TREATIES AND INTEREST EXPENSE ALLOCATION: MOVING IN A *NATWEST* ERLY DIRECTION

by Jessica L. Katz

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On July 7, 1999, in a long-awaited opinion, the U.S. Court of Federal Claims declared that the three-step method set out in reg. section 1.882-5 for determining interest expense allocable to the U.S. permanent establishment of a foreign corporation was inconsistent with the "separate enterprise" principle contained in Article 7(2) of the United States-United Kingdom income tax treaty. The court held in *National Westminster Bank, PLC v. United States* (*NatWest*) that Article 7(2) required profits attributable to a permanent establishment — including the deduction for interest expense — to be determined on the basis of the actual books of account of the permanent establishment, as if it were actually a separate, wholly independent entity dealing at arm's length with the remainder of the entity of which it is a part. The three-step formula in reg. section 1.882-5 fails to satisfy this standard, the court held, because it entirely disregards interbranch transactions and fails to adequately respect the actual interest expense shown on the books of the permanent establishment.

Article 7(2) of the U.K. treaty at issue in this case was modeled after the analogous provision of the OECD Model treaty, and the court relied on the OECD Model and the Commentary thereto in reaching its conclusion. Thus, says Katz, the case invites re-evaluation of the various issues and controversies that have long surrounded Article 7 of the OECD Model — most significantly, the acceptability of formulary apportionment methods and the recognition (or not) of interbranch transactions in determining profits attributable to a permanent establishment. In the first part of this report, she analyzes these issues and discusses whether the court's conclusion is a persuasive reading of the OECD Model and Commentary.

The proper interpretation of the OECD Model is not the end of the story, however, according to Katz. Though the issue presented in *NatWest* was relatively straightforward — the relevant provision of the U.K. treaty was explicitly based on the OECD Model, so the case could be resolved almost exclusively on the basis of the court's interpretation of the Model and the Commentary — not all cases can be so easily resolved. Therefore, she explains, the implications of the *NatWest* holding for cases involving other treaties are unclear. For example, what if the treaty at issue had been concluded after the IRS publicly announced its position that reg. section 1.882-5 is consistent with U.S. treaty obligations? Or what if the technical explanation to the treaty explicitly referenced the regulation, and there was evidence that the other country had seen the technical explanation? In the second part of this report Katz discusses the potential impact of these facts and others like them on the process of judicial treaty interpretation.

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On July 7, 1999, the U.S. Court of Federal Claims declared reg. section 1.882-5 inconsistent with the requirements of the United States-United Kingdom income tax treaty.[1] Various newspapers and publications immediately jumped on the decision, predicting ominously that the case could cause a "stampede" by foreign banks to recover "billions of dollars" in taxes.[2] In fact, the implications of the case are far less sensational than these blurbs suggest, and the press consequently moved quickly to bigger and better events. Though not on a par for general interest with salacious fraud inquiries and billion-dollar international mergers, however, for those of us immersed in the details and minutiae of international tax there could hardly be a more gripping event. This eagerly awaited decision, though it perhaps raises more questions than it answers, is the first case to tackle an exceptionally difficult and interesting tax issue head on.

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Reg. section 1.882-5 governs the determination of the U.S. interest expense deduction allowed to a foreign corporation engaged in a U.S. trade or business. Until 1981, such corporations determined the amount of interest expense allocable to effectively connected income — i.e., their U.S. interest expense deduction — under the same allocation and apportionment rules applicable to U.S. residents. Before 1977, these rules generally required corporations to allocate interest expense to the actual income-producing property or activity with respect to which the expense was incurred.[3] In practice, most foreign banks used the "separate entity" method; i.e., they determined their allowable interest deduction under section 882(c) based on the interest expense shown on the books of their U.S. branch.

In 1977, Treasury rejected this approach in favor of a rule requiring interest expense to be attributed to *all* activities and property regardless of the specific purpose (if any) for incurring the obligations on which the interest was paid. Reg. section 1.861-8(e)(2) of the 1977 regulations required a corporation's worldwide aggregate interest expense to be ratably apportioned to statutory groupings of income on the basis of the average total value of assets within each such grouping for the taxable year (or, in certain cases, on the basis of the ratio of U.S. to total gross income). This approach was premised on the principle that money is fungible.

Under the fungibility approach, a foreign corporation's interest expense deduction was calculated by apportioning the corporation's aggregate worldwide interest expense to the U.S. branch based on the ratio of U.S. to total assets. Thus, the amount of the deduction varied depending on the *average* worldwide interest rate of the corporation on all its obligations *in all currencies*. Foreign banks from strong-currency countries complained that using such an average interest rate placed them at a competitive disadvantage because their overall average cost of borrowing funds in all currencies was lower than their cost of borrowing U.S. dollars, resulting in a disproportionately low U.S. interest expense deduction. By contrast, the overall average cost of borrowing funds for banks from countries with weak currencies was generally higher than their cost of borrowing U.S. dollars, giving them an (allegedly) unfairly high interest deduction.

At least partly in response to these complaints, Treasury promulgated new regulations in 1981 applicable exclusively to foreign corporations. The "branch book/dollar pool" method set out in reg. section 1.882-5 used a U.S. dollar interest rate rather than an average worldwide interest rate to determine a foreign corporation's interest expense deduction.[4] The role of the fungibility principle thus was significantly reduced — under the regulation, only the level of leverage of the branch, and not the interest rate on the branch's liabilities, must be comparable to that of the corporation as a whole.

Reg. section 1.882-5 sets forth a three-step process for determining a foreign corporation's interest expense deduction under the branch book/dollar pool method.[5] First, the corporation must determine the value of its "U.S. assets"; i.e., assets that generate or could generate effectively connected income.[6] Second, the corporation's worldwide liability-to-asset ratio must be computed, and the value of U.S. assets determined in step 1 is multiplied by this ratio to determine the amount of liabilities "allowable" to the U.S. branch.[7] Finally, the corporation determines its interest expense deduction by comparing its "allowable" liabilities to the actual liabilities shown on the books of the U.S. branch. If the actual liabilities exceed the allowable liabilities, the branch is considered to be undercapitalized, and the interest on the excess actual

[1]*National Westminster Bank, PLC v. United States*, 44 Fed. Cl. 120 (1999) ("*NatWest*").

[2]*New York Times*, July 9, 1999, p. C1; *Financial Times*, July 8, 1999.

[3]*See* former reg. section 1.861-8(a) (1957 to 1977) (T.D. 6258, 1957-2 C.B. 368).

[4]In addition to the branch book/dollar pool method, reg. section 1.882-5, as promulgated in 1981, gave foreign corporations the option of using a "separate currency pools" method that incorporated the fungibility principle, but on a currency-by-currency basis. The revised version of reg. section 1.882-5 promulgated in 1996 also incorporates a separate currency pools method. The separate currency pools method was not at issue in *NatWest* and is not discussed in this article.

[5]Reg. section 1.882-5 was revised in 1996, but the revisions did not materially change the three-step formula for implementing the branch book/dollar pool method under the 1981 regulations. *See* T.D. 8658, 1996-1 C.B. 161.

[6]1996 reg. section 1.882-5(b); 1981 reg. section 1.882-5(b)(1).

[7]1996 reg. section 1.882-5(c); 1981 reg. section 1.882-5(b)(2).

liabilities is disallowed. If the allowable liabilities exceed the actual liabilities, the branch is considered to be overcapitalized. In this case, the corporation is permitted to deduct, in addition to the interest expense on the actual liabilities, an additional amount determined by applying the average U.S. dollar borrowing rate for *non-U.S.* branches to the excess allowable liabilities.[8]

In all three steps, transactions between different units of the corporation (interbranch transactions) are entirely disregarded. Thus, for example, a loan from the U.S. branch to its head office is not included in the value of U.S. assets determined in step 1, and a loan from the head office to the U.S. branch is not included in the "actual liabilities" determined in step 3.[9]

Reg. section 1.882-5 clearly applies to foreign corporations from non-treaty countries, which are taxed on income that is effectively connected with a U.S. trade or business. In addition, though, the Service and Treasury have repeatedly and consistently taken the position that the method set forth in reg. section 1.882-5 also applies to foreign corporations from treaty countries, which are taxed on income that is "attributable to" a U.S. permanent establishment. The U.S. view is that reg. section 1.882-5 is consistent with the provisions of U.S. bilateral income tax treaties (usually Article 7) that govern the determination of attributable profits. For example, in Revenue Ruling 85-7 the Service concluded that reg. section 1.882-5 is a permissible method for determining interest expense attributable to a U.S. permanent establishment under the United States-Japan treaty.[10] Revenue Ruling 89-115 reached the same conclusion with respect to the United States-United Kingdom treaty.[11]

Treasury has expressed the same view in the Treasury Technical Explanations accompanying a number of treaties concluded since 1989. More generally, the revised version of reg. section 1.882-5 promulgated in 1996 provides explicitly that the regulation provides "the exclusive rules" for determining a foreign corporation's interest expense deduction under all U.S. tax treaties.[12] These various pronouncements reflect two broader U.S. positions: first, that formulary methods of expense apportionment like reg. section 1.882-5 are permissible under treaties, and second, that treaties do not require recognition of interbranch transactions — or at least interbranch debt.

The U.S. view has been the subject of controversy since it was first announced. Banks, in particular, have been disputing Treasury's view — and sometimes disregarding it entirely when filing their U.S. tax returns — for many years. National Westminster Bank PLC (NatWest) was one such bank. From 1981 to 1987 (at least), NatWest, a U.K. bank, invoked the United States-United Kingdom treaty as authority to ignore reg. section 1.882-5 in computing the interest expense deduction attributable to its U.S. branch. On the basis of the treaty, the bank instead reported and deducted the interest expense actually shown on the books of its U.S. branch. On audit, the IRS asserted that NatWest's interest expense deduction should have been determined under reg. section 1.882-5 and disallowed the portion of NatWest's claimed deduction that exceeded the amount calculated under that regulation. NatWest paid the additional tax, and in November 1995, filed a complaint in the Court of Federal Claims seeking a refund.

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On July 3, 1996, NatWest moved for partial summary judgment on the threshold legal issue whether reg. section 1.882-5 is inconsistent with the United States-United Kingdom treaty. The court's ruling on this issue was eagerly anticipated by numerous interested observers. On July 7, 1999, the court issued its decision granting NatWest's motion. The court interpreted Article 7 of the United States-United Kingdom treaty to require that in determining profits attributable to a U.S. permanent establishment, the U.S. branch is to be regarded as an "independent, separate entity dealing at arm's length with other units of [the entity] as if they were wholly unrelated,"[13] and its interest expense deduction therefore "should be as shown on the books of account of the permanent establishment, with necessary adjustments, as if the permanent establishment were 'a distinct and separate enterprise . . . dealing wholly independently with' the foreign enterprise."[14] The court concluded that application of reg. section 1.882-5 to a U.S. branch of a U.K. bank was inconsistent with this principle.[15]

In light of the court's reliance on the OECD Model Treaty and Commentary, the *NatWest* opinion invites reevaluation of the various issues and controversies that have long surrounded Article 7 of the OECD Model — most significantly, the acceptability of formulary apportionment methods and the recognition (or not) of interbranch transactions in determining profits attributable to a permanent establishment. Does the decision foreclose the use of *all* formulary apportionment methods for interest expense in determining attributable profits under Article 7? Does it require recognition of interbranch interest expense, or any

[8]1996 reg. section 1.882-5(d); 1981 reg. section 1.882-5(b)(3).

[9]1996 reg. section 1.882-5(b)(1)(iv), (c)(2)(viii), (d)(2)(viii); 1981 reg. section 1.882-5(a)(5).

[10]1985-1 C.B. 188.

[11]1989-2 C.B. 130.

[12]1996 reg. section 1.882-5(a)(2).

[13]44 Fed. Cl. at 124.

[14]*Id.* at 131.

[15]The court considered the 1981 regulations, since the years at issue in the case were 1981-1987, but as discussed above, the method set forth in the 1996 revision of reg. section 1.882-5 does not differ materially from the branch book/dollar pool method of the 1981 regulations.

other interbranch transaction, on an item-by-item basis? And perhaps more interesting, is the court's reasoning and reading of Article 7 correct, or even persuasive? These questions and others like them are addressed in Part I of this report.

