAAP is mandatory. The short answer is yes. This was the case even before the enactment of section 103 Finance Act 2002, which was included for the avoidance of doubt.

Under section 11 ICTA the UK may impose corporation tax on profits attributable to a permanent establishment. That is in line with the position under the UK's double tax agreements. However the DTAs are concerned only with profit attribution, not with accounting methods or subsequent computation of the tax due. Section 60(1) ICTA 1988 provides that tax under Schedule D Case I will be charged on the full amount of the profits for the year. Case law has established that the full amount of the profits is to be established by reference to the profits computed in accordance with the normal principles of commercial accountancy, subject to any specific provisions of the Taxes Acts.

It is important to note that there is no statutory or case law link between the actual accounts prepared by a taxpayer and the Case I profit. The first step as laid down by the courts is not to look at the accounts but to ask what an accountant would have done. In this context that must mean an accountant working within the constraints of UK law and practice. So, whatever the accountancy principles under which accounts may actually be drawn up, the tax computation of a UK permanent establishment should always reflect UK GAAP.

This view, that UK accountancy standards apply regardless of the accountancy standards used in actually drawing up the accounts, was bolstered by the provisions of section 42 Finance Act 1998 which requires that profits be computed under Cases I and II of Schedule D on an accounting basis which gives a true and fair view. A true and fair view is provided when profits are calculated according to UK GAAP. Section 42(2) goes on to say that this does not require a person to comply with the requirements of the 1985 Companies Act except as to the basis of computation. So, although a foreign bank does not need to produce audited accounts which comply with all the Companies Act 1985 rules as to content and format, it does need to compute its tax profit as if it started from such accounts.

It follows that if permanent establishment accounts are drawn up using the local home country accounting standards, then any differences between those standards and UK standards must be considered and computational adjustments made to produce the same tax profit or loss as a computation based on UK GAAP.

13 BBA Examples

These are a series of questions put by the banking industry representative bodies to the UK Revenue during the course of consultation meetings in spring/summer 2002 to clarify particular issues and points. The UK Inland Revenue answers are reproduced below.

13.1 Example 1: branch which lends to corporate (retail customers)

Balance Sheet		**Profit and loss account**	
Loans to customers	1,000	Income @ 6 per cent	60
Funding from head office Free capital	1,000 nil	Interest expense @ 5 per cent	(50
		Pre-tax profit	10
Weighted risk assets	1,000		
Minimum Tier 1 capital @ 4 per cent	40		
Notional free capital say	40		
Average funding rate at 5 per cent	40		
BN25 disallowance (40x5 per cent)	2		

a) Is the form of calculation appropriate (i.e. disallowance = WRA x capital per cent x interest rate)?

b) Is 4 per cent minimum ratio appropriate to use?

Typically banks hold in excess of 4 per cent Tier 1 capital but some Tier 1 capital is tax deductible and bears interest in excess of normal funding rates.

Also banks typically hold at least 4 per cent Tier 2 capital mainly in the form of subordinated debt (which should be tax-deductible and which bears interest in excess of normal funding rates).

Hence taking the 4 per cent of regulatory minimum Tier 1 ratio would appear a reasonable proxy for a more detailed, time consuming and costly calculation.

Answer

a) We are trying to establish the amount of capital that the PE would have if it were a separate entity operating in the UK, and engaged in the same or similar activities in the same or similar conditions. This calculation would appear to provide an

answer, which could replicate the amount of capital and associated interest expense that the PE might have at arm's length so the form of calculation would appear to be appropriate.

b) Whilst we accept that the arm's length answer might fall within a certain range it seems unlikely that the answer will be a ratio of 4 per cent as most banks operate at a level of capital, particularly Tier 1 capital, considerably in excess of the minimum required by the FSA. and this implies more than the 4 per cent used in the above example. Nor do we accept that banks will normally have Tier 2 capital equal to Tier 1 capital or that Tier 2 will consist mainly of subordinated debt.

