[2019] UKUT 0277 (TCC)

Appeal numbers: UT/2017/0178
UT/2017/0179

CORPORATION TAX – UK branches of Irish banks – interest expense – whether deductible – attribution of notional capital – ICTA section 11AA(3)(b) – construction and application of UK – Ireland DTC

UPPER TRIBUNAL
TAX AND CHANCERY CHAMBER

(1) IRISH BANK RESOLUTION CORPORATION LIMITED
(in special liquidation)
(2) IRISH NATIONWIDE BUILDING SOCIETY

Appellants

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS

Respondents

TRIBUNAL: The Honourable Mr Justice Marcus Smith
Judge Timothy Herrington

Sitting in public at The Rolls Building, Fetter Lane, London EC4A 1NL on 15 and 16 May 2019

Philip Baker, QC and Imran S Afzal, instructed by KPMG Belfast, for the Appellants

David Milne, QC and Jonathan Bremner, QC, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the Respondents

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DECISION

A. TAXATION OF COMPANIES NOT RESIDENT IN THE UNITED KINGDOM ACCORDING TO UNITED KINGDOM LAW

5 1. In the United Kingdom, as in many other jurisdictions, a company resident in the United Kingdom is within the charge to corporation tax in relation to all of its profits, wherever arising.

2. Companies not resident in the United Kingdom are generally outwith the charge to corporation tax, unless a company carried on a trade in the United 10 Kingdom through a permanent establishment in the United Kingdom. Section 11 of the Income and Corporation Taxes Act 1988 ("ICTA 1988"), as in force at the material times, provided:

"(1) A company not resident in the United Kingdom is within the charge to corporation tax if, and only if, it carries on a trade in the United Kingdom through a permanent 15 establishment in the United Kingdom.

(2) If it does so, it is chargeable to corporation tax, subject to any exceptions provided for by the Corporation Tax Acts, on all profits, wherever arising, that are attributable to its permanent establishment in the United Kingdom."

3. Section 148(1)(a) of the Finance Act 2003 ("FA 2003") defines a 20 "permanent establishment" as "a fixed place of business…through which the business of a company is wholly or partly carried on".

4. As it stands, section 11 ICTA 1988 provides no guidance as to what profits are – and what profits are not – attributable to a corporation's permanent establishment. Some guidance is provided by section 11AA ICTA 1988, inserted 25 into that statute by section 149(2) FA 2003. So far as material, section 11AA provides:

"(1) This section provides for determining for the purposes of corporation tax the amount of the profits attributable to a permanent establishment in the United Kingdom of a company that is not resident in the United Kingdom ("the non- 30 resident company").

(2) There shall be attributed to the permanent establishment the profits it would have made if it were a distinct and separate enterprise, engaged in the same or similar activities under the same or similar conditions, dealing wholly independently with the non-resident company.

35 (3) In applying subsection (2) –

(a) it shall be assumed that the permanent establishment has the same credit rating as the non-resident company, and

(b) it shall also be assumed that the permanent establishment has such equity and loan capital as it could reasonably be expected to have in the circumstances specified in that subsection.

No deduction may be made in respect of costs in excess of those that would have been incurred on those assumptions."

Section 11AA ICTA 1988 came into effect in relation to accounting periods beginning after 31 December 2002.

B. THE NATURE OF PERMANENT ESTABLISHMENTS

5. The difficulty, in terms of working out what profits are attributable to a permanent establishment arises, at least in part, out of the nature of a permanent establishment.

6. A permanent establishment is not a separate legal person, distinct from the corporation of which it forms a part. For this reason, there is a terminological difficulty in describing dealings between a company and its permanent establishment, which translates into the difficulties of attribution that we have referred to:

(1) Because it is not possible for a person, acting in the same capacity, to deal with itself, it is in fact legally meaningless to say that a permanent establishment "pays" interest to the company or that the company "transfers" an asset to the permanent establishment. Such transactions can, in law, not take place and they amount to no more than internal bookkeeping on the part of the company.

(2) In saying this, we say nothing about the legitimacy or propriety of such book entries: this is simply an inevitable consequence of the fact that a permanent establishment is, in legal terms, indistinguishable from the company that has established it.

(3) For this reason, the fact that such transactions are legally without effect, does give rise to a terminological difficulty. We shall, in this decision, refer to the permanent establishment "paying" interest to the company or the "payment" of capital to the permanent establishment by the company as the best, shorthand, way of describing such dealings. However, at all times, we have in mind that these are not really legal transactions at all.

(4) For the same reason, there is a difficulty in attributing costs and profits to a permanent establishment. We have seen how section 11AA ICTA 1988 seeks to resolve that difficulty.

C. THE INVOLVEMENT OF DIFFERENT JURISDICTIONS AND DOUBLE TAXATION CONVENTIONS

7. Issues regarding the attribution of profits to a permanent establishment only arise where a company is resident in one jurisdiction and the permanent establishment is in another jurisdiction. In such cases, in order to avoid double

taxation (where two jurisdictions tax the same profit) or double non-taxation (where a profit is taxed by neither jurisdiction), the rules of the two jurisdictions will need to co-ordinate. Typically, such co-ordination will be in the form of a double taxation convention between the jurisdictions involved and, generally speaking, such double taxation conventions are bilateral. The purpose of a double taxation convention between two states is to ensure that a person (and here, we are talking about companies) does not pay tax twice on the same income (here, profit). Such conventions will, typically, identify different classes of income and then allocate taxing rights to those classes of income as between the states party to the treaty.

D. THE PRESENT APPEAL

8. This appeal concerns two companies resident in the Republic of Ireland: Irish Bank Resolution Corporation Limited ("Irish Bank") and Irish Nationwide Building Society ("Irish Nationwide"). We refer to them collectively as the Appellants. Both Irish Bank and Irish Nationwide traded in the United Kingdom through a permanent establishment in the United Kingdom – respectively, the "Irish Bank PE" and the "Irish Nationwide PE".

9. As between the United Kingdom and the Republic of Ireland, the issue of double (or double non-) taxation is dealt with by a double taxation convention dated 2 June 1976 (the "Convention"). The Convention was brought into force in the United Kingdom by the Double Taxation Relief (Taxes on Income) (Republic of Ireland) Order 1976,[1] with effect from 23 December 1976.

