

AFTER *NATWEST*: HOW COURTS SHOULD HANDLE OECD COMMENTARY IN DOUBLE TAXATION TREATY INTERPRETATIONS

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Rufus T. Firefly: Awfully decent of you to drop in today. Do you realize our army is facing disastrous defeat? What do you intend to do about it?

Chicolini: I've done it already.

Rufus T. Firefly: You've done what?

Chicolini: I've changed to the other side.

Rufus T. Firefly: So you're on the other side, eh? Well, what are you doing over here?

Chicolini: Well, the food is better over here.†

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† *DUCK SOUP* (Paramount Pictures 1933).

INTRODUCTION

National Westminster Bank, PLC (NatWest), a British bank that once had six U.S. branches, sought to dramatically decrease its tax burden within the United States between 1981 and 1987. The reason was obvious: although the U.S. market is very lucrative, hosting a large number of foreign bank branches and subsidiaries, the U.S. corporate tax rates for foreign corporations are very high compared to those of other countries.¹ For a period of eight years, NatWest shifted much of its U.S. branches' profits as "loan repayments" to its branches in Hong Kong, which had a significantly lower tax rate, thus decreasing its taxable income on the U.S. branches' books through interest deductions.² The Internal Revenue Service (IRS) uses these books to determine what amount of capital the branch utilized in connection with its operations, which it then uses to assess that branch's annual tax debt.³ When the IRS discovered that NatWest's U.S. branches were "borrowing" money from NatWest's Hong Kong branches and the U.K. home office, while taking an interest expense deduction for on-the-book interest "payments,"⁴ it ordered NatWest to pay taxes of over \$65 million.⁵ This disparity arose from NatWest's calculation of its interest expense, which the IRS disputed.⁶ After recalculating, the IRS found NatWest had an additional \$155 million in taxable income for the years 1981 to 1987.⁷ When the United Kingdom then offered NatWest only a partial foreign tax credit to cover a portion of the assessed debt, NatWest instead opted to pay the additional taxes and sue the IRS to recover the full amount of the IRS reassessment.⁸ After numerous suits and a final appeal to the Federal Circuit, NatWest received its tax refund.⁹

¹ The U.S. corporate tax rate is on a sliding scale, but for the largest corporations, it can reach 35%. See John D. McKinnon, *No Holiday on Tax Day*, WALL ST. J. BLOG (Apr. 18, 2011, 6:47 PM), <http://blogs.wsj.com/washwire/2011/04/18/no-holiday-on-tax-day> (noting that the U.S. corporate tax rate, which can reach 35%, is "among the world's highest"). By comparison, the corporate tax rate in Hong Kong is currently 16.5%. See INLAND REVENUE DEP'T, GOV'T OF THE H.K. SPECIAL ADMIN. REGION, A BRIEF GUIDE TO TAXES ADMINISTERED BY THE INLAND REVENUE DEPARTMENT 2010-2011, at 1-2 (2010) [hereinafter INLAND REVENUE DEP'T TAX GUIDE], available at http://www.ird.gov.hk/eng/pdf/tax_guide_e.pdf.

² See David Cay Johnston, *British Bank Wins Dispute with the I.R.S.*, N.Y. TIMES, July 9, 1999, at C1.

³ See Treas. Reg. § 1.882-5(d) (as amended in 2010).

⁴ Johnston, *supra* note 2; see also Nat'l Westminster Bank, PLC v. United States (*NatWest I*), 44 Fed. Cl. 120, 121-22 (1999) (referring to NatWest's intracorporate loans and payments in quotations).

⁵ See Nat'l Westminster Bank, PLC v. United States (*NatWest IV*), 512 F.3d 1347, 1349 (Fed. Cir. 2008).

⁶ *Id.*

⁷ *Id.* at 1349-50.

⁸ *Id.* at 1350. Countries often give tax credits to domestic taxpayers with international operations as a means to offset any double taxation. See I.R.C. § 904 (2006); see also *id.* § 1(h)(11)(C) (placing a limitation on foreign tax credit for dividends taxed as net capital gain). Each country determines what

The courts that presided over these suits all relied on the Organization for Economic Co-operation and Development (OECD) reports and guides available in 1975, when the United Kingdom and the United States signed their treaty on double taxation.¹⁰ The courts refused to give anything more than “minimal deference” to official OECD commentary available after that date.¹¹ But if courts intend to use these guides and reports as persuasive authority, they should look to subsequent reports and guides that address issues that could not have been foreseen at the time of ratification and give those materials a level of deference similar that given to materials available at the time of ratification. This was where *NatWest* courts went wrong: if they had looked to recent OECD commentary, they would have seen that the OECD addressed the issue in favor of the IRS’s interpretation.

When banks create permanent establishments (PEs) like branches or subsidiaries within other countries, they sculpt their tax planning according to the terms provided in a treaty between their home country and the country of establishment. These treaties aim to prevent the double taxation of the income of a single company.¹² Double taxation takes place when two countries, specifically a party’s home country and another country, tax the same income. Although some scholars maintain that the fear of double taxation is unfounded,¹³ avoiding it has nonetheless become a core purpose of tax legislation. Such concerns motivated the OECD to create a model convention for the avoidance of double taxation (Model Treaty).¹⁴ The OECD

international income taxes it will offset, *see, e.g.*, § 882(c)(3) (providing where limitations exist on foreign tax credits in the United States), and as in the case of *NatWest*, the amount offset does not often equal a total offset of international income taxes. *See NatWest IV*, 512 F.3d at 1350 (discussing how *NatWest* concluded it would be liable for \$37 million in tax liability without a corresponding tax credit in the United Kingdom).

⁹ *NatWest IV*, 512 F.3d at 1351–52.

¹⁰ Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, U.S.–U.K., Dec. 31, 1975, 31 U.S.T. 5668 [hereinafter U.S.–U.K. Treaty]. This Comment will not discuss the court’s failure to differentiate between the date that a treaty is signed and the date that the treaty is actually ratified. However, this distinction is important, since a signed treaty can have no effect until the Senate ratifies it, *see* U.S. CONST. art. II, § 2, cl. 2, and thus any reports or commentary available before it is ratified could arguably influence the language of the treaty.

¹¹ *NatWest IV*, 512 F.3d at 1358–59.

¹² For example, the treaty at issue in the *NatWest* litigation between the United States and the United Kingdom provides in its preamble that it is meant to avoid double taxation and prevent fiscal evasion of taxes. U.S.–U.K. Treaty, *supra* note 10, at pmb1.

¹³ *See, e.g.*, Herwig J. Schlunk, *How I Learned to Stop Worrying and Love Double Taxation*, 79 NOTRE DAME L. REV. 127, 150–56 (2003) (showing that a double income tax regime can be equivalent to a single nation’s income tax regime).

