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OUTLOOK FOR 2002 AND REVIEW OF 2001

This issue of *International Banking Focus* provides an outlook for the most significant legislative, regulatory and tax matters being addressed by the Institute at the outset of 2002 and a review of developments in these areas during 2001. These matters are further discussed in Institute memoranda and documents that are available on the Institute's member web site (www.iib.org/member). Please contact the Institute if you have any questions or require additional information regarding any of these matters.

ONGOING INITIATIVES BY THE INSTITUTE TO ACHIEVE REFORM OF ASSET PLEDGE/CAPITAL EQUIVALENCY DEPOSIT REQUIREMENTS APPLICABLE TO U.S. BRANCHES AND AGENCIES

OUTLOOK FOR 2002

The Institute is engaged in ongoing, extensive discussions with the Federal Reserve, the Office of the Comptroller of the Currency (OCC) and state banking authorities regarding the implementation of a flexible, risk-based – rather than mandatory – approach to asset pledge requirements applicable to U.S. branches and agencies of international banks.

The Comptroller of the Currency has proposed an amendment to the International Banking Act of 1978 (IBA) that would give him discretion in the application of "capital equivalency deposit" (CED) requirements to federal branches and agencies, and the Institute is pursuing the adoption of this necessary legislation in the new Congressional session that commenced in January. The Institute is also seeking support for the OCC's proposed amendment from states that individually have statutory flexibility regarding asset pledge requirements as well as from the Conference of State Bank Supervisors.

On January 30th, the OCC issued an interim rule modifying its implementation of the CED requirement to permit the OCC to vary the terms of the agreement pursuant to which the CED is maintained based on its assessment of the circumstances and supervisory risks present at a particular branch or agency. Under this risk-based approach, for example, the OCC on a case-by-case basis will permit a federal branch or agency to

The Institute's mission is to solve the many special legislative, regulatory and tax issues confronting **internationally headquartered** financial institutions that engage in banking, securities and/or insurance activities in the United States.
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withdraw amounts pledged in excess of the 5% minimum without prior OCC approval.

The Institute supports this action, which for the first time incorporates into federal law the principle that CED requirements should be applied on a risk-adjusted rather than across-the-board basis. Nevertheless, the existing IBA statutory scheme of a 5% minimum CED requirement remains in place. Until that statutory scheme is made discretionary, as the OCC has proposed to Congress, no regulatory modification alone will be sufficient. Accordingly, it is important that Institute members continue to voice support directly and through home country supervisors to the U.S. banking regulators and the U.S. Treasury Department for adoption of the legislative amendment proposed by the OCC.

The Institute also continues to support reform of New York's asset pledge requirements, which could be changed by regulatory action without the need for new legislation. Based on publicly available Call Report data, New York-licensed branches and agencies pledged over $31 billion of assets as of September 30, 2001, and OCC-licensed branches and agencies located in New York pledged over $4 billion. As of that date, 18 international banks headquartered in eight different countries had assets pledged in New York in excess of $750 million each. An additional 18 international banks headquartered in 11 different countries had pledged between $250 million and $750 million each.

To further support our efforts, the Institute is in the process of aggregating data from member Institutions on the number of individuals employed in New York State by international banks. This data will be extremely useful in underscoring for New York officials the significant economic benefits that international banks provide to the City and State. In addition, the New York City Partnership and Chamber of Commerce recently sent a letter to Superintendent McCaul and Charles Gargano, Chairman of the Empire State Development Corporation, expressing concern that the existing asset pledge requirements were a disincentive to investment and expansion by international banks in New York State.

REVIEW OF 2001

Throughout 2001, the Institute pursued discussions on multiple tracks with state and federal regulators concerning the application of a 5% asset pledge/capital equivalency deposit (CED) requirement to the U.S. branches and agencies of international banks, and submitted detailed policy arguments in favor of asset pledge reform to key Congressional leaders, senior Administration officials and Federal Reserve Board Chairman Greenspan.

The Institute has also raised this issue with the Basel Committee, requesting it to consider the consistency of a mandatory, across-the-board asset pledge requirement with the supervisory principles developed by the Committee, including the risk-based capital standards. In addition, a number of institutions, national and regional banking associations and home country supervisory authorities have voiced their strong support for asset pledge reform. On October 1st, the European Commission wrote the New York Superintendent of Banks urging reform of the asset pledge requirement to reduce its "discriminatory competitive effects".