It is recognised that some banks can issue innovative Tier 1 capital (provided they meet the conditions set by the regulator, one of which is that they must have Tier 1 capital of at least 6 per cent) and that this innovative Tier 1 capital can carry funding costs, which may be tax deductible. On the other hand, it is also possible to have Tier 2 capital which is equity and which does not give rise to a tax deduction.

In larger and more complex cases it may be appropriate to consider the extent to which a PE engaged in the same or similar activities in the same or similar conditions would have innovative Tier 1 capital as well as considering the amount and nature of any Tier 2 capital. However a simpler approach based on the arm's length level of equity capital, as in this example, may be more appropriate for smaller cases but even in these instances it seems very unlikely that the arm's length amount will be as low as 4 per cent.

13.2 Example 2: branch lends to customers and banks

As in example 1, except half the loans are to banks and attract a 20 per cent regulatory weighting i.e. WRAs are 600 (500 x 100 per cent + 500 x 20 per cent).

In this case, would the disallowance be based on the 600 of risk assets i.e. interest disallowance of 600 x 4 per cent (capital ratio) x 5 per cent (interest rate) = 1.2?

Answer

Obviously the appropriate capital ratio will vary from case to case but, apart from this, and assuming that the assets of 1000 are correctly attributable to the PE and are appropriately risk weighted, then we agree that the answer should be 60 per cent of that arrived at in Example 1. (Note, though, that this does not imply we accept that the answer is 1.2.)

13.3 Example 3: branch funded by third parties

As in Example 1, except all funding is from third parties.

Is the same result expected i.e. disallow 2 of interest albeit in this instance it is third party interest expense, which is disallowed?

Answer

We are attempting to attribute an arm's length amount of capital to the PE in order to arrive at the correct attribution of profits. This applies equally whether the funding for the branch is directly from third parties or via head office.

If the branch has risk weighted assets of 1000, and requires say capital of 70 to support them then 70 of capital from the head office must displace 70 of the amount raised from third parties (along with the associated interest costs) leaving the balance sheet to show 1000 funding (including capital) and 1000 assets. The surplus 70 funds raised from third parties is then appropriately to be regarded as money raised by the branch for other parts of the PE. (See 9.2.12)

13.4 Example 4: branch which acts as deposit taker and lends to head office

Balance Sheet

Loans to head office	1,000
Funding from third parties	1,000

Will there be no capital imputation in this case (on the basis that there is no risk in lending to head office as legally they are the same entity)?
Alternatively, does the 'notional separate company' approach require there to be an implied credit risk on interbranch lending and capital imputation, and if so, how much?
[Note that any such capital imputation would almost certainly lead to double taxation.]

Answer

Three Taxation Issues recognises that there may be instances where a branch is doing little more than providing services as a conduit for funds. If the branch is within the applicable circumstances for such conduit transactions as envisaged in Three Taxation Issues then it may be regarded as a representative or a commission agent remunerated not by interest but by an appropriate fee or "turn". The size of the turn would be appropriately related to the expenses involved and the risks, which the branch has to bear. We envisage that no capital would need to be attributed to support such transactions.

Following on from representations that have been made we are prepared to treat not just conduit transactions (within the same entity) but all intra-entity lending as nil risk weighted for the purposes of calculating the capital attributable to the branch at arm's length. This approach recognises that branches are not in fact the same, either legally or economically, as subsidiaries and that to place too much emphasis on the strict application of the separate entity leg of draft new Section11AA (2), ICTA 1988, in isolation from the same or similar circumstances leg, would lead to a multiplication of the balance sheet of the entity.

13.5 Example 5: branch with assets not treated as UK assets for tax purposes

As in Example 1, except half of the loans are not treated as assets of the branch for UK tax purposes (i.e. the margin and any loan losses are not taxed/relieved in the UK).

In this case as the risk assets of the UK branch are only 500 (not 1000) would the interest disallowance be based on that figure i.e. a disallowance of 1 (500 x 4 per cent x 5 per cent= 1)?