The proper interpretation of the OECD Model is not the end of the story, however. The issue presented in this case was relatively straightforward. The U.K. treaty was explicitly based on the OECD Model, and Article 7 of the U.K. treaty is almost identical to Article 7 of the Model. The U.K. treaty was concluded (though not ratified) before the promulgation of reg. section 1.882-5 and before the issuance of revenue rulings setting forth the IRS position that this regulation is consistent with U.S. treaty obligations. And there was no extrinsic evidence — for example, official treaty negotiation records — to shed light on the intent of the negotiators.[16] Thus, the case could be, and was, resolved almost exclusively on the basis of the court's interpretation of the OECD Model and Commentary.

The implications of the NatWest holding for cases involving other treaties are unclear.

The implications of the *NatWest* holding for cases involving other treaties are unclear. Would the court have reached the same conclusion if the treaty at issue had been concluded after issuance of reg. section 1.882-5, or after the IRS announced its position asserting the regulation's consistency with Article 7? What if the Treasury technical explanation of the treaty had contained an explicit reference to the regulation? What if there was evidence that the other country was aware of the U.S. position? In the face of additional facts such as these, would the court still have decided the issue solely on the basis of the OECD Model? Or, in an alternative formulation of the same question, is there any evidence that could have persuaded the court to conclude that reg. section 1.882-5 is consistent with the treaty? Part II of this report attempts to address some of the thorny issues of treaty interpretation that are left unanswered after *NatWest* and potentially limit the scope and effect of its holding.

I. *NatWest* & OECD Model Treaty and Commentary

The issue in *NatWest* was the determination of profits attributable to a U.S. permanent establishment of a U.K. bank. This determination is governed by Article 7 of the U.K. treaty. The pivotal language is in Article 7(2), which sets forth the "separate enterprise" principle. Under Article 7(2), the profits to be attributed to a permanent establishment are:

> 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.

The bulk of the court's opinion was devoted to interpreting this language and to assessing the impact of Article 7(3), which pertains to the deductions allowed in computing attributable profits and which explicitly modifies Article 7(2).

Because the U.K. treaty was based on the 1963 OECD Model Treaty, and Article 7(2) of the U.K. treaty is almost identical to the corresponding provision of the OECD Model Treaty, the court held that the OECD Model and Commentary were "presumed to have been in the minds of the negotiators when they drafted the [U.K.] Treaty."[17] Consequently, the court, like others before it,[18] found the Commentary to be a "persuasive" source of guidance in resolving disputes about the meaning of the U.K. Treaty.[19] Indeed, the OECD Commentary was essentially the *only* extrinsic source of guidance to which the court looked in interpreting Article 7(2) and (3) of the U.K. Treaty.[20]

On the basis of the Commentary, the court concluded that Article 7(2) requires attributable profits to be determined on the basis of the actual books of account of the permanent establishment, as if the permanent establishment were actually a separate, *wholly independent* entity dealing at arm's length with the remainder of the entity of which it is part. According to the court, this standard requires that interbranch transactions be respected and recognized, at least in the first instance. And though Article 7(3) may permit deviation from this standard for interbranch loans and interest expense in certain circumstances, it does not apply to a *bank's* interbranch interest. Reg. section 1.882-5 entirely disregards a bank's interbranch transactions and treats the U.S. permanent establishment as

[16]It appears that the taxpayer and the government both may have attempted to introduce records of treaty negotiations (presumably unpublished and unofficial) and/or affidavits of treaty negotiators. The court refused to consider them, however. The relevant judicial rulings, as well as the records themselves, remain under seal.

[17]44 Fed. Cl. at 125. The court in *NatWest* considered the Commentary to the 1963 OECD Model Treaty, which was in effect at the time the U.K. treaty was concluded. Revised Model Treaties and Commentaries were issued by the OECD in 1977 and 1992. Since 1992, the Model Treaty and Commentary have been updated and revised on an ongoing "ambulatory" basis. This article refers primarily to the OECD Commentary to Article 7 in effect in July 1999, which is quite similar in material respects to the 1963 Commentary. Differences are noted where relevant.

[18]*See Taisei Fire & Marine Ins. Co. v. Com'r,* 104 T.C. 535, 548-50, *Doc 95-4474 (38 pages), 95 TNT 86-21* (1995) (finding 1977 OECD Commentary to be relevant in interpreting treaty concluded before 1977); *The North West Life Assurance Co. of Canada v. Com'r,* 107 T.C. 363, 378, *Doc 96-32148 (71 pages), 96 TNT 242-14* (1996) (finding OECD Commentary to Article 7 to provide "helpful guidance" in interpreting United States-Canada treaty).

[19]44 Fed. Cl. at 125.

[20]The court also referred to the Senate Foreign Relations Committee report and to a Treasury report on the U.K. treaty, but these sources did little more than repeat the language of the treaty. *Id.* at 124.

"a unit of a worldwide enterprise" rather than as a separate, independent entity.[21] Thus, the court held, the regulation is inconsistent with Article 7.

This Part explores whether the court's conclusion is a persuasive reading of the OECD Model and Commentary.

A. Article 7(2)

The OECD Commentary to Article 7(2) sets forth the "central directive" on which allocation of profits to a permanent establishment is based:

> [T]he 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. This corresponds to the 'arm's length principle' discussed in the Commentary on Article 9.[22]

This is the "separate enterprise" principle, the scope and meaning of which has been the subject of much discussion and controversy. On one hand, this language can be strictly interpreted as requiring a permanent establishment to be treated as if it were truly independent, so that all "contractual" and other arrangements between it and the head office or other branches must be respected and taken into account in determining attributable profits to the same extent as contracts with third parties. The taxpayer took this view in *NatWest* and the court agreed, reading Article 7(2) to require "strict interpretation of the 'wholly independent/separate enterprise' concept."[23]

An alternative view is that the separate enterprise principle does not require treating the permanent establishment as an actual separate entity and respecting the profits actually recorded on its books. Instead, all that is required is to determine the profits that the permanent establishment "*might be expected* to make" *if* it were a separate entity. The government took this position in its briefs, arguing that the separate enterprise language of Article 7(2) is intended only to "lay down the guide post" of a hypothetical independent entity and is merely "a yardstick against which to measure a particular methodology, rather than a mandate."[24] According to the government, as long as a method of determining attributable profits yields "a reasonable measure" of the profits such a hypothetical separate entity would make, it is consistent with the separate enterprise principle and permissible under the Treaty.[25]

These two alternative readings of the separate enterprise principle could conceivably, depending on the method employed, result in attribution of the same amount of profit to a permanent establishment. It is certainly possible, however, and perhaps more likely, that different results would obtain. Furthermore, the two views produce very different answers to two key questions: the validity of using formulary methods to determine attributable profits, or indeed any method that does not recognize (at least as an initial matter) the individual transactions actually shown on the books and records of the permanent establishment, and the degree of respect to be accorded to interbranch transactions recorded on those books. Much of the controversy surrounding Article 7(2) has focused on these issues, which, though related, are analytically distinct. Both were addressed in *NatWest*.

1. Formulary methods. The government's position in *NatWest* — that *any* method of determining attributable profits (including a formulary method) is acceptable as long as the result it ultimately produces is a "reasonable measure" of the profit a separate entity "might be expected" to make — has a certain appeal. After all, a branch is not in fact a separate entity, and the transactions shown on the branch's books may not be equivalent to those of a true separate entity. For example, as the government pointed out in its brief, a branch of a bank may enter into loans that could not have been entered into by a separate company, because a branch can take advantage of the "parent's" capital reserves.[26] It is awkward and artificial to ignore the economic reality that the permanent establishment and the head office are part of a single entity.[27]

Nonetheless, disregarding this particular economic reality is precisely what the Commentary to Article 7 appears to require, at least as an initial matter. The Commentary is clear that in the "great majority of cases" the determination of attributable profits should start with the *actual* trading accounts of the permanent establishment to the extent such books and records exist, with adjustments as necessary to conform with the arm's-length principle.[28] According to the Commentary, "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."[29]

The government's position in *NatWest* thus is inconsistent with the principles plainly expressed in the OECD Commentary. Indeed, at the time *NatWest* was decided, the government's argument had already been

[21] *Id.* at 130.

[22] OECD Commentary, 1994, Art. 7, para. 11.

[23] 44 Fed. Cl. at 127.

[24] Plaintiff's Reply Memorandum in Support of Its Motion for Partial Summary Judgment and in Opposition to Defendant's Cross Motion for Partial Summary Judgment (filed 12/10/97) (NatWest Brief) at 28 & n.83, citing Cross Motion by United States and Response to Motion for Partial Summary Judgment by National Westminster (filed 4/30/97 under seal).

[25] Government's Reply Brief in Support of Its Cross Motion for Partial Summary Judgment (filed 3/16/98) (Gov't Brief) at 7.

[26] Gov't Brief at 29.

[27] *See* News Analysis, "Hybrids and Branches Disadvantage the Host Country," *Tax Notes*, July 19, 1999, p. 346 at 348 (elaborating on the somewhat hyperbolic, if possibly true, assertion that "[s]ince the Genoese invented letters of credit, international banking has operated on the principle that money is fungible.")

[28] OECD Commentary, 1994, Art. 7, paras. 11, 12.

[29] *Id.* para. 12 (emphasis added).

rejected by Tax Court in *North West Life Assurance Co. of Canada v. Com'r*,[30] primarily on the basis of the Commentary to Article 7. *North West Life* involved section 842(b), which provides that foreign insurance companies with U.S. branches are taxed on the greater of their actual effectively connected net investment income (ECNII) or a prescribed ECNII determined under a formula that requires multiplying the branch's actual liabilities by a percentage to determine "required U.S. assets," and then multiplying the "required U.S. assets" by another percentage. Both percentages are based on data relating to domestic insurance companies. The issue in the case was whether this formulary method of determining attributable profits is consistent with Article 7 of the U.S. treaty with Canada, which is materially identical to Article 7 of the OECD Model.

Though the NatWest opinion does not cite North West Life, the court's interpretation of Article 7 and the accompanying Commentary is consistent with the Tax Court's interpretation in North West Life.

The government argued first that Article 7 does not require a specific method of determining attributable profits and therefore permits either country to apply its domestic law in making that determination.[31] The Tax Court rejected this argument, concluding (primarily on the basis of the OECD Model and Commentaries) that although Article 7(2) is "murky," the better reading is that it does set forth a specific method: it requires attributable profits to be determined based on the actual facts of the particular permanent establishment, "by reference to the establishment's separate accounts insofar as those accounts represent the facts of the situation."[32]

The government then argued that the formula set forth in section 842(b) is consistent with this requirement and with the separate enterprise principle because the formula uses the liabilities actually shown on the branch's books to determine "the assets petitioner might be expected to hold if it were a separate entity."[33] The Tax Court rejected this argument as well, stating that "[w]hether the hypothetical amount of assets calculated pursuant to section 842(b) represents a reasonable estimate of the amount of assets petitioner would hold if it were a separate entity".is irrelevant, since that asset amount "is simply extraneous to petitioner's operations."[34] According to the court, it is not enough that a formula is "reasonable" or produces a "reasonable approximation" of the right result — the method itself must comport with the separate enterprise principle of the treaty, and this principle cannot be satisfied "merely by starting with the real facts as they relate to petitioner's permanent establishment and then incorporating extraneous data that is inconsistent with that principle."[35]

Though the *NatWest* opinion does not cite *North West Life*, the Court of Claims' interpretation of Article 7 and the accompanying Commentary in *NatWest* is consistent with the Tax Court's interpretation in *North West Life*. This interpretation — that the separate enterprise principle requires determination of attributable profits to start with the actual books of account of the permanent establishment — is virtually compelled by the language of the Commentary. A corollary issue that was not directly addressed by the court in *NatWest*, however, is whether a formulary method of determining attributable profits could ever be consistent with the separate enterprise principle. The Commentary requires only that attributable profits "be determined by reference to the establishment's accounts if these reflect the real facts."[36] Would it be possible to construct a formula that refers only to the accounts of the permanent establishment but does not necessarily recognize each individual transaction shown on the books (even if those transactions are not shown to be unreliable)? If so, would such a formula pass muster under Article 7(2)?