10. As stated, both Irish Bank and Irish Nationwide had permanent establishments in the United Kingdom, and it was common ground that the profits attributable to these establishments were chargeable to United Kingdom corporation tax. Corporation tax returns were submitted, and in each case, the Appellants claimed a deduction for interest paid by the permanent establishment to (as the case might be) Irish Bank or Irish Nationwide for borrowing that the permanent establishment had made from (as the case might be) Irish Bank or Irish Nationwide.

11. It will readily be appreciated that the amount of interest paid depends upon the level of borrowing of the Irish Bank PE and the Irish Nationwide PE, which in turn depends upon the level of capital attributed to each of these permanent establishments. Section 11AA(3)(b) ICTA 1988 contains clear direction as to the assumptions that should be made regarding the amounts of a permanent establishment's equity and loan capital.

12. The deduction for interest paid by each permanent establishment to Irish Bank or Irish Nationwide claimed was, in each case, disallowed by the Respondent, the Commissioners for Her Majesty's Revenue and Customs ("HMRC"). The reason for this disallowance was because, according to HMRC,

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[1] SI 1976/2151.

section 11AA(3)(b) ICTA 1988 precluded such deductions. That was because the returns submitted by Irish Bank PE and Irish Nationwide PE understated the amount of equity capital each permanent establishment was deemed to hold and so overstated the amount of loan capital and the associated interest charges.

5 13. There was no dispute between the parties as to the effect – in terms of corporation tax payable – of section 11AA(3)(b) ICTA 1988. Rather, Irish Bank and Irish Nationwide contended that the treatment of their tax returns so as to disallow the deduction for interest paid pursuant to section 11AA(3)(b) ICTA 1988 was precluded by the Convention. It was common ground that if this was 10 the effect of the Convention, then the Convention must prevail over section 11AA(3)(b) ICTA 1988 by virtue of section 788 ICTA 1988.

14. Thus, the question was whether, properly construed, the Convention required a different outcome to that mandated by section 11AA ICTA 1988 or whether the provisions of the Convention could be read or applied consistently 15 with section 11AA ICTA 1988.

15. HMRC's disallowance of the interest deductions was appealed to the First-tier Tribunal (Tax Chamber) (the "FTT"). The single issue before the FTT was the question of whether the approach required by section 11AA(3)(b) ICTA 1988 was precluded by the Convention. In a decision dated 22 September 2017 (the 20 "Decision"), the FTT concluded that it was not. Permission to appeal the Decision was given by Judge Sinfield on 5 December 2017, and now this issue comes before us.

E. THE PROVISIONS OF THE CONVENTION

16. The Convention's full title is the *Convention between the Government of* 25 *the United Kingdom of Great Britain and Northern Ireland and the Government of the Republic of Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains*. It forms the schedule to the Double Taxation Relief (Taxes on Income) (Republic of Ireland) Order 1976, which brings the Convention into force as a matter of English law.

30 In the Convention, the "Contracting States" are the United Kingdom and the Republic of Ireland. Article 8 of the Convention, which is entitled "Business Profits", provides:

"(1) The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State 35 through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.

(2) Subject to the provisions of paragraph (3) of this Article, where an enterprise of a Contracting State carries on business in the other Contracting State through a 40 permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected

to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment.

(3) In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses of the enterprise which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

(4) Nothing in the foregoing provisions of this Article shall affect any of the provisions of the law of a Contracting State relating specifically to the liability to tax of a life assurance company not having its head office in that Contracting State.

(5) No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

(6) Where profits include items which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article."

17. A number of points can be made in relation to Article 8 of the Convention in particular and in relation to the Convention generally:

(1) As is clear from Articles 8(1) and 8(2), the Convention allocates taxing rights as between the United Kingdom and the Republic of Ireland in accordance with the United Kingdom's (and, no doubt also, the Republic of Ireland's) domestic taxing regime for the profits of companies. Profits of companies are taxed where they are resident, save as regards the profits deriving from permanent establishments.

(2) The term "permanent establishment" is defined in Article 5 of the Convention. However, Article 5 does not shed any light on the meaning of an "establishment", which is nowhere defined in the Convention. It was common ground between the parties that both the Irish Bank PE and the Irish Nationwide PE were permanent establishments within Article 8.

(3) In terms of calculating the profits of a permanent establishment, it was common ground that the relevant provisions of the Convention were Articles 8(2) and 8(3). However, the Appellants contended that the Convention should be interpreted in light of other materials, which we consider further below.

(4) The Convention contains no dispute resolution provisions.

F. THE PARTIES' CONTENTIONS

18. As both the Appellants and HMRC accepted, in order for the appeal to succeed, the Appellants needed to demonstrate that the approach required by section 11AA(3)(b) ICTA 1988 was actually <u>precluded</u> by the Convention. In such a case, section 11AA would give way to the Convention. <u>If</u> the Convention

permitted the profits of a permanent establishment to be attributed in various different ways – in short, if there was a margin of appreciation in the manner in which a permanent establishment's profits could be calculated – one of which was consistent with section 11AA ICTA 1988, then section 11AA would be consistent with the United Kingdom's obligations under the Convention and there would be no reason for section 11AA not to be applied.[2]

19. The Appellants contended that the assumption that section 11AA(3)(b) ICTA 1988 required to be made regarding a permanent establishment's equity and loan capital when calculating the profits of that permanent establishment was not permitted by the Convention. The Appellant's written submissions put the point thus:

> "7. Section 11AA(3)(b) ICTA 1988 introduced into UK tax law the entirely novel assumption that a permanent establishment...of a non-resident company is to be treated as having such equity and loan capital as it could reasonably be expected to have in the circumstances specified in section 11AA(2) ICTA 1988, and that no deduction may be made in respect of costs (including interest) in excess of those that would have been incurred on that assumption. The disallowance of the interest expense (which would otherwise have been deductible under the provisions of the Corporation Tax legislation) proposed by the Respondents is based entirely and exclusively on section 11AA(3)(b) ICTA 1988.
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> 8. The approach of the Respondents involves attributing to the UK branches of the Appellants a *notional* amount of equity and debt capital, including an amount of "free capital" (on which no interest is deemed to have been incurred), which differs from the *actual* capital employed in the trade of the UK branches of the Appellants. It is an agreed fact that the branches of the Appellants had an actual amount of interest-free capital employed in their trade (in the form of retained reserves of the branches). The Respondents nevertheless seek to attribute to the branches of the Appellants a notional amount of equity and debt capital, including an amount of free capital, that differs from that actually employed in the trade of the branches, and to disallow an amount of interest deduction computed on a formulary basis which is based on this deemed amount of attributed capital. The disallowance of interest is referred to as a "Capital Attribution Tax Adjustment"."

