THE ADVANCED DIPLOMA IN INTERNATIONAL TAXATION

June 2022

MODULE 3.05 – BANKING OPTION

SUGGESTED SOLUTIONS

PART A

Question 1

Part 1

The approach governing the allocation of capital to permanent establishments ("PEs") is contained in part 1 of the 2010 OECD report on the attribution of profits to PEs.

Part 2 of the PE report describes the specific approaches to the capital attribution of PEs of banks under the authorised OECD approach (AOA). Assuming the branch is performing of all the risk related management activities for the financial assets, the AOA acknowledges numerous to allocate capital of the whole banking enterprise to the branch.

The method is to treat the branch as if it were a separate enterprise.

It should be noted that such a separate enterprise approach is only potentially workable if the risk weighting of the assets of the branch accounts for the portfolio effect, otherwise excess capital will be attributed to the branch.

The methods proposed by the OECD guidance (OECD report on attribution of profit to PEs (2010)) are:

Thin Capitalisation approach

This approach requires a comparison of the branch's portfolio of assets with that of separate enterprises operating under same or similar conditions in the jurisdiction.

It should be noted that this approach would be costly and arguably not comparable if the separate enterprise is limited in its activities because of separate capital requirements.

As an example, if the PE has 5% of the enterprise's assets and/or risks it will have attributed to it 5% of the enterprise's free capital.

As per the OECD, a disadvantage of this method is that when the bank PE is hypothesised as a separate enterprise would be smaller than the bank. As a result, it maybe be compared with similarly smaller independent banking enterprises. However, small independent banks are unlikely to be comparable to a PE that is part of a large banking enterprise. For example, they are likely to carry on different functions, have different risk profiles and different credit ratings.

So, it is questionable whether the small independent banks would be a reliable benchmark.

Capital allocation approach

This method means that the PE necessarily has proportionally the same composition of regulatory capital as the whole bank. Approach includes allocating the bank 's genuine free capital in accordance with the attribution of financial assets and risks.

To do this necessary to first attribute assets and risks and then risk-weighting the assets (RWA) of the entity by following the Basel standardised regulatory rules (BIS ratio approach).

Therefore, if a PE has 15% of the bank 's risk-weighted assets, it will have attributed to it 15% of the bank 's free capital.

It is necessary to allocate the total free capital of the bank, as opposed to just the regulatory minimum if the capital allocation approaches are to be used as a method for the application of the arm's length principle.

This is on the basis that all the assets and all the associated risks of the bank have been attributed to the various parts of the bank, including the head office, under the functional analysis.

An advantage of the capital allocation approach it is easy to implement and administer. However, it should be noted that it may depart from the arm's length standard if different companies within the group are required to maintain different levels of capital.

Economic capital allocation approach

This is an alternative of the capital allocation approach, that relies on the banks internal risk models. These models are satisfactory under the AOA, if they are approved by the regulators, applied consistently and adequately documented.

However, the OOECD consider that "*such measures do not appear to be very well developed even in banking institutions that have very sophisticated risk measurement systems" (OECD report on attribution of profit to PEs* (2010)).

Therefore, economic capital allocation approach does not involve risk weighting the assets according to a standardised regulatory approach.

Safe Harbour/ Quasi-thing capitalisation/regulatory minimum capital approach.

Requires the branch to have at least the same minimum amount of free capital as the domestic regulator would set for an independent banking enterprise operating in the same host country. The regulatory minimum free capital would be established as per the regulatory standards and the domestic tax legislation rules of the host country.

However, it should be noted that this approach ignores that the PE generally has the same creditworthiness as the Head office. So, this approach is not considered an authorised capital attribution approach. However, it may be acceptable as a safe harbour if the outcome is not the attribution of profits to the PE that are outside the range of profits that would result if one of the authorised OECD approaches to capital attribution had been applied.

The OECD state that a disadvantage of this approach is that if you only attribute the regulatory minimum capital for the jurisdictions where the banks has PEs; any free capital will be by default allocated to the head office. The problem with this is that such an approach is not in line with the arm's length principle i.e. the Head office could have an excess of capital.