¹⁴ The Model Treaty is itself called the Draft Double Taxation Convention on Income and Capital. DRAFT DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL (Org. for Econ. Co-operation & Dev. 1963) (updated 2010) [hereinafter MODEL TREATY], in ORG. FOR ECON. CO-OPERATION & DEV., REPORT OF THE OECD FISCAL COMMITTEE (1963) [hereinafter MODEL TREATY REPORT].

frequently updates the Model Treaty language,¹⁵ and it also releases reports, guides, and commentary that address potential conflicts that countries face when interpreting the language of the Model Treaty.¹⁶ A number of countries adopted the language of the Model Treaty, in whole or in part, when ratifying and adopting their own treaties to prevent double taxation.¹⁷ These include the United States and the United Kingdom, who based their double taxation treaty on the Model Treaty language.¹⁸

The U.S. tax system has responded to the idea of the time value of money: taxpayers want to pay as little tax as possible now (if ever), and the government wants as much tax as possible paid now rather than later.¹⁹ Corporate entities share this motivation. Obviously, NatWest hoped to pay as little tax as possible, and it hoped to do so by circumventing the system put in place by the IRS. When its actions were challenged, NatWest sought protection from the courts and received it.

The Federal Circuit upheld NatWest's actions as consistent with the United States–United Kingdom Treaty on the Prevention of Double Taxation (U.S.–U.K. Treaty),²⁰ affirming three lower court decisions that spanned a ten-year period. In the first decision, *NatWest I*,²¹ the Court of Federal Claims determined that the Treasury regulation the IRS applied to calculate NatWest's attributed profits²² violated the U.S.–U.K. Treaty.²³ Four years later, in *NatWest II*, the court analyzed a new calculation the IRS proposed to tax the bank.²⁴ But it found that this calculation also violated the U.S.–U.K. Treaty.²⁵ The Federal Circuit affirmed these decisions, as

¹⁵ Its most recent update took place in July 2010. See *OECD Approves Updates to Model Tax Convention, Transfer Pricing Guidelines and Report on Attribution of Profits to Permanent Establishments*, ORG. FOR ECON. CO-OPERATION & DEV. (July 22, 2010), http://www.oecd.org/document/20/0,3343,en_2649_37989746_45689428_1_1_1_1,00.html.

¹⁶ See, e.g., ORG. FOR ECON. CO-OPERATION & DEV., 2010 REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS (2010).

¹⁷ Many U.S. tax treaties with other countries include language practically identical to that of the Model Treaty. Compare *United States Income Tax Treaties—A to Z*, IRS, <http://www.irs.gov/businesses/international/article/0,,id=96739,00.html> (last updated Aug. 10, 2011), with MODEL TREATY, *supra* note 14 (containing similar structure and language).

¹⁸ *NatWest IV*, 512 F.3d 1347, 1353 (Fed. Cir. 2008) (“The ‘entire context’ of the 1975 Treaty is informed by, and is based on, the Office of Economic Cooperation and Development’s (‘OECD’) 1963 Draft Double Taxation Convention on Income and Capital . . .”).

¹⁹ See, e.g., Stephen B. Land, *Contingent Payments and the Time Value of Money*, 40 TAX LAW. 237, 237 (1987) (“Present value concepts invaded the federal income tax law in the early Eighties, when both practitioners and policymakers recognized the importance of the time value of money in determining tax burdens.”).

²⁰ *NatWest IV*, 512 F.3d at 1349.

²¹ *NatWest I*, 44 Fed. Cl. 120 (1999).

²² Treas. Reg. § 1.882-5 (1980). The Treasury regulation determined the allocable amount of profits to each branch of a foreign bank. See *infra* Part I.D for a full explanation of this regulation.

²³ *NatWest I*, 44 Fed. Cl. at 121.

²⁴ *Nat'l Westminster Bank, PLC v. United States (NatWest II)*, 58 Fed. Cl. 491, 492 (2003).

²⁵ *Id.* at 497–99.

well as that in *NatWest III*, but the issue in that case—including whether NatWest could treat its six U.S. branches as one PE for tax purposes²⁶—is outside the scope of this Comment and will not be discussed in detail.

In both *NatWest I* and *NatWest II*, the court relied on OECD commentary to give meaning to the ambiguous treaty language on the proper way to attribute profits to PEs. Yet their construction relied on the commentary and guidance available to both the United States and the United Kingdom at the time of ratification.²⁷ Although this might initially appear to be a reasonable interpretive strategy—focusing as it does on the ratifying parties’ expectations at the time of entering into the treaty²⁸—it fails to take into account situations that neither party could anticipate at the time of ratification and whether future commentary was within their expectations. The *NatWest I* court explained that the OECD drafters intended the commentary to be used in determining the mutual understanding of countries that created tax treaties based on the Model Treaty,²⁹ referring to the Model Treaty’s “detailed Commentaries designed to illustrate or interpret each Article.”³⁰ The *NatWest I* court did not explain why this language should limit commentary discussion to only the texts available at the time of ratification—probably because the Model Treaty does not include such limiting language.

The key to understanding the courts’ error is in the operation of the OECD Model Treaty. Since the inception of the Model Treaty, the OECD has issued commentary, reports, guides, and other tools to reach an understanding of the treaty language and to resolve conflicts as they arise.³¹ This Comment does not argue that courts should actually rely on OECD commentary even if such reliance was the intention of the Model Treaty’s drafters. Rather, it argues that if courts choose to rely on external sources like commentary to solve issues with respect to the language of the Model Tre-

²⁶ *NatWest I*, *Westminster Bank, PLC v. United States (NatWest III)*, 69 Fed. Cl. 128, 140–41 (2005), *aff’d*, 512 F.3d 1347, 1349 (Fed. Cir. 2008).

²⁷ *NatWest II*, 58 Fed. Cl. at 496–503 (accepting earlier OECD commentary and rejecting later OECD commentary, after a brief discussion, as “not reflect[ive of] the understanding of the 1975 Treaty partners”); *NatWest I*, 44 Fed. Cl. at 125 (“The initial explanatory material of the OECD Document and the Commentaries . . . are important and helpful in determining the probable mutual understanding of countries which used the Document as the basis for a tax treaty.”).

²⁸ *See NatWest II*, 58 Fed. Cl. at 503 (“[W]hile the 2003 Discussion Draft shows the continued thinking of the OECD on attributing capital to branches and its post-1995 evolving views on arm’s length principles, the 2003 Discussion Draft does not reflect the understanding of the 1975 Treaty partners, and is, thus, ultimately irrelevant to the court’s conclusion.”).

²⁹ *NatWest I*, 44 Fed. Cl. at 125.

³⁰ *Id.* at 125 n.6 (emphasis omitted).

³¹ The OECD issued new reports on the attribution of profits to permanent establishments in 2008 and 2010 along with new Model Treaty language for Article 7. *See Profits of Permanent Establishments: News & Events*, ORG. FOR ECON. CO-OPERATION & DEV., http://www.oecd.org/newsEvents/0,3382,en_2649_37989746_1_1_1_1_1,00.html (last visited Nov. 13, 2011).

ty and its successor ratified treaties, they should look at more than just the commentary available at the time of a treaty's ratification.

The *NatWest* courts left the IRS in a tough position. The U.S.–U.K. Treaty has since been altered to reflect changes in thinking about the attribution of profits to PEs.³² Yet potential issues unaddressed at the time of a treaty's ratification could very likely arise—in fact, we know they do arise because otherwise there would be no need for subsequent OECD commentary. Courts inevitably face situations in which they must decide whether to reach opposite decisions on the same treaty language because differing commentary existed at the differing times of ratification. This Comment proposes a method for dealing with treaties based on the OECD Model Treaty: as a matter of consistency, the IRS and any courts interpreting IRS determinations should look to the entirety of the OECD commentary rather than treating the Model Treaty as a static concept at the time two countries adopt its language in their own double taxation treaty.

