



**TC06121**

Tribunal refs: TC/2014/02089  
TC/2014/01047

*CORPORATION TAX — UK branches of Irish banks — interest expense — whether deductible — attribution of notional capital — ICTA s 11AA(3)(b) — UK-Ireland DTC art 8 — whether inconsistent with each other — no — attribution for which s 11AA(3)(b) provides permissible — appeals dismissed*

**FIRST-TIER TRIBUNAL  
TAX 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: Judge Colin Bishopp**

**Sitting in public in London on 8 and 9 November 2016**

**Mr Philip Baker QC and Mr Imran Afzal, counsel, instructed by KPMG LLP, for the appellants**

**Mr David Milne QC and Mr Jonathan Bremner, counsel, instructed by the General Counsel and Solicitor to HM Revenue and Customs, for the respondents**

## DECISION

### *Introduction*

1. These joined appeals relate to the disallowance by the respondents, HMRC, of the deduction by the appellants in the calculation of their profits subject to UK corporation tax of interest expenses which, the appellants say, were incurred wholly and exclusively for the purposes of the trade of their respective UK branches in periods between 2003 and 2007. I am not concerned with the amounts in issue, or other matters of similar detail, but solely with the question whether s 11AA(3)(b) of the Income and Corporation Taxes Act 1988 (“ICTA”), as inserted by s 149 of the Finance Act 2003 (“FA 2003”) with effect in relation to accounting periods beginning after 31 December 2002, precludes such deduction. It is common ground that, were it not for s 11AA(3)(b), the deduction would be allowed. The issue is exactly the same in each appeal, hence their joinder.

2. The first appellant, Irish Bank Resolution Corporation Limited (“IBRC”), is or was a company registered in Ireland but also carrying on business through a permanent establishment (a “PE”) in the United Kingdom. The second appellant, Irish Nationwide Building Society (“INBS”), was also registered in Ireland and it too traded in the United Kingdom through a PE. In July 2011, at which time the first appellant was known as the Anglo Irish Bank Corporation plc, the assets of the second appellant were vested in it, and it adopted its present name. IBRC was put into special liquidation in February 2013.

3. It is undisputed that because they had PEs in the UK, each of the appellants was chargeable to UK corporation tax on its profits attributable to its UK PE: see ICTA s 11. Accordingly they submitted UK corporation tax returns for the relevant periods. In each case they claimed a deduction for interest paid by the PE to the Irish “parent”. I use the term “parent” as a convenient shorthand; the PEs were in each case not subsidiaries but branches of the institution. HMRC’s position, and the reason for the disallowance, is that s 11AA(3) requires an assumption to be made that a PE has a certain level of capital, and that it disqualifies for deduction interest and other costs which would not have been incurred if the assumed level of capital was in fact held. The appellants argue that the attribution of a notional level of capital differing from the actual level of capital employed in the PE, as s 11AA(3) requires, is incompatible with the provisions of art 8 of the double taxation convention of 2 June 1976 between the United Kingdom and the Republic of Ireland (“the UK-RI DTC”), and that the terms of the latter must prevail.

4. I should mention before going further that over the period to which the evidence related the appellants underwent several changes of corporate structure, and most of the companies involved appear to have changed their names at least once. At the expense of historical accuracy, which in this respect is of no great moment in the present context, but in order to avoid unnecessary confusion, and unless there is a reason to do otherwise, I shall refer to the Irish-registered organisations which became IBRC and INBS collectively as IBRC, regardless of its or their actual names at the relevant time, and shall use the terms “UK PE” and “UK PEs”, as appropriate, to mean their respective UK operations, whatever their names may have been at any time.

5. Before me, the appellants were represented by Mr Philip Baker QC, leading Mr Imran Afzal, and HMRC by Mr David Milne QC, leading Mr Jonathan Bremner. Although there was no real dispute about the basic facts—indeed, I was provided with a

statement of agreed facts—I had the written and oral evidence of Mr Gordon Parker, a chartered accountant and the former UK Finance and Compliance Director of what was then the Anglo Irish Bank Corporation plc but became IBRC, who provided some additional background material. Much more contentious was the evolution of the Model Treaty of the Organisation for Economic Co-operation and Development, the OECD, on which the UK-RI DTC is based, and the genesis of s 11AA. On those topics I had the statements and heard the oral evidence of three witnesses: Dr Richard Collier, formerly a partner in the accounting firm PwC LLP; Mr John Neighbour, formerly a senior HMRC officer with experience in transfer pricing with particular reference to financial institutions but latterly a partner and now a part-time director of KPMG LLP (who represent the appellants); and Mr Graham Black, a senior HMRC officer with experience in the taxation of international banks. To put their evidence in context it is necessary to begin with the relevant law.

### *The law*

6. The starting point is s 11 of ICTA. It has since been re-written to the Corporation Tax Act 2009 (“CTA”), but as it was in force at the relevant time, and so far as material, it was as follows:

“(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 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.”

7. The meaning of “permanent establishment” was provided by FA 2003 s 148(1)(a) as “a fixed place of business ... through which the business of the company is wholly or partly carried on” and it is common ground that the appellants each had a PE which met that description.

8. As the appellants point out, s 11 contained little guidance on the identification of the profits “attributable” to the company’s UK PE. HMRC’s argument is that s 11AA (also rewritten to CTA) performed that function. The relevant subsections were as follows:

“(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-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.

(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.”

9. Schedule A1 to ICTA contained provisions supplementing s 11AA, but it is agreed that they are of no relevance to these appeals.

10. The disallowance of costs for which s 11AA provided is known as a capital attribution tax adjustment, or CATA. In this case the appellants and HMRC have agreed, on a without prejudice basis, what the CATA should be if HMRC are right and, also on a without prejudice basis, the appellants have paid that amount. They will accordingly be entitled to a refund if they are successful in these appeals.