Part 2

After the attributable capital has been calculated for a branch for tax purposes, it should then be analysed against the amount of free capital that has actually been booked in the balance sheet of the branch for accounting purposes.

It should be noted that if the free capital booked in the branch accounts is less than the capital attributable to the branch, it is highly probable that an adjustment will have to be made to the amount of interest expense allowed in the branch in the host country to reflect the free capital that it needs to support the risk weighted assets on its balance sheet.

Part 3

The terms back and middle office are commonly used to define support functions in a banking environment. These functions commonly include Operations, IT, HR or finance. The OECD acknowledge that a considerable support infrastructure is necessary in order to carry out a banking business.

It should be noted however, that although the terms —back, —middle and —front office are commonly used in describing the functions of a global banking enterprise, there is nothing in the authorised OECD approach that requires attention to be given to such distinctions.

Instead, the authorised OECD approach rather is concerned with determining the key entrepreneurial risk-taking functions and valuing those functions without regard to the label given to the function or activity but based on a functional and factual analysis.

Whether or not a particular activity is a key entrepreneurial risk-taking function will depend on the facts and circumstances of the particular business. The functional and factual analysis should determine if the activity is a key entrepreneurial risk-taking function or alternately a support function.

Functions other than key entrepreneurial risk-taking functions do still need to be taken into account, but economic ownership of financial assets is not attributed to such functions.

Question 2

Part 1

The FTT Regulations shall not apply in the context of market making activities where these are the activities of a investment company, credit institution, an entity that is a member of a foreign or domestic trading platform or where the entity acts as an intermediary and participates in transactions on financial instruments.

Where financial instruments include financial securities - equity securities, debt securities, units in collective investment schemes & financial contracts – forward contracts, bills of exchange and CDs.

Market making definition is purely for the purposes of FTT and makes no reference to other external sources defining market making, where the definition addresses the underlying legislative goal to avoid double taxation and to avoid taxation of transactions that are not speculative.

1st exemption relates to the provision of liquidity under a contractual framework where the firm quotes prices for given quantities on a trading platform, or in the context of OTC activities where it provides a firm price for the given financial instrument.

2nd exemption relate to transactions in the normal course of business leading to the execution of orders by clients i.e. where the firm facilitates the execution of client orders with the objective of enhancing liquidity to prevent unfavourable price movements. Holding an inventory with no demonstrable link to a client order will not benefit from the exemption.

3rd exemption relates to hedge positions taken to limit the risk arising from the execution of transactions in securities subject to FTT. The exemption includes the periodic adjustment of the hedge over the term of the contract. In this context a different underlying may be acquired to hedge the risk however there must be an identifiable link between the market-making activities and the hedge.

Part 2

Economic taxpayer

The economic taxpayer is the actual taxpayer who suffers the economic loss arising from the acquisition of an in scope security however the legislation provides that the 'debiting method relies on a financial institution', the statutory taxpayer.

Statutory taxpayer

The legislation provides that the tax shall be assessed and paid by the firm providing investment services (ISP), having executed the order to buy the securities or having traded the securities for its own account regardless of location. Where there is no ISP the custody account keeper must assess and pay.

The legislation recognises three categories of payee, the Broker – the firm providing investment services; the Dealer – a firm that has traded on its own behalf; the Custody account-keeper.

Where there is a chain of intermediaries the firm that received the order directly from the end buyer shall asses and pay the tax.

Where the obligation falls on the custody account keeper they do not have an obligation to apply the tax without disclosure by the economic taxpayer of necessary information to determine if an obligation arises.

Where an ISP is acquiring for its own account they must pay the applicable tax.

The taxpayer as determined above shall file information as prescribed by the 5th of the following month where the security is delivered by book entry in the central depositary, conversely where this is not the case the taxpayer must file required information by the 25th day of the following month.

PART B

Question 3

Part 1

HMRC identified six key principles that organisations wishing to prevent the criminal facilitation of tax evasion by associated persons should consider when establishing reasonable prevention procedures.

