

**BIAC Comments on OECD Revised Commentary on Article 7 of the  
OECD Model Tax Convention**

**July 31, 2007**

BIAC is pleased to provide the following comments and suggestions to the proposed Revised Commentary on Article 7 (dated 10 April 2007) (referred to herein as the “Revised Commentary”).

The Revised Commentary, in general, brings new clarity to the direction of the OECD’s work in the area of attribution of profits to a permanent establishment and the issues that arise in this area. They are, by definition, interim in that additional changes in the Model Convention and the Commentary for future application are anticipated, but they illustrate various broad issues that are appropriately raised now. This set of comments addresses these broad issues and also, in an Appendix, addresses specific paragraphs of the Revised Commentary.

There are three overarching procedural features of the Revised Commentary that frame our comments.

- First, several of the matters raised below arise because of the uncertainty over the “legal effect” of the Revised Commentary in treaty law and practice.
- Second, it appears to BIAC that there are many provisions in the Revised Commentary that have not been resolved fully and definitively by the CFA, but nevertheless the document puts them forth as fully developed.
- Third, various new administrative burdens and implementation issues are introduced without apparent justification (see comment numbers 6,7,8).

The effect of these two points is to put taxpayers at greater risk of double taxation in this area because they will be in the middle between the tax authorities that may easily (and under the new Commentary language perhaps justifiably) act in different ways.

We believe that concepts should not be introduced without strong consensus both as to the substance and to the commitment to implement them in treaties or treaty-related proceedings (such as competent authority or other mutual agreement procedures and arbitration.)

**GENERAL COMMENTS**

*1. Relief from Risk of Double Taxation and the Principle of Symmetry*

The business community continues to believe very strongly that it is absolutely essential that the Revised Commentary express a firm commitment to the full relief from double taxation that may arise as a result of the attribution of income to a permanent establishment.

As noted in the text for revised paragraph 43 potential double taxation is particularly evident in the context of the attribution of free capital which could lead to denial of interest expense deductions in calculating taxable income of a permanent establishment. For example, the

“quantum of interest deduction” allowable between host and resident countries is not a mere theoretical matter.

As currently drafted, the Revised Commentary contains insufficient language and mechanisms to prevent double taxation. Paragraph 44 addresses the potential for double taxation in the context of “different acceptable approaches for attributing ‘free’ capital to a permanent establishment.” It provides that the host country’s determination prevails if (i) the host state is using a method that is dictated by its domestic law, (ii) the host state and the residence state agree that the host state domestic law is consistent with an OECD authorized approach for attribution of capital, and (iii) the host state and the residence state agree that the host state method “produces a result consistent with the arm’s length principle in the particular case.”

We recognize that the issue of symmetry and relief from double taxation is a difficult one, and that this issue extends beyond the interpretation of Article 7. However, the difficulty of the issue does not justify putting into the Commentary concepts that, as a practical matter, may not be effective in meaningfully addressing the potential double taxation because they do not prevent tax authorities from taking inconsistent views, or concepts that may have unfortunate collateral consequences if applied in other contexts.

At a minimum, we believe that the Revised Commentary should contain an unambiguous statement that the relief from double taxation contemplated by the Model Treaty requires that the host country and home country reach a common understanding regarding the amount of income, the amount of interest expense and the amount of free capital to be attributed to a particular permanent establishment. We have been surprised by public statements in some countries implying that treaty obligations to relieve double taxation do not require full agreement on the amount of income and the amount of deductions attributed to a particular PE.

The business community categorically rejects the notion that flexible foreign tax credit cross crediting provisions provide an acceptable substitute for a complete mutual agreement as to the amount of income properly attributable to a specific permanent establishment. We urge the OECD and each of the member countries to reject such a view, and to categorically affirm a full commitment to relieve double taxation directly through mechanisms that lead to a mutual agreement between the home country and the host country on the amount of income and related expenses subject to tax in the PE jurisdiction.

The OECD must take a strong and unambiguous position in support of relief from double taxation so that this 10-year undertaking will maintain its credibility.

