# U.S. Proposed Global Trading Regs: Preliminary Questions Regarding Application

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On March 2, 1998, the U.S. IRS issued proposed regulations governing the allocation and sourcing of income derived from a "global dealing operation." (For prior coverage, see *Tax Notes Int'l*, Mar. 16, 1998, p. 837, or *Doc 98- 9254 (9 pages)*; for the full text of the global trading regs, see *Doc 98-7970 (115 pages)* .) The proposals include reg. section 1.482-8 (all section references are to the proposed Treasury regulations), which provides rules for allocating such income among controlled taxpayers, and reg. section 1.863-3(h), which provides rules for sourcing the income thus allocated. Amendments to other regulations are proposed to bring them into conformity with the new section 482 and section 863 provisions; for example, reg. sections 1.864-4, 1.894-1, and 1.988-4.

A preamble to the proposed regulations describes the results they intend to achieve and the principles that the IRS apparently believes should guide their application. In places, however, the mechanisms by which the regulations accomplish these results and effectuate these principles are unclear. In other places, the regulations themselves are ambiguous and subject to varying interpretations. A simple hypothetical fact pattern will serve to illustrate some of the interpretive questions posed by the regulations.

Suppose that A, a country A corporation, and B, a country B corporation related to A, conduct a dealing operation in swaps. B, which acts as the counterparty for all transactions with customers, records 2,000 of income from those transactions. B also incurs 100 of expense in operating the back office, which is elaborate and essential to the dealing operation, plus 1,000 of interest expense. B employs one trader at a cost of 100, and A employs four traders at a total cost of 400. Assume for the sake of simplicity that there are no separate marketers.

The proposed regulations apply to A and B only if they are "participants" in a "global dealing operation." The swaps operation in question appears to be a "global dealing operation" within the meaning of reg. section 1.482- 8(a)(2)(i) because pricing and risk management activities with respect to the execution of customer activities are conducted in more than one tax jurisdiction. In addition, A and B both appear to be "participants" in the global dealing operation within the meaning of reg. section 1.482- 8(a)(2)(ii). B qualifies as a participant because it is a "regular dealer in securities" as defined in reg. section 1.482-8(a)(iii). (The fact that B also conducts activities that are not "related activities" under reg. section 1.482- 8(a)(3)(ii)(B) -- e.g., back office activities -- does not appear to alter its status as a participant.) A is a participant because it is a member of a controlled group that includes a "regular dealer" (B), and it conducts "related activities" (pricing and risk management) within the meaning of reg. section 1.482-8(a)(2)(ii)(B). Income from A's and B's global dealing operation therefore must be allocated and sourced under the proposed regulations.

Allocation First, Then Sourcing

The proposed regulations seem to require that income be allocated under reg. section 1.482-8 before it is sourced under reg. section 1.863-3(h). Thus, in Example 5(v) of reg. section 1.482- 8(e)(8), taxpayers are instructed to "see reg. section 1.863-3(h) for the source of income allocated" to a controlled entity using a profit- split method set forth in reg. section 1.482- 8. And reg. section 1.863-3(h) provides rules for "sourcing income . . . from a global dealing operation that, under the rules of reg. section 1.482- 8, is earned by or allocated to a controlled taxpayer." The first step, then, is to allocate income from the global dealing operation to A and B using one of the methods set forth in reg. section 1.482- 8. The source of the income thus allocated to each entity is determined subsequently under reg. section 1.863- 3(h).

Allocation

Assume that, given the integrated nature of the A/B global dealing operation, a profit-split method is selected as the best method for allocating income under reg. section 1.482-8. A profit split allocates the "combined operating profit" (or loss) of a global dealing activity to participants based on the "relative value of each participant's contribution" to that profit. Reg. section 1.482- 8(e)(1).

*Combined Operating Profit*

Operating profit is "gross profit" less "operating expenses." Reg. section 1.482-8(e)(1),(3). Gross profit is "gross income earned by the global dealing operation." Reg. section 1.482- 8(e)(3). Operating expenses include certain expenses "not included in the computation of gross profit," suggesting that some expenses should be included in that computation. The nature of these expenses is not entirely clear, but in the instant case, when no other expenses are assumed, the "gross profit" of the global dealing operation is apparently equivalent to "gross income," 2,000.