In its various submissions, the Institute argued that an across-the-board requirement for branches and agencies to collateralize their deposits and other third-party liabilities cannot be justified on safety and soundness grounds and imposes substantial and unnecessary financial burdens that result in an uneven playing field for international banks vis-à-vis U.S. banks. In particular, we have emphasized the following considerations, which state a compelling case in favor of asset pledge reform:

- With the widespread acceptance of internationally agreed upon capital standards and the enhanced, risk-based supervisory oversight of internationally active banking organizations on a consolidated

basis, asset pledge requirements are not necessary for financially strong and soundly managed banks from countries that adhere to international capital and supervisory standards.

- No other country (except Canada) applies asset pledge requirements to American and other non-domestic institutions as host country regulator.

- While a number of countries do require local capital for branches (which is achieved by bringing in head office funding so that total assets exceed local liabilities), asset pledge requirements represent the only situation in which capital funds must be invested in particular types of lower interest-paying instruments rather than being freely available for whatever assets an institution may wish to acquire.

- There is a whole array of supervisory tools available to the host country regulator to achieve safety and soundness, including in particular the examination and supervision of branches so as to maintain sufficient assets to pay off depositors and other liabilities.

- In light of the tremendous costs and burdens associated with the asset pledge (the investment returns on eligible assets under this requirement are frequently below an international bank's cost of funds or otherwise result in significant opportunity costs of 40 to 50 basis points and even higher for some institutions), it should be a discretionary tool for use in remedial situations, rather than an across-the-board requirement.

- American and non-domestic banks operating here have to meet Basel capital standards for their global operations. To impose an asset pledge requirement on non-domestic banks' major operations in the U.S. is a significant additional burden beyond the existing global capital requirements.

INSTITUTE ADDRESSES COMPLIANCE ISSUES ARISING FROM THE IMPLEMENTATION OF ANTI-MONEY LAUNDERING PROVISIONS OF THE USA PATRIOT ACT OF 2001

OUTLOOK FOR 2002

The Institute is preparing a comment letter on the Treasury Department's proposed regulations implementing Sections 313 and 319(b) of the USA Patriot Act, which prohibit U.S. "covered financial institutions", including U.S. branches and agencies of international banks, from maintaining correspondent accounts for foreign shell banks and require them to maintain records identifying the owners of foreign banks for which they maintain correspondent accounts as well as the persons in the United States designated by such banks as their agent for service of process. Comments on the proposed regulations are due by Monday, February 11th. Reflecting the discussion of the proposed regulations at a meeting with member institutions on January 16th, the Institute's comment letter will urge adoption of a more limited definition of "correspondent account" and express support for the approach taken in the revised definition that is being developed by the New York Clearing House.

The Institute also will request clarification of the circumstances in which covered financial institutions would be required to close a foreign bank's correspondent account and suggest certain modifications to the form of certification appended to the proposed regulations in order to reduce the burden on covered financial institutions and foreign banks alike. The Institute will also support use of information reported in the FR Y-7 to disclose information regarding a foreign bank's ownership and seek clarification of several technical issues raised by the proposal.

In addition, the Institute sent a letter to Treasury on December 17, 2001 seeking clarification of provisions of Section 312 of the Act calling for application of enhanced due diligence standards with respect to correspondent accounts maintained by, or on behalf of, "a foreign bank operating under an offshore banking license".

The provisions of Section 312 are not effective until July 23, 2002, and the Treasury Department is directed by Congress to adopt implementing regulations by April 24, 2002 (however, Section 312 is effective on the specified date regardless of whether such regulations have been adopted). It is intended that the clarification sought in the Institute's letter will be reflected in these regulations.

The Institute's letter requested Treasury to clarify that for purposes of applying the enhanced due diligence standards called for under Section 312 a "foreign bank operating under an offshore banking license" means only a non-U.S. bank that (i) is organized as a separate legal entity and (ii) is prohibited from conducting banking activities with the citizens of, or in the local currency of, the country which has authorized its activities. Under this reading of the statute, Section 312 would not apply with respect to correspondent accounts maintained by branches in such jurisdictions that are used as "offshore banking centers" by banks chartered elsewhere.

In testimony before the Senate Banking Committee on January 30th, Deputy Secretary of the Treasury Kenneth Dam described the additional initiatives the Department has under way to implement the Patriot Act. These include development of proposed regulations regarding enhanced due diligence standards for private banking and correspondent accounts for foreign persons and the methods for identifying and confirming the identity of foreign nationals, as well as the "beneficial owners" of certain private banking and other types of accounts. The Institute will closely monitor these developments with a particular view to their potential impact on international banks and their U.S. operations. Members of the Committee emphasized their expectation that the requirements of the Act will be "promptly and effectively" implemented.