Answer

Assuming that it is correct to treat only half of the assets as attributable to the PE then if it does have only half the assets/risk weighted assets of example 1, it will only require half of the capital and there will only be half of the interest adjustment computed using the form of calculation shown in Example 1. (Note, though, that this does not mean we agree that the adjustment should be 1, for the reasons explained in (b) of our comments on Example 1.)

13.6 Example 6: branch where assets are booked outside the UK

The corollary to example 5 would be where assets are treated as part of the UK branch for UK tax purposes but are not booked in the UK (e.g. due to a centralised loan booking policy). In this case, if there were 500 of such assets, would these assets be included in determining the UK branch’s capital requirement and interest disallowance?

Answer

Attribution of assets and the income associated with those assets is not to be changed by the capital attribution legislation and therefore assets and income will still be attributed to a branch in accordance with Article 7 of the OECD Model Tax Convention (as amplified by the guidance contained in the Commentary and Three Taxation Issues).

So the answer here is yes, if the assets are properly attributable to the UK branch for tax purposes then they must be included when determining its capital requirement and the interest disallowance flowing from that.

13.7 Example 7: branch with surplus free capital

Balance Sheet

Loans (and WRAs)	1,000
Funding from head office	900
Allotted capital	100

a) If the amount of capital required (for tax purposes) were 40, there would be no disallowance. Would there be a notional deduction for interest expense on the 60 of surplus free capital (note that such interest would have been deductible if less free capital had been in place)?

b) Alternatively, could the surplus capital be taken into account in prior or subsequent years where the branch may otherwise suffer some interest disallowance?

Answer

a) No, at least not where only UK domestic law was applicable. There would be no notional deduction for interest on the 60 “excess” capital. If the branch actually has capital of 100 then its position is not any different from that of an over-capitalised subsidiary. But where there was a treaty between the UK and the bank’s home country, an adjustment might be required under the business profits article if the UK branch had more capital than would be the case at arm’s length.

b) No. The capital of an entity supports its activities and the risks inherent in those activities and at arm’s length banks have to show the regulator that they have sufficient capital to support their activities and risks on an on-going basis. We are attempting to attribute capital to the branch as if it were a separate entity trading in the UK in the same or similar conditions and therefore it will also need to have sufficient capital to support its activities and risks on an on-going basis. Therefore it will not be able to use a surplus of capital in one year to frank a deficit of capital in another year.

13.8 Example 8: branch expanding or contracting in size

Opening balance sheet: as per example 1

Closing balance sheet:

Loans (and WRAs)	2,000
Funding from head office	2,000
Allotted capital	nil

a) Would the capital figure, and hence interest disallowance be derived from:

(i) the opening balance sheet
(ii) the closing balance sheet
(iii) a simple average of the opening and closing balance sheets
(iv) something more complicated?

b) If anything other than (i), would current year post-tax profits be allowed to count as free capital to reduce interest disallowance?

Answer

a) It seems unlikely that there will be many cases where we will see 100 per cent growth, or conversely a 100 per cent fall, in the level of assets in one year, so this may be a rather extreme example. The complexity and frequency of the interest disallowance calculation will depend on the facts in a particular case but we are not expecting this to be calculated on a daily, weekly or even monthly basis in most instances.

At one end of the spectrum there may be a branch with relatively little movement in the level of assets in the year and therefore relatively little movement in the amount of capital that would be required to support those assets. In such a case it might be appropriate to calculate the level of capital and any associated interest disallowance by reference to the level of assets at the end of the year and to use a weighted average of interest rates charged to the branch i.e. along the lines of the calculation in example 1.