Part I discusses the role of foreign banks in the United States and how they are taxed. Part II analyzes the *NatWest* litigation, including the lower court decisions and the appellate court affirmation of those decisions. Part III focuses on the role of the OECD material in litigation. Part IV proposes a new way for courts to use OECD commentary when interpreting double taxation treaties. Applying this method, Part IV concludes that the corporate yardstick method would be the best means of assessing a PE's taxable income.

I. BACKGROUND

A. Foreign Banks in the United States

Foreign banks maintain a substantial presence in the United States. Total banking assets in the United States of foreign-related banking institutions exceed \$1.98 trillion, and total nonbanking assets are approximately \$2.58 trillion.³³ Foreign banks have numerous reasons to enter the U.S. market, from a desire to provide financial services to corporate clients that have expanded into the United States to the simple fact that the United States is “a significant force in international trade,” and thus many international transactions are denominated in U.S. dollars.³⁴ There are several ways banks can enter the U.S. marketplace. This Comment focuses on two: the branch and subsidiary forms.

³² See Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.–U.K., July 24, 2001, T.I.A.S. No. 13,161 [hereinafter 2001 U.S.–U.K. Treaty].

³³ RICHARD SCOTT CARNELL, JONATHAN R. MACEY & GEOFFREY P. MILLER, *THE LAW OF BANKING AND FINANCIAL INSTITUTIONS* 740 (4th ed. 2009).

³⁴ RAJ K. BHALA, *FOREIGN BANK REGULATION AFTER BCCI* 25 (1994).

I. Differences Between Branch and Subsidiary Form.—Under the International Banking Act of 1978 (IBA), Congress attempted to regulate PEs of foreign banks.³⁵ The IBA permitted foreign banks to create a PE in a number of ways, including via a branch or subsidiary.³⁶

The term “branch” is defined as “any office or any place of business . . . at which deposits are received.”³⁷ Branches have broad authority to conduct many types of banking business, such as making loans, issuing letters of credit, and brokering securities.³⁸ The IBA prescribes a pledge of assets as a minimum requirement to open a branch in the United States,³⁹ and it sets five percent of liabilities as a default.⁴⁰ But a branch is not separately capitalized, and it has “no assets that are independent of the foreign bank parent.”⁴¹ In other words, the bank’s home office must pledge a certain amount of assets, but the branch form does not require that the U.S. branch itself maintain any of this capital; instead, the capital can remain with the home office. This gives banks the ability to maintain their bank in the United States without needing to maintain large amounts of capital in that branch. Attempting to make the U.S. banking market a leveler playing field,⁴² the IBA provided foreign-related banks a regulated method of opening U.S. branches, which put them in roughly equal competitive positions with domestic bank branches.⁴³

A foreign bank can also create a bank in the form of a subsidiary. Subsidiaries are similar to branches, except they are independently capitalized and incorporated under state law.⁴⁴ There are two ways that a foreign bank can establish a subsidiary: it can acquire an existing U.S. bank, or it can form a new subsidiary bank de novo.⁴⁵ Subsidiaries are separately capitalized and subject to state and federal regulations.⁴⁶

³⁵ 12 U.S.C. §§ 3101–3111 (2006).

³⁶ CARL FELSENFELD, *INTERNATIONAL BANKING REGULATION* 20–21 (2d ed. 2007); *see* § 3101(3), (7).

³⁷ § 3101(3).

³⁸ FELSENFELD, *supra* note 36, at 21.

³⁹ § 3102(g)(1).

⁴⁰ *Id.* § 3102(g)(2).

⁴¹ BHALA, *supra* note 34, at 28.

⁴² *See* H.R. REP. NO. 95-910, at 5 (1978) (“The second objective [of the IBA] is to provide to the extent possible or appropriate equal treatment for foreign and domestic banks operating in the United States.”).

⁴³ Edward L. Symons, Jr., *The United States Context*, in *INTERNATIONAL BANKING REGULATION AND SUPERVISION: CHANGE AND TRANSFORMATION IN THE 1990S*, at 3, 13–14 (J.J. Norton et al. eds., 1994).

⁴⁴ BHALA, *supra* note 34, at 27.

⁴⁵ *Id.*

⁴⁶ *Id.*

Historically, most foreign banks in the United States have chosen to operate in branch form rather than through a subsidiary.⁴⁷ The branch form presents certain tax-related and non-tax-related advantages over the subsidiary form. The branch form prevents the branch from being subject to any federal or state lending limitations because the branch's capital is still under the control of the head office.⁴⁸ A U.S. subsidiary of a foreign bank, on the other hand, "must be newly capitalized at the time of its formation."⁴⁹ Further, when a subsidiary repays its home office for any capitalization provided, the return payment in the form of interest or dividends may be subject to taxation that is not offset with any tax credits from the home country.⁵⁰ Finally, foreign bank branches are not required to obtain federal deposit insurance so long as they restrict their deposit operations to foreign activities and do not accept deposits of below \$100,000.⁵¹

2. *Double Taxation Treaties and Bank Branches.*—Double taxation treaties seek to eliminate a potential circular transaction: First, a foreign bank with a U.S. branch is subject to income tax in its home country on its entire worldwide income. Then, the foreign bank is subject to income tax in the United States for its branch. Finally, the foreign bank's home country provides it with tax credits to offset the amount paid to the United States. Such circular transactions can often occur in the banking context, especially with deductions for interest expenses. Countries implement double taxation treaties in their tax policies to minimize this type of transaction.

There are, generally speaking, two regimes under which the IRS can tax the income of foreign banks in the United States. The IRS first determines whether the income is actually connected to the U.S. branch. If so, the IRS taxes that income as it would any income of a domestic corporation.⁵² When the IRS determines the income is not sufficiently connected to the activities of the U.S. branch, it then seeks to determine the source of the income.⁵³ Unconnected income consisting of interest yields a thirty percent tax rate—although double taxation treaties almost always preempt this.⁵⁴

⁴⁷ Alfred C. Groff & James F. Hoch, *Selected Issues in U.S. Taxation of U.S. Branches of Foreign Banks*, 1988 U. ILL. L. REV. 343, 343. Because the SEC rules do not apply to branches and because branches are themselves merely an "extension" of the head office, the head office will be responsible for any monetary issues that arise. A subsidiary is a separately incorporated institution within the United States, though, so its funds are distinct from its head office's.

⁴⁸ *Id.* at 344.

⁴⁹ *Id.*

⁵⁰ *Id.*

⁵¹ CARNELL, MACEY & MILLER, *supra* note 33, at 742.

⁵² Groff & Hoch, *supra* note 47, at 344–47.

⁵³ *Id.*

⁵⁴ *See id.* The United States has such treaties with, for example, the Netherlands, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.–Neth., Dec. 18, 1992, S. TREATY DOC. NO. 103-6; Austria, Convention for the Avoidance

Most treaties explicitly provide that interest in the parent–branch context is not subject to taxation in the foreign country. If, for example, two countries each have a bank that has one foreign branch in the other country, their treaty would provide that interest on loans between the branch and parent is nontaxable. Otherwise, each of the banks would pay tax on the interest and then would receive compensation from their home country in the form of a foreign tax credit. The end result would be the governments of each country collecting the same (or, at least, a similar) amount of tax and then giving out that same amount of money to the bank in the form of a foreign tax credit.