Our complete support of the goal of having the host country and the home country reach a full agreement on the income and deductions to be attributed to the permanent establishment leads business to support the impulse motivating the adoption of the symmetry principle described in the Revised Commentary. Nevertheless, we have reservations regarding the specific mechanism of home country deference to host country methodologies espoused in the Revised Commentary.

We question the premise that sound tax treaty policy supports the adoption of a uniform rule of home country deference to host country determinations as a principle of general treaty interpretation. In particular, the adoption of such a principle in the general context of the selection and application of transfer pricing methods under Article 9 would, in our view, be extraordinarily unwise and highly objectionable. We are concerned that it is only a short step from the adoption of the rule of home country deference in the context of the selection of the method for the attribution of free capital to a PE, to a more general application of such a rule. Adoption of a rule of home country deference in the entity characterization context seemed a sound and helpful idea; however, adoption of the same principle here may create a trend that is hard to resist in other contexts where a rule of home country deference to host country determinations could prove unwise.

If, notwithstanding these concerns, the determination is made to adopt the rule of home country deference in the Revised Commentary, we strongly suggest that great pains be taken to be clear that this rule has limited application only to the single issue of the allocation of free capital and the resulting attribution of interest expense.

Furthermore, as it is currently drafted, we are concerned that the rule of home country deference, dependent as it is on mutual agreement that the result of the host country methodology is consistent with arm's length dealing, may prove to be ineffective in driving true relief from double taxation. It is never difficult in practice for one country to argue that the result of another's methodology is non-arm's length, in which event the matter must be resolved through the MAP process in any event. Accordingly, we doubt that there is sufficient benefit in the rule of symmetry expressed in the Revised Commentary to warrant the risk that home country deference to host country determinations could become, bit by bit, an unhappy general principle of treaty interpretation.

Notwithstanding the foregoing comments, we understand very clearly the difficulties inherent in finding a more effective approach than the one proposed. It is an unfortunate consequence of the decision to permit multiple approaches to the attribution of free capital that disputes will arise, and that purely procedural responses to those disputes may prove inadequate. Arguments that calculations made under one "approved" methodology are more "arm's length" than calculations made under another "approved" methodology are unlikely to be consistently resolved on any principled basis.

Given that circumstance, we strongly suggest that the drafters consider, in lieu of the rule of deference contained in the Revised Commentary, the adoption of a principle that both home and host country in MAP proceedings will defer to a free capital attribution methodology adopted by the taxpayer provided, (i) that methodology is consistent with one of the approved methodologies in the Report, and (ii) is consistently applied by the taxpayer on a global basis so that neither double taxation or double non-taxation can arise. We remain convinced that any other approach to this problem will ultimately lead to double taxation because of the many opportunities for methodological and factual disagreement in applying the principles of Article 7 and the Report.

## 2. *Legal Effect of the Revised Commentary*

In addition to the specific substantive and procedural problems of the way the Revised Commentary is constructed relative to double taxation possibilities, it also raises a very serious treaty legality issue. Courts and others rely on the Commentary for guidance in interpreting treaties. The consequence of ambiguous guidance is to leave the taxpayer in the middle, subject to potentially conflicting approaches by the tax authorities with which it deals on cross border matters. This creates a new uncertainty in treaty matters. Multinational enterprises have no way of determining whether this revision to the Commentary is effective for existing treaties and or whether parties to existing treaties even agree on whether this Revised Commentary is applicable. What happens when the host tax authority says this approach is applicable but the tax authority of the residence says this approach is not applicable?

For example, the IRS Associate Chief Counsel (International) has stated that the authorized OECD approach only applies to a treaty that expressly provides for its application. Suppose the US is the country of residence but the host country interprets the treaty otherwise. Since the Commentary reflects the intentions of treaty partners, conflicting views among treaty partners as to whether the Revised Commentary apply to existing treaties or whether specific concepts under the Authorized OECD Approach are incorporated in existing treaty would affect which treaty partner (home or host country) must give relief from double taxation.

