Neutral Citation Number: [2020] EWCA Civ 1128

Case No: A3/2019/3060

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM UPPER TRIBUNAL TAX AND CHANCERY CHAMBER
Marcus Smith J & Upper Tribunal Judge Timothy Herrington
[2019] UKUT 0277 (TCC)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 28 August 2020

Before :

LORD JUSTICE PATTEN
LORD JUSTICE SINGH
and
LADY JUSTICE ROSE

- -

Between :

(1) IRISH BANK RESOLUTION CORPORATION LTD (IN SPECIAL LIQUIDATION)
(2) IRISH NATIONWIDE BUILDING SOCIETY — **Appellants**

- and -

THE COMMISSIONERS FOR HER MAJESTY'S REVENUE AND CUSTOMS — **Respondents**

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- -

Philip Baker QC and **Imran Afzal** (instructed by **Sharpe Pritchard LLP**) for the **Appellants**
David Milne QC and **Jonathan Bremner QC** (instructed by **HMRC Solicitor's Office**) for the **Respondents**

Hearing dates : 14 and 15 July 2020

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Approved Judgment

Covid-19 Protocol: This judgment was handed down remotely by circulation to the parties' representatives by email, release to BAILII and publication on the Courts and Tribunals Judiciary website. The date and time for hand-down is deemed to be at 10:30am on Friday, 28 August 2020.

Lord Justice Patten :

Introduction

1. Both Appellants are companies registered in the Republic of Ireland which, during the relevant accounting periods covered by this appeal, carried on business through a branch in the United Kingdom. Irish Bank Resolution Corporation Limited ("IBRC") was formerly Anglo Irish Bank Corporation plc. It opened an office in the UK in 1988 and in 1991 was granted branch status by the Bank of England which enabled it to undertake regulated financial services including the taking of deposits. Irish Nationwide Building Society ("INBS") opened a retail branch in the UK (in Belfast) in 1994 and provided loans for the purchase of domestic property. Most of its business became the provision of sterling-based finance to the developers of residential property operating in the UK market. The finance was raised from a number of sources including the wholesale market in London, sterling deposits at its UK branches and in an Isle of Man subsidiary of INBS, and inter-bank funding.

2. Both companies became insolvent as a result of the financial crisis which affected the property market from 2007 onwards. INBS is now a shell company and IBRC is in liquidation. But in the years with which this appeal is concerned they operated profitable businesses through their UK branches which rendered them liable to UK corporation tax.

3. Section 11 of the Income and Corporation Taxes Act 1988 ("TA 1988") as in force at the material time between 2003 and 2007 provided 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."

4. "Permanent establishment" ("PE") was defined by s.148(1)(a) of the Finance Act 2003 ("FA 2003") as "a fixed place of business … through which the business of a company is wholly or partly carried on". It is common ground that both the UK branches we are concerned with satisfied this description.

5. No guidance is given by s.11 TA 1988 itself as to the correct basis for identifying or calculating which of the company's profits should be treated as attributable to its PE in the UK but some further guidance was provided by s.149(2) FA 2003 which as well as substituting the replacement subsections (1) and (2) of section 11 as set out above also inserted into TA 1988 a new s.11AA in respect of accounting periods after 31 December 2002. It provided 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."

6. This appeal is primarily concerned with s.11AA(3)(b). In reliance on these provisions, HMRC have disallowed as part of the Appellants' calculation of profits the deduction of some of the interest which is shown in the accounts of the UK branches as an expense of the borrowings made by the branches in order to finance their lending business. HMRC have done so using what is described as a Capital Attribution Tax Adjustment ("CATA") which includes attributing to the PE notional additional free capital in cases where it is said that a PE operating as a distinct and separate enterprise in the manner contemplated by s.11AA(2) would have had a higher amount of free capital and therefore a correspondingly lower amount of borrowed capital. The result of applying the CATA to the accounts of the two branches in this case has been to disallow interest which was actually paid to third parties in the market as part of their cost of borrowing. But s.11AA(3)(b) can obviously be engaged in a wide variety of cases involving many different types of companies including those where a PE may have very little free capital or even third party borrowings and may depend for its capital on internal financing arrangements within the company which have little or no correspondence to the arm's length market conditions contemplated by s.11AA(2).

7. The ability of the UK to tax the profits of a non-resident company brings with it the obvious possibility of double taxation. The provisions of s.11 TA 1988 are by no means unique to the UK and can be found replicated in one form or another in the tax regimes of a significant number of other countries. To alleviate this problem, the Organisation for Economic Co-operation and Development ("the OECD") has since 1963 published a series of model double taxation conventions with accompanying commentaries in order to provide a suggested basis for the allocation of profits to a PE. In 1976 the UK and Ireland entered into such a convention ("the 1976

Convention") which came into force domestically with the making of the Double Taxation Relief (Taxes on Income) (Republic of Ireland) Order 1976.

8. The 1976 Convention itself is, of course, an international treaty between sovereign states but it impacts on domestic tax legislation because under s.788(3) TA 1988 the arrangements contained in a double taxation convention, once confirmed by Order in Council, have effect in relation to income tax and corporation tax "notwithstanding anything in any enactment". It is common ground on this appeal that the provisions of s.11AA(3)(b) are therefore effective only if and in so far as they provide a means of determining the profits of the company attributable to the PE that is within the scope of and therefore permissible under the relevant terms of the 1976 Convention.