Double taxation treaties do not always cover the entirety of interest expense. Where they do not, a branch has an incentive to treat the income as effectively connected. Foreign banks operating in the United States can deduct this additional interest expense from their effectively connected income—in other words, from their taxable income.⁵⁵ So when a double taxation treaty does not deflect all taxes on a branch’s interest expense, the branch would desire it to be effectively connected—and thus deductible on another front.

B. The OECD

When the United States and the United Kingdom entered into a treaty for the avoidance of double taxation, both parties relied on the Model Treaty Convention of the OECD. The OECD⁵⁶ formed in 1961 to help its member countries achieve sustainable economic growth.⁵⁷ Thirty countries are member nations of the OECD, including both the United States and the United Kingdom.⁵⁸ Although the OECD lacks formal lawmaking powers, it does issue reports, recommendations, and analyses on which member nations may rely when determining international monetary policy.⁵⁹ This commentary was intended to “be of great assistance in the application of the Conventions and, in particular, in the settlement of eventual disputes.”⁶⁰

of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.–Austria, May 31, 1996, S. TREATY DOC. NO. 104-31; and the United Kingdom, 2001 U.S.–U.K. Treaty, *supra* note 32.

⁵⁵ Groff & Hoch, *supra* note 47, at 346.

⁵⁶ A number of terms used by the OECD, including the term “Organization” in its name, are spelled in British English with an “s” instead of a “z.” Due to the *NatWest* courts’ reliance on the “z” spelling of these terms, this Comment will employ all of the “z” spellings.

⁵⁷ See *History*, ORG. FOR ECON. CO-OPERATION & DEV., http://www.oecd.org/pages/0,3417,en_36734052_36761863_1_1_1_1_1,00.html (last visited Nov. 15, 2011).

⁵⁸ For a complete list of all member nations and partner nations of the OECD, see *Members and Partners*, ORG. FOR ECON. CO-OPERATION & DEV., http://www.oecd.org/pages/0,3417,en_36734052_36761800_1_1_1_1_1,00.html (last visited Nov. 15, 2011).

⁵⁹ FELSENFELD, *supra* note 36, at 272.

⁶⁰ MODEL TREATY REPORT, *supra* note 14, at 18.

The prospect of double taxation is a major concern for the OECD because it has the potential to stifle global expansion and burden member countries.⁶¹ Double taxation of the combined economic profits of related corporations can occur “whenever countries use different allocation methods or use the same method but produce different transfer prices or different profits allocable to the corporations.”⁶² Such concerns gave rise to international efforts to develop a common allocation norm.⁶³

In 1963, the OECD developed the Model Treaty.⁶⁴ Its drafters attempted to guide member nations on how to format treaties between each other both to ensure that each country received its due taxes and to prevent

⁶¹ See Michael J. Graetz & Alvin C. Warren, Jr., *Integration of Corporate and Individual Income Taxes: An Introduction*, 84 TAX NOTES 1767, 1767–69 (1999) (discussing the American corporate “double” taxation system and its potential to stifle growth within the United States).

⁶² Brian D. Lepard, *Is the United States Obligated to Drive on the Right? A Multidisciplinary Inquiry into the Normative Authority of Contemporary International Law Using the Arm’s Length Standard as a Case Study*, 10 DUKE J. COMP. & INT’L L. 43, 52 (1999). The IRS relies on two methods to determine interest expense: formulary apportionment and separate accounting. When countries differ in their method of accounting, it can result in large tax windfalls or steep tax burdens for different international companies, depending on the countries in which they operate PEs.

The separate accounting method treats the parent and the PE as operating completely separate businesses in completely different settings. For example, imagine a Japanese car manufacturer with a PE located in Bulgaria, where corporate tax is very low. Now imagine that the car manufacturer produces a car for \$5000 in Japan with a retail price of \$25,000 in foreign markets. Under the separate accounting principle, the Japanese parent has an incentive to sell each car to its foreign PEs for as close to \$5000 as possible, leaving little taxable profit in the Japanese parent and shifting most of the profit to the Bulgarian PE, where it will be taxed at the country’s low tax rate.

The formulary apportionment method treats the parent and PE as operating a single business of manufacturing and selling cars. Their combined income per car would be \$20,000 (retail price less manufacturing costs). Now assume that the formula takes into account only payroll. If the Japanese parent and Bulgarian PE have payrolls of \$900,000 and \$100,000, respectively, then 90% ($\$900,000 \div \$1,000,000$) of the combined income of \$20,000 per car (that is, \$18,000) would be allocated to the Japanese parent. The remaining 10% of combined income (\$2000) would be allocated to the Bulgarian PE for taxation purposes.

From these examples, it becomes clear why two countries with opposite accounting methods could create both positive and negative consequences for different multinational companies. Consider, for example, that the Japanese parent sells cars to its Bulgaria PE for \$5,000. If Japan’s government then decides to apply a formulary apportionment method and Bulgaria’s government sticks with the separate accounting method, the result would be \$18,000 of double taxation. Japan’s formulary apportionment method would attribute \$18,000 of that car’s profits to the Japanese parent, and Bulgaria would tax the PE to the tune of \$20,000 for its separate allocation. The result is tax on \$38,000 despite an actual profit of only \$20,000.

If Japan were to apply a separate accounting method and Bulgaria a formulary apportionment method, the opposite would happen: a tax windfall to the car manufacturer. The Japanese parent would have no taxable profit (because it sold the car for the \$5000 it cost to manufacture), and the Bulgarian PE would have \$2000 of taxable income (its apportioned profit in the above example) taxed at Bulgaria’s far lower corporate rate.

These examples are adapted from several examples in Treas. Reg. § 1.882-5(d)(6) (as amended in 1996).

⁶³ Lepard, *supra* note 62, at 52.

⁶⁴ MODEL TREATY, *supra* note 14.

double taxation of multinational corporations.⁶⁵ As noted above, if every country maintained the same accounting method and operated under the same treaty, there would theoretically be no opportunity for double taxation or tax windfalls. Although not binding on any member nations, the Model Treaty proved influential when member nations drafted their own treaties for the purposes of avoiding double taxation.⁶⁶

Article 7 of the Model Treaty contains the language pertinent to the attribution of profits to a PE. Of particular relevance is Article 7(2):

Where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated [t]herein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.⁶⁷

Under the Model Treaty, the branch of a foreign corporation is to be treated as if it were “distinct and separate,” dealing “wholly independently” with its head office. This language proved the most contentious: what, after all, does it mean to operate distinctly from a parent company? The PE filing taxes must replicate this tax fiction because branches necessarily deal with their parents. A branch could look to its books and those of its parent to establish its independent operations. But as the *NatWest I* court noted when referring to Article 7’s commentary, the business records and the facts as they appear therein should be adjusted when the actual facts are different.⁶⁸

A further problem with interpreting the “distinct and separate” language is that, when a PE receives funds from its parent company, adjustments must be made for tax purposes so that these transactions appear to be at “arm’s length” rates.⁶⁹ “Arm’s length” looks to whether the parent company would have entered into the same transaction with an actually independent, similarly situated entity; if not, it then asks what the actual rate would have been.⁷⁰ For example, if NatWest loaned money to its subsidiaries at a lower interest rate, “arm’s length” would ask what interest rate NatWest would have offered the branch of another bank. Such adjustments

⁶⁵ See MODEL TAX CONVENTION ON INCOME AND CAPITAL: CONDENSED VERSION 7–9 (Org. for Econ. Co-operation & Dev. 2008) [hereinafter 2008 MODEL TREATY], available at http://www.oecd.org/document/28/0,3746,en_2649_33747_41231132_1_1_1_1,00.html. The 2008 version, unlike the 1963 Model Treaty, lays out the historical background that led to its formation. *Id.* It recognized the growing interdependence of the member nations and the increasing need to implement measures to prevent international double taxation.

