

Notice 94-40

Global Trading Advance Pricing Agreements

1994-1 C.B. 351; 1994 IRB LEXIS 213; 1994-17 I.R.B. 22; Notice 94-40

April 25, 1994

[*1] PURPOSE

Under an Advance Pricing Agreement ("APA"), the Internal Revenue Service ("Service") and a taxpayer agree on a transfer pricing methodology to be applied to any apportionment or allocation of income, deductions, credits, or allowances between or among two or more organizations, trades, or businesses owned or controlled, directly or indirectly, by the same interest. Rev. Proc. 91-22, 1991-1 C.B. 526, as corrected by Rev. Proc. 91-22A, 1991-1 C.B. 534, explains how to secure an APA from the Service.

The Service has concluded APAs with several taxpayers that have functionally fully integrated operations in the global trading of commodities and derivative financial products. These operations are characterized by the transfer of the authority to trade in a "book" of positions from trading location to trading location. This notice does not provide general guidance regarding the federal taxation of derivative financial products; rather it discusses the Service's experience with issuing these APAs. It also describes the method and factors that were used to allocate income derived from functionally fully integrated operations located in the United States and other tax jurisdictions. [*2] This notice does not discuss operations in the global trading of commodities and derivative financial products that are not characterized by the transfer of a book of positions. Taxpayers with operations that are not functionally fully integrated may nonetheless seek to secure an APA. However, different methodologies may be more appropriate for these taxpayers than the method described in this notice.

BACKGROUND

Historically, financial markets have been limited by the national boundaries within which they operated. However, the world's financial markets are becoming more integrated because of technological developments, financial innovation, and regulatory changes. Many financial intermediaries trade commodities and derivative financial products around the clock by maintaining traders in offices around the world ("global trading").

Four general functions are common to global trading operations; trading, sales, management, and support. A trader quotes prices, initiates buy and sell transactions, and determines whether and how to hedge transactions. A salesperson advises clients about ways to manage the price, interest rate, and currency exchange risks associated with their[*3] assets and liabilities, with a view toward selling them a derivative financial product or commodity. A manager controls or monitors the level of risk to which the institution is exposed and sets trading limits. Finally, the support function performs various wide-ranging activities that assist the first three functions; including technology and information systems development and provision, credit analysis of customers and counterparties, accounting, contract administration, and coordination of the transportation and delivery of physical commodities.

Different companies have integrated these functions in varying degrees for a variety of business reasons. However, two broad types of organization can be distinguished: operations that are functionally fully integrated and those that are not.

Global trading operations of companies that are functionally fully integrated are characterized by the centralized management of risk and personnel. The business is managed as one global position for purposes of risk management rather than several discrete businesses. Thus, a trading book is not independently maintained for each trading location. Rather, one book is maintained and the trading[*4] authority for that book is "passed" from trading location to trading location at the close of each trading day for that trading location (the "global book"). To assist in the management of the risk, a central credit department monitors the credit-related exposure of the transactions entered into by the traders.

This information is used by the home office to establish credit guidelines and customer credit limits to be applied by traders throughout the company.

The book for each product, or group of product, typically has one head trader or book manager who allocates trading limits for each trading location and determines guidelines for the book. The head trader is responsible for the economic performance of that book. Accordingly, the head trader is in frequent communication with other traders employed by the company. The head trader, therefore, acts as overseer of other trading personnel.

In a functionally fully integrated operation each office may be capable of performing the same functions as any other, subject to limits, procedures, and guidelines imposed by the home office. For example, it is common for one office to locate a seller of a commodity or derivative financial[*5] product and another office to locate a buyer, while either of those offices or a third office hedges the transaction. Each office in such a transaction contributes to the overall profitability of the global business.

The APA process has proven to be a useful vehicle to allocate the income of a functionally fully integrated global trading business between taxing jurisdictions. For each of the APAs concluded with taxpayers operating these businesses, the Service used a profit split method to allocate income of related operations between taxing jurisdictions. In each case, a taxpayer and the Service entered into an APA and the competent authorities of the United States and a treaty partner entered into an agreement to allocate the income pursuant to that method. The Service, treaty partners, and taxpayers found that the use of a profit split method to allocate the income of these functionally fully integrated global trading businesses was appropriate because of the volume and nature of transactions involved in these APAs. For these taxpayers, the profit split method permits the allocation of income in a way that reflects the contribution of each trading location to the profitability[*6] of the global book.

In the case of integrated businesses operating through separately incorporated subsidiaries located in different tax jurisdictions, the APAs were entered into pursuant to the authority of section 482 of the Code and an applicable income tax treaty. For integrated businesses incorporated in one tax jurisdiction but operating through unincorporated branches in other tax jurisdictions, the APAs were entered into pursuant to the authority of income tax treaties.

APA PROCESS

Generally, APAs issued to taxpayers that have functionally fully integrated operations in the global trading area have covered transactions in commodities and derivative financial products, as well as the related hedges used to minimize price risk or interest and currency exchange rate risk. APAs in the global trading area have been issued to domestic corporations trading through a subsidiary or branch located in a country with which the U.S. maintains an income tax convention ("treaty country"). They have also been issued to corporations that are located in treaty countries and that trade in the United States through a branch. Although the Service has not yet negotiated an APA with a foreign[*7] corporation trading in the United States through a domestic subsidiary, there is no procedural obstacle to issuing such an APA.