9. The 1976 Convention covers all forms of direct taxation on income and profits including capital gains. Article 5 contains a definition of permanent establishment in the same terms as s.148(1)(a) FA 2003 which includes a branch. Business profits are addressed in Article 8 in the following terms:

> "(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) 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.
>
> (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."

10. One can see that the wording of Article 8(2) has been adopted almost verbatim in s.11AA(2). The only difference is the use in s.11AA(2) of the phrase "dealing wholly independently with" which is found in Article 7(2) of the 1963, 1977 and 2008 model conventions but it has not been suggested that the reference in Article 8(2) of the 1976 Convention to "dealing at arm's length" makes any material difference to the effect of the relevant provisions.

11. The essence of the taxpayers' argument is that the reference in Article 8(2) to the PE being treated as a distinct and separate enterprise "engaged in the same or similar activities under the same or similar conditions" requires an assumption to be made not only that the PE is engaged in the same or similar type of business to the one it actually carried on but also that it should be taken to have traded with the same ratio of free to borrowed capital as it actually employed during the relevant accounting period. On this basis, it is said the UK is precluded by s.788(3) from relying on s.11AA(3)(b) in so far as that would lead to an adjustment in the amount of free capital it was taken to have employed in that period and a consequent disallowance of some of the interest charges on borrowed capital which it actually incurred. Mr Baker QC, for the Appellants, did, of course, recognise that if this construction of Article 8(2) is right, it must follow that the same outcome would apply to a PE which employed no free capital at all in the relevant accounting period.

12. Some reliance is also placed by Mr Baker on Article 8(3) of the 1976 Convention if the attribution of a notional amount of free capital to the PE would have the effect of disallowing the deductions which are mentioned. Article 8(3) is concerned with an allowance being made against the profits of the PE in respect of general administrative and other expenses incurred by the company itself in relation to the PE. In relation to administrative expenses, this seems to be a different exercise from the calculation of the profits attributable to the PE from its own activities and it is not clear how, if at all, it could be impacted by the operation of the CATA. The deduction of expenses incurred by the company might, however, be affected if they took the form of expenses on borrowings incurred by the bank on monies that were then used to capitalise the PE. It is however clear, and I think accepted by Mr Baker, that Article 8(3) cannot be construed so as to create an obstacle to the implementation of the CATA if, on the proper construction of Article 8(2), capital attribution is permissible. The two must be read consistently with each other. For this reason, Article 8(3) has not really featured in the argument either here or before the Upper Tribunal and the First-tier Tribunal.

13. On the Appellants' case, the ability of the UK to operate the domestic tax regime contained in s.11AA(3)(b) depends upon it negotiating and concluding an amendment to the 1976 Convention. This, Mr Baker says, could be achieved by the incorporation

in the 1976 Convention of a new Article 8 replicating the terms of the 2010 OECD model convention which contains a number of linguistic changes. These, he says, were intended to give effect to an OECD review project that commenced in the late 1990s and included a recognition that in a significant number of Member States the calculation of the profits attributable to the PE of a non-resident company was considered to be best achieved by a process of notionally capitalising the PE at the level at which it could reasonably be expected to have operated had it conducted its business as an independent enterprise of the kind contemplated by Article 8(2). The Appellants' case is that the implementation of this approach required a substantive change to the terms of what was then Article 7 of the model convention and that this was achieved by the 2010 re-draft. Mr Milne QC, for HMRC, relies, however, on the amended OECD commentary on the model convention published in 2008 which he says confirms that the approach based on an attribution of capital had long been used by Member States to implement the provisions of Article 7 and was recognised by the OECD as permissible under the terms of Article 7 of the model convention in its unamended form.

14. Both the Upper Tribunal (Marcus Smith J and Judge Timothy Herrington) ([2019] UKUT 0277 TCC) ("UT") and the First-tier Tribunal (Judge Colin Bishopp) ([2017] UKFTT 0702 (TC)) ("FtT") relied upon the 2008 commentary in their reasons for deciding to dismiss the taxpayers' appeals and a significant issue for us is whether the guidance contained in the 2008 OECD commentary is properly to be treated as no more than confirmatory of the scope of the existing Article 7 or whether it did introduce a substantive change in advocating the use of the CATA methodology which can only be given effect to by the adoption of the 2010 version of Article 7 of the model convention or something very similar.

<u>Principles of Construction</u>

15. Before I come to the OECD material it is necessary to say something about the correct approach to the construction of the wording of the 1976 Convention. Article 31 of the 1969 Vienna Convention on the Law of Treaties provides:

> "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 connexion with the conclusion of the treaty;
>>
>> (b) Any instrument which was made by one or more parties in connexion 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."

16. It was common ground that a convenient summary of these principles and the way in which they have been applied by the English courts is to be found in the judgment of Mummery J (as he then was) in *Inland Revenue Commissioners v Commerzbank AG* [1990] STC 285 at page 297 where the judge said:

"Before I examine the contrary submissions of the Crown, it is necessary to refer briefly to the approach to the interpretation of provisions, such as art XV, which have been agreed between sovereign states in a convention or treaty and have subsequently been given the force of law in the United Kingdom by reason of the implementing provisions of primary or secondary legislation. The parties are agreed that the correct approach is that laid down by the House of Lords in *Fothergill v Monarch Airlines Ltd* [1981] AC 251. That case gave rise to problems of comparison with a foreign language text (that is, the French text of the Warsaw Convention) which are not present in these appeals. The House of Lords had to compare the English text and the French text because of a provision in the convention that the French text should prevail if there was any inconsistency between it and the text in English. Putting that special feature on one side, that decision makes clear the approach which should be adopted by the court.