⁶⁶ See *supra* note 17 and accompanying text.

⁶⁷ MODEL TREATY, *supra* note 14, at 45–46, art. 7, para. 2.

⁶⁸ *NatWest I*, 44 Fed. Cl. 120, 126 (2009) (citing MODEL TREATY, *supra* note 14, at 82–83).

⁶⁹ See MODEL TREATY, *supra* note 14, at 82–83, art. 7, cmts. 11–12.

⁷⁰ See *id.* at 82, art. 7, cmt. 12 (“[I]t will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions.”).

are necessary to reflect the economic reality that PEs are not actually independent and distinct. There are limitations to this approach. NatWest is a good example why: its PEs could rely on its strong credit rating to secure loans that actually independent branches could not, and for tax purposes, no adjustment is made for this distinction. Although flawed, this approach best replicates the economic reality of how PEs operate. Tellingly, it was the IRS's measuring the NatWest branches via "similarly situated" branches that the *NatWest II* court rejected.⁷¹

C. *The U.S.–U.K. Treaty*

The United States and the United Kingdom first entered into a treaty on the prevention of double taxation on December 31, 1975.⁷² Both countries relied heavily on the Model Treaty, and large portions of the U.S.–U.K. Treaty repeat the Model Treaty language verbatim. The language of both treaties' Article 7(2) is practically identical.⁷³ The language of Article 7(3) diverges only slightly between the two. For example, the Model Treaty describes "purposes of the permanent establishment" as including "executive and general administrative expenses so incurred."⁷⁴ Yet the U.S.–U.K. Treaty goes into greater depth as to which of these executive and general administrative expenses are deductible, elaborating on the various costs that go into operating a PE.⁷⁵

Article 3 of both the Model Treaty and the U.S.–U.K. Treaty allows for the domestic law of the country to determine the meaning of any terms left undefined.⁷⁶ Because the U.S.–U.K. Treaty does not define the phrase "reasonable allocation," each of the countries applies its own domestic law to give meaning to this term.

D. *Evolution of the Taxing Regime in the United States*

In 1980, the U.S. Department of the Treasury issued Regulation 1.882-5 in its current form, which governs the apportionment of the interest expense of foreign corporations engaged in business in the United States.⁷⁷ The Regulation begins by explicitly disregarding loans and credit transac-

⁷¹ *NatWest II*, 58 Fed. Cl. 491, 502 (2003) (discussing the 2001 Discussion Draft).

⁷² The U.S.–U.K. Treaty took effect on April 25, 1980. U.S.–U.K. Treaty, *supra* note 10.

⁷³ Compare *id.* art. 7(2), with MODEL TREATY, *supra* note 14, at 45–46, art. 7, para. 2 (containing only two minor differences, one a substitution of "therein" for "herein" and the other an explicit reference to the provisions Article 7(3)).

⁷⁴ MODEL TREATY, *supra* note 14, at 46, art. 7, para. 3.

⁷⁵ The U.S.–U.K. Treaty goes on to say, "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)." U.S.–U.K. Treaty, *supra* note 10, art. 7(3).

⁷⁶ *Id.* art. 3, para. 2; MODEL TREATY, *supra* note 14, at 42, art. 3, para. 2.

⁷⁷ Treas. Reg. § 1.882-5 (1980).

tions among branches of the same foreign corporation.⁷⁸ The Regulation then applies a three-step formula to determine the allowable interest deduction.⁷⁹ This was particularly pertinent in the case of NatWest's U.S. branches, which deducted the interest expense from "loans" they received from the home office and Hong Kong.⁸⁰

Under step one, "asset determination," the IRS assesses the average total value of all assets of the branch that "generate, have generated, or could reasonably have been or be expected to generate income, gain, or loss effectively connected with the conduct of a trade or business in the United States."⁸¹ Except for noting that all values would be in U.S. dollars,⁸² the Regulation does not discuss a number of factors important to making such a determination, such as which items should be excluded or included in the definition of a U.S. "asset" or the status of assets acquired to artificially increase U.S. assets.

Step two, "determining liabilities," provides more direction to branches making the determination than the first step but leaves several key areas ambiguous. The Regulation determines liabilities by multiplying the asset value from the first step by one of two ratios: a fixed ratio or the actual ratio.⁸³ For banks, the fixed ratio of assets to liabilities is 5%; for all other businesses, 50%.⁸⁴ The Regulation gives banks the option of choosing to use its actual ratio or the default one.⁸⁵ If a branch opts to use the actual ratio method, that branch would determine the average total amount of corporate worldwide liabilities and the average total value of corporate worldwide assets.⁸⁶ When a bank branch is considered undercapitalized like NatWest's U.S. branches,⁸⁷ that branch will have a very low ratio for tax purposes. As a result, the branch will have very little "capital" for which it owes tax. The Regulation offers little guidance on essential factors, such as which country's tax principles would control the determination, which items would be classified as liabilities or assets, and how a branch should properly classify its interbranch transactions.

Finally, under step three, the Treasury allows for an interest deduction.⁸⁸ A taxpayer makes this calculation under either the "branch

⁷⁸ *Id.* § 1.882-5(a)(5).

⁷⁹ *Id.* § 1.882-5(a).

⁸⁰ *See supra* text accompanying note 2.

⁸¹ § 1.882-5(b)(1).

⁸² *Id.*

⁸³ *Id.* § 1.882-5(b)(2).

⁸⁴ *See id.* § 1.882-5(b)(2)(i).

⁸⁵ *See id.* § 1.882-5(b)(2).

⁸⁶ *Id.* § 1.882-5(b)(2)(ii).

⁸⁷ *See infra* Part II (discussing the *NatWest* litigation and the IRS's claims that the branches were undercapitalized).