"Operating expenses" include all expenses not included in the computation of gross profit except for interest, certain foreign and domestic taxes, and expenses not related to the global dealing operation. Reg. section 1.482- 8(a)(3). Operating expenses of the global dealing operation should thus include trader compensation (a total of 500, incurred by A and B) and back office expense (100, incurred by B), but not interest expense. The

combined operating profit for the global dealing operation is 1,400 (2,000 gross profit less 600 operating expenses).

*Profit-Split Factors*

A profit-split method should allocate operating profit based on the "relative value" of each participant's contribution to that profit. Reg. section 1.482-8(e)(1). The relative value of a participant's contribution is to be determined "in a manner that reflects the functions performed, risks assumed, and resources employed" by the participant. Reg. section 1.482- 8(e)(2)(i). The allocation ultimately must correspond to "the division of profit or loss that would result from an arrangement between uncontrolled taxpayers, each performing functions similar to those of the various controlled taxpayers" engaged in the global dealing activity. Id.

The relative dearth of uncontrolled comparables for integrated global dealing operations makes these principles far easier to articulate than to apply. The proposed regulations seem to recognize that comparables may not be available, stating that "the absence of external market benchmarks (for example, joint ventures between uncontrolled taxpayers) on which to base the allocation of operating profits does not preclude use of this method if the allocation . . . takes into account the relative contribution of each participant." Reg. section 1.482-8(e)(5)(iii).

This statement is somewhat mysterious, but the proposed regulations appear to contemplate the use of a single- or multifactor formula to measure the relative value of each participant's contribution. Reg. section 1.482- 8(e)(2)(i). The factors to be used depend on the functions, risks, and resources that produce that profit. Suppose the two most important profit- generating factors in the A/B global swaps dealing operation are trading (i.e., pricing and risk managing) and risk-bearing (including the provision of capital and taking advantage of a favorable regulatory climate). In addition, suppose B's sophisticated and efficient back office is integral to the profitability of the operation. In these circumstances, back office functions ("support") might comprise a third factor.

Though few comparables are available, papers filed in recent litigation reveal the allocation of derivatives trading profits in a joint venture between a trader and a capital provider. The trader, whose team provided all of the requisite expertise, received 38 percent of the profit. The capital provider, which contributed the financial and reputational backing and bore the counterparty risk, received 62 percent. Suppose that, on the basis of this real-world, publicly available example, it is concluded that 40 percent of operating profit should be attributed to trading, 50 percent to risk- bearing or providing capital, and 10 percent to support.

In applying the profit split, each of the factors in the multifactor formula must be "expressed in units of measure that reliably quantify the relative contribution" of each participant. Reg. section 1.482- 8(e)(2)(ii). Suppose it is concluded that trader compensation is the best measure of each participant's contribution to the 40 percent of operating profit attributable to trading; that notional volume is the best measure of contribution to the 50 percent of profit attributable to risk-bearing; and that back office expenses are the best measure of contribution to the 10 percent of profit attributable to support.

The chosen formula seems reasonable, but it is not clear that it passes muster under the proposed regulations. They state that a multifactor formula may be used (reg. section 1.482-8(e)(2)(i)), but they identify only one acceptable factor: trader compensation. What other factors may be used? Are there any that may not be used? On the one hand, the lack of guidance on this issue suggests that any and all factors that contribute to the generation of profit are permissible. On the other hand, the focus on trader compensation could indicate that acceptable factors are limited to functions like trading that, standing alone, would qualify an entity for "participant" status; i.e., marketing, sales, pricing, risk management, and brokering activities (reg. section 1.482- 8(a)(2)(ii)(B)). If this is the case, A would not be permitted to use support or, presumably, risk bearing/ capital as profit-split factors.