(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': per Lord Wilberforce (at 272) and Lord Scarman (at 294). A strictly literal approach to interpretation is not appropriate in construing legislation which gives effect to or incorporates an international treaty: per Lord Fraser (at 285) and Lord Scarman (at 290). 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 [1990] STC 285 at 298 as set out in the relevant United Kingdom legislative instrument: per Lord Diplock (at 279).

(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 acceptation': per Lord Diplock (at 281–282) and Lord Scarman (at 293).

(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: per Lord Diplock (at 282) referring to art 32 of the Vienna Convention, which came into force after the conclusion of this double taxation convention,

> but codified an already existing principle of public international law. See also Lord Fraser (at 287) and Lord Scarman (at 294).
>
> (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: per Lord Diplock (at 283–284) and per Lord Scarman (at 295).
>
> (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: per Lord Scarman (at 294)."

17. In addition to the OECD material, we have been supplied with a number of textbooks and other articles commenting on Article 7 of the model convention and the issues which arise about the attribution of capital. Although the views expressed in these publications are of some interest, they are of course no more than the views of their authors (however distinguished) on the issues discussed and are not in any sense authoritative in relation to the legal issues of construction which we have to decide. More importantly, we have been referred to three decisions of senior foreign courts in the United States, France and Spain where the same or similar issues have been discussed or decided. These, we consider, are of some interest in relation to the questions of construction raised by this appeal and I shall come to those decisions after considering the OECD model conventions and commentaries.

18. One area which was explored both here and during the earlier appeals in the FtT and UT is the prior practice of the Inland Revenue. Until the late 1970s the practice of the Inland Revenue was to attribute a notional amount of free working capital to the UK branches of a foreign bank in order to determine the level of interest which the PE could deduct in calculating the profits which were chargeable to corporation tax. The Inland Revenue adopted what became known as the PW Formula named after the accountants Price Waterhouse who had agreed it with the Inland Revenue in the 1950s. In a letter to Price Waterhouse in September 1957 the Inland Revenue described the agreement as being based on the "conception" of the London branch of each bank operating:

> "as an independent enterprise engaged in the same or similar activities under the same or similar conditions and dealing at arm's length with its Head Office. It is considered that this conception necessarily includes the assumption that the London branch commands sufficient free working capital to operate as an independent enterprise".

In that respect the agreement therefore mirrored the language of Article 8(2) of the 1976 Convention which, as I have explained, is derived from earlier versions of the OECD model conventions. But the PW Formula sought to calculate the amount of free capital that should be attributed to the branch by reference to the ratio of the bank's total free capital to its worldwide liabilities. That ratio was then applied (with some adjustments) to the London operation. This had the effect of attributing to the London branch a capital ratio which did not necessarily reflect the nature of the business which it conducted.

19. The apportionment of the bank's worldwide capital between its various branches according to this formula was eventually challenged by various foreign banks because in their view it had the effect of overstating the amount of free capital properly attributable to the business actually carried on by the particular branches and so exposed them to what was considered to be an excessive tax liability.

20. In 1978 these banks obtained an Opinion from Mr Michael Nolan QC (later Lord Nolan) and Mr Robin Mathew (now QC). One of the questions which they considered was what basis should be used for calculating the profits of a branch on the hypothesis contained in Article III(2) of the UK/USA Double Tax Convention (which used very similar wording to Article 8(2) of the 1976 Convention). They expressed the view that Article III(2):

> "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."

21. The Inland Revenue accepted that this Opinion correctly interpreted the provisions of Article III(2) of the UK/USA Double Tax Convention and abandoned the use of the PW Formula. In the Inland Revenue HMRC Banking Manual they confirmed that the formulaic approach was inappropriate and that their view as to how to measure free capital had come to be based on domestic law and double taxation agreements with the assistance of the OECD commentaries. In particular, they referred to the 1984 report entitled "Transfer Pricing and Multinational Enterprises: Three Taxation Issues" which they said had contributed significantly to their interpretation of the convention. I shall refer to this later when I consider the OECD material.

22. The UT took the view that the practice of the Inland Revenue in relation to the assessment of the profits attributable to the UK branch of a bank was inadmissible as an aid to the construction of Article 8(2) of the 1976 Convention. At [29]-[31] they said:

> "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. 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. 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."

23. This seems to me to be clearly right. Mr Baker submitted that Article 31 of the Vienna Convention should not be treated as an exhaustive and immutable code and I think that may be correct. As with any other set of legal principles, the norms of international law are capable of development and change. But what the UT said in [30] of its decision (which is derived from Article 31(3)(b) of the Vienna Convention) is an established norm of international law. By contrast with that, the Appellants have been unable to identify any established principle of international law which recognises the unilateral practice of a contracting state as an aid to the construction of a treaty. In that respect, there is no divergence between international law and the English private law system which has never received evidence of what a party to a contract believed that the language of the agreement meant except in relation to a claim for rectification. The legal meaning of the words used is an abstract question of law to be determined on an objective basis.

The OECD Publications

24. I can turn now to the OECD publications and what Mr Baker described as the OECD project which culminated in the changes reflected in the 2010 model convention. It is useful at the outset to reproduce the table which appears at [50] of the decision of the UT and shows the wording of Article 8 of the 1976 Convention alongside the relevant provisions of the 1963 and the 2010 OECD model conventions.