⁸⁸ § 1.882-5(b)(3).

book/dollar pool method” or the “separate currency pools method”;⁸⁹ the IRS applied the “branch book/dollar pool method” to NatWest’s books.⁹⁰

II. THE *NATWEST* LITIGATION

NatWest is based in the United Kingdom and engages in “a wide range of banking, financial and related activities throughout the world.”⁹¹ NatWest has 3600 branches worldwide.⁹² Six of these permanently established bank branches were within the United States during the years at issue in the *NatWest* litigation.⁹³ In addition to these branches, NatWest also maintained a subsidiary within the United States, called National Westminster Bank U.S.A.⁹⁴

The U.S. branches received the funds necessary to conduct their business by borrowing from either NatWest’s head office in the U.K. or other NatWest branches.⁹⁵ The U.S. branches were also able to borrow from other banks and lending institutions.⁹⁶ With these borrowed funds, the U.S. branches lent money to customers and occasionally to other NatWest branches, thereby generating interest income.⁹⁷

The IRS stopped treating this shifting of funds as interbranch lending for tax purposes when NatWest’s U.S. branches sent large sums of money to branches in Hong Kong, where tax rates were significantly lower than those in the United States.⁹⁸ At the same time, NatWest began to deduct the interest expense on these “loans.”⁹⁹ Because the IRS taxed all PEs under the Regulation, the IRS would have assessed a tax based on the amount of actual capital held by each branch.¹⁰⁰ Consequently, the IRS would not have been able to make an accurate tax determination if a branch shifted its funds to another jurisdiction and left little to no capital on the books. Because NatWest’s branches could remove these “loans” from their books by shifting the funds to Hong Kong, the capital amounts on the books were extremely low—the *NatWest* courts put the amounts consistently below

⁸⁹ *Id.* § 1.882-5(b)(3)(i)–(ii).

⁹⁰ *NatWest IV*, 512 F.3d 1347, 1351 (Fed. Cir. 2008).

⁹¹ *NatWest I*, 44 Fed. Cl. 120, 121 (1999).

⁹² *About Us*, NATWEST, <http://www.natwest.com/global/about-us.ashx> (last visited Nov. 19, 2011).

⁹³ *NatWest II*, 58 Fed. Cl. 491, 495 (2003). The six branches were the New York branch; the Nassau, Bahamas branch; the Cayman Islands branch; the International Banking Facility (IBF) branch; the Chicago branch; and the San Francisco branch. *Id.* The New York branch operated the IBF, Nassau, and Cayman Islands branches. *Id.* at 495 n.7.

⁹⁴ *Id.* at 495.

⁹⁵ *NatWest I*, 44 Fed. Cl. at 121.

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ The corporate tax rate in Hong Kong, for example, is currently 16.5%. See INLAND REVENUE DEPT’ TAX GUIDE, *supra* note 1, at 1–2.

⁹⁹ Johnston, *supra* note 2.

¹⁰⁰ For a description of the taxing structure under this version of the Regulation, see *supra* Part I.D.

1.75% of total assets.¹⁰¹ If the IRS were to rely strictly on the NatWest branches' books, the branches' taxable income would not reflect the economic reality: these "loans" to Hong Kong were merely a shift in capital to reduce their tax burden.

U.S. branches of foreign banks are not required by regulation to maintain any minimum amount of capital. Yet the capital that a branch actually requires to finance its day-to-day operations is part of the IRS's determination of what taxes that branch owes. Over the years in question, NatWest's books had designated capital ratios for U.S. branches ranging from 0.76% to 1.75%.¹⁰² These amounts are much lower than the capital required to actually operate a PE. By comparison, NatWest's U.S. subsidiary, which was required to follow SEC regulations, consistently had on its books a capital ratio of between 6.03% and 7.19%.¹⁰³

After the IRS audited NatWest, it increased the branches' taxable income by approximately \$155 million for the seven-year period from 1981 to 1987.¹⁰⁴ NatWest faced an additional tax liability of more than \$65 million—though corresponding U.K. tax credits covered some of this increase.¹⁰⁵ The IRS reached this amount by applying the articulated three-step formula of the Regulation to reformulate NatWest's proper interest expense deduction. Under this approach, which will be discussed in greater detail below, the IRS calculated NatWest's capital ratio based on the bank's worldwide liabilities and assets, thus allowing the U.S. branches' proper interest deduction to include the profits NatWest shifted and exclude interest on the "loans" from the branches' home office and Hong Kong branches.¹⁰⁶

Subsequently, in 1996, NatWest sued the U.S. government, claiming it overpaid its taxes and was entitled to a refund. Its argument, which the *NatWest I* and *NatWest II* courts and the Federal Circuit accepted, was that the Regulation, adopted in 1980 and enacted in 1981, was inconsistent with the preexisting 1975 U.S.–U.K. Treaty.¹⁰⁷ Both the *NatWest I* and *NatWest II* decisions, which were affirmed by the Federal Circuit, precluded the IRS from using a necessary tool in its arsenal to fight tax avoidance.

The central problem with the *NatWest* courts' interpretation is that it treats NatWest's interbranch transactions as done at arm's length. To characterize any of these interbranch transactions as reflecting arm's length terms and pricing is an economically untenable position. A NatWest branch would very likely provide a lower interest rate to its sister branches than it would to a branch of a different bank especially because NatWest's

¹⁰¹ *NatWest II*, 58 Fed. Cl. 491, 495 (2003).

¹⁰² *Id.*

¹⁰³ *Id.*

¹⁰⁴ *NatWest IV*, 512 F.3d 1347, 1349–50 (Fed. Cir. 2008).

¹⁰⁵ *Id.* at 1349. The U.K. tax credits did not cover \$37 million of this tax increase. *Id.* at 1350.

¹⁰⁶ *See id.* at 1351 (discussing the application of Treas. Reg. § 1.882-5 (1980)).

¹⁰⁷ *NatWest I*, 44 Fed. Cl. 120, 121–22 (1999).

head office maintained all of the U.S. branches' capital. Typical creditor concerns, which lead to higher interest rates, would not exist.

A. *NatWest I* Litigation

The *NatWest I* court held that the three-step formula of the Regulation, which the IRS employed to make a worldwide determination of NatWest's assets and liabilities, was inconsistent with the "separate enterprise" provisions of Article 7 of the U.S.–U.K. Treaty.¹⁰⁸ Analyzing the text of the U.S.–U.K. Treaty, the court determined that Article 7 treats U.S. branches as independent, separate entities.¹⁰⁹ According to the court's analysis, these independent entities deal at arm's length with other units of NatWest "as if they were wholly unrelated" except that the branches could deduct a reasonable allocation of home office expense.¹¹⁰ While the court noted that commentaries and reports contemporaneous with the signing of the U.S.–U.K. treaty generally supported its interpretation,¹¹¹ it did not even mention the subsequent commentary on the attribution of profits to PEs. Other *NatWest* courts noted that subsequent commentary supported the IRS's position but rejected the commentary as not reflective of the signatory parties' understanding.¹¹² But what if the signatory parties understood that the OECD would release future commentary to address issues that it could not have anticipated in 1963?

Turning to the 1963 OECD Commentary on Article 7, the court found that "where the books of account 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)."¹¹³ The court quotes language that it treats as dispositive: "[I]t is always necessary to start with the real facts of the situation as they appear from the business records . . ."¹¹⁴ The very language—to "start" with the business records—implies that, where the business records do not provide the facts as they truly exist, a proper analysis must turn to external facts. And to gauge NatWest's actual situation, the IRS had turned to the three-step formula of the Regulation, an approach the *NatWest* courts rejected.

The court turned to further language in the commentary on Article 7 about adjustments made to reflect arm's length transactions.¹¹⁵ After sifting

¹⁰⁸ *Id.* at 121.

¹⁰⁹ *Id.* at 123–24.