Alternatively in cases where there are large one off spikes or dips in the level of assets then it might be appropriate to calculate the level of capital required to and from the dates of those events. For instance if in the example set out above the level of assets doubled in a particular period and then stayed more or less constant until the end of the year it might be appropriate to look at the level of capital required from the beginning of the year until the change in asset levels took place and then from that date until the end of the year. However if the level of assets rose fairly constantly from the start of the year until the end of the year then an average of the year-end levels of assets might be more appropriate.

Overall what we are attempting to arrive at is a pragmatic calculation, which reflects the facts of a particular case.

b) If we were considering a subsidiary company carrying on a banking business then it could only count retained profits after an audit. There are clearly difficulties in replicating this in the branch situation and therefore we propose to accept that post tax profits could be included in the calculations of free capital to the extent that these funds have been kept in the UK and not remitted to head office. Where there are retained losses these should also be taken into account (as they would be by the regulator), and they will effectively increase the amount of capital that needs to be attributed to the branch.

In cases where it is appropriate to undertake a more detailed calculation of the amount of Tier 1 and Tier 2 capital that the PE would have if it were engaged in the same or similar activities in the same or similar circumstances (see example 1) then it may also be appropriate to take into account reserves and general provisions to the extent to which these would be taken into account by the regulator (for instance general provisions, that is, funds held in reserve against losses which have not yet been identified, are included in Tier 2 capital up to a maximum of 1.25 per cent of the sum of WRAs).

13.9 Example 9: branch with only off balance sheet business and minimal funding costs

Balance Sheet negligible but substantial off balance sheet risks (e.g. letters of credit) leading to weighted risk assets of 1,000.

a) Assuming the branch has nil interest costs, would there be nil interest disallowance?

b) Alternatively, would a notional disallowance be calculated as in Example 1, leading to a tax adjustment (i.e. notional income) of 2?

Answer

It seems unlikely that we will see this situation in practice, i.e. a branch with only off balance sheet risks. However as the inherent riskiness of this business is the same as in example 1, then assuming that we would in reality have some funding cost in the branch then we would expect the same answer as derived in example 1. (Note, though, that we do not accept that this answer would be 2 as computed there, for the reasons explained in (b) of our comments on Example 1.)

It should be borne in mind that we are trying to establish the amount of profit to be attributed to the branch and the attribution of capital is just one part of this process. Therefore even if there is no funding cost we will still want to attribute to the branch the amount of capital that it would have if it were a separate entity trading in the UK

in the same or similar conditions, and then to follow through the consequences of having done so.

So if, as in this example, the branch has risk weighted off balance sheet assets of 1000 (and we assume for simplicity's sake that it had assets of 1000 effectively risk weighted at 100 per cent) and at arm's length it would require capital of say 70 to support those assets then (as in example 3) the 70 capital from head office would firstly displace head office and/or third party funding costs incurred by the branch. If there are no such funding costs then the capital of 70 could be seen as giving rise to additional income (on the basis that funds would have been lent to Head Office or another permanent establishment), probably at the inter bank rate.

13.10 Example 10: branch with a trading book (minimal funding costs example required)

a) A branch whose only activity is a global trading book, with a capital requirement of 100. If only 20 per cent of the profits of this book are attributed to the UK branch under transfer pricing, would only 20 (20 per cent x 100) of capital be attributed to the UK branch in respect of its risks from this activity?

b) If the book were booked in the UK branch accounts (with 80 per cent of profits transfer priced out of the UK) would the branch be entitled to exclude 80 of the 100 capital requirements in determining its capital requirement?

c) If the amount of interest disallowance on imputed capital exceeds the total interest expense claimed for the year, would the branch be required to recognise notional income for UK tax purposes?

Answer

a) Essentially yes, if the UK is only properly entitled to 20 per cent of the profits from the global trading activities then it makes sense that only 20 per cent of the capital required to support those activities/risks is attributable to the UK.

b) Assuming that the UK is only properly entitled to 20 per cent of the profits and that it is appropriate to treat the other 80 per cent as arising elsewhere then again the answer would be yes.

c) Given the 2 answers above this scenario should not arise in either a) or b) of this example.