Article 7 of the 1963	**Article 8 of the 1976**	**Article 7 of the 2010 OECD**

OECD Draft Convention (differences with the 1976 Convention are marked in bold)	**Convention (differences with the 1963 OECD Draft Convention are marked in bold)**	**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	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	**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**

State in which the permanent establishment is situated or elsewhere.	State in which the permanent establishment is situated or elsewhere.	**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.**

25. The OECD also published model conventions in 1977 and 2008 but the differences between the 1977 model convention and the 1963 model convention are immaterial and the 2008 model convention was identical in terms to that published in 1977. In summary, therefore, the language of Article 7 of the model convention remained essentially unchanged between 1963 and 2010 and, as the evidence about the PW Formula illustrates, was in use in double taxation treaties as far back as the 1950s. This is consistent with the findings of the FtT (see [61] of its decision) that the UK practice since at least the 1950s was that it was necessary to determine the amount of free capital properly to be ascribed to a PE in order to assess the profits attributable to it for corporation tax purposes. The use for a time of the PW Formula forms part of this history.

26. In the 1963 Commentary on Article 7 of the model convention the OECD says this:

> "2. It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of European double taxation Conventions concluded since the war, and it is fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognised that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments 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 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.

This, however, is a matter of relatively minor importance. If there is agreement on general lines. Special cases may require special consideration, but it should not be difficult to find an appropriate solution if the problem is approached within the framework of satisfactory rules based on agreed principles.

…

Paragraph 2

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, 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 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 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 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 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 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 recognizes 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."

27. As mentioned earlier, there were no changes of substance in the OECD model conventions and commentaries published in 1977 and 1994 and, although these of course post-date the 1976 Convention, their significance is to confirm that the wording of Article 7(2) continued essentially unchanged throughout this period. In 2008, however, the OECD published a further edition of its model convention in which Article 7 continued in the same form as the 1963 edition (subject to the minor changes noted in the table at [24] above) but the commentary was, as the UT put it, significantly different.

28. In the introduction to the 2008 edition the OECD refers to the effect of changing economic conditions such as globalisation on its work and this is reflected in a number of the changes in the commentary. Many of these issues were considered in an OECD report published on 17 July 2008 on the "Attribution of Profits to Permanent Establishments". The report is a wide-ranging survey of the problems which occur in any determination of the profits of the PE and covers issues such as transfer pricing between companies and their PEs as well as the issue of capital attribution. The Report comprised Part I containing general considerations and Part II containing special considerations for applying the authorised approach to the PEs of banks.

29. In relation to capital attribution, the authors of the report confirm that what they describe as the authorised OECD approach does not limit the methods by which domestic tax regimes may seek to implement the provisions of Article 7 and that the attribution of capital is a well-recognised and justifiable method of attributing profits to a branch of an overseas bank. One sees this clearly in the following passages from the report from Part I:

> "B-2. Basic premise of the authorised OECD approach
>
> 12. The authorised OECD approach does not dictate the specifics or mechanics of domestic law, but only sets a limit on the amount of attributable profit that may be taxed in the host country of the PE. Accordingly, the profits to be attributed to a PE are the profits that the PE would have earned at arm's length if it were a legally distinct and separate enterprise performing the same or similar functions under the same or similar conditions and dealing wholly independently with the enterprise of which it is a PE, determined by applying the Guidelines by analogy. This is in line with one of the fundamental rationales behind the PE concept, which is to allow, within certain limits, the taxation of non-resident

enterprises in respect of their activities (having regards to assets used and risks assumed) in the source jurisdiction. In addition, the authorised OECD approach is not designed to prevent the application of any domestic legislation aimed at preventing abuse of tax losses or tax credits by shifting the location of assets or risks. Finally, where their domestic law does not recognise loss transactions in certain circumstances between associated enterprises, countries may consider that the authorised OECD approach would not require the recognition of a loss on an analogous dealing in determining the profits of a PE.

...

(iv) Attribution of free capital

31. The functional and factual analysis will attribute "free" capital (i.e. funding that does not give rise to a tax deductible return in the nature of interest) to the PE for tax purposes, to ensure an arm's length attribution of profits to the PE. The starting point for the attribution of capital is that under the arm's length principle a PE 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.

32. A key distinction between a separate legal enterprise and a PE is that one legal enterprise can enter into a legally binding agreement to guarantee all the risks assumed as a result of the functions performed by another legal enterprise. For such a guarantee to have substance, the "free" capital needed to support the risks assumed would reside in a different legal enterprise from that in which the transactions giving rise to the risks are booked. In contrast one of the key factual conditions of an enterprise trading through a PE is that the "free" capital and risks are not segregated from each other within a single legal enterprise. To attempt to do so for tax purposes (i.e. to treat one part of an enterprise as able to guarantee a risk assumed by another part of the enterprise) would contradict the factual situation and would not be consistent with the authorised OECD approach. Capital needed to support risks must be regarded as following the risks. In other words, capital needed to support risks is to be attributed to a PE by reference to the risks attributed to it and not the other way round.