REVIEW OF 2001

The USA Patriot Act, signed in the aftermath of the September 11th terrorist attacks, significantly expanded the authority of the United States Government to combat money laundering, with a particular focus on money laundering effected by non-U.S. persons through U.S. correspondent banks. The following are among the Act's principal provisions in this area:

- Effective upon enactment, Section 311 empowers the Treasury Department to apply "special measures" with respect to any jurisdiction, financial institution or type of international transaction that it finds to be of "primary money laundering concern". These measures include prohibiting, or imposing conditions on, the establishment or maintenance of a correspondent account in the United States for or on behalf of a foreign banking institution if the account involves a designated jurisdiction, institution or if a designated type of transaction can be effected through the account.

- Effective July 23, 2002, Section 312 requires the exercise of enhanced due diligence regarding a correspondent account maintained by or on behalf of a "foreign bank operating under an offshore banking license" or a bank licensed by a country designated as a "noncooperative" jurisdiction by the Financial Action Task Force (FATF).

- Effective December 25, 2001, Section 313 prohibits maintenance of a correspondent account for, or on behalf of, a foreign shell bank (generally, a bank that does not have any physical presence in the world and is not subject to oversight by any jurisdiction). In addition, U.S. correspondent banks must take "reasonable measures" to ensure that correspondent accounts they maintain for or on behalf of foreign

banks that are not shell banks are not used by such foreign banks to indirectly provide banking services to foreign shell banks.

- Also effective December 25, 2001, Section 319(b) requires U.S. correspondent banks to maintain records identifying the owners of foreign banks for which they maintain correspondent accounts, as well as the name and address of a person resident in the United States who is authorized by such foreign bank to accept service of process for records regarding the correspondent account. This latter provision facilitates implementation of another provision of Section 319(b) authorizing the Treasury and Justice Departments to issue a subpoena to any foreign bank that maintains a correspondent account in the United States for "records related to such correspondent account, including records maintained outside the United States relating to the deposit of funds into the foreign bank." Foreign banks that fail to designate an agent for service of process in a timely manner run the risk of their correspondent account being closed.

The Institute concentrated its attention initially on compliance issues arising under Sections 313 and 319(b). In this connection, we worked with the New York Clearing House and others in seeking guidance from Treasury regarding the actions U.S. correspondent banks, including U.S. branches and agencies of international banks, should take to satisfy the obligations imposed under these provisions of the Act. These efforts resulted in Treasury's issuance on November 20th of "Interim Guidance", which includes a model certification that U.S. correspondent banks may use to meet the applicable requirements. In its proposed regulations, Treasury subsequently proposed to codify the Interim Guidance, with certain modifications, and provide covered financial institutions a "grace period" to obtain the information required to ensure compliance with these requirements. The proposed grace period would be 90 days after publication of a final rule in the Federal Register. However, Treasury has emphasized that, notwithstanding this extension, covered financial institutions must promptly close the account of any foreign bank upon determination that it is a shell bank. The Interim Guidance and proposed regulations are available on the Treasury web site at www.ustreas.gov.press/releases/po813.htm and www.ustreas.gov/press/releases/po887.htm, respectively.

TAX DEVELOPMENTS AND OUTLOOK

IRS PROMISING ADDITIONAL GUIDANCE REGARDING NEW WITHHOLDING REGULATIONS AND QUALIFIED INTERMEDIARY ("QI") RULES

OUTLOOK FOR 2002

New regulations relating to withholding taxes and information reporting requirements on payments (including interest and dividends) made from U.S. sources to non-U.S. persons became effective on January 1, 2001. These regulations include special rules applicable to non-U.S. financial intermediaries that enter into QI agreements with the Internal Revenue Service, which are intended to reduce in certain important respects the information gathering and reporting burdens that non-U.S. financial intermediaries and their customers would otherwise bear under the new regulations. However, the QI procedures are themselves complicated and their implementation has required a material commitment of resources by every financial intermediary.

As financial intermediaries enter the second year under the new withholding regulations and QI rules, important guidance is still missing, which will have a significant impact on the workability and cost of the new rules. In particular, the IRS has promised to issue in the near future guidance that may simplify the documentation that a QI needs to receive from partnerships, trusts and other pass-through entities, as well as non-QI intermediaries, that are customers of QIs regarding their beneficial owners.

In addition, QIs await the release of revised guidelines (the "Guidelines") for the audits that must be performed by external auditors, at a QI's own expense, in respect of the second and fifth year of each QI agreement cycle (*i.e.,* for most QIs, 2002 and 2005). The Institute and several national banking associations severely criticized the first draft of the Guidelines, which was released by the IRS in October 2001, as imposing unduly burdensome and costly requirements on QIs.