¹¹⁰ *Id.* at 124.

¹¹¹ *Id.*

¹¹² *See, e.g., NatWest II*, 58 Fed. Cl. 491, 502–03 (2003) (rejecting the 2003 commentary supporting the IRS's position as not reflective of the signatory parties' understanding).

¹¹³ *NatWest I*, 44 Fed. Cl. at 126.

¹¹⁴ *Id.* (alteration in original) (quoting MODEL TREATY, *supra* note 14, at 82).

¹¹⁵ *Id.* at 126–27.

through a plethora of commentary discussing the need to adjust the branches' books to reflect these types of transactions, the court did not offer any help in formulating the best means for the IRS to make such an adjustment. The IRS would have to make some sort of adjustment; NatWest's interbranch transactions were clearly not done at arm's length. The court may have remained silent because it recognized that, although the formula used in the NatWest audit was inappropriate, the IRS would inevitably need to use *some* type of formula to determine adjustments to reflect arm's length transactions. Because the court's opinion criticized the application of the IRS's proposed formula, however, the court could not very well impose one itself especially because it lacks the IRS's expertise in this area.

Finally, the court laid out its reasons for finding the Regulation inconsistent with the U.S.–U.K. Treaty. First, the Regulation's computation of the interest expense deduction “disregard[ed] all interbranch transactions, even for banking operations.”¹¹⁶ Because the Treaty required each branch be treated as an independent and separate entity, the *NatWest I* court reasoned that all transactions, including interbranch ones, must be used in the calculation of assets and liabilities.¹¹⁷ At the same time, however, NatWest's interbranch transactions were hardly those that would be made by an independent entity: independent entities would not shift profits to another company as a repayment of a “loan” they never received. Second, the IRS computed the Regulation's second and third steps “on the basis of worldwide assets and worldwide liabilities of the *entire* foreign enterprise, rather than determining the interest deduction on the basis of the separate, independent operations” of the branches.¹¹⁸ Again, the *NatWest I* court refused to allow the IRS to avoid the independent and separate aspect of the Article 7 language even though NatWest's shifting of funds between branches bore no resemblance to the actions of actual independent entities.

B. *NatWest II* Litigation

After its defeat in *NatWest I*, the IRS searched for a new way to avoid refunding the taxes paid by the NatWest branches. The IRS's revised approach to attributing profits to the NatWest branches was the “corporate yardstick” method. Under this method, the IRS would have applied the capital ratio that a branch would have if it were independently incorporated.¹¹⁹ Again, knowing that NatWest's interbranch “loans” hardly constituted transactions that would occur between two actual independent parties, the IRS looked for a way to adjust NatWest's U.S. income. The IRS relied on the “separate and distinct” language of the U.S.–U.K. Treaty,¹²⁰ finding

¹¹⁶ *Id.* at 130.

¹¹⁷ *Id.*

¹¹⁸ *Id.* (emphasis added).

¹¹⁹ *NatWest II*, 58 Fed. Cl. 491, 495–96 (2003).

¹²⁰ *Id.* The relevant language of the U.S.–U.K. Treaty reads:

that the treaty allowed it to attribute to a branch “the amount of capital that a separately-incorporated bank of the same size as the branch would likely hold.”¹²¹ Relying on an expert report, the IRS proposed a capital ratio of assets to liabilities of between 6% and 7%.¹²² The calculated corporate yardstick capital ratio was far closer to the amount NatWest allocated to its U.S. subsidiary than the paltry 0.76% ratio it claimed for its U.S. branches. In the IRS’s opinion, the new ratio also better reflected the treaty language that says such an enterprise is treated as “dealing wholly independently” with its home office and other branches, at least for tax purposes.¹²³

Yet the *NatWest II* court still found that this method violated the U.S.–U.K. Treaty. It determined that the plain meaning of the U.S.–U.K. Treaty did not permit the government to impute capital to a branch.¹²⁴ Rejecting the IRS’s approach, the court determined that “separate and distinct” means “separate and distinct from the rest of the bank of which it is a part”¹²⁵ and thus determined that Article 7 only allowed the IRS “to adjust the books and records of the branch to ensure that transactions between the branch and other portions of the foreign bank [we]re properly identified and characterized for tax purposes.”¹²⁶ Using the branch books as the starting point, the *NatWest II* court found that imputing such capital went beyond the scope of the adjustments the U.S.–U.K. Treaty allowed.¹²⁷ Adjustments were permissible to ensure that interest payments reflected an arm’s length relationship—which, in NatWest’s case, did not actually exist. Yet the court rejected the IRS’s reliance on “‘hypothetical’ infusions of capital” to adjust the NatWest branches’ capital ratios, finding such adjustments impermissible under the U.S.–U.K. Treaty.¹²⁸

C. *NatWest IV* Federal Circuit Litigation

In 2008, the Federal Circuit Court of Appeals considered arguments for and against all three lower court *NatWest* decisions.¹²⁹ It addressed the same concerns discussed in the lower courts: the taxation of interest expense on intracorporate loans and the allocation of capital to the U.S.

[T]here shall . . . be attributed to that permanent establishment the profits which it might be expected to make if it were a *distinct and separate enterprise* engaged in the same or similar activities under the *same or similar conditions and dealing wholly independently* with the enterprise of which it is a permanent establishment.

U.S.–U.K. Treaty, *supra* note 10, art. 7(2) (emphasis added).

¹²¹ *NatWest II*, 58 Fed. Cl. at 497.

¹²² *Id.* at 495–96.

¹²³ *Id.* at 495.

¹²⁴ *Id.* at 497.

¹²⁵ *Id.*

¹²⁶ *Id.* at 497–98.

¹²⁷ *Id.*

¹²⁸ *Id.* at 498.

¹²⁹ *NatWest IV*, 512 F.3d 1347 (Fed. Cir. 2008).

branches.¹³⁰ The government appealed the rulings of all three *NatWest* decisions, arguing that not only was the IRS's determination based on NatWest's worldwide liabilities and assets under the Regulation consistent with the U.S.–U.K. Treaty but also that the proposed corporate yardstick method of *NatWest II* conformed with the treaty's language.¹³¹

The appellate court began by affirming the *NatWest I* decision.¹³² First, the court outlined what it considered to be the relevant commentary to Article 7 of the OECD Model Treaty. Because both the United States and the United Kingdom would have relied on the 1963 OECD Commentary at the time in which they entered into the Treaty, the court found this understanding to be the proper means of guidance for the U.S.–U.K. Treaty.¹³³ Analyzing the treaty according to this Commentary, the court ultimately agreed with NatWest's argument that the three-step formula of Regulation 1.882-5 was inconsistent with the U.S.–U.K. Treaty.¹³⁴ Like the Court of Federal Claims in *NatWest I*, the Federal Circuit disregarded as irrelevant any commentary on the attribution of profits to PEs issued subsequent to the signing of the U.S.–U.K. Treaty in 1975 even though the IRS regulation in question was not enacted until 1981. Because the post-1975 commentary did not exist at the time the two nations entered into the Treaty, the court did not consider it relevant.¹³⁵

The Federal Circuit next turned to the *NatWest II* decision, rejecting the government's efforts to apply the corporate yardstick method to impute capital to NatWest's U.S. branches.¹³⁶ The court agreed with NatWest's interpretation of Article 7(2) of the U.S.–U.K. Treaty, which focused on the Article's "same or similar conditions" language.¹³⁷ The government tried to emphasize the Article's "dealing wholly independently with" phrase.¹³⁸ The IRS's approach refused to treat the interbranch transactions as the U.S. branches dealing wholly independently with their home office and Hong Kong sister branches.¹³⁹

¹³⁰ See *id.* at 1351.