At a minimum, the Revised Commentary should clarify whether the CFA considers these revisions to be incorporated into existing bilateral treaties or intends a process by which

these revisions are to be incorporated into existing bilateral treaties. In addition, any reservations of any country with respect to the incorporation of these proposed revisions into the Commentary should accompany the adoption of updated Commentary that incorporates these proposed revisions.

One way to help address this is for each member state of the CFA to put into the official record of the CFA or of their domestic law, their position on the applicability of the Revised Commentary changes and what actions (audit, treaty negotiation or otherwise) they intend to take to with respect to them.

### 3. *Treatment of Intangible Assets*

The decision of the drafters to selectively implement some parts of the Report in the Revised Commentary, while retaining other sections of the existing commentary largely unchanged, leads to results that cannot be defended as being consistent with the language of the Model Treaty or sound treaty policy. In particular, the decision to retain largely unchanged the material in new paragraph 30 relating to intangible property, while simultaneously including the provisions of the Report relating to dependent agent permanent establishments in the Revised Commentary, gives rise to highly anomalous and economically unsupportable results.

As we read the Revised Commentary, a non-financial services entity would apply the following rules in allocating income and deductions to a permanent establishment. Business risks not related to intangible property would be allocated between the home office and the PE based on the significant people functions related to assuming and managing the risk. Tangible assets would generally be allocated based on location under the principles set out in the Report. The provisions of the Report related to intangible assets, however, would not be implemented and such assets (and the commercial risks and costs associated with such assets) would be allocated on some pro rata basis between the home office and the PE, presumably based on use rather than based on the location of significant people functions related to the development and protection of the intangible. (Paragraph 30 provides no guidance on the meaning of "use" in this context.) Income and expense would then be attributed to the PE by applying the Transfer Pricing Guidelines by analogy on the basis of the foregoing allocation of risks and assets.

Assume the existence of an Irish or Swiss principal company subsidiary of a US based multinational, and further assume that the principal company owns legal and beneficial ownership rights to product intangibles throughout Europe by virtue of its investments in R&D and marketing.<sup>1</sup> Assume further (arguendo) that the principal company has a dependent agent PE in Country A by virtue of the activities of a sales affiliate incorporated in that jurisdiction. Finally, assume that the dependent agent sales company has no personnel in Country A who are in any way involved with research and development activities that lead to the creation of product intangibles.

Under these circumstances the Revised Commentary would appear to suggest that the dependent agent PE would be deemed to "own" any business risks of the principal where the significant people functions related to the risks are undertaken by the dependent agent. It would also be deemed to own any tangible assets of the principal company located in Country A (these would be negligible in most circumstances). These asset and risk allocations are consistent with the principles set out in the Report.

However, the principles of paragraph 30 of the Revised Commentary would seem to most easily be read to treat the dependent agent PE in Country A as also owning a pro rata share of the intangible assets of the principal company (as well as the risks related to those

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<sup>1</sup> Such ownership could arise by virtue of the participation of the principal company in a bona fide cost sharing arrangement or by virtue of the principal itself having conducted R&D and / or

intangible assets). This allocation of intangible assets to the dependent agent PE would appear to result notwithstanding the fact that no individual employee of the enterprise (either of the principal company or the dependent agent sales company) located in Country A played any role at all in the development of the intangible assets and notwithstanding the fact that no entity in Country A made any financial contribution toward such development.<sup>2</sup> The Revised Commentary would, therefore, seem to expand the taxing jurisdiction of Country A to include a right to tax income derived from assets developed entirely outside of Country A, which have no functional relationship to Country A, and in which no person in Country A has made any financial investment.

Granting Country A the right to tax intangible property related income generated through economic activity taking place wholly outside of Country A is clearly inconsistent with the principles set out in the Report. It is also completely inconsistent with the separate entity approach to allocation espoused in Article 7(2). One would anticipate that the residence jurisdiction of the principal company would strenuously object to Country A's claim to tax income generated through economic activity taking place wholly in the residence jurisdiction. The result is simply wrong.