> 33. The attribution of "free" capital should be carried out in accordance with the arm's length principle to ensure that a fair and appropriate amount of profits is allocated to the PE. The purpose of the attribution is to inform the attribution of profits to the PE under Article 7(2). The Report describes a number of different possible approaches for applying that principle in practice, recognising that the attribution of "free" capital to a PE is not an exact science, and that any particular facts and circumstances are likely to give rise to a range of arm's length results for the "free" capital attributable to a PE, not a single figure. There is a common premise to the authorised approaches to attributing "free" capital, that an internal condition of the PE is that the creditworthiness of the PE is generally the same as the enterprise of which it is a part.
>
> …The conclusion of Part II stated:
>
> c) Conclusion on attributing capital to the PE
>
> 123. The attribution of capital among parts of an enterprise involved in a banking business is a pivotal step in the process of attributing profit to a bank PE. It determines the quantum of capital that the bank PE should be considered to have under the authorised OECD approach and the appropriate treatment of Tier I and Tier 2 capital under the tax rules of the PE's jurisdiction. This reflects the accepted view that a bank PE, just like any other type of PE, should have sufficient capital to support the functions it undertakes, the assets it uses and the risks it assumes. For this reason, the method by which capital is attributed is an important step in avoiding or minimising double taxation."

30. A number of these points are picked up in the 2008 Commentary:

> "2. Articles 7 and 9 are not particularly detailed and were not strikingly novel when 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 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 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 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."

31. Although [43]-[47] of the 2008 Commentary are new, it is clear from [7] of the Commentary that they were considered appropriate for inclusion by the OECD because they were not in conflict with earlier versions of the Commentary. As explained in [3] and [7], the format of Articles 7 and 9 of the model convention has never been prescriptive as to how profits should be attributed to a PE in accordance with the model described in Article 7(2) and the way in which the application of those criteria has been implemented has varied from state to state. But to succeed on this appeal Mr Baker's clients must establish that any attribution of capital which results in the disallowance of interest paid by the PE on the money it has borrowed is simply impermissible under Article 8(2) of the 1976 Convention. This is, of course, ultimately a question of construction but HMRC place considerable reliance on the 2008 Commentary as confirmation that Article 7(2) has always permitted a considerable degree of flexibility in the methods for attributing profits to a PE and that these can include various forms of capital attribution. On that basis, the 2008 Commentary, although new, would be admissible as an aid to the construction of Article 8(2) of the 1976 Convention which, as I have explained, adopted the wording of Article 7(2). It would only be inadmissible if the new material made substantive changes which are inconsistent with the commentaries in existence at the time of the 1976 Convention.

32. Mr Baker submitted that the new parts of the 2008 Commentary did make substantive changes in so far as they advocated a new approach to Article 7(2) of the model convention based on the attribution of free capital to the PE. These changes, he said, were given effect to by the re-drafting of Article 7 in the 2010 model convention, the text of which is included in the table at [24]. This represented the culmination of the OECD project which began in the 1990s and has resulted in the re-writing of Article 7.

33. There are, I think, a number of difficulties about that. Although the language of Article 7(2) of the 2010 model convention is new, it is by no means obvious that the new wording has effected any real change in the methodology for determining the profits attributable to the PE. The addition of the words "in particular in its dealings with other parts of the enterprise" emphasise that its status as an independent enterprise should be applied to any funding or supply arrangements with the overseas company and it is common ground that the concluding words of Article 7(2) use the language of transfer pricing which has been a concern of the OECD from the 1980s. None of that wording does more than to emphasise that the comparator created by Article 7(2) has to be considered both in relation to the external transactions and in relation to the PE's operation as part of the overseas company. The wording of the

new article 7(2) has replaced the old Article 7(3) which has been deleted and requires the arm's length pricing of any dealings between the PE and the company through which the PE carries out its function. None of this, however, addresses the issue of capital attribution and the phrase "under the same or similar conditions" which Mr Baker says creates the obstacle to the use of the CATA remains part of the new Article 7(2). As Rose LJ pointed out during the hearing, it is odd (on the Appellants' case) for those words to have been retained if one of the purposes of the re-draft was to introduce capital attribution as a preferred methodology for calculating the profits of the PE.

34. The second difficulty is that Mr Baker's explanation of what the 2008 Commentary was intended to achieve is contrary both to what the OECD considered it was doing as explained in [7] of the Commentary and to the findings of fact made by the FtT. The evidence which the FtT accepted was that some form of capital attribution had been UK revenue practice since the 1950s as the adoption of the PW Formula illustrates. The problem faced by the OECD was that the methods of doing this varied across different countries and in some cases involved the adoption of a formulaic approach which did not adequately recognise the scope and nature of the business actually carried on by the branch and the costs which that generated. The purpose of the review which culminated in the 2008 report and the new commentary was to identify preferred methods of calculating the attribution of capital and expenses to the PE which, if adopted generally, would reduce the risk of different tax treatments being adopted in each contracting state with double taxation or no taxation as the consequences.

Article 8

35. Turning then to the language of Article 8 of the 1976 Convention, it is clear from Article 8(1) that the purpose of Article 8 is to identify the profits of the overseas company which should be attributed to the PE and so be liable to tax in the contracting state where the PE is situated. It operates therefore to set limits to the amount of profits that are taxable domestically in those contracting states by reference to a set of criteria that are applied to the PE regardless of the actual mode of operation of its business.

36. The reference to profits being attributed to the PE on the basis of what "it might be expected to make if it were a distinct and separate enterprise" recognises that in many cases it will not operate in that way. Although therefore the first step must be to consider the accounts of the PE and the way it actually conducted its business, the profits of its operation may have to be calculated and, if necessary, re-stated using the comparator of a distinct and separate enterprise which deals at arm's length with the overseas company whilst "engaged in the same or similar activities under the same or similar conditions".