The Commentary to Article 7(2) does not answer this question. The Commentary to Article 7(4) appears on first reading to rule out formulary methods of profit apportionment. Article 7(4) of the OECD Model, which is rarely included in U.S. treaties, permits formulary apportionment of the total profits of an enterprise in certain circumstances. The Commentary to Article 7(4) states that such formulary apportionment differs from the methods envisaged in Article 7(2), "since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits."[37] According to the Commentary, a formulary apportionment method is generally "not as appropriate" as a method that looks only to the activities of the permanent establishment.[38] As the government pointed out in its brief in *NatWest*, however, Article 7(4) addresses only formulary allocation of the *total* profits of the enterprise, and not a formulary method that refers only to factors specific to the permanent establishment without regard to the rest of the enterprise.[39] Article 7(4) does not by its terms rule out the latter type of formula.

The Commentary to Article 7(3) is slightly more helpful. Article 7(3), which is discussed in more detail below, supplements Article 7(2) by clarifying the manner in which expenses may be taken into account in determining attributable profits. Paragraph 24 of the

[30]107 T.C. 363 (1996).
[31]*Id.* at 382, 384.
[32]*Id.* at 382-84, 386, 398.
[33]*Id.* at 386.
[34]*Id.* at 387.
[35]*Id.*
[36]OECD Commentary, 1994, Art. 7, para. 25.
[37]*Id.*
[38]*Id.*
[39]Gov't Brief at 16-17 & n.15.

Commentary to Article 7 pertains to both Article 7(2) and Article 7(3). Consistent with the Commentary to Article 7(2), that paragraph states that there usually are (or can be constructed) "adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision." This method is preferred "wherever it is reasonably practicable to adopt it."

The Commentary recognizes, however, that there may be circumstances in which there are no proper accounts for the permanent establishment, or "the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts." In such cases, another method may be used if such a method is customary; for example, in the case of an insurance company, the application of an "appropriate coeffecient" to gross premiums received from policyholders in the relevant country. Even when such methods are not customary, they may be necessary for practical reasons in exceptional circumstances. Paragraph 24 thus seems to contemplate that use of a method other than one that references the actual accounts of the permanent establishment may be consistent with the separate enterprise principle, at least in certain limited circumstances.

The government cited paragraph 24 in *North West Life* as support for the validity of section 842(b) under Article 7 of the Canadian treaty. The Tax Court declined to decide whether Article 7(2) and paragraph 24 would ever permit the use of formulas in determining attributable profits, but determined that use of a formula was invalid in *this* case even in light of paragraph 24, because the real facts — i.e., the accounts of the permanent establishment — were ascertainable.[40] Since the ascertainability of the facts and the existence and validity of accounts must be made on a case-by-case basis, and since formulas are by their very nature *not* case specific, it is hard to see how a generally applicable formula could ever be acceptable under the standard set out in paragraph 24. A formula that was applicable only if the books of account of the permanent establishment were nonexistent or shown to be unreliable might meet this standard — but a conditional formula such as this would obviate many of the advantages that one-size-fits-all formulas are designed to achieve in the first place (i.e., predictability and ease of administrative application).

The validity of formulary methods for determining attributable *profits* was not directly at issue in *NatWest*, since that case involved a formulary method for determining only a single item of expense. Nonetheless, in the course of analyzing the validity of that method, the court reinforced the view that Article 7(2) does not permit the use of formulary methods when the permanent establishment's books of account are available:

> Time and again throughout the commentary on Article 7, . . . one finds affirmation of the concept that where the books of a permanent establishment are, with adjustments, adequate to determine the profits . . . of the permanent establishment as a separate entity, then those books should be used *(and presumably not some substituted formula)*.[41]

The parenthetical is merely *dicta*, and it does not explicitly rule out the use of a formula that is based solely on the books of account of the permanent establishment (assuming such a formula could be constructed), but it does suggest that the court read Article 7 to incorporate a presumption against the use of formulas.

The court reinforced the view that Article 7(2) does not permit the use of formulary methods when the permanent establishment's books of account are available.

In both *NatWest* and *North West Life*, the government attempted to defend its use of a formula on policy grounds. In its briefs in *NatWest* the government repeatedly emphasized that a case-by-case analysis of the permanent establishment's accounts and determination of necessary adjustments would be extremely complicated and difficult, would "invite disputes," and would "undermine the predictability and administrative workability" reg. section 1.882-5 was designed to achieve.[42] It also emphasized that recognition of interbranch transactions shown on the books of a permanent establishment could permit the bank to improperly shift taxable profits out of the United States and that reg. section 1.882-5 is designed to prevent such distortions.[43] Similarly, in *North West Life* the government defended section 842(b) on the ground that foreign insurance companies have "significant discretion" in moving their assets from one taxing jurisdiction to another to escape taxation and that the provi-

[40]The court stated that under paragraph 24 (which was numbered as paragraph 23 during the years at issue in the case), before a method other than using the actual accounts of the permanent establishment may be adopted, this other method must be "customary and based on suitable criteria" *or* the circumstances must be exceptional, which the court concluded would be the case if the permanent establishment had no separate accounts. 107 T.C. at 387. This appears to be a slight misreading of paragraph 24, which in fact seems to sanction the use of other methods only when it has been "customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria" *and* there are no separate accounts. Paragraph 24 then goes on to state that even when such a course has not been customary, "it may, *exceptionally*, be necessary for practical reasons to estimate the arm's length profits."

[41]44 Fed. Cl. at 126 (emphasis added).

[42]Gov't Brief at 28-29 n.25, p.30, p.33 n.27.

[43]*Id.* at 2-3, 29-30.

attorney-adviser in Branch 5, assistant chief counsel (financial institutions and products); Rebecca L. Harrigal, chief of Branch 5; Bruce M. Serchuk, a senior technician reviewer in Branch 5; and Stephen Watson with Treasury's Office of Tax Legislative Counsel.

The witnesses represented the American Public Gas Association, The Tennergy Corp., the Public Energy Authority of Kentucky, the City of Thomson, Ga., the Municipal Gas Authority of Georgia, Marathon Oil Co., the National Association of Bond Lawyers, and The American Public Energy Agency, among other unnamed clients.

Not-So-Subtle Rebuke

All but one of the nine sets of witnesses represented entities that enter into prepaid contracts for utilities, primarily natural gas. The other witness, a representative of the National Association of Bond Lawyers, addressed more general issues. Perhaps the strongest rebuke of the proposed regulations came at the end of the hearing when unscheduled speaker Robert J. Eidnier of Squire, Sanders & Dempsey's Cleveland office spoke for his clients who buy and sell bonds for relatively small investors. The pronouncements in the preamble to the proposed regulations, expressing the Service's concern that prepaid supply contracts generate arbitrage, have "essentially eliminated" the "market, both primary and secondary" for tax-exempt bonds used to finance prepaid gas contracts, Eidnier told the government panel.

The pronouncements in the preamble have 'essentially eliminated' the 'market, both primary and secondary' for tax-exempt bonds used to finance prepaid gas contracts, Eidnier asserted.

"With all due respect, we submit that this was an inappropriate and unwarranted action by the Service. In the eyes of the market, the Service has tainted all gas prepayment bonds," Eidnier asserted. The Service has taken this action even though the agency "is just beginning its investigation of these bond issues," as "evidenced by the fact that the preamble was used as a vehicle to request information on these issues," he continued. Because "the current regulations demand a fact-intensive and thus individualized analysis for each and every gas prepayment issue," Eidnier argued, "the Service is not in a position to make blanket statements like those contained in the preamble that will so predictably have the devastating market effect that we have seen."

Though Eidnier said it is "too late to put this ugly genie back in its bottle," he urged "the Service to correct these preamble statements at the earliest possible moment." Specifically, he suggested that the IRS issue an announcement that these statements were premature and do not reflect any IRS conclusion regarding gas prepayment bonds. "We further suggest that any future statements regarding these bonds reflect the highly fact-intensive and individualized nature of the tax analysis and not purport to apply to all such bond issues," he told the panel.

Eidnier also expressed concern over how the IRS will audit bonds issued before the effective date of the regulations. Examination agents must consider that until recently bond counsel had little guidance from the IRS, he said. "Regulations cannot and should not attempt to anticipate every conceivable transaction," he added. Other witnesses also implored the drafters of the proposed regulations to get back to basics by focusing on the abuses that Congress intended the arbitrage rules to combat and by looking at prepaid gas contracts from a practical, business standpoint.

Municipalities and other utility providers enter into prepaid gas contracts because they are the only means available for ensuring that residential and business customers will have a reliable, reasonably priced supply of natural gas, witness after witness testified. Pay-as-you-go contracts are not practical options because they come with no guarantees; if the gas provider encounters an interruption in service, month-to-month customers are the first to lose their gas service and the last to get it back, the witnesses said.

Hugh Roberts, representing Marathon Oil Co., told the panel that he can *always* sell gas at market prices, so he needs an incentive to sign a contract promising to deliver gas to a municipality in the future. That incentive is the prepayment, he said.

Robert E. Knox, mayor of Thomson, Ga., reiterated a point made by many of the other witnesses when he said the proposed regulations jeopardize his ability to obtain a reliable gas supply for individuals and business. He also noted that the regulations inhibit his ability to entice industrial investment to his city. "I think you're splitting some mighty fine hairs" by concluding that prepaid gas contracts are driven by arbitrage considerations, Knox declared.

John Williams, president of The Tennergy Corp., an instrumentality of the state of Tennessee, told the panel that the goal in entering into a prepaid gas contract is to obtain a "super firm" supply of gas. Locking in a "super firm" supply means your municipality is sure to receive

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

In Article 7(3) of the U.K. treaty, the italicized language is replaced with the phrase: "including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment)."

A key issue in the *NatWest* case (and indeed a source of continuous uncertainty and controversy) is the effect of Article 7(3) on the "separate enterprise" principle expressed in Article 7(2). Article 7(3) appears to permit deduction of expenses incurred by another unit for the benefit of the permanent establishment at cost; i.e., without a profit element for the unit bearing the expense. In addition, Article 7(3) of the U.K. treaty explicitly permits allocation of some expenses. These are both "single entity" concepts, seemingly inconsistent with the fiction established in Article 7(2) that the permanent establishment is to be treated as a separate entity.

The Commentary recognizes this apparent conflict but then dismisses it. The Commentary states that while application of Article 7(3) "may raise some practical difficulties, especially in relation to the separate enterprise and arm's length principles underlying" Article 7(2), there is in fact "no difference of principle between the two paragraphs." According to the Commentary, Article 7(2) sets forth the central principle that the profits attributable to the permanent establishment must correspond to the profits a separate and independent enterprise would have made, while Article 7(3), rather than setting forth an alternative inconsistent principle, simply provides a rule applicable to the determination of those profits.[54] Though this explanation is a little murky, it seems to establish the precedence of the separate entity principle of Article 7(2), as the profits determined using the rules in Article 7(3) must ultimately comport with this principle.

Consistent with this reading, the Commentary to Article 7(3) provides that the determination whether a particular expense is incurred for the purposes of the permanent establishment must be made "keeping in mind" the separate enterprise principle of Article 7(2).[55] This seemingly would require the expenses taken into account in determining attributable profits to be those shown on the books of the permanent establishment. Article 7(3), however, clearly contemplates that there are circumstances in which this principle is not applicable. As the Commentary provides, the difficulty is in distinguishing between, on the one hand, circumstances in which a cost incurred by the enterprise should be treated as an expense incurred for the permanent establishment (i.e., deducted at cost, even though incurred by a unit other than the permanent establishment), and, on the other hand, circumstances in which:

> a cost incurred by an enterprise should not be considered as an expense of the permanent establishment and the relevant property or service should be considered, on the basis of the separate and independent enterprise principle, to have been transferred between the head office and the permanent establishment at a price including an element of profit.[56]

Much of the Commentary to Article 7(3) attempts to set forth standards governing this determination. The Commentary thus affects the manner in which both issues discussed above — use of formulary allocation methods and respect for interbranch transactions — should be analyzed with respect to expenses, as opposed to profits.