Senior management commitment

HMRC recommends senior management are involved in the communication and endorsement of the firm's policy on prevention of criminal facilitation of tax evasion; and should Formally approving the procedures once developed.

This can be demonstrated by adopting a formal policy statement regarding zero tolerance towards the criminal facilitation of tax evasion, that summarizes the consequences if associated persons contravene the organisation's policy.

Link to risk assessment process-senior managers should be involved in risk assessment process, design and implementation of policies and procedures. If senior management not involved in day to day management of this, must be able to at demonstrate oversight of the process.

Due diligence

HMRC guidance states that the application of existing due diligence procedures is not automatically adequate for addressing the risk of tax evasion facilitation.

Nevertheless, procedures should be proportionate to the risk, and the organisation needs to revisit the risk assessment.

In some cases, maybe necessary for an organisation to operate specific due diligence procedures to address the risk of facilitation of tax evasion and or have changing procedures for different parts of its business according to risk exposure, including enhanced due diligence for high risk services in the wealth management industry for example client tax advice.

Risk assessment

To help organisations, capture risk, HMRC suggest consulting the Financial Conduct Authority's ("FCA") guide for firms on preventing financial crime, the Joint Money Laundering Steering Group's ("JMLSG") and the Ministry of Justice's Bribery Act guidance – analysing them from a tax fraud perspective.

The risk of tax evasion facilitation must be clearly articulated across the organisation.

As part of the risk assessment, internal (employees) and externally (agents, representatives, contractors) should be identified which the objective of establishing if they have opportunity or incentive to facilitate tax evasion.

The risk assessment should include thought of the following risks, and classifying them as High, medium or low; as well as ensuring sufficient controls in place to manage risks identified.

- Country risk: contact with high risk countries that have unlikely to subscribe to the Common Reporting Standard and be given a low tax transparency score by the OECD.

- Product risk: organisations offering private wealth management services are particularly identified as facing significant risks. And how will such products be developed going forward.

- Transaction risk: what tax planning structures is the organisation using?
- Client risk: have tax onboarding procedures been documented, e.g. FATCA/CRS?

Policies and procedures

Post risk assessment, an organisation must document proportionate procedures to deal with those risks identified. A written policy would be beneficial, setting out (based on HMRCs risk factors):

- Controls the business has in place to deal with the risks
- Who are the associated person, Is the work of associated persons monitored?
- What are the organisations products that could be used to criminally facilitate tax evasion?
- Enforcement of compliance procedures.

Training:

Training in CCO should be undertaken for senior management as to the risks of corporate criminal liability. The legal, compliance and tax teams as to the scope and content of the legal regime. Operational and client facing staff on the business's procedures, how to avoid triggering the offences and also the whistle blowing policy. In addition, external associated persons, if such training is considered proportionate to the risks posed.

Monitoring:

- Decide who undertakes the review i.e. Internal or external party;
- Make reviews periodic and document;
- Obtain feedback from staff on the changes to processes executed; and
- Link to other areas of the organisation e.g., internal audit cycles.

Part 2

An organisation must “self-report” any acts of criminal facilitation that it has identified.

To do this, the organisation must use the online facility for authorised representatives to file a report via the government gateway. This is to inform HMRC that they have failed to prevent a representative from criminally facilitating UK tax evasion, consequently they could be guilty of a corporate failure to prevent offence under Part 3 of the Criminal Finances Act 2017.

HMRC’s guidance states that the individual and the company or partnership they are acting on behalf of have a right to remain silent i.e. self-reporting is voluntary. In addition, HMRC guidance states that the authorised person must not encourage anyone to commit a crime in order to obtain more information.

The self-reporting must contain:

- Name of the authorised representative making the filing and their job title;
- Jurisdiction where tax being evaded;
- Company UTR;
- A description of the offence including dates and values;

- (If available) description of the prevention procedures in place to prevent persons from criminally facilitating tax evasion; and

- History of previous disclosures made and regulatory bodies organisation is a member of.