The proposed regulations can also be read as limiting profit- split factors to those activities that constitute "nonroutine contributions" under reg. section 1.482-8(e)(6)(iii). Examples in the regulations use "nonroutine" activities as factors in a total profit split, but "routine" activities are compensated prior to the profit split, in the first step of a "residual" profit split. Reg. section 1.482-8(e)(8). It is not clear whether all of the profit- split factors used in our hypothetical would be nonroutine and, if not, whether they would be considered unacceptable for that reason. The proposed regulations state broadly that "a functional analysis" is required to identify routine and nonroutine contributions. Reg. section 1.482-8(e)(6)(ii). They also list a number of particular contributions that are "generally" or "almost invariably" considered nonroutine: pricing, risk management, product development, and information technology. Reg. section 1.482-8(e)(6)(iii). Contributions that are "typically" routine include transaction processing, credit analysis, and guarantees. Reg. section 1.482- 8(e)(6)(ii). Marketing "may be" nonroutine or, presumably, routine. Reg. section 1.482-8(e)(6)(iii). The proposed "support" factor has both routine and nonroutine elements -- transaction processing and information technology. The risk-bearing/ capital factor does not fall neatly into the set of examples for either category (although, as noted above, it is treated as routine in a residual profit-split example). Of course, risk- bearing/capital does constitute a profit-split factor in the one comparable for which data are publicly available.

Perhaps the answer is that, even if "nonroutine" status is required for factors in a total profit split, support and risk- bearing/capital factors are nonroutine here because they are "so integral to the global dealing operation that it is impossible to segregate them from the operation and find a separate market return for the contribution." This is the definition of "nonroutine" in the context of a residual profit split. Reg. section 1.482-8 (e)(6)(iii).

*Allocation*

Using the chosen profit-split formula, the 1,400 operating profit is allocated between A and B. The 40 percent, or 560, attributable to trading is allocated on the basis of relative trader compensation. A pays 80 percent of the trader compensation, so A is allocated 448 (80 percent of 560) of profit. The remaining 112 is allocated to B.

The 50 percent, or 700, of profit attributable to risk- bearing/ capital is then allocated on the basis of notional value. B holds all assets of the swap dealing operation because B is the legal counterparty to all transactions. Thus, the entire 700 is allocated to B.

Finally, the 10 percent, or 140, of profit attributable to support is allocated on the basis of back office expenses. B incurs all back office expenses, so the entire 140 is allocated to B.

Thus, based on the profit-split formula, a total of 448 is allocated to A and 952 is allocated to B.

Sourcing

Amounts allocated under reg. section 1.482-8 are sourced based on the residence of the participant. Reg. section 1.863- 3(h)(2). If a participant has more than one qualified business unit (QBU) that would qualify as a participant if it were a separate entity, source is determined by treating each such QBU as a separate controlled entity and "applying the rules" of reg. section 1.482-8. Reg. section 1.863-3(h)(3)(i). The amount allocated to a QBU is sourced based on the "residence" of the QBU. (Although the QBU concept has roots in subpart J, presumably the term is used here without any necessary link to currency issues.)

A has no QBUs. It would thus appear that the 448 allocated to A has a U.S. source on the basis of A's residence. B has no branches outside country B, but the proposed regulations provide that a QBU includes a trade or business that is "deemed to exist because of the activities of a dependent agent." Reg. section 1.863- 3(h)(3)(iv). An example suggests that B will be deemed to have a QBU in country A because traders employed by A have authority to enter into contracts in the name of B. Reg. section 1.863-3(h)(3)(v), example 3(ii). (Two observations about this conclusion: (1) the example seems to equate "authority to enter into contracts" with "dependent agent" status, which is a dubious proposition, see *The Taisei Fire and Marine Insurance Co., Ltd. v. Comm'r* , 104

T.C. 535 (1995); and (2) the regulations are silent on the possibility that B's activities in collecting income from customers might constitute a deemed QBU of A in country B under a similar analysis.) The source of the 952 allocated to B must thus be determined by applying the rules of reg. section 1.482-8 as if B's deemed QBU in country A were a controlled entity separate from B's head office. Reg. section 1.863- 3(h)(3)(i).

Presumably A is disregarded when the rules of reg. section 1.482-8 are reapplied under reg. section 1.863-3(h)(3)(i). It seems that reg. section 1.863-3(h)(3)(i) is intended simply to reallocate the 952 previously allocated to B between B's head office and B's deemed QBU in country A, not to reallocate the entire 1,400 operating profit among a controlled group consisting of A, B's head office, and B's QBU in country A. The former view is more consonant with the stated purpose of the regulation, which is to source income "allocated to" a controlled taxpayer that operates through one or more QBUs. Reg. section 1.863-3(h)(1), (3)(i).