On January 15th, the Institute held an important meeting in Washington with the senior IRS officials responsible for developing the Guidelines to express the concern that, if finalized without substantial revision, the Guidelines would impose unacceptably significant costs and burdens on QIs and may jeopardize the QI system. **These costs can be expected to amount to as much as several million dollars per audit year for larger institutions in fees to external auditors, while even smaller QIs will incur external audit costs of several hundred thousand dollars a year, in addition to significant internal costs.**

The Institute believes that as a result of the meeting and the letters and other communications from the Institute as well as quite a number of national banking associations, the IRS has a much clearer appreciation of the problems raised by the Guidelines and the need to dramatically reduce the compliance costs faced by QIs. However, the IRS still believes that it is necessary to conduct a statistically valid sampling to ensure that the "correct" amount of tax is being withheld and, if errors are identified, to extrapolate the amount of tax to be paid by a QI.

As a result, we believe that the IRS is likely to revise the Guidelines, as we have recommended, (i) to focus more heavily (and sensibly) on ensuring that appropriate policies, procedures and systems are in place rather than on auditing masses of paper documents, (ii) to relax the statistical sampling requirements (but probably not sufficiently), and (iii) possibly to stratify the level of audits by permitting the external auditors to forgo more detailed investigations if initial systems-based reviews demonstrate a high level of compliance. However, the IRS acknowledged that any such stratification, which would be a natural part of a standard IRS examination and could significantly reduce the costs of the external audits, would need to be carefully conceived, and may not be feasible, because the accounting firms have resisted exercising any discretion in performing their external audit functions.

Despite this progress, the Institute remains concerned that the costs to QIs – including external auditor fees, internal absorbed costs and potential assessments based on extrapolated amounts – will continue to remain unacceptably high unless the IRS is persuaded to adopt our fundamental recommendation that QIs be treated consistently with other groups of taxpayers and not be required to pay external auditors that in effect are "deputized" by the IRS to perform full blown audits on 100% of the QI population. Instead, every QI should be required to undergo an audit that verifies the adequacy of its policies, procedures and systems for complying with the QI agreement. The extensive step-by-step audit proposed in the IRS' guidelines would be reserved for limited cases (up to, say, 2% of QIs) selected by the IRS using an appropriate audit selection process.

Accordingly, the Institute urges member banks and national banking associations that concur with the Institute's evaluation to continue to convey their concerns directly to the IRS and the Treasury Department, in order to forcefully communicate the severity of the problem. The Institute believes that it is important that the IRS and the Treasury Department hear from as many interested parties as possible that the proposed external audit guidelines would impose unacceptably costly burdens on QIs and may jeopardize the viability of the QI regime.

REVIEW OF 2001

The year 2001 was the first year of the new withholding and reporting regulations and the QI rules, and many financial institutions began the complicated process of revising their documentation, reporting and information systems to comply with the new rules and, where necessary, seeking additional documentation from existing accountholders. Given the enormity of the task, the Institute expects that many institutions will continue to devote a considerable amount of time and energy in 2002 to this effort.

Having spent much of the year 2000 encouraging non-US financial institutions to become QIs (an effort that evidently was very successful, as over 2800 institutions and their branches applied to become QIs), the IRS devoted most of 2001 to preparing the external audit Guidelines. The Institute held a series of meetings with, and made several written submissions to, the IRS in the course of the year regarding the Guidelines. The key points made by the Institute regarding the first draft of the Guidelines were as follows:

1. *Guidelines Require Unreasonably Comprehensive Audits.* The Guidelines call for an extensive, step-by-step audit of virtually every aspect of a QI's performance of its responsibilities under a QI agreement. Thus, while the Guidelines follow the recommendation of the Institute and the five major accounting firms that there be precise "agreed-upon procedures" for the external auditors to follow and address in their report, the Guidelines depart from our fundamental recommendation that the procedures be tailored to encourage and confirm a high level of voluntary compliance by QIs, at a reasonable cost. Instead, the Guidelines continue to view the external audit function to a great extent as a tax collection mechanism.

The Institute recommended that the Guidelines replace the audit of each and every aspect of the QI agreement with a significantly more limited, targeted approach that focuses on the essential components of the QI process with a view to verifying the adequacy of, and identifying any weaknesses in, a QI's policies, procedures and systems, eliciting clear information regarding the overall compliance level and good faith of the QIs, and making recommendations for improvement. This can be supplemented by more comprehensive external audits in select cases (not exceeding, say, 2% of the QI population), as determined by the IRS using its standard audit selection process. Additionally, even the selective comprehensive audits should be flexibly structured to take account of a QI's information system instead of requiring manual checking of individual accounts.

2. *Statistical Sampling Should be Significantly Curtailed.* The Guidelines generally require that three statistical samples be created for each QI, representing the lesser of 456 accounts or 50% of the relevant population. Each account in the statistical sample must be examined separately to test compliance with numerous specific requirements under the regulations. Evidently, in the case of financial institution groups with multiple QIs under a single QI agreement, separate statistical samples must be created for each QI. Such an extensive statistical sampling and examination of accounts far exceeds the norm for regulatory audits, where a sampling of perhaps 30 out of 10,000 items is typical.