Post submission of the report, a reference number will be issued by HMRC. HMRC are legally permitted to share the contents of report with overseas tax authorities.

If the organisation has concerns over money laundering or terrorist financing self-reporters, where the organisation that they are acting for are regulated, it may be necessary to submit a suspicious activity report (SAR) to the National Crime Agency. If so, this must be completed before self-reporting tale's place.

If the authorised representative self-reports their organisation in a timely manner, this could be used as part of the organisations '*reasonable procedures'* defense if indeed they are charged with an offence. There is then the potential for this to be positively reflected penalties if convicted.

Question 4

The QI must implement a Compliance Programme (CP) under the authority of a Responsible Officer which includes policies, procedures and processes sufficient for the QI to satisfy the documentation, withholding and reporting obligations of the QI Agreement.

The RO must communicate policies and procedures to any line of business in scope of the QI Agreement obligations.

The RO must ensure that systems and processes are in-place that will allow the QI to fulfil its obligations under the QI Agreement.

The RO must monitor business practices and arrangement that affect the Qis compliance with the QI Agreement.

The Responsible Officer (RO) must be identified to the IRS on the respective application of the QI/WP/W. The RO must be an officer with sufficient authority to fulfil the duties of an RO and will act as a Point of Contact for the IRS.

The CP must be sufficient for the RO to make the required certifications providing that either effective internal controls exist or providing a qualified certifications.

The RO must disclose any Material Failures not previously disclosed. Where a Material Failure is generally a failure to fulfil the requirements of the QI Agreement or its FATCA requirements. In the event of a failure to withhold, report or make deposits such a Material Failure is limited to the results of a deliberate action on the part of one or more employees of the QI or as a result of a failure to establish internal controls, necessary to meet the requirements of the QI Agreement.

The RO must also disclose an Event of Default where this occurs if the QI fails to perform any material duty or obligation under the QI Agreement and the RO had actual knowledge or should have known the facts relevant to the failure to perform any material duty.

QI must arrange for the performance of a Periodic Review where required. The QI must maintain its Chapter 4 status.

Where the QI is a QDD it must make a good faith effort to comply with obligations under s.871, 881 Chapter 3 and 4 in respect to s.871(m) transactions. Consequent upon published deferrals the QDD is not required to perform a periodic review or provide requested factual information or make an internal controls certification to the IRS. However an internal record of a good faith certification and supporting information must be retained by the QDD.

The RO must ensure that where the QI is a QDD it has appropriate systems in-place to make the necessary determinations and calculations to identify s871m transactions and potential s.871(m) transactions.

The systems in place must determine whether the transactions is on a principal or non-principal basis, whether the transaction is as an Equity Derivative Dealer or not, whether the transaction exist for Federal Income tax purposes, whether the transaction is owned by the QDD and whether the transaction is Effectively Connected with a trade of business in the US, together with the appropriate systems to complete the necessary determination, withholding and reporting.

PART C

Question 5

DAC 6: EU based intermediaries now mandated to submit information on reportable cross-border arrangements to their home tax authorities.

Reportable information: include the identification of the intermediaries and relevant taxpayers, their country of residence and tax identification (TIN).

A summary of the arrangement must also be included in the report. The summary needs to contain information on the relevant hallmarks, facts on the first step of implementation, and information on the value of the reportable cross-border arrangement. Additionally identification of Member States that are affected or likely to be concerned by the reportable arrangement would be included.

'*Intermediary'* definition-any person that designs, markets, organizes, makes available for implementation or manages the implementation of a reportable cross-border arrangement.

Therefore includes: any person that, having regard to the relevant facts and circumstances and based on available information and the relevant expertise and understanding required to provide such services, knows, or could be reasonably expected to know, that they have undertaken to provide aid, assistance or advice with respect to a reportable cross-border arrangement.

Therefore, examples of intermediaries would include financial advisors, accountants, lawyers, and banks.

Note: if Intermediary not located in EU, or alternatively is bound by professional privilege, the obligation to report moves from the intermediary to the relevant taxpayer.