Moreover, the result is one that was specifically rejected in the process of drafting the Report. Early versions of the Report contained suggestions that intangible assets should be allocated on the basis of the place of use. After business comment at public consultations, the drafters expressly acknowledged that such treatment was improper and modified the language in order to allocate intangible assets on the basis of the significant people functions associated with the development and protection of the intangible assets in question. Having expressly acknowledged the inconsistency of a place of use rule for intangible assets with sound application of the existing language of Article 7(2), the OECD should not now backtrack and accord source countries the right to tax intangible property related income in situations where the source country plays no role in the creation and protection of that property. It certainly should not do so merely because the place of use rule is an artefact of the prior commentary.

The posited result arises purely because the Revised Commentary insists on mixing new and old principles without adequate consideration of whether the result of such a brew makes sense. The business community strongly urges the drafters of the Revised Commentary to reconsider the consequences of the retention in the Revised Commentary of new paragraph 30 in conjunction with those new income allocation principles that are included in the Revised Commentary. Even if the Revised Commentary is to be effective only on an interim basis, it should contain rules that make sense on an integrated basis. The treatment of intangible assets in the Revised Commentary fails that test.

#### 4. *Concern Regarding Inconsistencies between the Proposed Revisions and the 2007 Report*

The proposed revisions refer to the Report on Attribution of Profits as providing guidance but also indicate that the Report is not fully consistent with the Revised Commentary. Proposed Paragraph 7 states that the Report on Attribution of Profits, "to the extent that it does not conflict with the Commentary, provides guidelines for the application of the application of the arm's length principle incorporated in the [revised] Article." The Revised Commentary essentially abdicates its responsibility to clarify what portions of the Report are

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<sup>2</sup> The fact that paragraph 30 might require costs related to intangible property development to be allocated to and deducted by the dependent agent PE does not adequately address the problems raised by these rules. Uniquely in the case of intangible property, the associated development costs will often be incurred over many years, often including years preceding the assertion of a claim by Country A tax authorities that a dependent agent PE exists. Thus, even if current year expenses related to R&D are deductible in Country A under paragraph 30, Country A could well be claiming taxing rights over the fruits of expenditures for which it is not required to grant a deduction.

incorporated as consistent with the Commentary and what portions are excluded as inconsistent with the Commentary. If any portion of the Revised Commentary is inconsistent with the Report, as the drafters appear to believe, then the Revised Commentary should contain an affirmative enumeration of those portions of the Report that are not currently effective. Otherwise, those portions of the Revised Commentary incorporating elements of the Report by reference become hopelessly confusing and a certain source of future controversy.

We are also concerned about the legal effect of and inconsistencies in concepts introduced for the first time to the commentary in these revisions (para 22, most of 41, and 42-44).

5. *Concern Regarding Country Reservations*

If Article 7 were revised to be consistent with the Report and if the Revised Commentary at that time states that the Report “provides guidelines for the application of the arm’s length principle incorporated in the [revised] Article,” the Report should then be revised to include reservations of the OECD member countries (and non-OECD member countries) with respect to the Report. (Similarly, if the CFA were to conclude that the Report does not conflict with this revised Commentary and therefore “provides guidelines for the application of the application of the arm’s length principle incorporated in the [revised] Article,” the Report should also be revised to include reservations of the OECD member countries (and non-OECD member countries) with respect to the Report.)

6. *Use of Functional Analysis*

Although new Paragraph 18 consists essentially of language from old Paragraph 12.1 and is therefore not an objectionable revision, it still contains troubling language that should be changed in the Revised Commentary. Specifically, it states that agreements can be ignored if they reflect “purely artificial arrangements instead of the real economic functions of the different parts of the enterprise.”

As an example, the Revised Commentary identifies “where a permanent establishment involved in sales were, under an internal agreement, given the role of principal (accepting all risks and entitled to all the profits from the sales) when in fact the permanent establishment concerned was nothing more than an intermediary or agent (incurring limited risks and entitled to receive only a limited share of the resulting income) or, conversely, were given the role of intermediary or agent when in reality it was a principal.”

