COMMENTS CONCERNING PROPOSED GLOBAL DEALING REGULATIONS

UNDER SECTIONS 482, 863, AND 864

The following comments are the individual views of members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

These comments were prepared by individual members of the Committee on Foreign Activities of U.S. Taxpayers, the Committee on U.S. Activities of Foreign Taxpayers, and the Committee on Affiliated and Related Corporations. Principal responsibility was exercised by William W. Chip, Chairman of the Transfer Pricing Subcommittee of the Committee on Foreign Activities of U.S. Taxpayers. The comments were reviewed by Alfred C. Groff of the Section’s Committee on Government Submissions and by Michael Hirschfeld, Council Director for the Committee on U.S. Activities of Foreign Taxpayers.

Although members of the Section of Taxation who participated in preparing these comments have clients who would be affected by the federal tax principles addressed by these comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

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Date: August 29, 2000
EXECUTIVE SUMMARY

The proposed regulations determine the source of income from a global dealing operation and specify methods for determining the arm’s length allocation of that income among participants in the operation. The proposed regulations define a global dealing operation as the execution of customer transactions by a dealer in securities, derivatives, or foreign currency whenever any related activities (such as marketing, pricing, brokering, or risk management) are performed by a corporate affiliate of the dealer or by a foreign qualified business unit.

The principal suggestions in these comments are (1) that the definition of dealer be expanded to include dealers in financial products that would be section 475 dealers if the products were securities, (2) that the applicability of the specified transfer pricing methods to services be clarified by examples, and (3) that the treatment of capital when overall trading losses occur be reconsidered and clarified. The comments do not address several important policy issues, such as sourcing by reference to qualified business units and the treatment of interest in profit split formulas, in light of the extensive comments on those policies submitted by industry organizations.

COMMENTS

1. Section 1.482-8(a)(1) of the proposed regulations provides that section 1.482-8 determines the allocation of income from a global dealing operation among the “participants” in the operation. Section 1.482-8(a)(2)(i) defines “global dealing operation” as the execution of customer transactions in “financial products”, without defining “financial products”. Section 1.482-8(a)(2)(ii) includes within the definition of a global dealing “participant” only a “regular dealer in securities” or an affiliate of such a dealer, while section 1.482-8(a)(2)(iv) defines “securities” as including only section 475(c) securities plus foreign currency. We interpret these
provisions to mean that a global dealing operation may include dealing in financial products that are not securities, but only if the dealer is a regular dealer in securities. Given the rapidly changing nature of financial products, inclusion of dealing operations in products that are not section 475 securities is a sensible rule. However, we do not see any reason why the regulation should not cover dealers in non-security financial products that are not regular dealers in section 475 securities, provided that the dealers would qualify as section 475 dealers if their products were securities.

2. Example 4(i) of section 1.482-8(b)(5) of the proposed regulations states that TS adjusts the prices of its controlled transactions with T “so that it receives the same 4 basis point spread . . . that it would earn on comparable [uncontrolled] transactions”. Although “it” seems to refer to TS, the only other reference in the example to a 4-point spread is to the spread earned by T on its own uncontrolled transactions. Although the example illustrates an important principle, it would be helpful if the origin of the 4-point spread that the example uses as a benchmark for controlled transactions were clarified. This could be done simply by substituting ‘TS’ for ‘it’ in the quoted language.

3. The proposed regulations do not preclude the use of the comparable uncontrolled financial transactions method, the gross margin method, or the gross markup method to determine an arm’s length price for services, such as the services rendered by a selling entity to a regular dealer in securities. However, all of the examples of these methods in the proposed regulations describe only the sale of property or the entry into a derivatives contract. It would be helpful if the final regulations included some examples showing whether and how those methods could be applied to determine an arm’s length price for services. Some examples distinguishing
“service income” from “trading profits” would also be useful, since the regulations make this distinction and the concepts are sometimes difficult to distinguish.

4. Example 2 of section 1.482-8(e)(8) of the proposed regulations, which concerns the total profit split method, hypothesizes that traders are paid the same as marketers in a particular country, even though the traders “contribute substantially more to the profitability of the global dealing operation”. There is at least the appearance of inconsistency in this hypothesis, since the adjusted compensation of traders and marketers is then used as the measure of the relative contributions to profitability by the various global dealing participants. Expanding this example to explain the basis for its hypothesis would be helpful.

5. Example 3(v) of section 1.863-3(h)(3)(v) of the proposed regulations, which concerns the residual profit split method, states that amounts allocated to the global dealing participants that employ marketers and traders “is [sic] sourced according to the residence of each participant”. Since those participants are providing a service to the securities dealer participant, this statement seems to contradict proposed section 1.863-3(h)(2). Given the longstanding and broadly accepted principle that personal services income is sourced where the service provider is located, we recommend that this seeming contradiction be resolved in favor of proposed section 1.863-3(h)(2), so that services income will be sourced in the country where the marketers and traders are located, without regard to where the entity that employs them is domiciled.

6. Section 1.864-6(b)(2)(ii)(d)(3) of the proposed regulations provides that foreign-source interest or dividend income shall be treated as “attributable to the foreign corporation’s U.S. trade or business” only if and to the extent that the interest and dividends would be treated as U.S. source if section 1.864-3(h) were to apply to such amounts. This provision could be read
to imply that attribution to a U.S. trade or business is a sufficient nexus to make foreign-source dividends and interest of a foreign corporation taxable in the United States. However, IRC section 864(c)(4) provides that such income is taxable only if the foreign taxpayer has “an office or other fixed place of business within the United States” and the income is derived “in the active conduct of a banking, financing, or similar business within the United States or is received by a corporation the principal business of which is trading in stocks or securities for its own account”. We recommend that proposed section 1.864-6(b)(2)(ii)(d)(3) be made consistent with section 864(c)(4) by referring to the foreign corporation’s “U.S. fixed place of business” rather than to its “U.S. trade or business”.

7. Example 5(iv) in proposed section 1.482-8(e)(8) implies that capital is a routine contribution that should be compensated prior to splitting residual profits or losses among participants providing other, nonroutine contributions. An unstated implication is that the provider of capital in a global dealing operation should be compensated by the other participants, mainly those that employ traders and marketers, should any net trading losses be incurred. Can this be right when the very function of capital in a global dealing operation is to assume the risk of loss? Indeed, in the real world (e.g., hedge funds) it is more common for the owners of capital to bear all trading losses and to receive, in compensation, the lion’s share of trading gains. Economically, the share of income and loss attributable to the provision of capital depends on the legal arrangements between the global dealing participants. In principle, parties dealing at arm’s length could agree that the capital provider bears none, some, or all of the risk of loss, provided that the capital provider was adequately compensated for whatever amount of risk was assumed. It would be helpful if the regulations confirmed this principle or explained the basis for any contrary principle that the regulations are attempting to implement.
8. The most recent OECD discussion draft on “global trading” reserves on several controversial issues, such as how to calculate the amount and source of income to capital, that would be decided in the United States if the present version of the proposed regulations were made final. We recommend that the United States make every effort to achieve a consensus on these issues, at least among the OECD members that are financial center countries, before finalizing the proposed regulations.