3. *Substantial External Audit Costs are not Warranted.* The combined requirements of detailed, comprehensive audits and large statistical samples will result in significant costs being imposed on QIs, comprising both external auditors' fees and internal administrative and systems costs. Compliance costs can be expected to amount to several million dollars per audit year for larger institutions in fees to external auditors, while even smaller QIs will incur external audit costs of several hundred thousand dollars a year, in addition to significant internal costs. The imposition of such prohibitive costs on QIs is shortsighted and counterproductive since these institutions are merely performing custodial services, they often operate at small profit margins and they are voluntarily accepting QI status. Indeed, the IRS does not, and cannot, perform such an extensive audit on any other group of taxpayers, nor does it require any other group of taxpayers to perform such an extensive audit at its own expense.

4. *Burdens are Compounded by Treatment of Pass-through Entities and Old Accounts.* The burdensome costs of complying with the Guidelines are severely exacerbated by the failure of the IRS to provide workable guidance for the treatment of accounts held by non-qualified intermediaries, partnerships, trusts and other collective investment vehicles that are treated as pass-through entities for U.S. tax purposes. Under existing rules, a QI must obtain adequate documentation with respect to each beneficial owner through such an entity, and the Guidelines require the external auditors to check compliance with respect to such indirect owners. Similarly, the QI agreements require QIs to obtain adequate documentation with respect to each account opened prior to the effective date of the applicable "know your customer" rules, and the Guidelines require the external auditors to check compliance with this requirement.

5. *Underwithholding Amounts Should not be Extrapolated from the Statistical Samples.* In response to prior comments, the Guidelines indicate that if the external auditor determines that there has been underwithholding, the IRS will direct further procedures to determine whether and how to make a projection of the underwithholding amount and will permit the QI to propose more appropriate, alternative bases for determining the amount of underwithholding. These modest improvements do not adequately protect QIs from the specter of IRS agents imposing prohibitive underwithholding adjustments, which will inevitably be borne by the QIs because they would not be traceable to any customers. The QI audit function must be re-focused to ensure adequate compliance and to remedy shortcomings in the process rather than to raise tax revenues from financial intermediaries that are acting in good faith with a set of very complicated, detailed rules and are merely custodians operating with very thin profit margins. An approach that is more consistent with this objective and with the tax law generally would be to impose penalties (up to a maximum amount of, say, $250,000) for material failures to comply with a QI agreement without reasonable cause.

6. *The Guidelines' Proposals Regarding Internal Auditors are Unworkable.* The Guidelines allow the external auditor to use a QI's internal audit staff and internal audit reports to the extent it chooses, but provide that the external auditor remains personally responsible for the audit and must certify that the use of the internal audit personnel and reports has not affected the accuracy of the external auditor's report. These conditions render it impossible for internal auditors to meaningfully participate in the audits, since we understand that external auditors cannot satisfy these conditions under their professional standards. Instead, we have previously recommended that QIs with developed, independent, internal audit functions should be permitted to have the compliance examination function divided between its external and internal auditors, each of which would issue an "agreed-upon procedures" report covering the items for which it is responsible.

7. *The Guidelines' Proposals for Discretionary Waivers of External Audit are Too Limited and Impractical, and they Need to be Expanded.* The proposed Guidelines permit the IRS to waive the performance of external audits in three cases. The conditions for qualifying for a waiver are too limited and impractical. For example, while the IRS may waive one external audit (other than the first one) in each six-year cycle for a QI that has made reportable payments to no more than 2000 direct and indirect account holders, and instead allow the QI to perform the audit with its own personnel, the QI may not use statistical sampling in that case. Another exception that is too restrictive would allow the internal auditors to perform one of the audits in each cycle where the QI has a substantial and independent internal audit department that has audited the QI's compliance under the QI agreement for each of the three years prior to the year to be audited.

INSTITUTE REMAINS CONCERNED ABOUT THE OECD DISCUSSION DRAFT ON THE TAXATION OF BANK BRANCHES AND OTHER PERMANENT ESTABLISHMENTS

OUTLOOK FOR 2002

The Organization for Economic Cooperation and Development has invited the Institute and other interested groups to attend a public consultation on April 11-12 for the purpose of discussing the OECD's "Discussion Draft" document on the taxation of bank branches.