1. Formulary allocation and Article 7(3). Whereas Article 7(2) probably is best read as creating a strong presumption against the use of formulary methods for determining attributable profits, Article 7(3) appears to contemplate the use of formulary methods for allocating expenses, at least in some circumstances. Article 7(3) of the U.K. treaty is more explicit than the OECD Model, providing for deduction of "a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole." Article 7(3) of the OECD Model does not include this language, but the Commentary suggests that the OECD language is intended to permit similar types of expense allocation.[57] For example, the Commentary provides that costs of creating intangibles generally should be treated as attributable to all parts of the enterprise that make use of them and so should be allocated among those parts without any markup for profit.[58] Similarly, according to the Commentary provision of services that are part of the general management or administrative activity of the company (for example, a common system of training for em-

[54] OECD Commentary, 1994, Art. 7, para. 17.

[55] *Id.* para. *17.1.*

[56] *Id.*

[57] At least one commentator has expressed the view that the government should have disputed the relevance of the OECD Commentary on Article 7(3) of the OECD Model to the interpretation of Article 7(3) of the U.K. treaty because of this different language, despite the fact that the U.K. treaty was explicitly based on the OECD Model. *See* Sheppard, "Hybrids and Branches Disadvantage the Host Country," *Tax Notes,* July 19, 1999, p. 346 at 347. This argument is questionable in light of the fact that the OECD Commentary suggests that the OECD language is intended to achieve the same result as the U.K. treaty language. Indeed, the IRS itself has minimized the difference, holding in Revenue Ruling 89-115 that the "analysis of the appropriate method of allocating interest expense" is the same under the OECD language and the U.K. treaty language. Rev. Rul. 89-115, 1989-2 C.B. 130, 131.

[58] OECD Commentary, 1994, Art. 7, para. 17.4.

ployees) usually should be allocated on an actual cost basis to the various parts of the enterprise without any markup for profit.[59]

The question is when and in what circumstances formulary allocation is acceptable. Should Article 7(3) be read to justify formulary allocation of *all* expenses, or are there situations in which the separate enterprise principle of Article 7(2) must be given effect by respecting the expenses actually shown on the books of the permanent establishment? The government devoted a large portion of its *NatWest* brief to the general argument that Article 7 is not intended to prohibit all formulary methods for determining a permanent establishment's interest expense deduction, as well as to the more specific argument that the "reasonable allocation" language of Article 7(3) of the U.K. treaty (which is not included in the OECD Model) explicitly permits use of such a formula.[60] According to the government, Article 7(3) provides for "an integrated approach to the determination of branch interest — regardless of whether it was incurred by the branch or anywhere else within the corporation, and regardless of whether it was incurred for a variety of corporate purposes, or for the branch alone."[61]

It seems fairly clear on the basis of the Commentary, NatWest, and North West Life that the government will be battling uphill in attempting to defend any formulary method of expense allocation under Articles 7(2) and 7(3).

The taxpayer, however, argued that Article 7(3) of the U.K. treaty does not permit the entire amount of a bank permanent establishment's interest expense deduction to be determined using a formulary method. Instead, Article 7(3) should be read to require deduction of the interest expense *actually* incurred by the permanent establishment for its own purposes and shown on its books, and, in addition, to permit deduction of a "reasonable allocation" of interest expense incurred by the home office or a branch for the benefit of the bank as a whole, if any. In other words, interest expense incurred by the permanent establishment for its own purposes and shown on its books should be respected in the first instance, even if the permanent establishment is also allowed to deduct an allocated amount of interest incurred (by the permanent establishment or elsewhere in the entity) for the purposes of the bank as a whole.[62]

Though the government's reading is not illogical, especially in light of the "reasonable allocation" language of the U.K. treaty, the court adopted the taxpayer's view, holding that under Article 7(3) of the U.K. treaty a bank branch is entitled to deduct "normal deductible expenses" reflected on its books as well as "a reasonable allocation of general and administrative expenses incurred for the purposes of the foreign enterprise as a whole."[63] This reading of Article 7(3) may in fact be more consistent with the Commentary's strong preference for separate entity treatment, since it construes the exception to separate entity treatment more narrowly than the government's interpretation. As the Commentary states, subject to the possibility that it might be appropriate or necessary to allocate administrative expenses incurred by the head office, "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."[64]

By adopting this reading, the court in *NatWest* expressed its view that formulas that do not meet this standard — i.e., formulas that ignore or inadequately respect the actual amount of expense incurred by a permanent establishment — are inconsistent with Article 7(2), even as modified by Article 7(3). It is possible, however, that a formula that is based on the transactions actually shown on the permanent establishment's books and does not incorporate extraneous information might be acceptable under Article 7, even for expenses that are incurred by the permanent establishment specifically for its own purposes. The *NatWest* opinion does not completely foreclose this possibility. Nonetheless, it seems fairly clear on the basis of the Commentary, *NatWest*, and *North West Life* that the government will be battling uphill in attempting to defend any formulary method of expense allocation under Articles 7(2) and 7(3) of the OECD Model, even one that properly takes the books of the permanent establishment into account.

2. Interbranch interest expense. As in the case of Article 7(2), even after determining that Article 7(3) requires respect for the expenses actually incurred by a permanent establishment (in addition to allowing an allocation of overhead-type expenses) there remains the separate question whether this principle extends to interbranch expenses. As discussed above, the separate enterprise principle of Article 7(2) seems to require that interbranch transactions shown on the permanent establishment's books be respected, at least as an initial matter. Based on the "clear wording" of Article 7(2), the court stated in *NatWest*, "one would suppose" that the emphasis on the "use of a permanent establishment's books of accounts even with respect to intracorporate transactions" would apply to *all* items of interbranch income and expense.[65]

The Commentary to Article 7(3), however, explains that this is not the case. There are some types of interbranch payments that should *not* be respected, even as an initial matter. The problem is determining the category into which any particular expense falls.

[59] *Id.* para. 17.7.
[60] Gov't Brief at 9-11.
[61] *Id.* at 11.
[62] NatWest Brief at 16-18.
[63] 44 Fed. Cl. at 123-24, 128.
[64] OECD Commentary, 1994, Art. 7, para. 16.
[65] 44 Fed. Cl. at 127.

According to the Commentary, the essential question in making this determination is whether the internal transfer of property or services is of the type that the enterprise would have conducted with third parties in the ordinary course of its business; i.e., whether the expense is incurred by the permanent establishment in the course of performing activities whose goal is to realize a profit for the permanent establishment. If so, it is generally proper to recognize the expense shown on the books of the permanent establishment, including a profit element.[66] If not — i.e., if the expense is incurred in performing a function "the essential purpose of which is to rationalize the overall costs of the enterprise or to increase in a general way its sales" — then the expense should be ignored.[67] As an example, the Commentary provides that when one branch sells goods (either finished or raw) to another for resale, it is normally appropriate for the provisions of Article 7(2) to apply and for the expense of the purchasing branch to be recognized (adjusted as necessary to conform to the arm's-length standard).[68]

In addition to this general rule, the Commentary describes certain specific categories of interbranch payments that usually should be disregarded in determining attributable profits. One of these is interbranch royalties. The Commentary states that it is generally preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise that make use of them. Thus, payments of royalties from one branch to another generally should be ignored.[69]

Another category of expense to which the Commentary gives significant attention is interbranch interest. The Commentary describes some of the problems that may result from recognizing interbranch loans or the interest payments thereon and concludes that "the ban on deductions for internal debts and receivables should continue to apply generally."[70] This statement corresponds to paragraph 15 of the 1963 Commentary (cited in *NatWest* and in effect at the time the U.K. treaty was concluded), which provided that interbranch interest payments "should not be allowed as deductions in computing the permanent establishment's taxable profits."

The conclusion that interbranch interest expense should be disregarded is, however, explicitly "subject to the special problems of banks mentioned below."[71] The Commentary provides "below" (in language virtually identical to the 1963 Commentary) 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 (as distinct from capital allotted to them), in view of the fact that making and receiving advances is closely related to the *ordinary business* of such enterprises.[72]

The meaning of this "special considerations" language is open to some debate. The court concluded in *NatWest* that though this provision is somewhat cryptic, it is best read to mean that the general rule prohibiting recognition of interbranch debt and interest was not intended to apply to banks and other financial institutions whose "ordinary business" is the borrowing and relending of money.[73]

There are some types of interbranch payments that should not be respected, even as an initial matter. The problem is determining the category into which any particular expense falls.

This conclusion is not explicit in the Commentary. As the government emphatically pointed out in its briefs in *NatWest*, the Commentary does not describe what the "special considerations" applicable to banks might be. Nonetheless, the *NatWest* court's conclusion follows logically, if not necessarily, from the principles expressed in the Commentary. As described above, the Commentary sets forth a general rule that interbranch expenses reflecting transactions that are part of the "normal course of business" of the enterprise — for example, transfers of goods for resale — should be respected. As the court points out in *NatWest*, interest is "the most ordinary of expenses" for a banking enterprise engaged in the borrowing and relending of funds.[74] Because borrowing and lending funds outside the enterprise is the main business of a bank, it is logical to assume that most money lent by one branch to another will in fact have been borrowed at some stage from a third party and will eventually be lent to a third party.[75] Thus, interbranch loans are a bank's analogue to a manufacturing company's interbranch transfers of goods for resale, and respecting those loans produces a result consistent with the result obtained under Article 7 for nonbank enterprises.[76] Ignoring a bank's interbranch interest expense would cause profits to be attributed to U.S. bank permanent establishments in a manner "dramatically different" from other industries.[77] Consequently, as the court concluded, it is reasonable to interpret the "special considerations" language to mean that the ban on interbranch debt does not apply to banks.

[66]OECD Commentary, 1994, Art. 7, paras. 17.1, 17.2.
[67]*Id.* para. 17.2.
[68]*Id.* para. 17.3.
[69]*Id.* para. 17.4.
[70]*Id.* para. 18.3.
[71]*Id.*
[72]*Id.* para. 19; 1963 Commentary para. 15.
[73]44 Fed. Cl. at 127.
[74]*Id.* at 128.
[75]*See* OECD Report, "The Taxation of Multinational Banking Enterprises," in *Transfer Pricing and Multinational Enterprises — Three Taxation Issues,* 1984 (OECD Bank Tax Report), at para. 49.
[76]*Id.*
[77]NatWest Brief at 16.

This interpretation is also consistent with the separate enterprise principle of Article 7(2). The strong preference expressed in the Commentary to Article 7 for determining attributable profits based on the actual facts and books of account, adjusted as necessary, supports a general presumption that such accounts should be used unless there is a clear directive otherwise and suggests that exceptions — such as the general ban on recognition of interbranch interest — should be construed narrowly. Reading the "special considerations" language of the Commentary to except banks from the ban on recognition of interbranch interest is consistent with these principles and is a logical way of reconciling Articles 7(2) and 7(3).[78]

3. Reg. section 1.882-5 and the separate enterprise principle. Assuming for the sake of discussion that a formulary interest expense allocation method that properly takes the books of the permanent establishment into account could satisfy Article 7, the question in *NatWest* was whether reg. section 1.882-5 is such a method. The government spent a great deal of time in its *NatWest* brief arguing that Article 7 does not prohibit all formulary expense allocation — an issue which the court did not even address, much less resolve — but it spent comparatively little defending the particular formulary allocation method set forth in reg. section 1.882-5.[79] What defense it offered was based on the argument that reg. section 1.882-5 does comport with the separate enterprise principle because it "considers assets, liabilities, and interest expense" on the third-party transactions actually recorded on the books of the permanent establishment.[80] According to the government, the regulation "pays particular regard to the branch's own activities and is heavily drawn from its own books and records."[81]

Under the government's view of Article 7 — that the separate enterprise principle is merely a "yardstick" rather than a mandate — it is possible, though by no means certain, that reg. section 1.882-5 might have passed muster. The government might have been able to successfully argue that the interest expense deduction calculated pursuant to the regulation approximates an arm's-length amount of interest expense that a hypothetical separate entity might have incurred.[82] In light of the court's determination that Article 7 does in fact "mandate" a strict separate enterprise approach and requires initial respect for the actual books and records of the permanent establishment, however, the regulation was clearly doomed. As the court concluded, reg. section 1.882-5 does not in fact treat U.S. permanent establishments as if they were actual separate entities dealing at arm's length with the outside world and the rest of the enterprise.