These are easy distinctions to make linguistically, but very difficult to apply in commercial facts and the proposed revision gives no guidance on how the determination is to be made. In the absence of such guidance, the language is essentially an invitation to a taxing authority of a host jurisdiction to conclude that the permanent establishment in the host jurisdiction is, in the case of a profitable business, the principal or, in the case of a losing business, the agent, and for the taxing authority of the residence jurisdiction to take the opposite position.

This example should be deleted in its entirety.

7. *Concern Regarding Compliance if a MNE is Deemed to have a PE*

In the Report on profit attribution a clear separation is made between the definition of a PE (Article 5) and the profit attribution to that (deemed) PE (Article 7).

Currently, there is a great deal of debate and many differences of opinion concerning what exactly constitutes a PE. Therefore MNEs may often find themselves in a position where tax authorities deem the MNE to have a PE although they did not intend to have one.

If the documentation requirements included in the Report on the attribution of profits to PEs are fully adopted by the OECD and an MNE is ultimately deemed to have a PE, it will not have complied with all the documentation requirements as outlined in this report. Any future

OECD publications relating to these documentation issues should be clear that a taxpayer that prepares appropriate documentation based on its reasonable interpretation of the PE standard should not be treated as having failed to satisfy its documentation obligations merely because it is ultimately held to have a PE in the country in question.

8. *Concern about the Level of Work Required Regarding Documentation of Profit Attribution to PEs*

We are pleased to see language in the Revised Commentary that acknowledges the burden that the multitude of rules have imposed on taxpayers, but we do not see that there have been any specific or effective proposals to reduce that burden significantly. Concern about the level of work required to properly document the profit attributable to a PE, especially since the documentation effort requires very sophisticated analyses (attribution of (free) capital and possibly intellectual property). These types of analyses are relatively new, complex and challenging. However these types of analyses are not yet fully embedded in current TP practice.

It remains the question if this additional work provides more comfort to the taxpayer and security/certainty to the tax authorities or whether these analyses only provide for more discussion because of the technical difficulties that will lead to discussions between tax authorities with different incentives. If this leads to lengthy discussions the concern for double taxation and/or lengthy and costly arbitration procedures is again reinforced.

9. *Relation to Controlled Foreign Company Provisions*

BIAC believes that Paragraph 13 is too broad an endorsement of domestic CFC regimes in light of the other principles used in the Commentary. Suppose that a country introduced a CFC regime that effectively taxed a resident company on all profits of foreign subsidiaries. That would be totally disproportionate. It would effectively seek to undermine fair tax competition through general lower tax rates, something OECD has said it supports or at least does not view as harmful. Surely CFC legislation should only be regarded as not contravening Article 7 if it is proportionate to its legitimate target of countering tax avoidance? This would be in keeping with the Cadbury decision by the ECJ in the EU context. Recent discussion materials presented on this topic in the UK indicate that the problematic nature of CFC rules relative to Article 7 are continuing.

10. *Relation to EU law*

Paragraph 2 of the Revised Commentary reinforces that profits of PE should be determined as if the PE had been a separate enterprise. EU freedoms may be interpreted in a way that a PE of a foreign EU country should not be discriminated as compared to a domestic establishment of a company. E.g. taxation of dealings such as internal transfer of property could be questioned since such dealings are usually not taxed when both the local establishment and its head-office are located in the same country (current exit tax debate within the EU). Consideration should be given to addressing the potential conflict issue with the EU freedoms in the Revised Commentary.

## APPENDIX

### SPECIFIC COMMENTS ON PARAGRAPHS OF THE REVISED COMMENTARY:

**Para 10:** We support the rejection of the Force of Attraction idea because it is not consistent with the separate entity approach. The PE should only be taxable for income that can be attributed to the economic substance of the PE (based on significant people functions, Part 1).

**Para 11:** Suggest adding to the last sentence “ ... (or vice versa)”. Just to ensure there is no doubt this works both ways.