20. In short, the Appellants contended that a Capital Attribution Tax Adjustment was contrary to the Convention, which obliged HMRC to compute a permanent establishment's profit by reference to that establishment's books of account only.

21. For its part, HMRC accepted that a Capital Attribution Tax Adjustment was required by section 11AA(3)(b) ICTA 1988. HMRC contended that this approach was one of the approaches to the calculation of a permanent establishment's

[2] See paragraph 17 of HMRC's written submissions: "In order to succeed in their appeals, the Appellants have to go so far as to establish that the attribution of capital by [section 11AA(3)(b) ICTA 1988] is precluded by Article 8(2) of the [Convention]. This is the only basis upon which the Appellants seek to challenge the amendments which have been made to the Returns".

profits permitted by the Convention. HMRC did not go so far as to say that the Convention obliged this approach. HMRC did not have to do so, for the reasons given in paragraph 18 above. It was enough for the Convention not to preclude this approach, and that is precisely what HMRC contended.[3]

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G. THE CONSTRUCTION OF TREATIES

22. The issue between the parties was, therefore, a question of the construction of the Convention. Treaties that have been incorporated into the law of the United Kingdom are to be construed on broad principles of general acceptation, rather than in the strict manner according to which statutes are generally construed.[4] An English Court will construe a treaty in line with the approach laid down in Article 31(1) of the Vienna Convention on the Law of Treaties, which provides:[5]

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> "A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose."

23. In construing the stipulations of treaties so incorporated, regard may be had to:

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(1) Foreign case law;[6]

(2) Text books and articles;[7]

(3) Provided the material is public and accessible, and provided it points to a definite legislative intention, the travaux préparatoires of the convention in question.[8]

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24. In addition to the wording of the Convention, the Appellants relied upon various materials in support of their contention that the approach required by section 11AA(3)(b) ICTA 1988 was precluded by the Convention. These materials included:

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(1) Various publications of the Organisation for Economic Co-operation and Development (the "OECD").

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[3] See paragraph 26 of HMRC's written submissions.

[4] In *Stag Line Ltd v. Foscolo, Mango & Co Ltd*, [1932] AC 328 at 350, Lord MacMillan, considering the rules in the Schedule to the Carriage of Goods by Sea Act 1924, said that in construing provisions scheduled to an Act of Parliament that have an "international currency" and "must come under the consideration of foreign courts", it is "desirable that in the interests of uniformity that their interpretation should not be rigidly controlled by domestic precedents of antecedent date, but rather that the language of the rules should be construed on broad principles of general acceptation". See also *James Buchanan & Co Ltd v. Babco Forwarding and Shipping (UK) Ltd*, [1978] AC 141 at 152.

[5] *Fothergill v. Monarch Airlines Ltd*, [1981] AC 251.

[6] *James Buchanan & Co Ltd v. Babco Forwarding and Shipping (UK) Ltd*, [1978] AC 141 at 161.

[7] *Fothergill v. Monarch Airlines Ltd*, [1981] AC 251 at 274, 283-284 and 287.

[8] *Fothergill v. Monarch Airlines Ltd*, [1981] AC 251 at 278 and 283.

(2) The prior practice, regarding the taxation of permanent establishments, within the United Kingdom; and

(3) Certain decisions of courts in other jurisdictions regarding conventions similar to the present Convention, as well as the contents of various commentaries and books.

25. We consider that the OECD publications described in paragraph 24(1) and the materials described in paragraph 24(3) are matters that we can properly take into account when construing the Convention. We describe the OECD publications in Section I. In Section J, we consider the construction of the Convention, in light of these and other relevant materials.

26. We do not consider the prior practice, described in paragraph 24(2), to be material that should properly be taken into account when seeking to construe the Convention. Section H gives our reasons for declining to take this prior practice into account.

H. HMRC'S PRIOR PRACTICE

(1) The Appellants' case

27. The Appellants relied upon the prior practice of HMRC in assessing the profits of permanent establishments in support of their construction of the Convention. The Appellants' written submissions state:

> "60. The determination of the profits of UK branches of foreign banks has a long history. In the 1950s, the Inland Revenue approached the issue by imputing a notional amount of "free working capital" in order to determine the interest deduction for the branch, and considered that such an approach was consistent with the "business profits" articles of the United Kingdom's double taxation conventions. This approach was referred to as the "PW Formula" because the terms of the notional capital attribution was agreed in a formula with Price Waterhouse.
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> 61. In the 1970s, however, this approach for determining the profits of the UK branches of foreign banks was challenged by several foreign banks, who obtained opinions from Michael Nolan, QC (later Lord Nolan) and from Frank Hayworth-Talbot, QC. The seminal opinion is that of Michael Nolan, QC and Robin Mathew dated 7 December 1978. That opinion analysed the provisions of the "business profits" article of the UK-US double taxation convention (which are identical in substance to the provisions in the [Convention] and concluded:
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>> "...in our view the Convention gives no authority to write into the branch accounts a level of capital which the branch does not have. To do this is to go against the scheme of Article III [the equivalent of Article 8 of the Convention] and the requirements of the paragraph (2) hypothesis that the United Kingdom branch is trading under "...the same or similar conditions...". This directs that the actual conditions under which the United Kingdom branch trades are taken into account. It is those conditions which dictate the expenses in question.

...The notional interest formula may very well result in the disallowance of actual expenditure which is attributable to the branch and that is something which Article III plainly does not authorise."[9]

62. The Inland Revenue accepted at the time that this opinion correctly reflected the interpretation of the "business profits" article of the relevant double taxation conventions. The opinion was quoted as authoritative in the Inland Revenue's Banking Manual (which was made publicly available in December 1994). As a consequence, the Inland Revenue abandoned the PW Formula (except where it was retained in a few cases, by agreement), and accepted instead that it was necessary to identify the actual capital employed in the trade of the branch, and not a notional amount."

(2) Inadmissibility of this material

28. HMRC objected to this material on grounds that HMRC's practice was a question of fact on which the FTT had not ruled and which factual issue could not now be introduced in an appeal on points of law only.[10]

29. There is also a further – and in our judgment altogether more fundamental reason, which we put to the parties in argument – why this material is inadmissible. That is because this material is irrelevant to the question of construction that we have to answer. The unilateral practice of a taxing authority – no matter how well-advised – is not material that can support or contradict a particular interpretation of a treaty.