First, the regulation entirely disregards interbranch transactions. Thus, in step 1 of the calculation the branch's effectively connected assets, which are used to determine its allowable liabilities, are inaccurate because interbranch assets are excluded. In step 3, the determination whether the branch is over- or undercapitalized is distorted because the actual liabilities shown on the branch's books, which are compared with "allowable liabilities" to determine adequacy of capitalization, do not include interbranch liabilities. And if the branch is determined to be properly capitalized, the permanent establishment is permitted to deduct only the third-party interest expense shown on its books. Interbranch interest expense is disregarded.

As the court concluded, it is reasonable to interpret the 'special considerations' language to mean that the ban on interbranch debt does not apply to banks.

Second, even if reg. section 1.882-5 recognized interbranch transactions (or even if Article 7(3) were not read to require such recognition), the formulary allocation method set forth in the regulation would be inconsistent with Article 7 because it does not properly respect the actual expense incurred by the permanent establishment. As discussed above, the Commentary states 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,"[83] and the court interpreted Article 7(3) to permit a permanent establishment to deduct the actual amount of interest expense it incurs, in addition to a "reasonable allocation" of expense incurred for the benefit of the enterprise as a whole.

Under the regulation, however, a branch's interest expense deduction depends not on the amount of liabilities it actually incurs, but on its "allowable"

[78]This interpretation of the "special considerations" language is also supported by the 1984 OECD Bank Tax Report, *supra* note 75. This report sets out the virtually unanimous view of the OECD member countries that intra-bank payments of interest should be taken into account, adjusted as necessary, and that it is not permissible to ignore the actual payments of interest by the permanent establishment. OECD Bank Tax Report para. 53. The report was issued after the U.K. treaty was concluded, however, and the court did not rely on it in *NatWest*. As noted in the report, the United States explicitly disagrees with the majority view.

[79]The government devoted more energy to attempting to prove, on the basis of extrinsic evidence, that regardless of the proper interpretation of Article 7 *in vacuo*, the United Kingdom and the United States intended formulary methods such as reg. section 1.882-5 to pass muster under Article 7. These arguments are discussed in greater detail below.

[80]Gov't Brief at 31.

[81]*Id.* at 31-32.

[82]The 1984 OECD Bank Tax Report suggested that reg. section 1.882-5 "might" produce "much the same result" as recognition of interbranch interest expense — but only if a number of assumptions are made (for example, that the cost of borrowing eurodollars to produce U.S. connected income is equal to the average cost of all eurodollar borrowing by the bank). 1984 OECD Bank Tax Report, *supra* note 75, paras. 56, 57.

[83]OECD Commentary, 1994, Art. 7, para. 16 (emphasis added).

liabilities, which are computed in step 2 by multiplying the branch's assets by a ratio. The taxpayer can choose whether to use an arbitrary fixed ratio or the actual *worldwide* liability-to-asset ratio of the entity, but it cannot, as the separate enterprise principle would seem to require, determine the ratio based on the amount a hypothetical entity in the branch's shoes could actually borrow against the assets shown on its books. The regulation thus treats a branch as a unit of a single entity rather than as a separate entity.

Similarly, the branch's interest expense deduction is not equal to the actual interest expense it incurs. Instead, step 3 compares the branch's allowable liabilities with its actual liabilities. If the branch is determined to be overcapitalized — i.e., its allowable liabilities exceed its actual liabilities — additional allowable liabilities equal to the amount of the excess are imputed to it. However, the interest expense deduction permitted the branch on these imputed liabilities is not the amount of interest expense the branch itself would have incurred if it had actually borrowed from third parties. Instead, it is based on the rates paid by the non-U.S. branches of the entity on U.S. dollar obligations.

Both of these aspects of reg. section 1.882-5 — lack of respect for the books of the permanent establishment and failure to recognize interbranch transactions — are inconsistent with a strict reading of Article 7, and the combination is predictably fatal. The government attempted to defend the regulation on the ground that reliance on the actual books of a permanent establishment would invite abuse. The books of a bank branch, according to the government, are different from the books of a separate banking entity, and interbranch debt shown on the books might reflect profit-shifting strategies, such as non-arm's-length rates or an unduly high level of debt in relation to the branch's capital.[84] Determining whether the books are reliable and making appropriate adjustments would require "complex and difficult analyses" and would "invite disputes and . . . undermine . . . predictability and administrative workability."[85]

The court was unswayed by these arguments and did not even address them in its opinion. Indeed, though the government's somewhat plaintive recital of the potential difficulties of a strict separate enterprise approach is sympathetic, these policy issues are, as the Tax Court concluded in *North West Life,* simply irrelevant to the determination whether the regulation is consistent with Article 7. Interbranch interest expense might well be subject to manipulation and abuse. But the fact that the interest expense shown on a branch's books *could* be unreliable does not mean that the government can assume that *all* such interest expense shown on the books of *all* U.S. permanent establishments is unreliable without examining the actual facts of the particular permanent establishment. Reg. section 1.882-5 does not simply disregard interbranch interest expense that is shown to be unreliable. Instead, as the court points out, it completely and systematically disregards, as an initial matter and before any fact-based inquiry, *all* interbranch interest, assets, and liabilities.[86] Such a fact-based inquiry might indeed be difficult, complicated, and time consuming — but this is what the Model and Commentary require.

The taxpayer's 'victory' may be somewhat pyrrhic — or may not even be a victory at all.

Although it would not eliminate an "extremely difficult or impossible transaction-by-transaction analysis of the branch's individual transactions,"[87] one can imagine a formula that in the first instance respects *all* transactions on a branch's books, including interbranch transactions; determines the branch's level of capitalization based on its actual activities and the assets actually shown on its books; and if the branch is determined to be overcapitalized, imputes additional interest based on the branch's actual borrowing rate. The *NatWest* court might have reached a different conclusion if it had been faced with such a formula. But the use of a formulary method stacks the deck against the government at the outset, and when the formula, like reg. section 1.882-5, disregards portions of the branch's actual books and records and incorporates data extraneous to the branch itself, it is difficult to defend under the Model and Commentary — even if it is eminently justifiable on policy grounds.

4. 'Adjusted as necessary': The caveat that ate the rule? On first glance, *NatWest* appears to be a total victory for the taxpayer — an unqualified judicial blessing on recognition of interbranch interest expense. On closer reading, however, it becomes evident that the taxpayer's "victory" may be somewhat pyrrhic — or may not even be a victory at all. The court did not hold that a permanent establishment's interest expense deduction is equal to the interest expense shown on its books, whether interbranch or third party. It held that a permanent establishment's deductible interest expense is this amount *adjusted as necessary* to impute adequate capital to the branch and to ensure that the interest expense deduction reflects arm's-length rates.[88] In other words, if, after starting with the actual books of the permanent establishment as required by the separate enterprise principle, it is determined that the books do not reflect adequate capital or that the interbranch interest expense on the books is not at arm's-length rates, the booked amount must be adjusted to arrive at an appropriate interest expense deduction.

[84]Gov't Brief at 29.
[85]*Id.* at 33 n. 27.
[86]44 Fed. Cl. at 130.
[87]Gov't Brief at 31.
[88]44 Fed. Cl. at 123, 126, 128, 131.

Though the court devoted little attention to this caveat, it is difficult to overemphasize its significance. The court describes two separate qualifications to the general principle of respect for interest expense shown on a permanent establishment's books. Both are responses to the potential ease of manipulating interbranch transactions. First, booked interbranch interest expense must reflect arm's-length rates. Otherwise the bank could shift profits into or out of a permanent establishment simply by changing the interest rate on interbranch loans. Second, the branch must have an adequate level of capital. Bank regulations generally require a separate banking entity to maintain its own capital, but these requirements may not apply to a branch. Thus, a bank can make interest-bearing loans to a permanent establishment in situations in which it would be required to make interest-free capital contributions to a subsidiary, thereby shifting profits out of the permanent establishment. This problem can be remedied by ensuring that the branch is adequately capitalized; i.e., by denying a deduction for interest expense on "loans" that should be treated as "equity."

The larger issues arise with respect to the second issue — the permanent establishment's level of capitalization. It is not generally problematic to determine whether interbranch interest expense is booked at arm's length rates. As the OECD concluded in the Bank Tax Report:

> The widespread existence of markets for the borrowing and lending of money in various forms, the fact that banks frequently borrow and lend large sums to each other on inter-bank markets and the common phenomenon of recognized inter-bank lending rates indicates that it would normally be possible to derive arm's-length interest rates for transactions between various parts of a banking enterprise from the rates charged in comparable transactions between independent parties.[89]

Of course, finding transactions that are truly "comparable" — e.g., transactions with the same terms in which the participants have the same credit levels — may not be easy. But at least the goal and the process of determining whether the interest expense shown on a permanent establishment's books reflects arm's-length rates and adjusting it if it does not are relatively straightforward.

The question whether a branch's capital is "adequate" is murkier, and the process for making the determination is less defined. Neither the court nor the Commentary gives much guidance as to how such a determination is to be made. An obvious approach is to start with the assets actually shown on the branch's books and then compare the liabilities shown on those books to some standard or "yardstick" to determine whether the booked assets can support the booked liabilities. If not, then interest on the "excess" liabilities may not be deducted in determining attributable profits.

[89]OECD Bank Tax Report, *supra* note 75, para. 36.

This leaves the problem of what "yardstick" to use. There are many possibilities, and some are more consistent with a strict separate enterprise principle than others. On one hand, the yardstick could be one that looks only to the branch itself. For example, the branch's booked liabilities could be compared to the amount that hypothetical independent third-party lenders would loan to a separate corporation with the type and amount of assets actually shown on the branch's books, or to the amount of liabilities that bank regulators would permit an actual banking subsidiary with those assets. These standards determine an "adequate" level of capital based on the actual facts and circumstances of the particular branch.

These issues are difficult, and attempting to answer them creates an 'enigma inside a conundrum' effect.

Alternatively, the "yardstick" could be one that is external to the branch. For example, the branch's level of capitalization could be compared to that of the bank as a whole — which is in fact the approach taken by reg. section 1.882-5 — or to the average level for all U.S. banks, or to the average level for all U.S. banking subsidiaries of foreign banks. These methods are less consistent with the separate enterprise principle.

The court's opinion in *NatWest*, and in particular its rejection of the reg. section 1.882-5 method (step 2) for determining adequate capitalization, suggests that the chosen method should be as consistent as possible with the separate enterprise principle. This makes sense in light of the Commentary, but it introduces an element of circularity into the determination, since the purpose of the capitalization inquiry is at least partly to determine whether to strictly apply that principle at all — i.e., whether to respect the transactions, especially interbranch transactions, shown on the branch's books. How can it be correct to determine whether the separate enterprise principle should be respected by using a method that incorporates any aspect of that principle? For example, should interbranch assets be taken into account in determining the adequacy of a branch's capital, considering that adequate capital is in a sense a prerequisite for recognition of interbranch interest expense? And if not, isn't the implication that step 2 of reg. section 1.882-5 could be an appropriate method of determining whether the capitalization of the branch is adequate, even if the regulation is invalid as a generally applicable method for calculating a branch's interest expense?

These issues are difficult, and attempting to answer them creates an "enigma inside a conundrum" effect. In practice, however, theoretical purity is not attainable, and probably is not the ultimate goal anyway. The books and records of all businesses, even separate corporations, have an element of arbitrariness, and it may frequently be possible for a person starting from "ground zero" to construct profit figures that more correctly reflect the facts than the figures shown on the books. Yet according to the Commentary, the books nonetheless form the starting point for the attributable

profit determination, and there is "no justification for tax administrations to construct hypothetical profit figures *in vacuo*."[90] Some baseline must be chosen or else the attributable profit determination would be completely unworkable, and this baseline is the books.

Thus, it seems relatively safe to assume that it is not necessary under *NatWest* to thoroughly test, analyze, and justify every individual interbranch (or other) transaction shown on a permanent establishment's books. What *NatWest* and the Commentary seem to require is that the method for determining whether a branch is adequately capitalized conform as closely with the separate enterprise principle as it is possible to do while attempting to ensure that the inquiry is reasonably meaningful. For example, the principles underlying the court's opinion, and its rejection of reg. section 1.882-5, suggest that it may be reasonable to test whether interbranch liabilities are reliable by reference to booked assets, *including* interbranch assets. Similarly, if a branch is determined to be undercapitalized, the adjustment most consistent with the *NatWest* opinion is probably simply to disallow the interest expense incurred on the "excess" liabilities, rather than applying a formula (such as reg. section 1.882-5) to determine what the appropriate interest deduction should be.