11. The UK-RI DTC was brought into force in the United Kingdom by the Double Taxation Relief (Taxes on Income) (Republic of Ireland) Order 1976, SI 1976/2151, with effect from 23 December 1976, and it remained in force without amendment throughout the period with which I am concerned. If there is an inconsistency between domestic legislation and a DTC, the latter must prevail: see ICTA s 788. The particular provisions of the UK-RI DTC on which the appellants rely are paras (1) to (3) of art 8, entitled “Business Profits”:

“(1) The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carried 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) 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 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.”

12. That provision is based upon, and derived from, art 7 of the pre-2010 OECD Model Convention on Income and on Capital (“the OECD Model”). I shall have more to say about the OECD Model later.

#### *Inland Revenue practice*

13. Much of the appellants’ arguments focused on the practice prior to the introduction of s 11AA. What was then the Inland Revenue decided, during the 1950s, that a form of CATA was needed, and it agreed on a formula with Price Waterhouse, as it then was: it became known as the “PW formula” and initially gained a measure of general acceptance. In the 1970s, however, several foreign banks challenged the formula, with the support of opinions from distinguished counsel. The seminal opinion, as the appellants describe it, is that of Mr Michael Nolan QC (later Lord Nolan) and Mr Robin Mathew (now QC) of 7 December 1978. The focus of the opinion (“the Nolan

opinion”) was the DTC between the United States and the UK, but its “business profits” article (Article III) was materially identical to art 8 of the UK-RI DTC. The opinion recorded the Revenue’s view “that the United Kingdom branch must be given a notional capital base”, but the conclusion of the opinion was as follows:

“... 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 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.

Accordingly the ‘notional interest formula’, under which interest is disallowed to the extent that the (actual) capital account of the branch falls short of an amount (estimated by the Revenue) which would be required as ‘free working capital’ by an independent banking enterprise is in our opinion unwarranted. 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. ... the formula may offer a convenient method of avoiding the difficulties involved in the allocation [of] actual receipts and expenses, but in our opinion it is not sound in law.”

14. The Inland Revenue accepted that the opinion was correct and it was described as “authoritative” in the Inland Revenue’s Banking Manual, which was made publicly available in December 1994. The use of the PW formula was generally abandoned, and the new approach was to identify the capital actually employed in a PE’s trade, rather than adopt a notional amount; indeed, say the appellants, the Inland Revenue accepted that no assumption of a notional capital base could be made. Mr Baker referred me to a letter written by a member of the Inland Revenue’s International Division to Midland Bank, as it was then, in March 1989. The letter explained the Inland Revenue’s then thinking. It began by describing the practice of attributing capital to an extent determined by use of the PW formula, and then continued, in a passage on which Mr Baker places some emphasis:

“These arrangements were widely adopted at the time [*ie* until the late 1970s], but it should I think be remembered that this was at a time when the London banking market was very different from today. In particular what was in mind broadly was what might be called ‘retail’ banking. The basic proposition that an independent enterprise would need to command significant free working capital came under challenge with the development of the Euromarkets. Many branches of foreign banks were established in London with the primary purpose of borrowing funds in London for on lending in London or to head office and they did not always need significant funds to be advanced from head office to enable them to do so. And for some years we have taken the view that since free capital is not required of a branch by the banking authorities in this country, to introduce the notional presence of such capital may well go beyond the scope of the arm’s length concept in the double taxation agreements having regard to the provision that the bank and branch relationship should be considered to operate under the same or similar conditions but between two separate entities.

Nevertheless branches of banks do have capital funds and assets – the simplest example may be where a branch of a foreign bank acquires premises for the purposes of its trade, but there are also other examples: where the profits of the branch are retained for use in its trade or where, for one reason or another, funds

representing the capital of the bank as a whole are placed in London other than as intra branch deposits of the same character as might have been made between one bank and another. In some cases the original 1957 [PW] agreement method is still in use, but in others regard is had to actual capital of the branch having regard to what are the physical assets etc. In other cases it has become clear that there are, as a question of fact, no capital funds available to the London branch for use in its trade.

Broadly, the Revenue position is that we seek to look at the reality of the situation and are prepared to accept that there is no London capital where the facts support this view.”

15. A method of calculating capital attribution similar to the PW formula had been adopted in the United States but it was found by the US Court of Federal Claims in *National Westminster Bank plc v United States of America* (1999) 44 Fed Cl 120 (“the *NatWest* case”) to be “inconsistent with the ‘separate entity’ treatment provided by Article 7 of the Treaty”. The Treaty referred to is a later version of the US-UK DTC than that considered by Mr Nolan and Mr Mathew, but art 7 of that treaty was materially the same as art III of its predecessor as well as art 8 of the UK-RI DTC.

#### *The evidence*

16. Mr Parker joined a UK-registered subsidiary of IBRC in 1990, as its financial controller with particular responsibility for finance, tax and regulatory matters. The subsidiary was an authorised deposit-taking institution. IBRC also had a UK PE, and in 1991 the subsidiary and the PE were merged. Mr Parker held various offices at a senior level, ultimately UK finance director, and was responsible for, among other things, the UK PE’s tax affairs.

17. The UK PE, which held a banking licence granted by the Bank of England, initially undertook only commercial lending. It engaged in little deposit taking, and was dependent for most of its capital on the Irish parent, by way of borrowing for which it paid interest at, Mr Parker recalled, 3-month LIBOR. The remainder of the capital it had at that time—the early 1990s—was derived from the limited deposits it took, and retained profits. In the late 1990s the UK PE expanded, by opening branches and taking commercial deposits. The intention, Mr Parker said, was to make the UK PE self-sufficient, and if possible generate reserves which other group entities could draw on for their own capital needs. It continued to borrow from the Irish parent, though was less reliant on such borrowing as the deposits it had accepted grew, and it was also able to transfer profits to the parent. In 2004 the UK PE began to undertake retail banking, and the deposits it received from its retail customers, together with the other capital it generated from its UK business, had the result that by September 2006 it was no longer dependent on borrowing from the parent; indeed, at the end of that year it was the parent which was indebted to the UK PE.