30. It is permissible to look to the subsequent conduct of the parties to a treaty to see if there is a subsequent agreement or practice that goes to the meaning of the treaty.[11] Such agreement or practice would have to be evidenced, and would have to demonstrate a bilateral agreement or practice involving both parties to the treaty.[12] No such agreement or practice was alleged here; and we consider the point to be a factual one, that could only properly be raised before the FTT.

31. We do not consider that the unilateral practice of a contracting party – even if that practice shows a careful attempt by that party to abide by a treaty – can affect the meaning of that treaty or constitute material going to its construction.

32. Accordingly, for these two reasons, we do not have regard to HMRC's practice in terms of assessing the profits of permanent establishments.

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[9] Emphasis supplied by the Appellants.

[10] Written submissions of HMRC at paragraphs 43-45.

[11] See Article 31(3) of the Vienna Convention on the Law of Treaties.

[12] We assume a bilateral treaty, as the Convention was. Matters may be different in the case of a multilateral treaty, which is a point that does not arise for consideration.

I. OECD PUBLICATIONS

(1) Introduction

33. Double taxation conventions are common in many jurisdictions, and the OECD formulates model draft double taxation conventions and provides commentaries in relation to these. The Convention, as both parties accepted, is based upon the work of the OECD and closely follows the OECD draft convention which was current in 1976, when the Convention was concluded.

34. We were shown none of the travaux préparatoires that preceded the conclusion of the Convention. But, given the fact that the Convention closely tracks the then-published OECD draft, it impossible to conclude that the Contracting States would not have taken the OECD publications into account. We proceed on the basis that the OECD material pre-dating the Convention should be treated like travaux préparatoires.

35. The same cannot be the case as regards OECD publications post-dating the Convention. *Ex hypothesi*, such material cannot have been taken into account by the Contracting States and cannot amount to travaux préparatoires. At most, such materials are to be treated as text books and articles elucidating the meaning of the Convention. Of course, we recognise that the further removed, both in terms of time and in terms of subject matter (the OECD draft conventions and – more particularly – the commentaries evolved), the less helpful such materials are likely to be in terms of elucidating the Convention.

36. Our attention was drawn to a decision of the Spanish Audencia Nationale, *ING Direct v. Central Court for Economic and Administrative Matters*.[13] This case concerned a double taxation treaty between Spain and the Netherlands, whose authoritative language in the event of divergence was English and whose wording (Article 7) closely tracked that of the Convention. The treaty was concluded on 16 June 1971.

37. Considerable portions of the Audencia Nationale's decision[14] concerned the extent to which OECD publications post the treaty (i.e. post-dating 1971) were relevant to the construction of the treaty. The Spanish court held that they were not. Whilst the construction of treaties incorporated into English municipal law is matter for English law, we draw some comfort from the fact that our approach is consistent with such foreign case law (such as this decision) as was drawn to our attention.

38. The following paragraphs set out the various OECD publications that we have found helpful.

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[13] (2012) 18 ITLR 680.

[14] At 751*ff*.

(2) 1963 Report of the OECD Fiscal Committee

39. In 1963, the OECD Fiscal Committee published a *Draft Double Taxation Convention on Income and Capital* (the "1963 OECD Draft Convention"), together with a commentary (the "1963 Commentary"). This material
5 significantly pre-dated the Convention, and we treat it as part of the travaux préparatoires.

40. The 1963 Commentary noted, at paragraph 34:

"For each of the Articles in the Convention there is a detailed Commentary which is designed to illustrate or interpret the provisions. In the more important cases, the
10 Commentary also contains a general exposition of the problem and of the principal solutions adopted in the Model Conventions of the League of Nations or in the existing bilateral Conventions and states why the Fiscal Committee has chosen the solution proposed. As these Commentaries have been drafted and agreed upon unanimously by the experts appointed to the Fiscal Committee by the Governments of the Member
15 countries, they are of special importance in the elaboration of international fiscal law. They are therefore a great improvement as compared to the Commentaries on the Mexico and London Model Conventions which were merely a working instrument, prepared by the Secretariat of the League of Nations, which did not commit the Fiscal Committee of that Organisation. Although the present Commentaries are not designed to be annexed in
20 any manner to the Conventions to be signed by Member countries, they can nevertheless be of great assistance in the application of the Conventions and, in particular, in the settlement of eventual disputes."

41. The equivalent Article in the 1963 OECD Draft Convention is Article 7. Comparing the material provisions of this Article with those of Article 8 of the
25 Convention. Differences in the texts are marked in **bold**:

Article 7 of the 1963 OECD Draft Convention	Article 8 of the Convention
1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.	1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.
2. Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing **wholly independently** with the enterprise of which it is a permanent establishment.	2. **Subject to the provisions of paragraph (3) of this Article**, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing **at arm's length** with

	the enterprise of which it is a permanent establishment.
3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.	3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses **of the enterprise** which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

The drafting differences are, thus, relatively insignificant.

42. The 1963 Commentary on Article 7 states:

"*Paragraph 2*

5 10. This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral Conventions that have been concluded since the war, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, 10 instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Normally, this would be the same profit that one would expect to be reached by the ordinary processes of good business accountancy. In the great majority of cases, therefore, trading accounts of the permanent establishment – which are 15 commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches – will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally, there may be no separate accounts…But where there are such accounts they will naturally form the starting point for any 20 processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent 25 establishment and to adjust as may be shown to be necessary the profit figures which those facts produce.

11. Even where a permanent establishment is able to produce proper accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts, in 30 accordance with the general directive laid down in paragraph 2. Adjustment of this kind may be necessary; for example, because goods have been invoiced at prices which are not consistent with this directive, and profits have thus been diverted from the permanent establishment to the head office or vice versa.

12. In such cases, it will usually be appropriate to substitute for the prices used 35 ordinary market prices for the same or similar goods supplied on the same or similar conditions…

Paragraph 3

13. This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. It is valuable to include paragraph 3, if only for the sake of removing doubts. The paragraph specifically recognises that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise it may be appropriate to take into account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred for the purposes of the permanent establishment should be the actual amount so incurred.

14. Apart from what may be regarded as ordinary expenses, there are some classes of payment between permanent establishments and head offices which give rise to special problems, and it is convenient to deal with them at this point. The next five paragraphs discuss three specific cases of this kind and give solutions for them. It should not, of course, be inferred that it is only in relation to the three classes of payments mentioned in these paragraphs that problems may arise; there may well be payments of other kinds to which similar considerations apply.