The case of loss in the PE should also be mentioned, e.g. “symmetrically a loss can be attributed to the PE even though the enterprise as a whole has made a profit”; such a loss should follow the same treatment as loss incurred in a company in the State of the PE.

**Para 14:** Besides the main question of the deemed deal between the PE and the head office (HO), there can be the case of two actual deals made with the same customer, the one by the HO (for example sale and delivery of an equipment) and the other one by the PE (e.g. starting the whole equipment and maintaining it). According to new § 10 the profit made by the HO will not be attracted by the State of the PE. However, the tax administration will be tempted to challenge the amount of profit allocated to the sale and delivery on the one hand, and to the settling and maintenance in the other hand just because there is only one entity in front of the customer.

**Para 15:** We applaud the approach that consists in starting with the accounting data of the entity to measure the profit of the PE. Only when those accounts prove improper can the tax administration try and find another valuation.

**Para 17:** We agree that a functional analysis is at the basis of any proper valuation of the PE's taxable profit. However, the functional analysis should consider the activities of the PE in the context of the activities of the enterprise as a whole only to the extent the latter are in relation with the PE's activities.

**Para 18, 7th line:** “... , these trading accounts could be accepted by the tax authorities”. Suggest to replace 'could' with 'should'. As the sentence basically assumes the situation is in accordance with economic reality/functions performed, there should be no reason to limit the acceptance.

**Para 19:** Accounting records are more than a "useful starting point" but a "necessary starting point". However, documentation doesn't need to be contemporaneous as underlined by the 95's Guidelines.

**Before new Para 20: former Para 14 suppressed:** We think that the first half of this paragraph is still of interest in describing some actual cases or situations.

**Para 22:** Taxation of the PE resulting from a dependent agent. We agree on the separation of the two potential taxpayers: the dependent agent and the enterprise having a PE. Language should be added in this paragraph of the Commentary that the functional and factual analysis described in this paragraph is not intended to provide any inference as to whether or not a PE exists under Article 5(5), nor is the Commentary intended to lower the P.E. threshold. The Commentary acknowledges that the existence of a PE under Article 5(5) requires an independent analysis.

**Para 26:** The statement in new Paragraph 26 to the effect that Paragraph 3 of Article 7 determines which expenses are allocable to a permanent establishment, but does not do so on the basis of tax deductibility of such expenses, is too limited. By allocating such expenses to the permanent establishment, Article 7 is requiring that, in computing the taxable income of such permanent establishment, the host jurisdiction treat such expenses as deductible to the same extent that it would treat such expenses as deductible if incurred by a resident. Otherwise, attributing the expenses becomes meaningless.

As currently worded Paragraph 26 is too broad and could cover far more than it is intended to cover. The paragraph is intended to permit states to apply their normal statutory limitations on deductions for things like Travel and Entertainment, Company Cars and to use their own statutory depreciation regimes for fixed assets. However, as worded the scope is far broader and may allow deductions to be disallowed to the PE where such an action is not in accordance with the commentary. For example, the lack of an invoice could be used to deny a deduction under local law and would be clearly inappropriate in this case.

Since an entity cannot contract with itself it is also highly unlikely to invoice itself but might rather rely on less formal ways of documenting the allocation of head office expenses to the PE. It is important that the article place some limits the ability of member states to deny deductions for expenses properly attributable to the PE. Such limits should make clear that deductions for head office expenses properly charged to a PE should not be disallowed because they occurred at the head office. Deductions for these expenses should be allowed to the same extent that they would be allowed to a domestic enterprise.

**Para 37:** The analysis of the "internal loan" creates a discrepancy with the general approach:

1. The exclusion of "internal loans" from the deemed dealings that are otherwise taken into consideration is not well grounded.

A financial loan is a dealing as other sort of dealing and must be treated equally in the new commentary.