18. I accept that evidence, which was largely uncontroversial. I should also record, in case it should be thought relevant, that it was not suggested, and I have no reason to think, that the appellants and other group companies indulged in any artificial manipulation of their borrowings from each other.

19. Dr Collier explained in his witness statement that before his retirement he had specialised in the taxation of banks, and that he had headed his firm’s banking practice. He also represented the firm at the OECD, and participated in the OECD’s work

relating to tax treaties, transfer pricing and the attribution of profits to PEs. He added that his doctorate was in international taxation.

20. Dr Collier's witness statement dealt with some of the history of capital attribution policies, but one can begin for present purposes in the late 1990s, when the OECD embarked on a project which led, although not until 2008, to the publication of a report, *The Attribution of Profits to Permanent Establishments*. The approach adopted was recognised at the time, by the OECD itself, to be novel, and it was dependent on the use of a "working hypothesis". The Preface to the report explained its approach as follows:

"2. There is considerable variation in the domestic laws of OECD Member countries regarding the taxation of PEs. In addition, there is no consensus amongst the OECD Member countries as to the correct interpretation of Article 7. This lack of a common interpretation and consistent application of Article 7 can lead to double, or less than single taxation. The development of global trading of financial products and electronic commerce has helped to focus attention on the need to establish a consensus position regarding the interpretation and practical application of Article 7.

3. As a first step in establishing a consensus position, a working hypothesis (WH) has been developed as to the preferred approach for attributing profits to a PE under Article 7. This approach builds upon developments since the last revision of the Model Commentary on Article 7 in March 1994, especially the fundamental review of the arm's length principle, the results of which were reflected in the 1995 OECD Transfer Pricing Guidelines (the Guidelines). The Guidelines address the application of the arm's length principle to transactions between associated enterprises under Article 9. The basis for the development of the WH is to examine how far the approach of treating a PE as a hypothetical distinct and separate enterprise can be taken and how the guidance in the Guidelines could be applied, by analogy, to attribute profits to a PE in accordance with the arm's length principle of Article 7. The ongoing development of the WH will not be constrained by either the original intent or by the historical practice and interpretation of Article 7. Rather the intention is to formulate the preferred approach to attributing profits to a PE under Article 7 given modern-day multinational operations and trade."

21. Dr Collier described the evolution of the new approach, and the concern expressed by many banks, the kinds of institution most likely to be affected by any change, that there be a single method applied uniformly in every country, and a further concern expressed more widely that any new method should be compatible with existing DTCs. Those concerns were not immediately dispelled, and Dr Collier described a succession of discussions and consultations in which he was involved. He was, he said, surprised, given the uncertainty about what might eventually be the OECD position, when he saw in July 2002 a draft of what was to become ss 11 and 11AA of ICTA, the more so as he perceived that the draft was inconsistent with the trend of the OECD discussions. He was also concerned that the draft clauses were incompatible with art 7 of the OECD model, which had been adopted in many of the UK's DTCs.

22. Dr Collier was aware of the Nolan opinion, and had seen a further opinion, to the same effect, of Mr Frank Heyworth Talbot QC. The view that there was "no authority to write into the branch accounts a level of capital which the branch does not have", as the Nolan opinion put it, was widely recognised to be correct, including by the Inland Revenue itself, and there was no evident justification for a departure from that settled

practice. In Dr Collier's experience, prior to the 1990s PEs were never deemed to have capital beyond the level they actually had; the calculation of that capital included that actually allocated by the parent, but no notional element was added. The introduction of s 11AA(3) therefore marked a significant change and, Dr Collier believed, would necessitate the renegotiation of many DTCs.

23. As I have mentioned, Mr Neighbour was until recently a partner in the firm of accountants which represents the appellants, but he was offered as a witness by HMRC, to speak of his experience, both while an assistant director in HMRC's Business International Division and, before that, as an official of the OECD itself, of the discussions which led to the revision of art 7 of the Model Treaty, and the publication of the revised Commentary. One of his main responsibilities while he was at the OECD was the project on the attribution of profits to PEs.

24. Mr Neighbour said that he had had no contact with, or involvement on the affairs of, either appellant while at HMRC or KPMG but, understandably, he felt somewhat embarrassed, in a professional sense, about giving evidence in view of his later career. However, no objection was taken to his doing so, and I treat him as an impartial witness.

25. The relevant work began, Mr Neighbour said, in 1998. It was driven by a recognition that modern business practices and regulatory requirements no longer dictated that capital was formally allotted to bank branches, and that it was easier for banks to book profits in branches remote from the activity which led to the earning of those profits. Such developments had the potential to undermine the arm's length principle of profit attribution for which art 7 was intended to provide. The *NatWest* case showed that member countries were taking divergent views about capital attribution, leading to the risk of double taxation, or of profits escaping tax, and further investigation revealed no unanimity of view. It became clear that the guidance given in the Commentary was out of date and that it was inadequate in modern conditions. Although it supported the principle of the notional attribution of capital to branches when it was appropriate to do so, it gave no assistance to Member Countries on the manner in which they should do so. Mr Neighbour's recollection was that although several countries raised objections to the proposed changes, or additions, to the guidance, none argued that capital attribution was objectionable in principle. As Mr Milne placed considerable emphasis, in this respect, on a passage in Mr Neighbour's witness statement I set it out:

“... at no time in my recollection did any country suggest that Article 7 prohibited the attribution of capital to a bank branch per se and it was not included in the list of difficult issues that may require a detailed analysis to see if any potential changes could be implemented by changing the Commentary or even the wording of the Article itself or in the list of possible reservations that would be required to preserve this particular view if held by any country. Rather, it was accepted that the principle of capital attribution was clear from the existing wording of the Commentary but that what was needed was a common approach and detailed guidance on how to determine the quantum of capital to be attributed to the branch.”