15. The first of these cases relates to interest, royalties and other similar payments made by a permanent establishment to its head office in return for money loaned, or patent rights conceded, by the latter to the permanent establishment. In such a case, it is considered that the payments should not be allowed as deductions in computing the permanent establishment's taxable profits. (Equally, such payments made to a permanent establishment by the head office should be excluded from the computation of the permanent establishment's taxable profits.) It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances, etc (as distinct from capital allotted to them), in view of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises. Furthermore, if an enterprise makes payments of interest, etc, to a third party and these payments in part relate to the activities of the permanent establishment, then a proportionate part of them should naturally be taken into account in calculating the permanent establishment's profits insofar as they can properly be regarded as expenses incurred for the purposes of the permanent establishment."

(3) 1977 and 1994 OECD publications

43. In 1977, and again in 1994, the OECD published further commentaries. The wording of these commentaries was different to that of the 1963 Commentary, but not materially so: neither party placed any reliance on these differences.

44. Although the 1977 commentary published a model draft convention which contained some differences when considered against the 1963 OECD Draft Convention, these differences are immaterial. (At the beginning of Article 7(2),

the words "Subject to the provisions of paragraph 3…" are inserted; and in Article 7(3), "In the determination of…" is replaced by "In determining…".) Again, neither party relied on these (wholly immaterial) differences.

5 45. We note that the 1977 Commentary post-dates the Convention, but in any event adds little to the 1963 OECD Draft Convention or the 1963 Commentary.

(4) The 1984 report on transfer pricing

46. In 1984, the OECD committee on fiscal affairs published a report entitled *Transfer Pricing and Multinational Enterprises* (the "1984 Transfer Pricing Report"). This report considered, amongst other matters, the question of interest
10 on capital allotted to branches of banks (i.e. permanent establishments of banks). We do not propose to set out the very detailed consideration accorded to this question in the1984 Transfer Pricing Report: the issues arising are considered (albeit in a less detailed form) in a later document, which we set out in paragraph 48 below. As this report post-dates the Convention, we accord it the limited
15 weight described in paragraph 35 above. The same goes for the remaining OECD material that we consider in this Section.

(5) 2008 Report of the OECD Fiscal Committee

47. In 2008, the OECD published an *Income and Capital Model Convention and Commentary*. The model convention – at least so far as Article 7 is concerned
20 – was identical to that published in 1977, and so contained no material changes, when compared with the 1963 OECD Draft Convention.

48. The commentary (the "2008 Commentary") on Article 7 is, however, significantly different:

"2. Articles 7 and 9 are not particularly detailed and were not strikingly novel when
25 they were adopted by the OECD. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between associated enterprises, has had to be dealt with in a large number of double taxation conventions and in various models developed by the League of Nations before the OECD first dealt with it and the solutions adopted
30 have generally conformed to a standard pattern.

…

3. It is generally recognised that the essential principles on which this standard pattern is based are well founded and, when the OECD first examined that question, it was thought sufficient to restate them with some slight amendments
35 and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another. Modern commerce organises itself in an infinite variety of ways, and it would be
40 quite impossible within the fairly narrow limits of an Article in a double taxation

convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise.

4. It must be acknowledged, however, that there has been considerable variation in the interpretation of the general directives of Article 7 and of the provisions of earlier conventions and models on which the wording of Article 7 is based. This lack of common interpretation of Article 7 can lead to problems of double taxation and non-taxation. For that reason, it is important for tax authorities to agree on mutually consistent methods of dealing with these problems, using, where appropriate, the mutual agreement procedure provided for in Article 25.

5. Over the years, the Committee on Fiscal Affairs has therefore spent considerable time and effort trying to ensure a more consistent interpretation and application of the rules of the Article. Minor changes to the wording of the Article and a number of changes to the Commentary were made when the 1977 Model Tax Convention was adopted. A report that addressed that question in the specific case of banks was published in 1984. In 1987, noting that the determination of profits attributable to a permanent establishment could give rise to some uncertainty, the Committee undertook a review of the question which led to the adoption, in 1993, of the report entitled Attribution of Income to Permanent Establishments and to subsequent changes to the Commentary.

6. Despite that work, the practices of OECD and non-OECD countries regarding the attribution of profits to permanent establishments and these countries' interpretations of Article 7 continued to vary considerably. The Committee acknowledged the need to provide more certainty to taxpayers: in its report *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, adopted in 1995, it indicated that further work would address the application of the arm's length principle to permanent establishments. That work, resulted, in 2008, in a report entitled *Attribution of Profit to Permanent Establishments*. The approach developed in that report was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus has been on formulating the most preferable approach to attributing profits to a permanent establishment under Article 7 given modern-day multinational operations and trade.

7. The approach put forward in that Report deals with the attribution of profits both to permanent establishments in general (Part I of the Report) and, in particular, to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (Part II of the Report, which deals with permanent establishments of banks, Part III, which deals with permanent establishments of enterprises carrying on insurance activities). The Committee considers that the guidance included in the Report represents a better approach to attributing profits to permanent establishments than has previously been available. It does recognise, however, that there are differences between some of the conclusions of the Report and the interpretation of the Article previously given in this Commentary. For that reason, this Commentary has been amended to incorporate a number of conclusions of the Report that did not conflict with the previous version of this Commentary, which prescribed specific approaches in some areas and left considerable leeway in others. The Report therefore represents internationally agreed principles and, to the extent that it does

not conflict with this Commentary, provides guidelines for the application of the arm's length principle incorporated in the Article.

…

43. A different issue, however, is that of the deduction of interest on debts actually incurred by the enterprise. Such debts may relate in whole or in part to the activities of the permanent establishment; indeed, loans contracted by an enterprise will serve either the head office, the permanent establishment or both. The question that arises in relation to these debts is how to determine the part of the interest that should be deducted in computing the profits attributable to the permanent establishment.

44. The approach suggested in this Commentary before 1994, namely the direct and indirect apportionment of actual debt charges, did not prove to be a practical solution, notably since it was unlikely to be applied in a uniform manner. Also, it is well known that the indirect apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties. It is also well known that direct apportionment of total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustments may need to be made to reflect economic reality, in particular the fact that an independent enterprise would normally be expected to have a certain level of "free" capital.