With regard to the timeline for implementation, EU Member States were required to adopt and issue national laws requiring compliance with the Directive by 31 December 2019 and apply the new rules from 1st July 2020.

Retrospective element of directive: Directive and consequently the reporting obligation applies to transactions implemented as from 25 June 2018.

The first item filing deadlines were 31st August 2020, this is with respect to reportable transactions implemented between 25th June 2018 and 1st July 2020 ("*first reporting period*"). Record keeping for any transactions that have occurred since 25th June 2018 was therefore essential.

The first "*regular*" information exchange between EU Member States had to take place by 31 October 2020.

Now that this first reporting period has passed, a reportable arrangement must be reported within 30 days beginning on the day after the arrangement was made available/ready for implementation, or when the first step in the implementation was undertaken, whichever occurs first.

Information regarding reported arrangements will be automatically exchanged by the competent authority of each EU Member State every three months via the use of a secure central directory. Intermediaries who provided aid, assistance or advice are required to file the information with their tax authority within 30 days starting on the day after they provided such aid, assistance or advice.

A *'reportable cross-border arrangement'* is any cross-border tax planning arrangement that's exhibits one or more of the hallmarks listed in the Directive and concerns at least one EU Member State.

Hallmarks cover a broad range of transactions, for example, certain deductible payments that are taxed at a rate of zero or close to zero when received.

Certain arrangements, for example, those that fall within the specific transfer pricing hallmark, must be reported even if they do not satisfy the "*main benefit*" of obtaining a tax advantage test. These include an intra-group cross-border transfer of functions, risks or assets; and transactions that contain hard-to-value intangibles.

Should intermediaries, or taxpayers fail to comply with reporting requirements penalties will apply. The directive states that the penalties must be "effective, proportionate and dissuasive". However, these penalties are set by the by the domestic legislation of the individual EU member state. The Directive also states that if a tax authority does not react to a reportable cross-border arrangement, this does not infer any acceptance of the validity or tax treatment of that arrangement.

Question 6

Part 1

Since 2016, the charge on the short-term equity or liabilities has decreased from 0.180% in 2016, to 0.150% in 2019, down to 0.100% for financial year 2021.

In the same period, the charge on long term equity or liabilities also decreased from 0.090% in 2016, to 0.075% in 2019, down to 0.050% in 2021.

Part 2

Since the introduction of the UK levy in 2011, it applied to the global consolidated balance sheet of UK-headquartered banks. However, it only applied to the UK balance sheet of a foreign-headquartered bank.

However, effective 1 January 2021, the UK bank levy's territorial scope was reduced in that it from this date, it only applied to the UK balance sheet for all banks. This change is likely to result in a reduction in the bank levy paid in years after 2021.

Paragraph 47 of Schedule 19 contains the UK bank levy's anti-avoidance measures. The aim of such measures being to eliminate the ability of banks to avoid and/or reduce a UK bank levy liability through avoidance techniques.

The avoidance legislation specifics a two-step test:

1. At least one entity must have entered arrangements. Includes any arrangements whether legally enforceable. These could include a set of transactions or indeed just a single transaction.

2. Main purpose/one of the main purposes of any entity, in entering into any part of the arrangements, is to avoid or reduce a charge or assessment to the UK bank levy.

For an anti-avoidance rule to apply point 1 and point 2 above must have been satisfied. If the two-point test is met, the bank levy is charged or assessed. Such an assessment could include increasing a charge that would otherwise be reduced, or assessing a charge to the bank levy that would otherwise be avoided, alternately.

One of the policy objectives of the bank levy is to encourage banking groups to implement lower risk funding strategies. As a result, the anti-avoidance legislation includes exemptions for arrangements to the extent that they have this specified effect of implementing lower risk funding strategies.

Part 3

Paragraphs 66(1)(a) refers to double taxation relief (DTR) being granted with regard to any '*equivalent foreign levy'*.

In order to obtain the DTR the foreign levy must:

- Adhere to the proposals for the design of bank levies in the International monetary fund ("IMF") 2010 paper "*a fair and substantial contribution by the financial sector"*;

- Be based on the balance sheet assets or liabilities and be in similar intent to the UK levy; and

- Not be a tax on income, profits or gains.