26. The working hypothesis was introduced, Mr Neighbour said, as a means of seeking unanimity, and of determining whether it would be sufficient to amend the guidance, or a new art 7 would be needed. Consensus of a sort was reached in 2006,



when a Report setting out the authorised OECD approach, or AOA. The consensus was not complete because the Report stated that any one of three methods—capital allocation, thin capitalisation and quasi-thin capitalisation—might be used; the common feature, on which all agreed, was that they should lead to arm's length attribution of capital in the determination for tax purposes of the profits of a branch. It was recognised by then that art 7 would need to be re-drawn. The new approach, which Mr Neighbour agreed represented a significant change, was adopted in 2008. However, the change was that in the new Commentary clear guidance was given when it had been lacking before; Mr Neighbour remained firmly of the view that the old version of art 7 did not preclude the notional attribution of capital but did not make it explicit.

27. Mr Black worked in the International Division of the Inland Revenue in the early 1990s, leaving in 1995 but returning to a similar role in 1999. He was the international banking specialist in the division (though he too had had no involvement in the appellants' affairs) and he was the UK's delegate to the OECD for the purpose of participation in its project on the taxation of PEs. He was also involved in the work which led to the introduction of s 11AA.

28. His evidence was that capital is critical to the operation of a bank, and that, since banks normally trade through branches rather than subsidiaries, it is important to ensure that the amount of capital attributable to a PE in a country other than that of the parent is fairly determined in order that profits are taxed, or losses relieved, in the country in which they are generated or suffered, and that banks which perform a proper attribution or trade in only one jurisdiction are not put at a disadvantage by comparison with banks which are able, by adopting an artificial means of attribution, to shift profits to minimise their tax burden. The aim was to ensure that banks, and other similar organisations, operated on a level playing field.

29. Mr Black knew of the PW formula, which had been in use until the late 1970s when it was challenged by some American banks because certain characteristics of the London market, when they were fed into the formula, led to the attribution of more than a realistic level of capital to their UK operations. It was accepted that the formula had some shortcomings, and that an improved method was needed. At this time, he said, there was no internationally agreed approach. Once the PW formula was abandoned the initial approach was to leave the determination of a PE's capital to negotiation between the bank concerned and the tax inspector, but that approach led to inconsistency both in methodology and in outcomes. There was, Mr Black said, universal recognition that some method of attribution, meaning of determining the amount of capital actually used by a PE, was needed, but only limited agreement about what that method might be.

30. The problem was not confined to the UK, Mr Black continued, and there was a good deal of divergence between the approaches taken in different countries, in some cases driven or influenced by the capital requirements imposed by regulatory bodies. That divergence resulted in some cases in unfair tax charges, and it led the OECD to reconsider the Model Treaty and in particular, in this context, art 7. At the same time banking practices were changing, with the consequence that the risk of double taxation, if each country adopted its own approach, was increasing.

31. The OECD programme, and the working hypothesis, aimed to treat a PE as far as possible as an independent entity, and as if its relationships with other parts of the same organisation were on an arm's length basis. Again, there was no disagreement, said Mr

Black, about the need for a fair attribution of capital; the difficulty lay in finding a way of achieving it. Most of the work was done by a steering group of which Mr Black was a member. The process of finding a consensus was protracted but, he said, a common understanding emerged and it was incorporated in a revised art 7 and a new Commentary. Section 11AA was introduced while the discussions were still under way, but it reflected, Mr Black said, the UK's understanding of the emerging consensus and modern banking practice, and was designed to avoid double taxation.

32. Mr Black was aware of the Nolan opinion, and that it had been accepted as correct by the Inland Revenue for many years, and he also accepted that the PW formula continued to be used by some banks until the 1990s. It was because of an increasing recognition that the PW formula no longer reflected modern conditions that it was progressively abandoned. He agreed with Mr Baker that there was a difference between capital actually allotted to a PE, and the attribution of a notional amount, but said that the aim, both at the OECD and in the UK, was to arrive at an agreed approach in order to determine what was, in reality, the amount of capital used by the PE to generate its profits.

#### *The appellants' arguments*

33. Mr Baker's starting point was HMRC's historical practice of adopting the amount of the capital actually employed by a PE in determining the amount of profit which attracted UK corporation tax. That practice reflected the Nolan opinion, and was, he said, the only approach compatible with arts 8(2) and (3) of the UK-RI DTC. Those provisions reflected, almost verbatim, the terms of art 7 of the OECD Model, which had remained materially unchanged since 1963, and was the Model in place at the time the UK-RI DTC was entered into. It was not until 2008, after the period with which I am concerned, that the OECD made material changes to the Commentary, and not until 2010 that the OECD Model itself was amended. Through the 1980s and 1990s HMRC had consistently accepted that there was nothing in art 7 of the OECD Model, and correspondingly art 8 of the UK-RI DTC, which supported the attribution to a UK branch of a non-resident bank of an amount of capital which differed from the amount actually employed in the trade of that branch.

34. In the United States a formulary approach to the determination of the amount of interest to be allowed in computing the profits of a US branch of a foreign bank had been adopted. That approach was challenged in the *NatWest* case, on the basis that the formulary approach, including the attribution of a notional amount of capital, was incompatible with the provisions of the relevant DTC. The bank was successful in establishing that the attribution of a notional amount of capital was incompatible with the "business profits" article of the DTC, and that it was the actual amount of capital employed in the trade of the branch that had to be recognised. Significantly, the UK government intervened in order to argue, with the UK banks, that the notional attribution of a deemed amount of capital was incompatible with the separate enterprise concept contained in the double taxation arrangements. The same conclusion was recently reached by the French Conseil d'Etat (the court of final appeal in tax matters) in *Re Bayerische Hypo und Vereinbank AG* (2014) 18 ITLR 1 and by the Spanish equivalent of the Court of Appeal in *ING Direct and others v Central Court for Economic and Administrative Matters* (2015) 18 ITLR 680.