37. Read in that context, the same or similar provisions must obviously refer to the business activities actually carried on by or through the PE and the market conditions which prevailed at the relevant time. The purpose of Article 7 is to apportion the profits of the overseas company actually earned during the relevant accounting period and this does not therefore require or justify an assumption that either the PE or the company carried on business or had sources of income which did not in fact exist.

38. But the attribution of profits involves a different exercise of determining what proportion of the company's receipts and expenses should be taken into account in determining the taxable profits of the PE. This exercise has to be undertaken in a wide variety of economic and other circumstances in which the profits or expenses booked to the PE may not adequately reflect the income generated by the business which it actually carried on or the expense which would normally be incurred in an operation of that kind.

39. The adoption of an objective standard in the form of the Article 7(2) comparator will therefore in most cases necessitate some departure from the way in which the company has conducted and accounted for the business of its PE. That is not, I think, disputed by Mr Baker. He accepted that in cases where there are no accounts or the accounts are defective in some way it would be legitimate for HMRC to make a capital attribution which differed from that recorded in the branch accounts. But in my view the powers conferred by the 1976 Convention are not limited to these circumstances. In order to operate the hypothesis of a distinct and separate enterprise dealing at arm's length including with the overseas company of which it is part, it seems to me that it is necessary to compare the way in which the PE financed and accounted for its business with what it would have done had the PE operated as a separate enterprise. Otherwise the comparator provisions of Article 8(2) cannot work. To construe the phrase "same or similar conditions" as requiring the PE's actual ratio of free to borrowed capital to be applied would be self-defeating. It would rob Article 8(2) of any real ability to depart from the accounting treatment of the PE which the overseas company might choose to adopt and it would make the application of a uniform test of attribution impossible.

40. For these reasons, I regard the construction of Article 8(2) relied on by the Appellants as an unlikely one given the purpose of these provisions. And since it is not compelled by the ordinary meaning of the words used when read in their context, I would reject it. Although there may be a number of different ways of giving effect to Article 8(2), the CATA is undoubtedly one of them and there is nothing in the language of Article 8(2) which prevents that being adopted by the UK.

41. Although this view is consistent with the 2008 Commentary, it is not dependent on it. I have reached my conclusions from a reading of Article 8(2) in its proper context. But I would add that, as all the OECD commentaries have stressed, the provisions of Article 7 of the model convention going back to 1963 have never been intended to lay down precise or exhaustive sets of rules and have always given contacting states a measure of flexibility in deciding how to implement them. They are umbrella provisions. It would, in my view, be inconsistent with this approach to interpret "same or similar conditions" in the way in which the Appellants suggest.

42. The UT were therefore correct in my view to reject the Appellants' construction of Article 8(2) for the reasons which they gave and I would dismiss the appeal. But, for completeness and out of deference to the Courts concerned, I want to say just a little about the three foreign cases to which we were referred.

(1) *National Westminster Bank plc v The United States*

43. The bank in these cases ("NatWest") sought a refund of income taxes which were paid by its branches in the United States. The US Internal Revenue Service ("IRS") had re-computed the bank's claims for the deduction of interest expenses recorded in the books of the US branches under a US Treasury Regulation which excluded interest expenses based on inter-branch transactions and estimated the amount of capital held by the branch based on a fixed ratio or a ratio of NatWest's average total worldwide liabilities to average worldwide assets. The formula was not unlike the PW Formula used by the Inland Revenue up to 1978. This had the effect of increasing NatWest's taxable income by some US$ 155m for the years at issue.

44. The 1975 US/UK Double Taxation Treaty contained an Article 7 in similar terms to Article 8 of the 1976 Convention. In the first of three cases, NatWest claimed that the formula used in the Treasury Regulation to calculate deductible interest was inconsistent with Article 7 of the Treaty. The United States Court of Federal Claims upheld the claim. In relation to Article 7 of the US/UK Treaty it said:

> "The foregoing examination of Article 7 of the Treaty, pre-ratification reports of the Treasury Department and the Senate, and Commentaries intended to assist in interpretation leads to the conclusion that the Treaty contemplates that a foreign banking corporation in the position of plaintiff will be subjected to U.S. taxation only on the profits of its U.S. branch and that such profits should be based on the books of account of such branch maintained as if the branch were a distinct and separate enterprise dealing wholly independently with the remainder of the foreign corporation, provided that the financial records of the branch, especially those reflecting intra-corporate lending transactions, are subject to adjustment as may be necessary for imputation of adequate capital to the branch and to insure use of market rates in computing interest expenses. In addition to normal deductible expenses reflected on the books of the branch, as adjusted, there shall be allowed in the determination of the profits of the U.S. Branch a reasonable allocation of general and administrative expenses incurred for the purposes of the foreign enterprise as a whole."

45. The Treasury Regulation was held to operate contrary to Article 7 for a number of reasons. It treated the branch as a unit of the bank rather than as a separate entity and applied the formula without regard to the actual assets and liabilities shown on the books of the branch.

46. In a second case also in the United States Court of Federal Claims the bank sought rulings on how the branches' deductible interest was to be calculated if not according to the formula in the Treasury Regulation. I shall refer to this case as "*NatWest 2*". One of the issues raised was whether treating the branch as a distinct and separate enterprise required the attribution of additional capital at a level which would meet the regulatory and marketplace requirements applicable to a separate US bank. The case centred on the meaning of a "separate and distinct enterprise". The argument for

NatWest was that this did not contemplate a branch being treated as a separately incorporated bank to which the regulatory requirements applied. The Court agreed. It said:

> "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 characterized 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 armslength [sic] 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. Moreover, as discussed below, the government's reading does not reflect the shared expectations of the parties, as evidenced by the legislative history surrounding the Treaty."