45. Consequently, the majority of member countries consider that it would be preferable to look for a practicable solution that would take into account a capital structure appropriate to both the organisation and the functions performed. This appropriate capital structure will take account of the fact that in order to carry out its activities, the permanent establishment requires a certain amount of funding made up of "free" capital and interest bearing debt. The objective is therefore to attribute an arm's length amount of interest to the permanent establishment after attributing an appropriate amount of "free" capital in order to support the functions, assets and risks of the permanent establishment. Under the arm's length principle a permanent establishment should have sufficient capital to support the functions it undertakes, the assets it economically owns and the risks it assumes. In the financial sector regulations stipulate minimum levels of regulatory capital to provide a cushion in the event that some of the risks inherent in the business crystallise into financial loss. Capital provides a similar cushion against crystallisation of risk in non-financial sectors.

46. As explained in section D-2(v)(b) of Part I of the Report *Attribution of Profits to Permanent Establishments*, there are different acceptable approaches for attributing "free" capital that are capable of giving an arm's length result. Each approach has its own strengths and weaknesses, which become more or less material depending on the facts and circumstances of particular cases. Different methods adopt different starting points for determining the amount of "free" capital attributable to a permanent establishment, which either put more emphasis on the actual structure of the enterprise of which the permanent establishment is a part or, alternatively, on the capital structures of comparable independent enterprises. The key to attributing "free" capital is to recognise:

- the existence of strengths and weaknesses in any approach and when these are likely to be present;

- that there is no single arm's length amount of "free" capital, but a range of potential capital attributions within which it is possible to find an amount of "free" capital that can meet the basic principle set out above.

47. It is recognised, however, that the existence of different acceptable approaches for attributing "free" capital to a permanent establishment which are capable of giving an arm's length result can give rise to problems of double taxation. The main concern, which is especially acute for financial institutions, is that if the domestic law rules of the State where the permanent establishment is located and of the State of the enterprise require different acceptable approaches for attributing an arm's length amount of free capital to the permanent establishment, the amount of profits calculated by the State of the permanent establishment may be higher than the amount of profits calculated by the State of the enterprise for the purposes of relief of double taxation."

(6) The 2010 Convention

49. In July 2010, the OECD introduced a *Model Tax Convention on Income and on Capital* that contained a revised draft convention (the "2010 OECD Draft Convention"), together with a revised commentary (the "2010 Commentary").

50. Given the changes to in the wording of the 2010 OECD Draft Convention, when compared to the 1963 OECD Draft Convention, we do not consider it appropriate to rely upon the 2010 OECD Draft Convention for the purposes of construing the commentary. At most, the differences illustrate the mischief that the OECD considered it was addressing. Nevertheless, for completeness, we set out the 1963 OECD Draft Convention, the Convention and the 2010 OECD Draft Convention:

Article 7 of the 1963 OECD Draft Convention (differences with the Convention are marked in **bold**)	**Article 8 of the Convention** (differences with the 1963 OECD Draft Convention are marked in **bold**)	**Article 7 of the 2010 OECD Draft Convention** (differences with the 1963 OECD Draft Convention are marked in **bold**)
1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.	1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to that permanent establishment.	1. **Profits** of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits **that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State**.

2. Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing **wholly independently** with the enterprise of which it is a permanent establishment.	2. **Subject to the provisions of paragraph (3) of this Article**, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing **at arm's length** with the enterprise of which it is a permanent establishment.	2. **For the purposes of this Article…, the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.**
3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.	3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses **of the enterprise** which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.	3. **Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.**

51. It is unnecessary for us to refer to the 2010 Commentary. Nor is it necessary to refer to any subsequent OECD publications.

J. THE CONSTRUCTION OF THE CONVENTION

52. We begin with the wording of the Convention itself. The critical provisions are Articles 8(2) and 8(3).[15] Article 8(2) obliges the Contracting State hosting the

[15] Set out in paragraph 16 above.

permanent establishment (here: the United Kingdom, and hereafter the "Host") to attribute for the purposes of taxation the profits which that permanent establishment "might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with the enterprise of which it is a permanent establishment".

53. Two points emerge very clearly from this:

(1) First, the Convention explicitly requires the Host to assume that the permanent establishment is a "distinct and separate enterprise". Self-evidently, this is not in fact the case: by definition, a permanent establishment is not a distinct and separate enterprise.[16]

(2) Secondly, the Convention does not lay down one single specific way in which this exercise is to be carried out. This is obvious from the drafting of the Convention itself but is clear also from the 2008 Commentary set out in paragraph 48 above. The 2008 Commentary makes clear that there was considerable variation or divergence in terms of state practice when applying Article 7 of the 1963 OECD Draft Convention.[17] The 2008 Commentary does not suggest that this divergence arises because some states were infringing the terms of the model convention. Rather, the OECD was recognising an unsatisfactory breadth in the manner in which Article 7 could be applied. The 2008 Commentary explained the OECD's efforts in seeking a consistent practice.[18] For our purposes, these efforts are irrelevant. What matters is that the OECD was recognising – and we agree – that Article 7 of the 1963 OECD Draft Convention and Article 8 of this Convention can be complied with in a variety of ways.

54. Article 8(3) – to which Article 8(2) is expressly made subject – is clarificatory of the general directive in Article 8(2).[19] It makes clear that in determining a permanent establishment's profits, the permanent establishment's expenses incurred for its purposes may be deducted.

55. In those cases where the permanent establishment keeps its own books of account,[20] these records ought to be the starting point for any assessment of a permanent establishment's profits. It is quite clear that the starting point is not some hypothetical construct, but the true or actual revenues and expenses of the permanent enterprise:

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[16] See paragraph 6 above.

[17] See paragraph 4 of the 2008 Commentary.

[18] See paragraphs 5*ff* of the 2008 Commentary.

[19] As paragraph 13 of the 1963 Commentary (set out in paragraph 42 above) makes clear.

[20] As was the case here: as the OECD made clear in the 1963 Commentary, such records will commonly be available in well-run businesses.

(1) This is made very clear from the wording of Article 8(3), which says that there "shall be allowed as deductions expenses of the enterprise which are incurred for the purposes of the permanent establishment". This is very clearly a reference to the actual figures, not some hypothetical construct.

5 (2) This is consistent with the 1963 Commentary, which notes that Article 8(2) (to use the Convention's numbering) cannot justify the construction of "hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment".[21]

10 56. To this extent, we agree with the submissions of the Appellants: the starting point is the actual records, including (for example) the capital actually attributed to the permanent establishment.