35. The position taken by HMRC in the current appeals cannot be reconciled, said Mr Baker, with the Nolan opinion, earlier Revenue practice in applying precisely the same wording, the stance taken by the UK government when it intervened in the *NatWest* case or with the decisions of the US, French and Spanish courts.

36. There is nothing in ICTA s 11AA(2), said Mr Baker, which is novel, or inconsistent with art 8 of the UK-RI DTC—on the contrary, it merely reflects what art 8 says. What is novel is sub-s (3), which operates, or purports to operate, by modifying s 11AA(2) in order to insert an attribution of notional capital. Its introduction in 2003 marked a complete change of position by the Inland Revenue. Hitherto they had not only endorsed the Nolan opinion, but had expressly treated it as authoritative. The notion that the UK PE of an overseas financial institution should have assumed, or deemed, capital differing from that actually employed represents a real departure from what went before and, absent an amendment of the UK-RI DTC, the DTC must continue to be interpreted as it had been before s 11AA was enacted, and it must prevail over sub-s (3).

37. Conspicuously, Mr Baker continued, unlike provisions which are clearly intended to override a treaty, s11AA(3) contains no words such as “notwithstanding any provisions contained in a double taxation arrangement”, and HMRC have not argued or even suggested in their statement of case that s 11AA(3) does override the UK’s existing double taxation arrangements. It is to be noted, too, that the Irish equivalent of s 11AA (s 25 of the Taxes Consolidation Act 1997) does not include any provision matching sub-s (3) but is, and still is, in precisely the same form as the pre-2003 version of ICTA s 11.

38. In *Inland Revenue Commissioners v Commerzbank AG* [1990] STC 285 Mummery J provided a description of the proper approach to the interpretation of an international treaty which was, in essence, a summary of what the House of Lords had said on the subject in *Fothergill v Monarch Airlines Ltd* [1981] AC 251. Mummery J’s description, has been approved by the Court of Appeal and the House of Lords on several subsequent occasions. Omitting the references to the speeches in the House of Lords it is as follows:

“(1) It is necessary to look first for a clear meaning of the words used in the relevant article of the convention, bearing in mind that ‘consideration of the purpose of an enactment is always a legitimate part of the process of interpretation’. A strictly literal approach to interpretation is not appropriate in construing legislation which gives effect to or incorporates an international treaty. A literal interpretation may be obviously inconsistent with the purposes of the particular article or of the treaty as a whole. If the provisions of a particular article are ambiguous, it may be possible to resolve that ambiguity by giving a purposive construction to the convention looking at it as a whole by reference to its language as set out in the relevant United Kingdom legislative instrument.

(2) The process of interpretation should take account of the fact that—

‘The language of an international convention has not been chosen by an English parliamentary draftsman. It is neither couched in the conventional English legislative idiom nor designed to be construed exclusively by English judges. It is addressed to a much wider and more varied judicial audience than is an Act of Parliament which deals with purely domestic law. It should be interpreted, as Lord Wilberforce put it in *James Buchanan &*

*Co. Ltd v. Babco Forwarding & Shipping (UK) Limited*, [[1978] AC 141 at 152], “unconstrained by technical rules of English law, or by English legal precedent, but on broad principles of general acceptance”.’

(3) Among those principles is the general principle of international law, now embodied in art 31(1) of the Vienna Convention on the Law of Treaties, that ‘a treaty should be interpreted in good faith and in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose’. A similar principle is expressed in slightly different terms in McNair’s *The Law of Treaties* (1961) p 365, where it is stated that the task of applying or construing or interpreting a treaty is ‘the duty of giving effect to the expressed intention of the parties, that is, their intention as expressed in the words used by them in the light of the surrounding circumstances’. It is also stated in that work (p 366) that references to the primary necessity of giving effect to ‘the plain terms’ of a treaty or construing words according to their ‘general and ordinary meaning’ or their ‘natural signification’ are to be a starting point or *prima facie* guide and ‘cannot be allowed to obstruct the essential quest in the application of treaties, namely the search for the real intention of the contracting parties in using the language employed by them’.

(4) If the adoption of this approach to the article leaves the meaning of the relevant provision unclear or ambiguous or leads to a result which is manifestly absurd or unreasonable recourse may be had to ‘supplementary means of interpretation’ including *travaux préparatoires*.

(5) Subsequent commentaries on a convention or treaty have persuasive value only, depending on the cogency of their reasoning. Similarly, decisions of foreign courts on the interpretation of a convention or treaty text depend for their authority on the reputation and status of the court in question.

(6) Aids to the interpretation of a treaty such as *travaux préparatoires*, international case law and the writings of jurists are not a substitute for study of the terms of the convention. Their use is discretionary, not mandatory, depending, for example, on the relevance of such material and the weight to be attached to it.”

39. In *Revenue and Customs Commissioners v Anson* [2015] UKSC 44, [2015] STC 1777 Lord Reed added, at [56]:

“Put shortly, the aim of interpretation of a treaty is therefore to establish, by objective and rational means, the common intention which can be ascribed to the parties. That intention is ascertained by considering the ordinary meaning of the terms of the treaty in their context and in the light of the treaty’s object and purpose. Subsequent agreement as to the interpretation of the treaty, and subsequent practice which establishes agreement between the parties, are also to be taken into account, together with any relevant rules of international law which apply in the relations between the parties. Recourse may also be had to a broader range of references in order to confirm the meaning arrived at on that approach, or if that approach leaves the meaning ambiguous or obscure, or leads to a result which is manifestly absurd or unreasonable.”