Question 7

Both Bank Beta and Delta are QDD.

Client ← Bank Beta ← Bank Delta

Withholding

Bank Delta holds the physical and will receive any dividend amounts gross of withholding as a QDD, making a manufactured dividend payment (Dividend Equivalent Amount(DEA)) to Bank Beta also gross of withholding, whereas Bank Beta will pay the DEA to the client net of withholding at the applicable treaty rate.

Reporting

Bank Delta and Bank Beta will issue a 1042-S to the next participant in the withholding chain with a copy sent to the IRS and a 1042 to the IRS. The 1042-S will document the recipient as an entity and the payment as a dividend substitute payment with in the case of the document issued to Beta an authority for exemption under Chapter 3 as a QDD that assumes primary withholding obligations.

Assumptions:

- The security is subject to Chapter 3 withholding;
- Bank delta holds the security in the capacity of an Equity Derivatives Dealer ;
- The client is not a QDD;
- All parties are correctly documented for FATCA purposes; and
- All parties to the transaction are Non Resident Aliens.

Given the above assumptions other than the fact that only Bank Beta is a QDD, the withholding and the reporting would be the same.

Question 8

Representations that no withholding taxes will apply to future payments made on the laws in effect on the date the parties enter into the agreement.

Each party makes the Payer tax representations in reliance on the accuracy of the Payee tax representations and the tax forms, document or certificates furnished by the Payee, that are thought necessary to support the legal conclusion that no withholding is required by any relevant jurisdiction to withhold tax from the payments it makes. where relevant jurisdictions are the Payer's home jurisdiction, the jurisdiction in which the Office through which the Payer is acting in the transaction is located and the jurisdiction in which the Agreement is executed. Where a Payee exemption exists the Payer will normally require the Payee to make a representation that it is eligible for such an exemption.

Under current US regulations as a general rule payments attributable to notional principal contracts (NPC) are not subject to US withholding tax but may subject to US Information reporting and backup withholding obligations, as a results generic Payee representations have been developed whose objective is to reduce or eliminate any withholding or backup considerations, namely:

IRS 1042-S Reporting: NPC payments generally must be reported on Form 1042-S if considered effectively connected with the conduct of a US trade or business (ECI). The regulations provide a safe harbour if the Payee represents that they are a US Person or a non-US Branch of a foreign person.

IRS Form 1099 Reporting and Backup withholding: NPC payments must be reported on IRS Form 1099 unless the Payee is a corporation or otherwise exempt or is a foreign person.

A swap payment under an ISDA agreement that is not exempt from 1099 reporting is also subject to backup withholding unless a valid US Tax ID No is also provided. Re-characterization of a swap payment as interest arises where there is a "significant" up-front payment. However a foreign person may not be subject to withholding if the interest is ECI or Portfolio interest and subject to exemption or full exemption in accordance with a treaty is provided.

The generic sample Payee representations provided in the 2002 Agreement are:

- A US Person;
- A non-US Person with no US office;
- A multi branch non-US persons with both a foreign office and a US office; and
- A non-US persons acting only through a US office.

Where the Payee is :

A US Person: the Payer will not be required to report payments on a Form 1042-S, but will be required to report on Form 1099 unless the Payee is a corporation and backup withholding will also be required unless the Payee provides a valid US TIN.

A non-US Person with no US office: the Payer will not be required to report payments on From 1042-S or Form 1099.

A multi branch non-US persons with both a foreign office and a US office: the Payer will not be required to report payments on Form 1099. The Payer will not be required to report payments on Form 1042-S for payments made to an address outside the US or to a bank account outside the US on. Where the arty enters into swaps from both a US and non-US Branch but directs that payments should be made to a non-US Branch or to a bank account outside the US cannot make this representation. Relying on this representation requires due consideration of ECI rules.

A non-US persons acting only through a US office: the Payer will not be required to report any payments on From 1099, but may be required to report on Form 1042-S.