57. However, this is only the starting point. It is perfectly possible for the permanent establishment's books of account quite properly to record the financial
15 position of the permanent establishment, but in such a way as to fail to reflect the hypothesis that Article 8(2) obliges the Host to make, namely that the permanent establishment must be treated as "if it were a distinct and separate enterprise engaged in the same or similar activities and dealing at arm's length with the enterprise of which it is a permanent establishment". In other words, if and to the
20 extent that the permanent establishment's business has not been conducted on this basis, the books of account must be adjusted so as to reflect the hypothesis laid down in Article 8(2) of the Convention.

58. That, we consider, is clear from the wording of the Convention. It is also supported by the 1963 Commentary, which makes clear that the books of account
25 "naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits".[22] Indeed, the 1963 Commentary explicitly refers to the need, in certain circumstances, to "rectify" a permanent establishment's books of account.[23]

59. Thus, where there is a mismatch between the permanent establishment's
30 books of account and the position as it would have been, if the permanent establishment "were a distinct and separate enterprise engaged in the same or similar activities and dealing at arm's length with the enterprise of which it is a permanent establishment", then the latter case prevails. The wording of Article 8(2) of the Convention is clear; and the 1963 Commentary is equally clear:[24]

[21] See paragraph 10 of the 1963 Commentary, set out in paragraph 42 above.

[22] See paragraph 10 of the 1963 Commentary, set out in paragraph 42 above.

[23] See paragraph 11 of the 1963 Commentary, set out in paragraph 42 above.

[24] See paragraph 11 of the 1963 Commentary, set out in paragraph 42 above.

"Adjustment of this kind may be necessary; for example, because goods have been invoiced at prices which are not consistent with this directive, and profits have thus been diverted from the permanent establishment to the head office or vice versa."

60. The example used in the 1963 Commentary refers to the pricing of goods as between the enterprise and its permanent establishment. But the position is exactly the same so far as the permanent establishment's capital is concerned: if the level of equity capital (or "free" capital, as the OECD describes it[25]) allocated to the permanent establishment is different to that which would have been allocated had the permanent establishment been a distinct and separate enterprise, then that distortion must be adjusted for. Otherwise the costs of the permanent establishment will not reflect the position required by Article 8(2) of the Convention: they will be too high, because the permanent establishment's books of account will reflect interest payments in respect of loan capital that would be higher than they should be. In this way, profits can be diverted from the permanent establishment to the head office or vice versa, which is one of the mischiefs the OECD model rules – and so the Convention – seek to avoid.

61. Section 11AA(3)(b) ICTA 1988 caters for such possible distortions by ensuring that the permanent establishment's books of account are cross-checked and adjusted – by way of the Capital Attribution Tax Adjustment – if and to the extent that these records fail to reflect the equity and loan capital that the permanent establishment ought to have if it were "a distinct and separate enterprise, engaged in the same or similar activities under the same or similar conditions, dealing wholly independently with the non-resident company".

62. We do not say that section 11AA(3)(b) ICTA 1988 is the <u>only</u> way in which the provisions of Article 8 of the Convention could be implemented. But this manner of implementation is, we hold, entirely consistent with, and permitted by, the terms of the Convention.

63. It follows that the Appellants' appeal must be dismissed. We consider that the conclusion we have reached as to the meaning of Article 8 is entirely consistent with the foreign case law we were shown. That case law emphasises the importance of a starting point fixed in reality – that is, based upon the books of account of the permanent establishment. None of these cases suggests that a subsequent adjustment to those books of account cannot be undertaken. That is unsurprising, given the wording of the 1963 OECD Draft Convention.

64. We were shown case law from the United States, France and Spain as follows:

[25] See paragraph 46 of the 2008 Commentary, set out in paragraph 48 above.

The United States

(1) In *National Westminster Bank plc v. United States of America*,[26] the National Westminster Bank plc ("NatWest") claimed a tax refund in relation to tax paid in the United States between 1981 and 1987. The question, in this case, was whether a US Treasury Regulation, which contained a formula to determine deductible interest for the calculation of taxable income of NatWest's permanent establishment in the United States, was consistent with the double taxation treaty between the United States and the United Kingdom. This treaty was materially the same as the terms of the Convention.

(2) The central issue in dispute was that the US Treasury Regulation determined deductible interest by reference to the enterprise as a whole (including the permanent establishment) rather than (at least in the first instance) by reference to the permanent establishment itself. The United States Court of Federal Claims put the point thus:[27]

> "In practical terms, the precise, narrow, issue for resolution at this juncture in the proceedings is whether, in the determination of the interest expense deduction for the US branch, the interest expense reflected in its books of account – with appropriate adjustments, if necessary, to reflect imputation of adequate capital and arm's length, market interest rates in intra-corporate "borrowing" transactions – may be used in calculating [NatWest's] US tax liability, or whether, with respect to interest expense, the [United States] may require use of a formulary approach, such as that in [the US Treasury Regulation], which disregards intra-corporate "lending" transactions reflected in the books of account."

(3) The Court considered the sort of OECD materials already considered in Section I above, and concluded that the US Treasury Regulation was inconsistent with Article 7 of the treaty between the United States and the United Kingdom:[28]

> "We find that rather than treating the US branch of foreign enterprises as separate entities, the regulation plainly treats each US branch as a unit of a worldwide enterprise and, thus, is inconsistent with the "separate entity" provision of Article 7(2) of the Treaty."

(4) Following on from this decision, the United States sought to calculate the liability in tax of NatWest's permanent establishment in accordance with the provisions of the treaty. This matter, also, came before the United States Court of Federal Claims, *National Westminster Bank plc v. United States of*

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[26] (1999) 44 Fed Cl 120.

[27] At 123.

[28] At 130.

America.[29] The Court summarised the respective positions of the United States and NatWest as follows. Beginning with that of the United States:[30]

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> "The [United States] contends that in order to give meaning to the notion of a "separate and distinct" enterprise under Article 7 of the US-UK Treaty, the government should be allowed to treat a branch of a foreign bank as if it were a separately incorporated bank, for purposes of determining the amount of "capital" the branch is deemed to hold. Under the government's approach, the "capital" appearing on the US branch's books would be adjusted to include such additional capital as the branch would likely hold if it were a separately incorporated US bank. The government proposes using a "corporate yardstick" to determine the appropriate amount of capital a separately incorporated branch of the same size would hold…"

(5) As regards NatWest:[31]

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> "NatWest argues that the US-UK Treaty, and relevant legislative history surrounding Article 7, do not allow for the attribution of capital based on a "corporate yardstick" theory. NatWest argues that the Treaty does not allow the taxation of branch profits as determined by a fictional amount of branch capital. Instead, NatWest argues that the Treaty requires that the properly maintained books of the branch be used to determine the taxable profits attributable to the branch as if it were "separate and distinct" from its parent. In this connection, NatWest argues a "corporate yardstick" is not needed to give meaning to the phrase "separate and distinct" enterprise. NatWest argues that Article 7 does not allow the taxing authority to impose a capital ratio on the branch that is not based on the reality of the branch's actual circumstances."