40. HMRC’s arguments based on the OECD’s reports and Commentaries to the OECD Model were misconceived. They post-dated the UK-RI DTC and could have no bearing on its proper interpretation. Rather, as the extract from the preface to the discussion draft to which Dr Collier had referred showed, the OECD recognised that changes in the characteristics of world trade, and differing interpretations of art 7 of the OECD Model, demanded a fresh look at the manner in which PEs were taxed, but that

fresh look was for the future, when a new version of art 7 and the Commentary were published. There was no relevant revision to the Commentary until 2008, and art 7 was not amended until 2010, but both of those events occurred after the end of the relevant period. The new version of art 7, at para 2, did support the attribution of capital for which HMRC argue:

“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.”

41. That new wording represented a material change from the old version of art 7, and could not be taken as mere clarification of what was already the position—had that been so it would have been sufficient to amend the Commentary. The UK has entered into several DTCs since the amendment of art 7, all adopting the new wording, but the UK-RI DTC has remained unaltered. An examination of one of those DTCs, a new agreement with the US concluded in 2001, was informative, said Mr Baker. The text of the DTC itself followed the new OECD Model:

“ ... 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 business profits that 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. For this purpose, the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets used, risks assumed and activities performed by the permanent establishment.”

42. The DTC was accompanied by an Exchange of Notes which said, with respect to art 7:

“It is understood that the OECD Transfer Pricing Guidelines will apply, by analogy, for the purposes of determining the profits attributable to a permanent establishment. Accordingly, any of the methods described therein—including profits methods—may be used to determine the income of a permanent establishment so long as those methods are applied in accordance with the Guidelines. In particular, in determining the amount of attributable profits, the permanent establishment shall be treated as having the same amount of capital that it would need to support its activities if it were a distinct and separate enterprise engaged in the same or similar activities....”

43. That paragraph showed, said Mr Baker, that the UK recognised, even before the introduction of s 11AA, that specific wording was needed if capital greater than the amount actually held was to be attributed to a PE. The UK-RI DTC lacks any similar provision and it follows that it should be interpreted consistently with the OECD Model on which it was based. That Model did not support the attribution of notional capital, and the CATA on which HMRC had determined in this case should be rejected accordingly.

*HMRC's arguments*

44. The foundation of HMRC's case is that one must first determine the taxable profits of a UK PE, by reference to domestic law as it was in force during the accounting period in question, and only then consider whether an applicable DTC demands that the result must be modified. Here, as the appellants accept, s 11AA requires an attribution of capital to be made and, as the appellants also accept, it is only if art 8(2) of the UK-RI DTC precludes that attribution that they can succeed in these appeals. It is not enough that art 8(2) does not require an attribution to be made; it must be precluded.

45. Mr Milne, too, relied on what Mummery J said in *IRC v Commerzbank*, and in addition on art 31 of the Vienna Convention, to which Mummery J referred, which is as follows:

“1. 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 the light of its object and purpose.

2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes: (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty; (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

3. There shall be taken into account, together with the context: (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation; (c) any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.”

46. An analysis of art 8(2) of the UK-RI DTC shows, said Mr Milne, that the profits attributable to a UK PE must be computed with regard to four linked assumptions: (1) that the PE is a distinct and separate enterprise; (2) that it is engaged in the same or similar activities to those it is in fact engaged in; (3) that it is so engaged under the same or similar conditions as would apply to it if assumptions (1) and (2) were the case; and (4) that it is dealing at arm's length with the enterprise of which it is the UK permanent establishment.

47. A retail banking company trading as a distinct and separate enterprise would necessarily have a capital base. Such a base would be needed not only to satisfy regulatory requirements, but also in order to secure a sufficient credit rating such that the company can itself borrow on interest terms which enable it to lend at a greater rate from which it may derive a profit while remaining competitive, and to provide it with a cushion, or buffer, with which it can survive untoward events. The form of capital which most effectively satisfies those requirements is free capital, that is capital upon which the enterprise is not required to pay any interest, most commonly equity, retained profits or reserves. If the company was entirely dependent on customers' deposits or borrowing it would, Mr Milne argued, be unlikely to be able to earn a worthwhile profit.

48. The terms of s 11AA(2) are materially identical to art 8(2). All that sub-s (3) does is to specify that one of the “same or similar conditions” under which the UK PE operates as a “distinct and separate enterprise” is that it has such equity and loan capital as it could reasonably be expected to have were it, in fact, a separate enterprise engaged in the same or similar activities. Even if the appellants are right to argue, said Mr Milne, that art 8(2) does not require an attribution of capital (a proposition he did not accept) there was nothing in it which precluded such an attribution. Moreover, the appellants had offered no explanation of how, if their analysis was right, a PE supported by (say) interest-free loans would be operating “under the same or similar conditions” as a “distinct and separate enterprise”, nor how such a PE would be at arm’s length to the parent enterprise. In other words, without some capital attribution the PE would not meet the requirements of art 8(2), irrespective of s 11AA(3).

49. The overseas cases on which the appellants rely—the *NatWest* case, *Bayerische Hypo und Vereinbank* and *ING Direct*—must be treated with some caution, said Mr Milne, because they do not relate to comparable situations. In the *NatWest* case the court was considering only whether a formulary method was appropriate: it did not decide that all methods of capital attribution were precluded by article 7(2) of the US-UK DTC. The appellate court declined to consider an alternative argument by the US government that capital held by the head office should be imputed to the branch, but it did so because that argument had not been advanced in the court below. The French law under consideration in *Bayerische Hypo*, unlike s 11AA(3), did not authorise the attribution of capital, and the Spanish legislation considered in *ING Direct* was also materially different from s 11AA(3). None of those decisions, properly analysed, supports the proposition that art 8(2) of the UK-RI DTC precludes all methods of capital attribution.