Nevertheless, the proposed regulations provide no specific guidance on how to "allocate" income between an entity's head office and its "deemed" QBU in another country. Example 3(vi) of reg. section 1.863-3(h)(3)(v) suggests that compensation for the use of capital must be sourced according to "where the capital is employed." This conclusion has no apparent predicate in the regulations, which otherwise suggest that this amount is sourced based on the residence of the capital provider (at least when the capital provider is a participant). Neither the example nor the regulations define where capital is "employed" (the Service's view on this subject appears in the preamble to the regulations).

In any event, example 3(vi) applies only to capital treated as a routine contribution in a residual profit split. The method applied to our hypothetical fact pattern is a total profit split using capital, support, and trading as allocation factors. Under reg. section 1.482-8, portions of operating profit attributable to each of these factors are first allocated to B, as explained above. It is unclear whether and how each of these portions is to be reallocated between B's head office and B's deemed QBU in country A. In one sense, any reallocation to that deemed QBU would be redundant, since the activities performed by the QBU -- i.e., activities performed by A in B's name on behalf of the swaps dealing operation - - are the very activities that justified the allocation of 448 of operating profit to A under reg. section 1.482-8. A has no other activities relating to the global dealing operation.

Example 3(vi), however, suggests that amounts allocated to B should be reallocated to B's country A QBU for purposes of sourcing based on the "employment" of B's capital by A's traders. But which amounts are subject to such reallocation? Example 3(vi) implies that the slice of operating profit allocated to B based on risk-bearing/ capital is a prime candidate for such reallocation. But what about the slices attributable to trading and support? Amounts of 112 and 140 have been allocated to B on the basis of those factors. Should those amounts, which are products of the formula used in making the initial allocation, also be subject to reallocation to B's QBU in country A?

Cash Transfers and Interest Expense

The proposed regulations allow participants in a global dealing operation to combine their individual dealing profit and related expenses. This combined operating profit is then allocated among the participants. The amount allocated to a particular participant may be more or less than the participant's booked profit. The effect of this process is to transmit profit and expense across entity and country boundaries for U.S. tax purposes, and presumably the commensurate cash may follow without further U.S. tax consequences. Thus, since A apparently is to earn 448 on the hypothetical facts, presumably B may (must, or face collateral tax consequences?) pay 848 to A, enough for A to compensate its traders and earn 448 of profit. The payment from B to A has no independent U.S. tax effect. Since A's expenses were taken into account in determining the combined operating profit subject to the profit split, there is no tax deduction for the compensation paid to A's traders. Including such expenses in operating profit effectively "allocates" them according to the profit split.

Interest expense is excluded from this process, even though it may be significant in amount for financial institutions involved in many types of global dealing. Interest expense, thus, remains trapped within individual entities and countries. This fact will presumably make comparables even more elusive, since it is doubtful that parties acting at arm's length would agree to split profits without regard to a major expense of the dealing operation.

Within an entity interest is apportioned independent of the reg. section 1.482-8 allocation, which may give rise to two distinct types of distortion. Of 1,400 operating profit, 448 was allocated to A under reg. section 1.482-8 and 952 was allocated to B. Thus, while 32 percent (80 percent of 40 percent) of gross income and operating expenses are allocated to A, the entire 1,000 of interest expense remains in B. After the allocation, and independent of sourcing (but assuming no other expenses), A will report a profit of 448 while B will report a loss of 48.

As noted above, some or perhaps all of the 952 allocated to B under reg. section 1.482-8 is reallocated under reg. section 1.863- 3(h) between B's deemed QBU in country A and B's head office. The interest deduction is apportioned under the appropriate regulations, either those applicable to U.S. corporations or those applicable to foreign corporations, depending on the situation. If the factors used to reallocate B's 952 of operating profit do not track the factors used to apportion interest expense, B's overall loss of 48 will not be divided pro rata between its deemed QBU in country A and its head office. This will add a second element of distortion to the first one.

Conclusion

Gadzooks. The proposed regulations may be needed and correct in concept, but they do have their complications, policy implications, and open questions. From a broad perspective, one may ask whether other countries are likely to accept the U.S. view of the world as reflected in these regulations. If they do not, does the U.S. competent authority have the staff to take on the resulting issues of double taxation? To assess what and how many those issues may be, it is instructive to posit first country A, then country B, as the United States of America.

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