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(6) The Court's conclusion was expressed as follows:[32]

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> "The Treaty states in Article 7(2) that the business profits attributed to a permanent establishment are those "profits that it might be expected to make if it were a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions…dealing wholly independently with the enterprise of which it is a permanent establishment." At the crux of this motion is the meaning of the phrase "separate and distinct". <u>Both parties agree that the starting point for determining the branch's profits as a "separate and distinct" entity is the separately maintained books and records of the branch. The parties disagree over the extent to which the Treaty allows the taxing authority to adjust the books and records of the branch.</u> As noted above, the government argues that to give meaning to the phrase "separate and distinct", the taxing authority is allowed to attribute to a branch the amount of capital that a separately incorporated bank of the same size as the branch would likely hold. According to the government, the taxing authorities can therefore treat a certain amount of the borrowings of the branch received from its head office as equity capital infusions, which do not carry an

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[29] (2003) 58 Fed Cl 491.

[30] At 495.

[31] At 496.

[32] At 497-498.

interest charge, even if, in fact, the branch used borrowings for bank lending purposes and paid interest to the head office on those funds.

NatWest argues in response that the Treaty, by its terms, does not contemplate that a branch be treated as a separately incorporated bank. NatWest contends that Article 7 assumes that a branch's books and records should be controlling except to the extent that adjustments are required to ensure that the records correctly reflect the true nature of all transactions between the branch and the rest of the bank. According to NatWest, the phrase "separate and distinct" allows the taxing authorities to adjust the books and records of a branch where the branch's books and records are in error with respect to the branch's capital account, or include interest payments that are not consistent with an arm's length relationship between the branch and the rest of the bank of which it is a part. According to NatWest, nothing in the language of Article 7 allows the government to tax the profits of a branch based on outside capital regulatory requirements that do not apply to the branch.

The Court agrees with NatWest. There is nothing in the language of Article 7 to suggest that the government is allowed to impose capital requirements on a branch that are the same as those imposed on separately incorporated banks in order to give meaning to the phrase "separate and distinct". The phrase "separate and distinct" does not mean the branch should be treated as if it were "separately incorporated", but instead "separate and distinct" means separate and distinct from the rest of the bank of which it is a part. Thus, Article 7 of the Treaty simply allows the taxing authorities to adjust the books and records of the branch to ensure that transactions between the branch and other portions of the foreign bank are properly identified and characterised for tax purposes. For example, if equity capital infusions are in fact made to the branch and are not properly identified as equity infusions, the taxing authority cannot allow interest payments on those amounts. Similarly, Article 7 allows the books and records of the branch to be adjusted to ensure that interest payments between the branch and other parts of the entity reflect an arm's length relationship. There is nothing in the plain words of the Treaty that allows the government to adjust the books and records of the branch to reflect "hypothetical" infusions of capital based upon banking and market requirements that do not apply to the branch. In short, the government's reading of Article 7 goes too far...".[33]

(7) We agree with HMRC that the issue in this case was whether a formulary method of attribution was appropriate and it was held that it was not. The court simply decided that the profits attributed to the branch must be calculated by reference to the underlying activities of that branch.

(8) There was a third round in the United States Court of Federal Claims – *National Westminster Bank v. United States of America*[34] and an appeal to

[33] Emphasis supplied.

[34] (2005) 68 Fed Cl 128.

the United States Court of Appeals.[35] It is unnecessary to quote from these decisions.

France

(9) Our attention was drawn to a decision of the French Conseil d'Etat, *Re Bayerische Hypo und Vereinbank AG*.[36] The unofficial translation of this decision shows that the double taxation convention in issue – that between France and Germany dated 21 July 1959 – predates all of the OECD material summarised in Section I above. Moreover, parts of the treaty were materially different from the Convention. Specifically, Article 4(6) provided:

> "The profits derived from the activities of a permanent establishment shall as a general rule be determined on the basis of the balance sheet of the establishment. In this connection, account shall be taken of all expenditure attributable to the establishment, including a proportion of the general expenses of the enterprise..."

It is also necessary to note that French domestic tax law is very different to that pertaining in the United Kingdom and – we anticipate – Ireland in that companies are taxed only on profits from activities carried out in France.

(10) In these circumstances, and for these reasons, we found this decision of limited value in the circumstances of this appeal. Nevertheless, we note that the Conseil d'Etat stressed that neither French law nor the treaty between France and Germany "authorises the state to assume the expenditure and profits of the branches as if they had conducted their business within the framework of a different capital structure".[37] This is suggestive – if no more – of a similar approach to that we consider to be the correct one.

Spain

(11) We referred, in paragraph 36 above, to a decision of the Spanish Audencia Nationale, *ING Direct v. Central Court for Economic and Administrative Matters*.[38] So far as the substantive application of Article 7 was concerned, the Spanish court took the view that "Article 7 of the Spanish-Dutch Agreement does not expressly envisage a correction of the permanent establishment's book result based on the assignment of part of the capital or own resources of the parent company to the taxpayer, nor is that indicated in the Commentaries on the OECD's Model Agreement in force during the taxation periods subject to adjustment".[39] Again, we consider this to be consistent with the approach we have taken.

[35] 512 F 3d 1347 (Fed Cir 2008).

[36] (2014) 18 ITLR 1.

[37] At 22.

[38] (2012) 18 ITLR 680.

[39] At 764.

K. DISPOSITION

65. For the reasons we have given, the Appellants' appeal is dismissed.

66. Any application for costs in relation to this appeal must be made in writing within one month after the date of release of this decision. As any order in respect of costs will, if not agreed, be for a detailed assessment, the party making an application for such an order need not provide a schedule of costs claimed with the application as required by rule 10(5)(b) of the Tribunal Procedure (Upper Tribunal) Rules 2008.

The Hon Mr Justice Marcus Smith

Judge Timothy Herrington

Release date: 9 October 2019