50. HMRC’s approach is consistent, Mr Milne said, with the OECD’s Commentaries on the Model Tax Convention issued up to and including 2008. At the time the UK-RI DTC was signed, on 2 June 1976, the relevant OECD Commentary was that issued in 1963. The section relating to art 7 did not expressly address the question of capital attribution, but it did state that the provisions of the article “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”. It added, with respect to art 7(3) (art 8 of the UK-RI DTC) that:

“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 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 its 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.”

51. The 1963 Commentary also said that payments of loan interest made by a PE to the parent “should not be allowed as deductions in computing the permanent

establishment's taxable profits", although it added that "It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (eg 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". Similar comments were made in the Commentary which accompanied the revised OECD Model issued in April 1977 (after the UK-RI DTC had come into effect). In 1984, a further OECD report "*Transfer Pricing and Multinational Enterprises: Three Taxation Issues*" said that in a country where it is necessary or permissible for the tax accounts and the financial accounts of an enterprise to differ from each other it was possible

"for the tax authorities to treat an appropriate part of the payment by a branch of a foreign bank to its head office as remuneration for the use of equity capital, if this is in fact what it does represent, and this treatment is not in itself discriminatory, notwithstanding that the financial accounts of the branch do not show such equity capital."

52. In 1994, the OECD Commentary was amended again, but it was consistent with its predecessors in remarking that the business profits provisions of art 7 "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". It went on to refer back to the 1984 report which, it said,

"also addresses the issue of the attribution of capital to the permanent establishment of a bank in situations where either actual assets were transferred to such a branch and in situations where they were not. Difficulties in practice continue to arise from the differing views of Member countries on these questions and the present Commentary can only emphasise the desirability of agreement on mutually consistent methods of dealing with these problems."

53. Neither the 1984 report nor the 1995 Commentary offered a solution to the difficulties but, as Mr Neighbour had said, in 1998 an attempt was made to modernise art 7 and the relevant part of the Commentary. As the programme proceeded, various reports were published, of which the most important was that published in 2008. The OECD recognised, at para 7 of the Commentary, that some of the conclusions arising out of this project were consistent with the existing Commentary, while others were not, but "left considerable leeway". The 2008 Commentary on art 7 also contained the following passage, on which Mr Milne laid some emphasis:

"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 then 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 expenses 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 organization 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. ... 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 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 principles set out above.”

54. The appellants could not dismiss that passage as the signal of a change, said Mr Milne. It is, rather, a clarification, and nothing in it precludes the approach taken by s 11AA. It can, in addition, legitimately be taken into account in interpreting art 7 and, with it, art 8(2) of the UK-RI DTC. Décarry JA, with whom the other judges agreed, made that point in the Canadian Federal Court of Appeal case *The Queen v Prévost Car Inc* [2009] FCA 57:

“[9] ... counsel for both sides agree that the Judge was entitled to rely on subsequent documents issued by the OECD in order to interpret the Model Convention. I share their view ...

[10] The worldwide recognition of the provisions of the Model Convention and their incorporation into a majority of bilateral conventions have made the commentaries on the provisions of the OECD Model a widely-accepted guide to the interpretation and application of the provisions of existing bilateral conventions ...

[11] The same may be said with respect to later commentaries, when they represent a fair interpretation of the words of the Model Convention and do not conflict with the commentaries in existence at the time a specific treaty was entered and when, of course, neither party has registered any objection to the new Commentaries ...

[12] I therefore reach the conclusion, that for the purposes of interpreting the Tax Treaty, [later OECD reports and commentaries] are a helpful complement to the earlier Commentaries, insofar as they are eliciting, rather than contradicting, views previously expressed.”

55. Mr Milne referred me to other authorities, including academic writing, to the same effect but I do not think it necessary to elaborate on the point. The authorities all show, said Mr Milne, that once it is accepted, as the appellants do, that the 2008 Commentary supports HMRC’s approach, the argument that it is not relevant because it was published long after the UK-RI DTC was signed in 1976, and that capital attribution is not possible without an amendment first being made to the business profits article of the DTC, loses any force. Moreover, Mr Neighbour’s evidence (see para 25 above) was that no country argued that art 7 of the Model Treaty precluded capital attribution.

56. The appellant’s reliance on HMRC’s supposed prior practice, too, is misconceived. The Nolan opinion was sought only because, despite the signature of the UK-RI DTC in 1976, HMRC were continuing to use the PW formula, and the opinion was given more than two years after signature of the DTC. It could therefore cast no light, said Mr Milne, on the understanding of the UK and Irish governments when the DTC was entered into. In any event, the objection to the PW formula was that it was formulary; there was no objection to *some* method of capital attribution. That was, in substance, Mr Black’s evidence: the question was not whether capital could be attributed to a PE, but what was the appropriate measure of the attribution, and all the documentary evidence showed that HMRC and before it the Inland Revenue had consistently sought to determine the appropriate attribution, whether by the subsequently discredited PW formula or by some other method.

57. Indeed, said Mr Milne, in three joint opinions of Mr Michael Flesch QC and of Mr Baker, provided in 1997, 1998 and 2001 for the purposes of the *NatWest* litigation, it was clearly recognised that it was consistent Inland Revenue practice to determine the free working capital of a PE for the purposes of art 7 of the OECD Model (or art 8 of the UK-RI DTC), and that, prior to its general abandonment, the PW formula had been in widespread use. In the second of those opinions, at para 8, its authors said:

“What one can say is this: In 1975, at the time that the Convention was under negotiation, the Inland Revenue applied a formulary approach with respect to the determination of the working capital (and hence the amount of allowable interest) of a number of foreign banks having branches in the UK. And it is clear from the [Inland Revenue’s] Banking Manual that, at least in the case of some banks, the PW Formula continued to be employed even after 1978.”