47. Both these decisions were appealed to the United States Federal Court of Appeals together with a third case in which the US Government unsuccessfully sought a motion for reconsideration of the decision in *NatWest 2* in order to allow it to introduce an alternative capital allocation theory for the determination of the profits of the US branches. The Court of Appeals upheld all of the first instance decisions. In relation to *NatWest 2*, it confirmed that the branch was not to be treated as if it were a separately incorporated US bank subject to the regulatory capital requirements which that would entail. It said:

> "Under the proper reading of the "same or similar" clauses, it becomes clear that the "dealing wholly independently with" language requires taxing authorities to scrutinize intracorporate transactions involving a permanent establishment to ensure that the transactions are accurately characterized and reflect arm's length terms and pricing. Conversely, the Government's reliance on "dealing wholly independently with" is at odds with a proper reading of the "same or similar" clauses. To conclude

> that "wholly independently" requires that the U.S. Branch be taxed as if it were subject to regulatory and market capital requirements is to ignore the fact that the U.S. Branch does not operate under conditions in which it is subject to these requirements. In essence, the Government would read the "same or similar conditions" language out of the 1975 Treaty.
>
> …
>
> In the instant case, the real facts of the situation are that the U.S. Branch is not required to maintain any minimal amount of capital. Therefore, because the corporate yardstick would essentially recharacterize loans that bear an interest expense as equity capital infusions based on regulatory and domestic market requirements that do not apply to the U.S. Branch, the corporate yardstick ignores the real facts of the U.S. Branch's situation and violates the 1975 Treaty as informed by the 1963 Draft Convention. As stated by the trial court in *NatWest II*, "The Commentary confirms that the purpose of any adjustment should be to reflect the real facts of the branch's transactions with the entity of which it is a part.""

48. Although the United States Court of Appeals referred favourably to part of the Nolan Opinion, its consideration of whether capital could be notionally attributed to the branch really turned on the argument of the IRS that the branch should be regarded as a US bank. The Court did not therefore have to consider a more nuanced approach to this question such as that embodied in s.11AA(3)(b) and its denial of the IRS notion for reconsideration means that we do not know what its reaction would have been to some other form of CATA. There is nothing in the decision to the effect that any form of capital attribution is precluded by the phrase "same or similar conditions" which is the argument we have to consider. Nor, of course, did the Court have the benefit of the later OECD publications which have illuminated much of the thinking behind the provisions of Article 7 of the model convention.

(2) *Re Bayerische Hypo and Verinbank AG* 18 ITLR 1

49. This is a decision of the French Conseil d'État concerning the taxation of the French branches of foreign banks. The branches obtained loans from their parent banks at very high rates of interest and sought to deduct the interest as an expense. This was disallowed up to the level of capital that the branches would have required had they been subsidiary banks registered in France. The Conseil d'État held that this tax treatment contravened Article 4 of the France/Germany Double Taxation Convention which is in similar terms to Article 8(2) of the 1976 Convention:

> "5. On the one hand, the provisions of art 4(1) cited above have as their object and effect to restrict the right of the French authorities arising from art 209(1) of the General Taxation Code to tax profits resulting from the exploitation in France of a branch of a foreign company, by limiting that right to the taxation only of profits attributable to that branch. The

> provisions of para (6) of the same article have as their object and effect to impose on the same authorities that, in determining the latter profits, the deduction is permitted for all expenses incurred, whether in France or abroad, for the purposes of the branch.
>
> 6. On the other hand, it is not appropriate, in interpreting the provisions of art 4(2) cited above, to refer to the Commentaries drafted by the Fiscal Committee of the Organisation for Economic Co-operation and Development on art 7 of the Model Convention published by that organisation, since those Commentaries are subsequent to the adoption of the provisions at issue. In the version applicable to the facts in this case, these provisions must be understood as authorising the state of the branch to attribute to the latter the profits that would have been realised if, instead of dealing with the other parts of the enterprise, it had been dealing with separate enterprises under normal conditions and at market prices. On the contrary, these provisions do not have as their object nor, consequently, their effect of permitting that state to attribute to the branch the profits which would have been earned if the taxpayer had been provided with its own funds in an amount different from that which, being inscribed in the written accounts produced by the taxpayer, accurately reflects the charges and capital-provisions made between the different parts of the enterprise. In particular, the tax administration may not substitute for the latter amount the capital which the branch would have had to be granted, by virtue of the applicable regulations and having regard, specifically, to the risks to which it is exposed, if it had been a separate legal person.
>
> 7. It follows from this that the terms of art 209(1) of the General Taxation Code which subject to corporation tax 'profits ... the taxation of which is attributed to France by an international convention relating to double taxation' cannot, any more than the rules mentioned in para 3, have the effect of granting to the French tax authorities the right to tax the profits determined in accordance with the contested reassessments."

50. As in the *NatWest* case, the argument centred on whether the branches should be treated as if they were French registered banks. The Conseil d'État does not seem to have based its decision on the "same or similar conditions" wording and perhaps, most important of all, refused to have regard to later OECD publications such as the 2008 Commentary regardless of whether they were merely confirmatory of the existing effect of the provisions of the model convention. The decision is therefore of limited assistance in the present case.