It seems relatively safe to assume that it is not necessary under NatWest to thoroughly test, analyze, and justify every individual interbranch (or other) transaction shown on a permanent establishment's books.

Though this approach seems reasonable, it remains to be seen how these issues will be resolved. In *NatWest* the court addressed only the legal question of the standard to be applied under Article 7. The factual determination of whether the actual interest shown on the books of the taxpayer's U.S. branch should be respected presumably will be the subject of a subsequent inquiry (assuming the government does not file an interlocutory appeal or settle the case). It will be interesting to see how the court applies the principles elucidated in the opinion to real facts. The results, hopefully, will provide some useful guidance regarding the determination whether and when transactions shown on a permanent establishment's books should be respected, and if not, how they should be adjusted.

II. The Outlook Beyond the OECD Model

As discussed above, the U.K. treaty at issue in *NatWest* was concluded (though not ratified) before the issuance of reg. section 1.882-5 and before any official pronouncements of the U.S. views on Article 7 and interest expense allocation. In addition, the treaty was explicitly based on the OECD Model, and much of its language is virtually identical to Article 7 of the Model. Thus, the task before the court in *NatWest* essentially boiled down to one of interpreting the OECD Model in light of the Commentary.

The obvious question is the extent to which the relevance of the holding is limited by these circumstances. How might the court have held if the language of the treaty at issue differed from the OECD Model, or if the treaty had been concluded after the IRS announced its general position that reg. section 1.882-5 is consistent with U.S. treaty obligations under Article 7, or if the Treasury technical explanation to the treaty referred explicitly to the regulation? Which of these facts, if any, might have caused the court to reach a different conclusion?

This section discusses the potential impact of these facts and others like them and suggests ways of looking at some of the issues that could arise if a court were to have such other facts before it when determining the validity of reg. section 1.882-5 under a U.S. treaty.

A. Basic Principles of Treaty Interpretation

The principles of treaty interpretation should inform any judicial inquiry into the validity of a U.S. regulation under a particular treaty. Though this article does not purport to exhaustively examine those principles or to propose a coherent framework for treaty interpretation, an understanding of the basic rules is helpful in analyzing the limits of the *NatWest* holding.

A tax treaty is "the law of the land," like a statute, and has the full force and effect of any other law. Treaties are also, however, agreements between nations, and they are generally construed more like contracts than like statutes.[91] Unlike statutes, treaties generally establish broad principles rather than setting out specific rules, so strict rules of statutory construction must be "relaxed" when interpreting treaties.[92] In addition, treaties, unlike statutes, are the product of negotiation with other sovereign nations and are reciprocal. Therefore, the criterion for resolving ambiguity is the "mutual intent of the signatories of the treaty" rather than the intent of the legislature in the country in which the interpreting court is located.[93] For these reasons, the principles of statutory interpretation that are typically applied to the code — a "literal interpretative" approach involving close reading of the language — are "not easily adapted to the treaty context."[94]

[90]OECD Commentary, 1994, Art. 7, para. 12.

[91]*Coplin v. United States*, 6 Cl. Ct. 115, 126 (1984), *rev'd on other grounds* 761 F.2d 688 (Fed. Cir. 1985), *aff'd* 479 U.S. 27 (1986); *see Zicherman v. Korean Air Lines Co.*, 516 U.S. 217, 226 (1996) (treaty is both the law of the land and an agreement among sovereign states).

[92]Federal Income Tax Project, The American Law Inst., *International Aspects of United States Income Taxation II* 26 (1991) [hereinafter ALI Project].

[93]*Id.* at 26-27.

[94]H. David Rosenbloom, "Current Developments in Regard to Tax Treaties," 40 *Inst. on Federal Tax'n* section. 31.03[2], pp. 31-39-31-40 (1982); *see* Klaus Vogel et al., *United States Income Tax Treaties* 26 (updated to 1996).

The principles of contract interpretation are more readily adapted. The basic goal in interpreting treaties, like contracts between private parties, is to ascertain the intent of the parties and construe the agreement "in a manner consistent with that intent."[95] Thus, the "general principles applicable to the construction of written instruments" apply to the construction of treaties.[96] Treaties, however, generally are construed more liberally than contracts between private parties.[97] Courts tend to be more willing to look beyond the written words of the agreement and to examine all available evidence to determine what the parties intended when they chose the language of the treaty.[98] As one court stated:

> [T]o give the specific words of a treaty a meaning consistent with the genuine shared expectations of the contracting parties, it is necessary to examine not only the language, but the entire context of agreement. We must therefore examine all available evidence of the shared expectations of the parties . . . .[99]

Ultimately, the key issue in treaty interpretation is to give the words of a treaty a meaning consistent with the 'genuine shared expectations' of the contracting nations.

Indeed, though the language of a private contract generally controls its meaning if that language is clear, courts may not give literal effect to the language of a treaty if this would effect a result "inconsistent with the intent or expectations of its signatories."[100] Ultimately, then, the key issue in treaty interpretation is to give the words of a treaty a meaning consistent with the "genuine shared expectations" of the contracting nations.[101]

B. Impact of Model & Commentary: A Presumption?

With these principles in mind, we can turn to the interpretation of Article 7 (or the equivalent "business profits" article) of U.S. tax treaties. In many treaties — perhaps the majority — the business profits article is based, explicitly or implicitly, on Article 7 of the OECD Model and uses language identical or nearly identical to the language of the Model. In addition to *NatWest*, various other cases have held that the OECD Commentary is potentially relevant to the interpretation of treaties based on the Model. For example, in *North West Life* the court stated that the OECD Commentary provides "helpful guidance."[102] And in *Taisei Fire & Marine Ins. Co. v. Com'r,* the Tax Court interpreted the United States-Japan treaty with reference to OECD Commentary adopted *after* the treaty in issue was ratified.[103] Indeed, the Commentary itself states that it has become a "widely accepted guide to the interpretation and application of the provisions of" the various bilateral conventions that incorporate the provisions of the OECD Model.[104]

The court in *NatWest* made an official pronouncement as to the proper interpretation of Article 7 of the OECD Model in light of the Commentary. Of course, this pronouncement is subject to challenge on appeal, but in the meantime — and, assuming this interpretation is upheld as correct, in the future — all U.S. treaties based on the OECD Model must be construed against this background. Certainly the parties to a treaty could agree between themselves that the language of the OECD Model means something different from what the *NatWest* court said it means — after all, each treaty must be interpreted on its own facts, and the goal is to ascertain the intent of the actual parties to the specific treaty at issue. Conceivably, the same words could have different meanings in different treaties to which the United States is party.[105]

Nonetheless, in the absence of some explicit, persuasive evidence, the use of the OECD language probably should be viewed as creating a presumption that the parties intended the language to have its commonly accepted meaning in the OECD community. One reason for such a presumption is that it would be "wholly unrealistic" to think that treaty negotiators who chose language derived from the OECD Model "were not familiar with and therefore did not know-

[95]*Maximov v. United States,* 299 F.2d 565, 568 (2d. Cir. 1962), *aff'd* 373 U.S. 49 (1963).

[96]*Tucker v. Alexandroff,* 183 U.S. 424, 436, 437 (1902).

[97]*See Air France v. Saks,* 470 U.S. 392, 396 (1985); *Choctaw Nation of Indians v. United States,* 318 U.S. 423, 431-32 (1943); *Factor v. Laubenheimer,* 290 U.S. 276, 293-94 (1933).

[98]*See Factor,* 290 U.S. at 294-95; *Great-West Life Assur. Co. v. United States,* 678 F.2d 180, 183 (Ct. Cl. 1982).

[99]*Maximov,* 299 F.2d at 568.

[100]*Sumitomo Shoji America, Inc. v. Avagliano,* 457 U.S. 176, 180 (1982) (quoting the Supreme Court opinion in *Maximov,* 373 U.S. at 49, 54); *Coplin,* 6 Cl. Ct. at 127-28. *But see Snap-on Tools, Inc. v. United States,* 26 Cl. Ct. 1045, 1066, *92 TNT 171-31* (1992) (citing the concurring opinion of Justice Scalia in *United States v. Stuart,* 489 U.S. 353, 372 (1989) for the proposition that the language of an agreement is the best evidence of the intent of the parties — but nonetheless referring to and apparently relying on extrinsic evidence when that evidence supported the court's conclusion), *aff'd without published op.* 26 F.3d 137, *Doc 94-4566, 94 TNT 88-14* (Fed Cir. 1994).

[101]*Maximov,* 299 F.2d at 568.

[102]107 T.C. at 378.

[103]104 T.C. 535, 548-51 (1995); *see also United States v. A.L. Burbank & Co.,* 525 F.2d 9, 15-17 (2d Cir. 1975) (in holding for the taxpayer, noting that the OECD Commentary supported the taxpayer's position without deciding whether the Commentary was relevant), *cert. denied* 426 U.S. 934 (1967).

[104]OECD Commentary, 1995, Introduction, para. 15.

[105]Of course, under a strict "plain language" approach, like that of Justice Scalia, the meaning of particular words would not vary depending on the context. Under such an approach, the language of Article 7 of the U.K. and OECD Model treaties would always have the meaning given it in *NatWest* (assuming that decision is upheld). Given that the vast majority of courts have adopted a significantly more liberal approach to treaty interpretation, however, such a result is unlikely.

ingly accept the common meaning of that language as agreed among the OECD member countries."[106] According to one commentator, when a treaty is based on the OECD Model it is "only logical to assume . . . that the intent of the parties was to adopt the Commentary interpretation."[107] Thus, the presumption should be that the Commentary interpretation "represents the intention of the parties."[108] If a country has an objection to a particular interpretation, it may change the "default" presumption for its treaties by entering an observation or reservation.[109]

In addition, the parties to a treaty are "free to deviate from" the OECD Model and Commentary, and frequently do.[110] In such cases, of course, the presumption that the parties intended to adopt the Commentary interpretation is no longer applicable. For example, U.S. negotiators clearly know how to draft language in Article 7 explicitly providing for recognition or nonrecognition of interbranch interest expense. In a number of U.S. treaties Article 7(3) provides that no deduction shall be allowed for "amounts, if any, paid . . . by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments . . . , by way of commission, . . . or by way of *interest on moneys lent to the permanent establishment*."[111] And in some treaties the last clause regarding interest is qualified by the language "*except in the case of a banking enterprise*."[112] It is not unreasonable to presume, in the absence of evidence to the contrary, that by choosing to adopt the OECD language rather than language such as this, U.S. negotiators were agreeing to the commonly held view of Article 7 as interpreted by the Commentary.

Another factor supporting such a presumption is that the goal of avoiding double taxation is best served if the contracting states adopt consistent interpretations of common treaty provisions. The Model and the Commentary further this goal by providing "a source from which courts of different states can seek a common interpretation."[113] This rationale may justify giving weight even to versions of the Commentary adopted after the treaty at issue was ratified.[114]

Finally, a presumption in favor of the Commentary interpretation is supported by the OECD Council's recommendation that OECD member countries conform to the Model "as interpreted by the Commentaries thereon."[115] An OECD recommendation can be regarded as imposing some sort of obligation, even if not legally enforceable, on the member countries unless a country has entered reservations or "material reasons" weigh against adoption of a particular provision of the Model.[116]

C. Overcoming the OECD Presumption

If the text of a treaty is clearly derived from the OECD Model, and there is no evidence to support an alternative reading, it is logical to presume that the parties intended to adopt the surrounding context, including the Commentary.[117] The question, then, is what evidence, if any, is sufficient to overcome this presumption.

1. Domestic law and practice. The government argued in its briefs in *NatWest* that the domestic law and practice of the United States and the United Kingdom at the time the U.K. treaty was concluded "confirm" that the countries "intended" to permit formulary determination of the interest expense deduction under Article 7.[118] According to the government, at the time the treaty was being negotiated both the United States and the United Kingdom used formulas to determine the interest expense properly allocable to a branch of a foreign bank for purposes of each country's *domestic* law. The United States, for example, used reg. section 1.861-8, and the United Kingdom used the so-called "PW Formula."

There are at least two problems with this argument. First, frequently one of the purposes or effects of concluding a treaty is to *change* the result that would obtain under either country's domestic law. Thus, the mere fact that either or both countries uses a formula for domestic purposes does not say anything about whether they intend that formula to be valid under the treaty — and similarly, the mere fact that one country knows the other uses a formula does not alone establish that the former knows the latter intends that formula to be valid under the treaty.