58. In their third joint opinion Mr Flesch and Mr Baker added that

“... even if an amount of capital is allotted to the UK branch of a foreign bank (which is not a requirement of UK law), it will be necessary to calculate the amount treated as allotted capital, which, if larger than the allotted capital, will result in more free working capital and a greater disallowance of interest.”

59. That comment, made in 2001, pre-dated the introduction into UK domestic law of s 11AA, and at that time it was made there was no express requirement of attribution. Later in the same opinion appears the observation:

“The Banking Manual clearly takes the position that interest expense can be allowed on funds borrowed by the branch from head office, but only to the extent that such funds do not represent the free working capital of the branch as calculated in accordance with Appendix 9.A [to the Banking Manual].”

60. The UK government’s position in the *NatWest* case was not, as the appellants suggest, to argue that capital attribution was inappropriate; its position was merely that formulary attribution could not be justified. But even if, contrary to his submissions, the appellants could show that HMRC’s present position differed from their, or the Inland Revenue’s, earlier practice, or that it differed from their position in the *NatWest* case, said Mr Milne, it would not assist them because it was necessary to construe the UK-RI DTC according to its own terms. There was nothing in it to preclude the operation of s 11AA(3), and that provision must therefore be respected.

#### *Discussion and conclusions*

61. I agree with Mr Milne, and largely for the reasons he advanced, that s 11AA(3) does not offend art 8 of the UK-RI DTC. His reasons seem to me to be correct because I am satisfied, first, that even though the method of doing so may have changed, it has been recognised in the UK, and has been the UK practice, since at least the 1950s that it is necessary to determine the amount of free capital properly to be ascribed to a PE in order to assess the amount of profit chargeable to tax in the jurisdiction in which that PE operates; that the OECD Model and Commentaries likewise recognise, even if until 2010 and 2008 respectively they did not spell out, the same necessity; and that art 7 of the pre-2010 version of the OECD Model, reflected in art 8 of the UK-RI DTC, did not preclude the attribution for which HMRC argue.

62. It will be apparent from what I have said of the evidence that Dr Collier’s recollection differed from that of Mr Neighbour and Mr Black, but in my judgment what they said is more consistent than is Dr Collier’s evidence with the contemporary documentation. Leaving aside the Nolan opinion, to which I will return, all of that documentary evidence is consistent with the proposition that it is necessary to make a determination of a PE’s properly allocated free capital if fiscal fairness is to be achieved—that is, if profits are not to be taxed twice, or escape taxation altogether. On a fair reading, it is apparent from that documentary evidence that, even if the need for capital attribution, or notional attribution, is not express, it is implicit. Whatever its methodological failings, it is difficult to understand why the PW formula was introduced if that was not its aim. The passages from the joint opinions of Mr Flesch and Mr Baker which I have set out are themselves consistent only with an underlying assumption that some capital attribution, or at least determination of the amount of free capital or its equivalent actually used, is required. Dr Collier described the discussions which began in the late 1990s as novel, but in my judgment the novelty lay in the approach, and in the resolve to find a consensus about a problem which, as Mr Neighbour and Mr Black said, had not previously been addressed. I see nothing in the earlier Commentaries which might lead to a contrary conclusion, and I agree with him that the later Commentaries support his position.

63. The clear, and as I understand it uncontroversial, purpose of art 8(2) of the UK-RI DTC is to segregate the profits of an entity resident in one of the two contracting countries so that those earned, on a fair assessment, by a PE carrying on business in the other country are taxed there, and not in the parent's country, while the parent's profits, excluding those of the PE, are taxed in the parent's country of residence. The underlying aim, equally clearly and uncontroversially, is to avoid double taxation or an escape from taxation. As I see it, art 8(2) achieves that aim by eliminating distortion, whether that distortion is deliberate or merely the accidental consequence of the entity's structure or manner of operation. I do not understand how the distortion can be eliminated if the PE, though it is to be treated, as art 8(2) puts it, as a "distinct and separate enterprise", "dealing at arm's length with the enterprise of which it is a permanent establishment", is nevertheless to be shielded from the adjustments or attribution which it is necessary to make if those requirements are to be met.

64. If that conclusion is right it seems to me impossible to argue that there is anything offensive about s 11AA(3). The assumptions for which it provides are no more than art 8(2) requires: that the PE has the same credit rating as its parent, reflecting the art 8(2) assumption that the PE is trading "under the same or similar conditions"; and that it "has such equity and loan capital as it could reasonably be expected to have", reflecting the art 8(2) assumption that it is a "distinct and separate enterprise". In other words, s 11AA(3) seems to me to do no more than give effect to the art 8(2) requirements.

65. At first sight that conclusion seems contrary to the view expressed in the Nolan opinion, quoted at para 13 above. Although the opinion is not binding on me, a statement of such eminent authorship is obviously of great persuasive value. However, I agree with Mr Milne that the target of the opinion was not the question whether any attribution was permitted or excluded, but whether the mechanistic approach of the PW formula was offensive. So much seems to me clear from the second of the two quoted paragraphs: the fear was that the application of the formula would itself result in a failure to comply with, in that case, Art III of the US-UK DTC.

66. For the reasons I have given the appeals are dismissed.

67. I conclude by thanking counsel on both sides for their impressive, and extremely scholarly, submissions.

#### *Appeal rights*

68. This document contains full findings of fact and reasons for the decision. Any party dissatisfied with this decision has a right to apply for permission to appeal against it pursuant to Rule 39 of the Tribunal Procedure (First-tier Tribunal) (Tax Chamber) Rules 2009. The application must be received by this Tribunal not later than 56 days after this decision is sent to that party. The parties are referred to "Guidance to accompany a Decision from the First-tier Tribunal (Tax Chamber)" which accompanies and forms part of this decision notice.

**COLIN BISHOPP  
TRIBUNAL JUDGE**

**RELEASE DATE: 22 SEPTEMBER 2017**