If the PE had been a separate and distinct enterprise, a loan could have been agreed between enterprise 1 (HO) and enterprise 2 (PE). It does not mean that all the accounts between those two enterprises (either trade creditor, trade debtor or others) have to be analysed as a loan. What must be analysed as a loan is the debt the enterprise 2 (PE) would have contracted either with a third party company or a bank, and at which conditions. This is a pure factual analysis that must be conducted without any prejudice.

Then, the "internal loan" is in agreement with the 2006 Report on attribution of profits to PE approach and can be regarded as a deemed dealing between HO and PE, dealing whose conformity with the arm's length principle should be checked. The computed interest on such loan will be a component of the profit to be attributed to the PE, as opposed to the sharing of an interest actually paid to a third party.

One should take the opportunity of this re-writing of article 7 commentary to grant the "internal loan" the status of all the other internal dealings.

2. The limitation of the interest payment to the allocation of effectively paid interest between the HO and the PE is not better grounded.

It is in contradiction with the provision of § 11 which states that allocation of profit to PE must be determined by a direct valuation and should not result from a mere sharing of a global profit between HO and PE.

3. The "free capital" mechanism is not adapted to a non-financial business.

It is not applicable in practice and it is grounded on concepts that do not apply to such business, all the more than, at the end, it is used to a mere allocation of actually paid interest and not to the determination of the fair financial charge attributable to the PE.

The concept and mechanism of "free capital" has been developed in the 2006 Report in order to estimate the fair level of equity that the PE, if a separate and distinct enterprise, would have needed.

Such study was initiated when the parts II and III of the 2006 Report were prepared and the experience of the financial sector was used to build up the "free capital" concept and mechanism.

The "free capital" valuation is based on concept and experiences typically attached to the finance industry and which are not found in the non-financial sector.

The principle stated in new Paragraph 41 of the commentary is: "under the arm's length principle a PE should have sufficient capital to support the function it undertakes, the assets it economically owns and the risks it issues."

The free capital determination results from a complex and complicated process that can be summed up as follows:

### **Measuring the risk and valuating the assets attributed to the PE**

As said in Paragraph 142 of the 2006 Report: "Enterprises that are not banks or non-bank financial institutions are less likely to measure risks and value assets for business purposes on a day-to-day basis and will not be subject to regulatory requirement requiring them to do so". We agree with such a statement and would add up that the above valuations are not only not done but also not doable.

The functional analysis, which is the only method to be used in those circumstances, will provide us with the functions and risks to be attributed to the PE.

The asset to be attributed in whole or in part to the PE is a more difficult task.

Valuation of fixed tangibles assets raises not much difficulty.

Valuation of intangibles is difficult in itself but in the present case it could introduce a "vicious circle": most valuation methods are based on the capitalization of an income and, precisely, the "free capital" determination tries to extract an income from the valuation of the assets.

There is no valuation of business risks in the companies and we are not aware of method available for that.

### **Determining the "free capital" needed to fund the assets and support the risks attributed to the PE**

This is the area where the non-financial enterprises are completely different from the financial ones. Indeed there is no rule commonly accepted which would link the value of assets and risks to a certain level of capital.

Tangibles fixed assets can be financed either by equity or by borrowings, dedicated or not, and there is no general rule on the proportion to be found between the two sources of financing.

Intangibles assets, which are those that bear the largest importance in the allocation of profit, are normally not financed at all in the balance sheet, unless they have been purchased from a third party. Most of the time, the valuable intangible assets have been created within the enterprise and all of them are not protected assets as trademarks and patents are.

Risks linked with the business are hardly measurable and they are normally not taken into accounts in designing the several sources of financing the enterprises.

Therefore, there is no possibility in practice to determine what would be the "free capital" need to fund the assets and risks attributed to a PE in a non financial enterprise.

**Para 46:** Suggest adding to the last sentence after "practical reasons to estimate the arm's length profits" the phrase "based on other methods." In some cases accounts are not prepared at the time, and profit allocation based on apportioning profits to a PE by reference to the total profits of the company may not be appropriate/desirable. By adding this wording we would leave some room for a practical solution in these situations.