The government argued that the fact that both countries used formulas for domestic purposes under the 1945 U.K. treaty meant they intended that practice to continue under the new treaty, because the analogue to Article 7 in the 1945 treaty was substantially similar to the new Article 7. Regardless of domestic law, how-

[106]ALI Project, *supra* note 92, at 54.

[107]Hugh J. Ault, "The Role of the OECD Commentaries in the Interpretation of Tax Treaties," *in Essays on International Taxation* 61, 65 (Herbert H. Alpert & Kees van Raad, eds., 1993).

[108]*Id.*

[109]*Id.*

[110]*Id.*

[111]*See* U.S. treaties with China (Art. 7(3)), Indonesia (Art. 8(3)), Kazakstan (Art. 6(3)), South Africa (Art. 7(3)); Tunisia (Art. 7(3)), Ukraine (Art. 7(3), not yet in effect), Venezuela (Art. 7(3), not yet in effect). These treaties are based on the U.N. Model.

[112]*See* U.S. treaties with India (Art. 7(3)), Mexico (Art. 7(3)), Philippines (Art. 8(4)). The Technical Explanation to the U.S. treaty with Mexico states that the exception in Article 7(3) for bank interest "was not intended to override" reg. section 1.882-5. In light of the clear language of the provision, however, it seems unlikely that a court would respect Treasury's interpretation in the absence of additional evidence indicating that Mexican negotiators agreed with this position.

[113]Klaus Vogel, "Double Tax Treaties and Their Interpretation," 4 *Int'l Tax & Bus. Law.* 1, 39 (1986); Ault, *supra* note 107, at 65-66.

[114]Robert Thornton Smith, "Tax Treaty Interpretation by the Judiciary," 49 *Tax Law.* 845, 890 (1996)); *see Taisei Fire & Marine Ins. Co. v. Comr*, 104 T.C. 535 (1995) (referring to subsequently adopted Commentary in interpreting treaty).

[115]*See* OECD Commentary, 1995, Introduction, para. 3.

[116]Vogel, *supra* note 113, at 40-41.

[117]*Id.* at 41-42; *see* Rosenbloom, *supra* note 94, at section 31.04[2], p. 31-63.

[118]Gov't Brief at 12-21.

ever, it is not clear that either country imposed a formula on permanent establishments of the other under the 1945 treaty, or if it did, that such a practice was valid under that treaty.[119] Indeed, there is some suggestion (though it is not entirely clear) that U.K. courts held the U.K. formula to be inconsistent with the 1945 treaty.[120] In any event, domestic practice under the prior treaty does not necessarily bear on the intent of the treaty negotiators with regard to the *new* treaty.

Second, the fact that the countries jointly intended formulary methods to be permissible under the treaty, if that fact could be established, does not go to the legitimacy of the particular formula at issue here — reg. section 1.882-5 — which had not been promulgated at the time the treaty was concluded in 1975 (though it had by the time instruments of ratification were exchanged in 1980).

In the absence of additional evidence, contemporaneous domestic law and practice of the treaty countries at the time of negotiation seems a dubious basis from which to divine the intent of the parties.

In sum, in the absence of additional evidence, contemporaneous domestic law and practice of the treaty countries at the time of negotiation seems a dubious basis from which to divine the intent of the parties.

2. Unilateral expressions of U.S. position. There are various ways in which the IRS and Treasury can express a view regarding the meaning of a treaty provision and its consistency with a code provision or regulation. In the case of reg. section 1.882-5, these expressions have taken the following forms:

- In 1984 the OECD Committee on Fiscal Affairs issued a publication entitled *Transfer Pricing and Multinational Enterprises: Three Taxation Issues.* One of the reports included in that publication addressed the taxation of multinational banking enterprises. This "OECD Bank Tax Report" stated the view of the majority of OECD member countries that it is necessary under Article 7 to take interbranch payments of interest into account in ascertaining the arm's-lengths profits of a branch of a bank.[121] It also, however, reported that the United States (as well as Japan) *disagrees* with this interpretation. The report states that the United States is "of the view that the conclusions reached by the majority of OECD Members . . . go too far and in particular do not properly reflect the words or apparent intent of . . . the Commentaries to Article 7 of the OECD Model Convention."[122] Through the report, the United States expressed its view that reg. section 1.882-5 is consistent with Article 7 of the OECD Model.[123]
- In 1989 the Service issued Revenue Ruling 89-115, which addressed the validity of reg. section 1.882-5 under Article 7(3) of the U.K. treaty. The Service concluded that because the treaty does not provide a specific rule, U.S. domestic rules — specifically, reg. section 1.882-5 — apply in determining the interest expense deduction for a U.S. permanent establishment of a U.K. bank.[124] In Revenue Ruling 85-7 the Service had reached an identical conclusion under Article 8(3) of the United States-Japan treaty (which corresponds to Article 7(3) of the OECD Model).[125] In its brief in *NatWest*, the taxpayer argued that Revenue Ruling 85-7 has no bearing on the proper interpretation of the U.K. treaty, because Article 8(3) of the Japanese treaty permits deduction for expenses "reasonably connected with" the profits attributable to a permanent establishment, while Article 7(3) of the U.K. treaty, as described above, allows deduction of expenses "incurred for the purposes of" the permanent establishment, including a "reasonable allocation" of certain expenses. The Service, however, found the difference in language to be immaterial, holding that the "analysis of the appropriate method of allocating interest expense" is the same under both treaty provisions.[126]
- On March 5, 1996, Treasury issued a revised version of reg. section 1.882-5. The method for determining a foreign corporation's interest expense deduction under the new regulation is similar in most material respects to the "branch book/dollar pool" method set forth in the 1981 regulation at issue in *NatWest*. Unlike the old regulation, however, the new regulation provides explicitly that "the provisions of this section provide the exclusive rules for determining the interest expense attributable to the business profits of a permanent establishment under a U.S. income tax treaty."[127]
- In September 1996, Treasury issued a new U.S. Model Tax Treaty. Article 7(3) of the 1996 U.S. Model is identical to Article 7(3) of the U.K.

[119]In 1978, however, the Service did rule that the formulary allocation and apportionment method for interest expense that was then in effect, reg. section 1.861-8(e), was valid under the United States-Japan treaty and so applied to U.S. permanent establishments of Japanese persons. The 1945 U.K. treaty was technically still in effect at the time of that ruling, since the new U.K. treaty, though it had been concluded in 1975, was not yet ratified. *See* Rev. Rul. 78-423, 1978-2 C.B. 194.

[120]NatWest Brief at 30; Brief *Amicus Curiae* of the Government of the United Kingdom of Great Britain and Northern Ireland (filed 12/23/97) at 25.

[121]OECD Bank Tax Report, *supra* note 75, at paras. 47, 53.

[122]*Id.* para. 52.

[123]*Id.* paras. 54, 56, 57, 70(c).

[124]1989-2 C.B. 130.

[125]1985-1 C.B. 188. An earlier ruling had concluded that reg. section 1.861-8 (the predecessor to reg. section 1.882-5) was consistent with that treaty. Rev. Rul. 78-423, 1978-2 C.B. 194.

[126]1989-2 C.B. at 131.

[127]Reg. section 1.882-5(a)(2) (T.D. 8658, 3/5/96).

treaty. The Treasury technical explanation to Article 7(3) of the Model states that the provision "permits (but does not require) each Contracting State to apply the type of expense allocation rules provided by U.S. law (such as in Treas. Reg. sections 1.861-8 and 1.882-5)."

- The Treasury Technical Explanations of a number of treaties concluded since 1989 contain language similar to the Technical Explanation of the 1996 U.S. Model Treaty.[128] The Technical Explanation of a treaty is issued after a treaty is signed and is given to the Senate when the treaty is offered for its consideration. In "rare" cases, the Technical Explanation is actually sent to the negotiators for the other government.[129]

The U.K. treaty at issue in *NatWest* was concluded before any of these issuances, so the court was not required to reconcile them with its interpretation of Article 7 and the Commentary.[130] After *NatWest*, then, the effect of these unilateral expressions of the U.S. position remains undetermined.

In general, courts interpret treaties for themselves and are not bound by the interpretations proffered by others, but the meaning given them "by the departments of government particularly charged with their negotiation and enforcement," though not conclusive, generally is given "great weight."[131] Deference, however, "is not the same as blind acceptance," and courts have held that:

> There is no authority for the proposition that a court construing a treaty must follow the interpretations suggested by our government where that interpretation is unreasonable or runs contrary to what the court determines was the intent of the high contracting parties.[132]

The key here is the use of the plural-part*ies*. The judicial obligation is to "satisfy the intentions of *both* of the signatory parties,"[133] and it is the meaning attributed to a treaty provision by *both* government agencies charged with treaty negotiation and interpretation — not merely the U.S. government agency — that is entitled to some deference.[134] Complete deference to the IRS's interpretation would be inconsistent with the goal of effectuating the *shared* expectations of the parties.[135]

The issue, then, is not what the IRS says the language of Article 7(3) means, but what the parties actually *intended* it to mean. To what extent, if any, do the IRS pronouncements bear on this determination? Clearly, they have minimal relevance for treaties concluded before their issuance. For treaties concluded later, the IRS pronouncements suggest the intent of one party to the treaty — the United States. With the exception of Treasury Technical Explanations to a specific treaty, however, they are not conclusive even as to this, since they are not specific to any one treaty and therefore cannot reflect the *actual* negotiating histories and treaty provisions of a particular U.S. treaty.[136] Even specific Technical Explanations do not reflect the "official" U.S. intent with respect to the particular treaty, because they are not voted on by the Senate.[137]

Nonetheless, the pronouncements do reflect the "generic" U.S. view as to the meaning of Article 7. The question, then, is whether it can be assumed, without evidence, that U.S. treaty partners are aware of these pronouncements and consequently of the U.S. position. Do the pronouncements create an inference that, by accepting the language of Article 7 without modification, the other party to a U.S. treaty acquiesced to the U.S. interpretation of that language?

In *Xerox Corp. v. United States*, the government argued that the Treasury technical explanation to the U.K. treaty supported its interpretation of Article 23 of that treaty. The Claims Court found that the technical explanation accurately reflected U.S. intent, noting that the Senate had the technical explanation before it when considering the treaty, and the record "does not indicate any disagreement in the Senate" with the interpretation set forth therein. More significantly, the Claims Court placed great weight on the fact that copies of the technical explanation were (allegedly) sent to the U.K. negotiators. Despite the fact that "[k]nowledge of the U.S. interpretation . . . was clearly before the House of Commons during its own ratification debate," the U.K. ratified the convention in the form approved by the Senate "without further reservation or amendment." Thus, the court held, the U.K. had "tacitly" accepted the U.S. interpretation set forth in the technical explanation.[138]

[128]*See, e.g.*, Treasury Technical Explanations of Article 7 (or the equivalent business profits article) of U.S. treaties with Austria, France, Germany, Ireland, Mexico, the Netherlands, Portugal, Switzerland, Thailand, and Turkey.

[129]ALI Project, *supra* note 92, at 18.

[130]The court briefly addressed Revenue Ruling 89-115, but the relevance of the ruling to the issue at hand was unclear. The court merely stated that it "disagreed" with the conclusion reached in the ruling. 44 Fed. Cl. at 131.

[131]*Kolovrat v. Oregon*, 366 U.S. 187, 194 (1961); *see United States v. Stuart*, 489 U.S. 353, 369 (1989); *Sumitomo Shoji America, Inc. v. Avagliano*, 457 U.S. 176, 184-85 (1982); *Factor v. Laubenheimer*, 290 U.S. 276, 295 (1933).

[132]*Coplin v. United States*, 6 Cl. Ct. 115, 136 (1984), *rev'd on other grounds* 761 F.2d 688 (Fed. Cir. 1985), *aff'd* 479 U.S. 27 (1986); *see North West Life Assurance Co. v. Com'r*, 107 T.C. 363, 380 (1996).

[133]*Xerox Corp. v. United States*, 41 F.3d 647, 652, *Doc 94-10767 (24 pages), 94 TNT 238-20* (Fed. Cir. 1994) (emphasis added), *cert. denied* 516 U.S. 817 (1995).