The Discussion Draft could have a major impact on the manner in which a multinational bank is taxed in each country in which it conducts business. In particular, the Discussion Draft proposes a new, comprehensive framework for determining the amount of profits that should be attributed to the various foreign branches (and head office) of a multinational bank. Significantly, the document proposes to allocate equity capital to each branch (for purposes of determining its deductible interest expense) based on the risk-weighted assets (and off-balance sheet exposures) of the branch, utilizing the risk-weighted capital standards under the Basel Accord for bank regulatory standards.

The Institute is very concerned that if adopted, the Discussion Draft's proposed approach to allocating capital could have a significant adverse impact on the worldwide tax position of many multinational banks. Preliminary indications are that the Basel Accord-based approach generally would increase the amount of capital allocated to a multinational bank's U.S. and other non-home country branches (because banks tend to concentrate their low-risk weighted assets in their home office), thereby shifting deductible interest expense from the U.S. and other branches to the home country and increasing the tax burden on multinational banks outside their home country. The overall impact of a Basel-based approach on the worldwide tax position of any particular bank would depend on the interplay of numerous factors.

Moreover, the Institute believes that key features of the Discussion Draft are flawed on technical, practical and policy grounds. In particular, while it may seem perfectly logical and simple to adopt for tax purposes the same capital allocation method that is used for regulatory purposes, in fact, it is neither logical nor simple to do so, but would raise significant administrative and practical complications and would produce distorted results. Also, the Discussion Draft would impose unnecessary complexities and burdens regarding the tracing of assets to particular locations and the performance of functional analyses of straightforward banking operations. Furthermore, the Discussion Draft would not achieve a sufficient level of uniformity in the treatment of multinational banks by different tax authorities.

REVIEW OF 2001

The OECD released its Discussion Draft in February 2001. This significant release by the OECD proposes a new, comprehensive framework for applying the permanent establishment (PE) concept that is integral to income tax treaties. The proposed approach is set forth as a working hypothesis (WH) of an appropriate method for determining the amount of profits that should be attributed for tax purposes to each PE, or branch, of a bank or other enterprise. The Discussion Draft emphasizes that the WH is a work in progress, and solicits public comment on the general approach as well as on specific issues addressed in the document.

Essentially, the WH advanced by the Discussion Draft has the following basic elements:

- *"Functionally Separate Entity" approach for determining the profits of a PE, applying arm's length principles.* The WH would attribute to each PE the profits that the PE would have earned at arm's

length if it were a separate enterprise performing the same functions under the same or similar conditions, determined by applying the arm's length principles developed for related enterprises.

- *Functional analysis to hypothesize PE/separate enterprise.* Each PE would be treated as a hypothetical separate enterprise by attributing to it the functions and activities conducted, the assets used, and the risks assumed, by it, and taking into account the dealings between it and other parts of the enterprise. The profits of this hypothesized separate enterprise would be determined under appropriate transfer pricing methods. The Discussion Draft touches upon some of the difficult issues in determining the hypothetical PE/separate enterprise, including how to attribute intangibles and other assets, credit rating, capital and funding costs to the PE.

- *Basel risk-weighted capital approach to attribute equity capital to a PE.* For purposes of determining the deductible interest expense of each PE, the equity capital of a bank would be allocated to each PE in proportion to the relative amount of risk-weighted assets (and off-balance sheet exposures) attributable to the PE, utilizing the risk-weighted capital standards under the Basel Accord for bank regulatory purposes. The imputed equity capital would reduce the amount of debt funding, and interest expense, deemed to be incurred by a PE.

In June, the Institute submitted to the OECD a lengthy and comprehensive paper commenting on the Discussion Draft. The Institute's paper can be accessed through the Institute's web site at www.iib.org/6-28OECDfinal.pdf. The paper developed the theoretical, policy and practical objections to the WH that are described above.

INSTITUTE CONTINUES TO URGE IRS TO ISSUE FURTHER GUIDANCE REGARDING THE DETERMINATION OF AN INTERNATIONAL BANK'S DEDUCTIBLE INTEREST EXPENSE

OUTLOOK FOR 2002

The Treasury Department and the IRS have indicated that they understand the need to issue further guidance under regulation section 1.882-5 and related provisions regarding the calculation of an international bank's deductible interest expense. The Institute believes, however, that this is a multi-year project, and is unlikely to produce guidance until further progress is made regarding the global dealing regulations and the OECD Discussion Draft on the taxation of permanent establishments.

REVIEW OF 2001

The Institute met with Treasury Department International Tax Counsel Barbara Angus and Deputy International Tax Counsel Patricia Brown in July and argued that, after a hiatus of several years, it is now time for the Treasury Department and the IRS to provide additional, much-needed guidance regarding the computation of an international bank's deductible interest expense under regulation section 1.882-5. The Institute pointed out that, while this project was pursued at various levels in the years after the March 1996 issuance of final and proposed regulations section 1.882-5, in recent years we had been told that it would be held in abeyance while efforts were made in the OECD to address conceptual issues in the aftermath of the *Natwest* case and pending finalization of the global dealing regulations.