(3) *ING DIRECT v Central Court for Economic and Administrative Matters* 18 ITLR 680

51. This is a decision of the Spanish Audencia Nacional concerning the Spanish branch of a Dutch bank. The Spanish tax authorities attributed free capital to the PE in proportion to the transactions it carried out and made an adjustment to its tax return which they said complied with the 1971 Spain/Netherlands Double Taxation Treaty. As in the other foreign cases, they did so on the basis of treating the branch as an independent company. Article 7 of the 1971 Treaty was in the same form as Article 7 of the model conventions up to 2010. The Spanish court held that it could not construe Article 7 with the assistance of what was said in the 2008 Commentary because in their view that and indeed some of the earlier commentaries in articulating the development of the principles of attribution had made substantive changes to the framework of the model conventions which could not be applied retrospectively.

52. With respect to the Spanish Court, I disagree with this. As I have tried to explain earlier in this judgment, the structure of Article 7 of the model convention leaves a wide degree of flexibility as to how the test it lays down should be implemented and the 2008 Commentary is an articulation of various methods of attributing capital that have long been in operation by states which have adopted the model convention wording.

Conclusion

53. In my view the words relied on by the Appellants, when read in context, do not impose the restriction for which they contend. I would therefore dismiss their appeal.

Lord Justice Singh :

54. I agree that this appeal should be dismissed for the reasons given by Patten LJ. I would like to add a few words of my own in relation to the constitutional and international law aspects of this case. There were times during the hearing when it appeared to me that some confusion has crept into this area of law because insufficient attention has been paid to the important distinction between different parts of the state.

55. What is in issue in the present case is the ability of the UK Parliament to enact a measure such as section 11AA of the TA 1988, as amended in 2003. That is primary legislation. It has nothing to do with acts of HMRC, which is not the legislature; it is part of the executive. This is not an application for judicial review of the acts of HMRC or any other part of the executive. For this reason alone, I regard reference on behalf of the Appellants to the alleged past practices of HMRC to be completely irrelevant to the issues which we have to decide. They might be relevant if this were an application for judicial review and what was said, by way of example, was that HMRC had acted in a way which was unfair because it breached a legitimate expectation: see the classic exposition by Bingham LJ in *R v Inland Revenue Commissioners, ex p. MFK Underwriting Agents Ltd* [1990] 1 WLR 1545, at 1569-1570. But in the present context HMRC was acting to give effect to primary legislation, section 11AA. That was enacted by Parliament. Even if there is a legitimate expectation created by the past practice of HMRC it cannot prevent HMRC giving effect to the will of Parliament; indeed, it is the duty of HMRC to give effect to

that will. The question in this case is: what in truth *is* the will of Parliament where a provision in primary legislation is said to conflict with a double taxation convention? The answer to that question is provided by section 788(3) of the TA.

56. Ordinarily the constitutional position in the UK would be that this Court would be bound to give effect to section 11AA because it is primary legislation enacted by the UK Parliament, which is the supreme legislative body in this country. This would be so whatever might be said in an international treaty. Nor could it make any difference that the treaty is incorporated into domestic law by an Order such as here, since secondary legislation must give way to primary legislation.

57. It would also ordinarily be the case that it would be immaterial that Parliament itself has provided, in section 788(3) of the TA, that a provision in a double taxation treaty is to override a contrary provision in primary legislation. This is because the FA 2003, which inserted section 11AA into the TA, came after section 788 was enacted and the doctrine of implied repeal would have the effect that this Court would have to give effect to the later Act of Parliament, which would supersede an earlier Act to the extent of their inconsistency. However, it is clear that, in the context of double taxation treaties, the doctrine of implied repeal does not operate. The legal position can be compared to the position as it has been until recently (before the UK's withdrawal from the European Union) under section 2 of the European Communities Act 1972, which applied to Acts of Parliament which came after that Act just as much as it did to earlier Acts. It is now well established that in the constitution of the UK there can be "constitutional" statutes, which are not "ordinary" statutes. In particular, the doctrine of implied repeal will not apply to them: see *Thoburn v Sunderland City Council* [2002] EWHC 195 (Admin); [2003] QB 151, at [62]-[63] (Laws LJ) and *R (Miller) v Secretary of State for Exiting the European Union* [2017] UKSC 5; [2018] AC 61, at [67].

58. It is also important to bear in mind that, for the purposes of international law, the state is one undivided entity. The party to an international treaty is simply the UK. International law is not concerned with the internal division of functions which are determined according to the constitution of a particular state. International law simply requires the UK to comply with its treaty obligations.

59. In this case we are concerned with the interpretation of an international treaty. As Patten LJ has said in his judgment, subsequent state practice can sometimes be a relevant aid to interpretation, in accordance with the Vienna Convention on the Law of Treaties, Article 31(3)(b). However, since there is more than one party to a treaty, what is required is evidence of practice on the part of both parties to that treaty. As the Upper Tribunal rightly said, the unilateral practice of one party cannot alter the meaning of a treaty.

60. Mr Baker QC submitted before us that the Upper Tribunal was wrong to consider that the Vienna Convention is exhaustive as to what can be taken into account in the interpretation of treaties. While it may be true that the Vienna Convention is not exhaustive (and Mr Milne QC did not suggest that it is), what still has to be shown is that there is some other rule of international law which permits something else to be taken into account. Rules of international law have two main sources: they may be found in either treaty law or in customary international law. There is nothing in treaty

law other than what is set out in the Vienna Convention to which Mr Baker was able to point. Nor was he able to point to any rule of customary international law to support his submission.

Lady Justice Rose :

61. I agree with both judgments.