[134]*See Sumitomo Shoji America, Inc. v. Avagliano*, 457 U.S. 176, 184-85 (1982); *Snap-on Tools, Inc. v. United States*, 26 Cl. Ct. 1045, 1071 (1992), *aff'd without published op.* 26 F.3d 137 (Fed Cir. 1994).

[135]Smith, *supra* note 114, at 888-89; see *North West Life*, 107 T.C. at 380.

[136]*See* NatWest Brief at 11 n.40.

[137]Smith, *supra* note 114, at 889 n.207; *see Snap-on Tools*, 26 Cl. Ct. at 1072 (no indication that the Senate was aware that the effect of ratifying the treaty would be to repeal a certain statutory rule). The Senate generally does, however, have the Technical Explanation before it when it considers a treaty.

[138]*Xerox Corp. v. United States*, 14 Cl. Ct. 455, 463-64 (1988), *rev'd* 41 F.3d 647 (Fed. Cir. 1994).

This holding was reversed on appeal.[139] The Federal Circuit did not comment on the general relevance of the technical explanation and did not reach the issue whether the lower court's presumption regarding U.K. acquiescence was justified, since it held that there was no evidence in the record supporting the government's claim that the technical explanation had been sent to the U.K. negotiators at all.[140] The appellate court emphasized, however, that a treaty must be construed "in accordance with the intent of *both* signatories," and concluded that the record before it was so "one-sided" that "it would violate any reasonable canon of construction to infer mutual assent by the signatories to the position taken by the Treasury."[141]

Even if it could be proved that the technical explanation had been sent to the U.K. negotiators, the conclusion of the Claims Court in Xerox simply went too far.

Indeed, even if it could be proved that the technical explanation had been sent to the U.K. negotiators, the conclusion of the Claims Court in *Xerox* simply went too far, for "[e]ven a conscientious negotiator cannot justly be charged with agreeing with everything that passes over his desk unless he makes a specific protest."[142] The Claims Court recognized this in a later case involving the same issue as *Xerox*, stating that "an understanding of a position which forms the basis of a negotiated international agreement cannot be arrived at 'tacitly,' but must be achieved consciously and deliberately by both parties."[143]

If courts are reluctant to infer a treaty partner's acquiescence from the technical explanation to the particular treaty at issue, it seems unlikely that they would be willing to make such an inference from non-treaty-specific government issuances, such as revenue rulings and the U.S. Model Treaty technical explanation, even if those issuances predated the treaty at issue.[144] Such reluctance to infer agreement from "mere passivity" seems justified.[145] As one commentator points out, "[a] court has no warrant to impose on the other Contracting State the burden of reviewing our unilateral . . . materials, just as presumably we would object if a United Kingdom court charged the United States with the burden of reviewing whatever materials the United Kingdom government prepared and published or sent us."[146] Courts must decide for themselves the best interpretation of a treaty provision, and in this determination unilateral U.S. materials should at best be "suggestive."[147]

This conclusion is especially logical when, as in the case of Article 7 and recognition of interbranch interest, the view expressed in the IRS pronouncement is at odds with the widely accepted interpretation of the OECD Model and Commentary. In such a situation it seems far more natural to presume that the *United States* is aware of the majority view and knows how most OECD member nations interpret Article 7. Consequently, the failure of the U.S. negotiators to insist on treaty language that clearly expresses their view or to otherwise ensure that the other country knows of and agrees to the U.S. interpretation, and the failure of the Senate to enter a reservation or amendment requiring a change in the treaty language,[148] should create an inference of *U.S.* acquiescence to the majority view, rather than vice versa. It seems reasonable to insist that deviation from the commonly accepted understanding of a treaty provision cannot be arrived at "tacitly," but must be "conscious and deliberate."

3. Evidence of bilateral intent. The above analysis suggests that it would be erroneous to infer acceptance by a treaty partner of the U.S. view that reg. section 1.882-5 is consistent with Article 7 from the mere fact that the treaty was concluded after the IRS and Treasury publicly announced their view.[149] This conclusion assumes that there is no evidence that the other party actually intended to agree to the U.S. position. In the absence of such evidence, it is reasonable to presume that by adopting language derived from Article 7 of the OECD Model, the parties intended to adhere to the more widely held interpretation of that provision.

The most effective way to overcome this presumption, of course, is to use different language that clearly expresses a different intent. For example, in a number of U.S. treaties, Article 7(3) states explicitly that interbranch payments of interest, royalties, and similar payments are to be disregarded. The argument raised by

[139]41 F.3d 647 (Fed. Cir. 1994).

[140]*Id.* at 656.

[141]*Id.* The Federal Circuit also noted that the Treasury's position "was not embraced by the Senate." *Id.* at 655-56.

[142]ALI Project, *supra* note 92, at 36.

[143]*Snap-on Tools*, 26 Cl. Ct. at 1073.

[144]On a number of occasions courts have explicitly declined to rely on revenue rulings and revenue procedures issued *subsequent* to the treaty at issue. *NatWest*, of course, is one example. As another example, in *Snap-on Tools* the Claims Court held that the relevant revenue procedure, which was issued on the date the U.K. treaty took effect (i.e., after its ratification), "simply announces the IRS position on the issue; it lacks binding precedential value on this court." 26 Cl. Ct. at 1070. Addressing the same issue, the Federal Circuit in *Xerox* stated that a revenue procedure "can not change the terms and purpose of a treaty." 41 F.3d at 657.

[145]*See* ALI Project, *supra* note 92, at 36.

[146]Smith, *supra* note 114, at 889 n.206.

[147]*Id.* at 889.

[148]In "advising and consenting" to a treaty, the Senate has a number of options available to it. It can condition ratification on an amendment or issue a reservation, both of which indicate a change in the obligations imposed by a treaty and both of which require the other country to agree. Alternatively, it can issue an "understanding" or "interpretation," which is intended merely to clarify or explain rather than to substantively affect treaty obligations. *See* Staff Memorandum to the Senate Foreign Relations Comm., 95th Cong., 1st Sess, *The Role of the Senate in Treaty Ratification* (Comm. Print 1977).

[149]*See* Smith, *supra* note 114, at 889 n.206.

the taxpayer in *NatWest* would be foreclosed under these treaties.

Though altering treaty language may be the best way to overcome a presumption as to its meaning, it surely is not the only way. Each treaty must be analyzed on its own facts, and if two countries clearly agree that the language of the OECD Model should have a different meaning for purposes of their treaty, that intent should be respected, and the agreed-on meaning should prevail. The issue in every case is determining whether *both* signatories intended and expected the language to have the alternative meaning.

An explicit agreement by the negotiators of both countries regarding the meaning of specific treaty language, concluded in the course of negotiations and made public in an "officially recognized form" (such as an exchange of notes or memorandum of understanding), is the best way (other than modifying the treaty language itself) to establish common intent.[150] Even unilateral materials may be sufficient to establish such intent, however, if it can be proved that the other party actually agreed with the U.S. position.[151] For example, though nothing should be presumed from the fact that the Treasury Technical Explanation to a treaty was sent to the other country's negotiators, it may be appropriate to infer the other country's acceptance of the U.S. position when there is evidence that the other country accepted the Technical Explanation as an accurate reflection of the agreement actually reached by the two countries.[152] The Canadian Department of Finance, for example, has generally accepted the technical explanation to the United States-Canada treaty,[153] and the technical explanation thus should be treated as highly persuasive evidence of the parties' joint intent.

What if it can be established that the other country was *aware* of the U.S. position with respect to the particular treaty language at issue, but not that it *agreed* with such language? If there was evidence showing definitively that the other country was in fact aware of the U.S. position during the treaty negotiations, a presumption of acquiescence might be justified. It seems likely, however, that such definitive evidence would also establish whether or not the other country agreed with the U.S. position. Evidence establishing "awareness" but not agreement or disagreement is probably uncommon, and a presumption of awareness should not be sufficient.

In *United States v. Alvarez-Machain*, the Supreme Court analyzed whether the extradition treaty between the United States and Mexico negated the jurisdiction of U.S. courts to try a Mexican criminal defendant abducted from Mexico to the United States.[154] A much earlier case, *Ker v. Illinois*, had answered this question in the negative under the Peruvian treaty. In holding for the government in *Alvarez-Machain*, the Court noted that in 1905, the Mexican Charge (an official in the Mexican government) had written to the Secretary of State protesting the trial of an abducted citizen, and the Secretary had responded that this result had been decided by *Ker* and that Mexico's remedy was to request extradition of the abductor. According to the Court, this evidence established that the Mexican government was aware of the so-called *Ker* doctrine at the time the Mexican extradition treaty at issue was concluded in 1978. Yet despite this knowledge, the 1978 treaty contained no language curtailing the effect of *Ker*, supporting the government's argument that neither Mexico nor the United States intended it to do so.[155]

NatWest serves up a feast of difficult and interesting issues, but answers relatively few of them.

The Court held that the exchange of letters without a subsequent change in treaty language was sufficient to create a presumption that Mexico acquiesced to the U.S. position on the abduction issue. This reasoning is not entirely persuasive. For one thing, the exchange of letters occurred in 1905, while the extradition treaty was negotiated in 1978. It does not seem particularly appropriate to infer that the Mexican treaty negotiators were aware of the position of the U.S. negotiators in 1978 from the fact that, more than 70 years before, the Secretary of State had informed the Mexican Charge of the U.S. position at that time. There was no evidence that the treaty negotiators were in fact aware of the *Ker* doctrine in 1978. In any event, as discussed above, it is not clear that it is appropriate *ever* to infer acquiescence from non-action.

* * * * *

NatWest serves up a feast of difficult and interesting issues, but answers relatively few of them. On the basic legal issue — the validity of reg. section 1.882-5 in light of the U.K. treaty — the court reached what is probably the more correct, even if not indisputable, conclusion. But the ultimate implications of the decision for particular taxpayers remain unclear. Contrary to the hy-

[150]*See* ALI Project, *supra* note 92, at 47. Unofficial materials, such as notes taken by treaty negotiators for one country, may indicate that that negotiator thought the other country agreed. They do not, however, establish whether the other country did in fact intend to agree, only that the particular negotiator believed that it did. It appears that the taxpayer and the government attempted in *NatWest* to introduce this type of evidence. The court refused to consider it, for reasons that are unclear from the publicly available briefs, but possibly because of the inherent unreliability of such materials. *See* Gov't Brief at 15.

[151]ALI Project, *supra* note 92, at 48-49.

[152]*See id.* at 36 ("If a treaty partner expressly agrees with a U.S. Technical Explanation, this should represent an agreement of the contracting parties which is to be given effect.").

[153]*See* Canadian Department of Finance, Rel. No. 81-16 (Feb. 4, 1981) (cited in Rosenbloom, *supra* note 94, section 31.01 at p. 31-8 & n.27; ALI Project, *supra* note 92, at 19; and *North West Life*, 107 T.C. at 385).

[154]504 U.S. 668 (1992).

[155]*Id.* at 665-66 & n.11.

perbolic claims of at least one seemingly reputable news publication, the court did *not* order a refund of $180 million in U.S. taxes.[156] It addressed only the limited legal issue whether reg. section 1.882-5 is consistent with the U.K. treaty. The court concluded that it is not — but has not yet determined the interest expense deduction to which *NatWest* is entitled under the treaty. Much will depend on how this determination is made — and it may not be made at all if the case is settled.

Assuming the case is not settled, and assuming the legal issue is upheld (either on an interlocutory appeal to the Federal Circuit or on a regular appeal after the remainder of the issues in the case are decided by the Court of Claims), foreign banks will have to ask themselves a number of questions in charting their course. Probably most important is whether the provisions or history of their particular treaty establish that formulary methods such as reg. section 1.882-5 were mutually intended to be valid under Article 7 or the equivalent. If not, each corporation must then examine its own particular facts in light of the Court of Federal Claims' capital adequacy determination to assess whether a treaty-based method would produce a better result than reg. section 1.882-5 for any years that remain open. This assessment can be made on a year-by-year basis, since taxpayers can choose each year, without constraint, whether to determine their attributable (or effectively connected) income under a treaty or the code.[157]

[156] *Financial Times*, July 8, 1999.

[157] *See* Rev. Rul. 80-147, 1980-1 C.B. 168; Rev. Rul. 84-17, 1984-1 C.B. 308.

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