The APA process is a flexible procedure whereby a taxpayer decides which global books it wants covered. Each of these APAs was tailored to take account of the unique facts and circumstances of the taxpayer. These APAs divided the business' worldwide trading profits or losses among the trading locations according to an agreed upon profit split method.

FACTORS USED IN GLOBAL TRADING APAs

Set forth below is a general description of the global trading APAs that the Service has concluded with functionally fully integrated taxpayers. In each of these APAs, the Service, the taxpayer, and a treaty partner agreed that the worldwide income for each global book to be covered by the APA should be allocated among the taxpayer's trading locations pursuant to a profit split method. The method was intended to measure the economic activity of each trading location and its contribution to the overall profitability of the worldwide business. Three critical factors were identified: 1) the relative value of the trading location (the "value factor"), 2) the risk associated [*8]with a trading location (the "risk factor"), and 3) the extent of the activity of each trading location (the "activity factor"). Each of the factors was weighted to reflect its relative contribution to the overall profitability of a taxpayer's worldwide business. Moreover, the APAs did not adopt a uniform measurement of these factors; rather, different measurements were adopted in each

APA to reflect the taxpayer's particular facts and circumstances as closely as possible. Relevant considerations in adopting a measurement for each factor included: the taxpayer's management structure and management information system capability, the functions performed, risks assumed, and capital employed by each trading location.

The value factor is a direct measure of the contribution of a trading location to the worldwide profits of that business. Trading commodities or derivative financial products generates the profit and loss for the business. For the taxpayers covered by these APAs, traders were the most significant resource in generating trading profit or loss for the company because they typically had customer lists and knowledge of the market. Traders are responsible for negotiating[*9] prices at which trades will be made, executing the transactions, and determining the hedging strategies to be used. Their compensation often is based upon a salary and a discretionary incentive bonus that depends upon their contribution to the profitability of the book. The sum of the compensation paid to traders in a particular trading location is a direct indication of the trading location's contribution to the profitability of the worldwide book. Thus, the Service, the taxpayer, and the participating treaty partner viewed compensation of the traders at a trading location as the best measure of the value of a trading location. Accordingly, this factor was weighted more heavily than others.

The risk factor measures the potential risk to which a particular trading location exposes the worldwide capital of the organization. This factor provides an important indication of the contribution of that trading location to the production of gross profits of the business. Based on the unique characteristics of each taxpayer, the risk factor was measured in several different ways, such as the maturity weighted volume of swap transactions (determined by multiplying the notional amount [*10] of each swap transaction entered into by its maturity) or open commodity positions at the end of the year entered into in that trading location. Sometimes this factor was weighted more heavily than others.

The activity factor serves as another measure of a trading location's contribution to the production of gross profits of the business. This factor was measured by reference to the compensation of key support people at a trading location (for example, back office support) or the net present value of transactions executed at a trading location (determined by aggregating the present values of the cash flows computed at the inception of each transaction for each trading location).

APPLICATION OF THE METHOD

The first step in applying the agreed upon method is to determine the amount of trading profits or losses to which the method will apply. Typically, this includes worldwide profits and losses from trading the class of commodities or derivative financial products and related hedges that the taxpayer and the Service have agreed to include within the APA, less expenses that are directly related to the production of trading income or loss, such as compensation of certain personnel, [*11] trading computer systems, and broker commissions (the "worldwide net income or loss"). Other expenses, including office supplies, rent, and communications, were allocated to the trading locations that incurred them. However, expenses that are required to be computed under specific Code or regulatory rules, such as interest expense deductions under § 1.861-9T of the Temporary Regulations or § 1.882-5 of the regulations, were allocated under the appropriate provisions.

The second step in applying the method is to calculate the ratio that results from each factor. For example, to determine the ratio for the value factor, the total U.S. trader compensation is divided by the total worldwide trader compensation. That result, possibly multiplied by a weighting factor, is the ratio for the value factor.

Once the three ratios are determined, the percentage of worldwide net income or loss attributable to the U.S. is calculated by taking the sum of the three factors and dividing them by the sum of the weights given to each factor.

Finally, to determine the amount of worldwide net income or loss attributable to the U.S., the worldwide profit or loss is multiplied by the percentage described[*12] above.

RELEVANCE TO FUTURE APAs

This notice is not intended to prescribe a method or factors that will necessarily apply in all APAs with functionally fully integrated global trading operations, nor is it intended to limit the use of other methods or factors if they more appropriately measure the contribution of each trading location to the profitability of the business. The method and factors described in this notice may not necessarily accurately measure the economic contribution of each trading location to the profits of the business for a particular fully integrated global trading company. In addition, due to a

particular taxpayer's management structure or management information system capabilities, other methods or factors may be appropriate. In both of these cases, other methods or factors will be used if those methods or factors more appropriately measure the contribution of each trading location to the profits of the business. In addition, different methodologies may be appropriate for operations in the global trading of commodities and derivative financial products that are not functionally fully integrated and not characterized by the transfer of a single book of[*13] positions.

DRAFTING INFORMATION

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