The Institute requested that two guidance projects be opened: *first,* to provide clarification regarding numerous practical issues in determining the nature and amount of a bank's worldwide assets and liabilities in accordance with U.S. tax principles for purposes of the "actual ratio" under the regulation; and *second,* to finalize

the proposed regulation and provide guidance regarding the appropriateness of netting or integrating liabilities and assets in the context of derivatives, hedging transactions, securities repo transactions and securities loans.

Apparently in response to that meeting, the IRS issued Notice 2001-59, in which it requested comments on whether the interest allocation rules, pursuant to which an international bank determines its deductible interest expense for U.S. tax purposes, should be modified to provide integrated treatment (such as netting of interest expense and income and/or assets and liabilities) of certain financial transactions.

In its comment letter, the Institute referred to its lengthy and comprehensive paper addressing these questions that comprised part of its May 1996 comments on proposed and final regulation section 1.882-5. The Institute recommended flexibility in allowing international banks to elect to apply either a gross or a net method under appropriate circumstances. However, in the event the IRS decides to adopt a single approach, the Institute recommended that the regulations adopt a uniform, expansive netting approach, in order to minimize complexities for international banks and to avoid potentially severe distortions.

The Institute also urged the IRS to provide guidance regarding the other main topics addressed in our 1996 comments – (i) the application of the "actual ratio" of a bank's worldwide liabilities to worldwide assets and (ii) the selection of an inappropriately low "fixed ratio" of 93%, based on a misunderstanding of bank regulatory capital standards and their relevance to regulation section 1.882-5. The Institute intends to pursue these very important issues in the coming year.

DEVELOPMENTS REGARDING PROPOSED GLOBAL DEALING REGULATIONS

IMPLICATIONS FOR 2002

The Institute understands that the Treasury Department and the IRS are hoping to finalize the global dealing regulations during the course of the coming year. In addition, discussions are expected to continue among the United States' major trading partners and the members of the OECD regarding the details of an international approach to the taxation of global dealing operations. In this regard, the OECD has solicited comments from the Institute and other interested parties regarding the OECD's 1998 working paper on the taxation of global trading operations. If and when an international consensus emerges and the global dealing regulations are finalized, one of the most significant sources of potential exposure for international banks and their affiliates will be mitigated.

REVIEW OF 2001

During 2001, the Institute continued its discussions with the U.S. Treasury Department and the IRS regarding the proposed regulations, issued in March 1998, concerning cross-border dealing operations in foreign currencies, securities and derivatives. As advocated by the Institute, the new rules adopt an arm's length approach for determining the amount of profits from a cross-border dealing operation that is subject to U.S. taxation.

Of importance to all member banks, the proposed regulations would provide relief for interbranch transactions in foreign exchange and other financial products between an international bank's U.S. operations and its head office or other branches outside the United States.

The proposed regulations are of great significance to the international banking community. When finalized, they will dramatically improve the substantive rules governing the U.S. taxation of the securities, derivatives and foreign currency dealing operations of international banks and their affiliates.

Under the proposed regulations, the amount of profits from a cross-border dealing operation that are taxable by the United States—regardless of whether the U.S. activity is conducted through a branch or a corporation or partnership—is to be determined on the basis of the arm's length principle generally applicable to other transfer pricing situations. Thus, the portion of the profits taxable by the United States would be limited to the relative economic value of the contribution of the U.S. branch or affiliate to the activity.

By contrast, the existing rules (unless overridden by an applicable tax treaty) are inconsistent with economic reality in that they often attribute to the U.S. branch the full amount of profit from a securities, derivatives or foreign currency transaction where the U.S. branch has any material participation in the transaction, regardless of the role played by other offices or affiliates outside the United States. In addition, the existing rules do not recognize interbranch transactions—for example, between the U.S. branch's foreign exchange desk and the bank's home office. These rules often produce uneconomic results and are in conflict with the tax rules of other countries in which global dealing activities may be conducted. As a result, multinational banks, securities firms and derivatives dealers face tremendous tax uncertainties, exposures and risks of multiple taxation of their profits from cross-border dealing activities.

The Institute has expressed its strong support for the overall approach of the proposed regulations, in its written comments, at the July 1998 public hearing and in private discussions with the Treasury Department and the IRS, but has criticized certain specific aspects. For example, the Institute has argued that the proposed regulations should provide greater flexibility in the treatment of capital and the treatment of "deemed" permanent establishments or qualified business units ("QBUs"). In addition, the Institute has urged that international banks and their affiliates be allowed to elect to apply the proposed regulations on a retroactive basis.

In October, the Institute submitted a letter to the Treasury Department International Tax Counsel, Barbara Angus, and the Deputy International Tax Counsel, Patricia Brown, describing a possible approach to address a controversial aspect of the proposed global dealing regulations – the treatment of situations in which a non-U.S. company (such as a bank or securities or derivatives dealer) could be deemed to have a "permanent establishment" or QBU in the United States as a result of activities on its behalf by a U.S. affiliate.

While the Institute had expressed its concerns regarding the treatment of QBUs when the proposed regulations were originally released, this issue has complicated the finalization of the regulations because U.S.-headquartered securities firms have recently pointed out that, in the absence of relief, the new global dealing rules could result in particular hardship for them.

The Institute's October letter was a follow-up to discussions in July with Mss. Angus and Brown, at which the Institute urged that the proposed global dealing regulations be finalized soon because of their importance to international banks and their affiliates that are dealers in securities, derivatives and commodities. Essentially, the Institute's proposal, which builds on a previous suggestion made by the Institute, is that the U.S. participant in a global dealing operation should be permitted (subject to certain conditions and limitations) to report all of the U.S.-related income from that operation, including income of non-U.S. affiliates that do not otherwise file U.S. tax returns.

INSTITUTE TESTIFIES AT JUNE IRS HEARING CONCERNING PROPOSED REGULATIONS REQUIRING BANKS TO REPORT DEPOSIT INTEREST PAID TO NONRESIDENT ALIEN INDIVIDUALS

The Institute testified at the June 21st IRS hearing on proposed regulations (issued in January 2001) that would impose reporting requirements for interest on bank deposits of nonresident alien individuals (NRAs).

The proposed NRA reporting requirements are intended primarily to enable the United States to provide information, pursuant to the information exchange provisions of tax treaties, to an NRA's home country tax authority regarding the NRA's interest income from U.S. bank deposits.

The Institute's testimony emphasized the points made in the Institute's February 27th comment letter regarding the proposed regulations. The Institute argued that it would be counterproductive for the United States to act unilaterally to provide foreign governments with information on the savings income of NRAs. Many NRA individuals maintain deposits in the United States in reliance on the confidentiality of their banking relationship. Unilaterally imposing information reporting requirements with respect to interest paid on these deposits would strongly encourage NRAs to withdraw their funds and transfer them to the many jurisdictions that do not impose such requirements. The outflow of funds from the U.S. banking system that would result from the proposed rule would be harmful to depository institutions in the United States and more generally to the U.S. economy. The Institute also questioned whether the limited benefit to the United States from this proposal merits the imposition of the costs and burdens of compliance on the banking industry.

Given the significant opposition to the proposed regulations by banking organizations and politicians, including those based in Florida, it is unclear at this time whether the IRS will seek to finalize the proposed regulations in the near future.

INSTITUTE COMMENCES LOBBYING EFFORTS REGARDING POSSIBLE COMBINED NY STATE AND CITY REPORTING BETWEEN BRANCHES AND SUBSIDIARIES OF INTERNATIONAL BANKS

OUTLOOK FOR 2002

The Institute expects to pursue its proposal to amend the New York State and City tax laws so as to provide for the filing of a single combined report by a non-US bank that has a branch in NY and the bank's U.S. affiliates that are subject to NY State and/or City taxation.

The main purpose of this proposal is to eliminate the discriminatory treatment of international banks (compared to their U.S. competitors) and enable them to offset income of their branches with losses of their U.S. subsidiaries. The impact of this proposal on specific taxpayers may vary, however, depending on the amount of income and/or loss in the branch and its U.S. affiliates and the relative level of NY apportionment factors in each entity. As a result, the Institute has incorporated in its proposal a grandfather provision, which would enable groups to elect to continue to be subject to the existing rules.

While the timing of direct legislative efforts in this regard has been affected by the post-September 11th political and fiscal climate, the Institute expects to commence discussions regarding the technical aspects of the proposal with the NY Department of Finance.

REVIEW OF 2001

During 2001, the Institute continued to participate in meetings of the New York State Finance Department's Financial Modernization Task Force, which has been considering revisions of the NY Tax Law to account for changes in the banking, securities and insurance industries arising from the Gramm-Leach-Bliley Act. As an outgrowth of these meetings, the Institute has developed its proposal to amend the New York State and City tax laws so as to provide for the filing of a single combined report by a non-U.S. bank that has a branch in NY and the bank's U.S. affiliates that are subject to NY State and/or City taxation.

After refining the technical aspects of this proposal with the assistance of PricewaterhouseCoopers and the Institute's tax counsel at Cleary, Gottlieb, Steen & Hamilton, the Institute presented its proposal in a December letter to the staffs of the NY State and City tax departments.

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