¹³¹ *Id.* at 1353. The IRS raised a third argument on appeal concerning discovery of the NatWest head office's books, *id.*, but this argument was not addressed in any lower court decision and will not be addressed here.

¹³² *Id.* at 1359.

¹³³ *Id.* at 1358–59.

¹³⁴ *Id.* at 1359.

¹³⁵ *Id.* at 1358–59.

¹³⁶ *Id.* at 1362.

¹³⁷ *Id.* at 1360.

¹³⁸ *Id.* The language of Article 7(2) reads as follows:

[T]here shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

U.S.–U.K. Treaty, *supra* note 10, art. 7(2).

¹³⁹ See *NatWest IV*, 512 F.3d at 1360–61.

The court determined, however, that NatWest's interpretation more accurately comported with the treaty. The "wholly independently" language, the court said, required that *any* interbranch transactions be "accurately characterized and reflect arm's length terms and pricing."¹⁴⁰ It did not require that the U.S. branches be treated as if they were subject to SEC and market requirements.¹⁴¹ Yet without being able to impute capital to NatWest or look to NatWest's worldwide income, how could the IRS possibly make adjustments to accurately characterize the transactions? The Federal Circuit did not say. Recent OECD commentary, though, does, and the corporate yardstick is just such a means.

III. LOOKING TO THE COMMENTARY IN ITS ENTIRETY

The OECD frequently releases new discussion drafts and commentary.¹⁴² It develops these documents to assist countries in their interpretation of the Model Treaty as new and previously unforeseeable conflicts arise.¹⁴³ In 2008, for example, the OECD released a discussion draft of a new Article 7 to its Model Treaty.¹⁴⁴ Then, in July 2010, the OECD released the final language of the new Article 7 of the Model Treaty.¹⁴⁵ As countries like the United States continue to rely on the Model Treaty language when crafting their own double taxation treaties,¹⁴⁶ it is important to note that the OECD continues to publish new guidance to assist in the interpretation of such treaties. Section A of this Part notes that the drafters very much intended for those relying on the Model Treaty to apply any commentary that became available to address certain unforeseen issues. Section B argues

¹⁴⁰ *Id.*

¹⁴¹ *Id.*

¹⁴² A quick survey of the available documents on the OECD's website shows that in 2008 alone the OECD released the Model Tax Convention on Income and on Capital - Articles 7, 11, 24, 25, and 26; the report on the attribution of profits to permanent establishments; a discussion draft on a New Article 7 (Business Profits) of the OECD Model Treaty Convention; and a discussion draft on the Transfer Pricing Aspects of Business Restructurings.

¹⁴³ The new Article 7, for example, attempts to incorporate into its language the different problems and solutions the OECD addressed in its Report on the Attribution of Profits to Permanent Establishments. See *OECD Approves Updates to Model Tax Convention, Transfer Pricing Guidelines and Report on Attribution of Profits to Permanent Establishments*, ORG. FOR ECON. CO-OPERATION & DEV. (July 22, 2010), http://www.oecd.org/document/20/0,3343,en_2649_37989746_45689428_1_1_1_1,00.html.

¹⁴⁴ ORG. FOR ECON. CO-OPERATION & DEV., DISCUSSION DRAFT ON A NEW ARTICLE 7 (BUSINESS PROFITS) OF THE OECD MODEL TAX CONVENTION (2008), available at <http://www.oecd.org/dataoecd/37/8/40974117.pdf>.

¹⁴⁵ ORG. FOR ECON. CO-OPERATION & DEV., THE 2010 UPDATE TO THE MODEL TAX CONVENTION (2010), available at <http://www.oecd.org/dataoecd/23/43/45689328.pdf>.

¹⁴⁶ See, e.g., Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.–Japan, Nov. 6, 2003, S. TREATY DOC. NO. 108-14 (updating the U.S.–Japan Treaty in compliance with the Model Treaty's language).

that uniformity among countries benefits not only the OECD but also the economy in general.

A. Interpretive Methodology: Shared Expectations

The *NatWest* courts, citing to the “Contracting State” language of the U.S.–U.K. Treaty, used a theory of contract interpretation and therefore only gave strong deference to commentary available in 1975.¹⁴⁷ Its interpretive methodology is inherently flawed because treaties like that at issue in the *NatWest* litigation are unique in that they evolve. The Model Treaty and the subsequent treaties adopting its language are not one-off treaties like declarations of peace between warring nations. The Model Treaty is an evolving document,¹⁴⁸ and the OECD releases subsequent commentary and drafts precisely to address unforeseen issues. As the Model Treaty evolves, the United States will likely base future treaty language on the most recent version. U.S. courts should at least consider all OECD commentary relevant to the issue before them because the OECD’s continual release of updated commentary is part of the treaty countries’ “shared expectations.”

Interpreting the Model Treaty by using only “the understanding of the 1975 Treaty partners,”¹⁴⁹ the *NatWest* courts ignored years of subsequent answers to problems and situations that OECD member nations encountered and wanted addressed. The decision of *NatWest II* court, unlike other decisions made by that court, acknowledged the existence of the OECD’s evolving views.¹⁵⁰ The rejection of these arguments as diverging from the “genuine shared expectations”¹⁵¹ of the United States and the United Kingdom misinterprets the countries’ shared expectations. Both are member nations of the OECD.¹⁵² Article 3 of the OECD Convention, which both the United States and the United Kingdom ratified, states that member nations

¹⁴⁷ See *NatWest IV*, 512 F.3d 1347, 1350 (Fed. Cir. 2008).

¹⁴⁸ See 2008 MODEL TREATY, *supra* note 65, at 8 (“The Fiscal Committee of the OECD had envisaged, when presenting its Report in 1963, that the Draft Convention might be revised at a later stage following further study. Such a revision was also needed to take account of the experience gained by Member countries in the negotiation and practical application of bilateral conventions, of changes in the tax systems of Member countries, of the increase in international fiscal relations, and of the development of new sectors of business activity and the emergence of new complex business organisations at the international level.”).

¹⁴⁹ *NatWest II*, 58 Fed. Cl. 491, 503 (2003).

¹⁵⁰ See *id.* at 499–503 (discussing the 1984 Report on the Taxation of Multinational Banking Enterprises, the 2001 Discussion Draft on the Attribution of Profits to Permanent Establishments, and the 2003 Discussion Draft on the Attribution of Profits to Permanent Establishments: Part II (Banks)). The court ultimately rejected the use of any of this subsequent commentary, though, because it did not reflect the “genuine shared expectations of the contracting parties.” *Id.* at 502 (quoting *Maximov v. United States*, 299 F.2d 565, 568 (2d Cir. 1962)).

¹⁵¹ *Id.* at 502 (quoting *Maximov*, 299 F.2d at 568).

¹⁵² See *supra* note 58 and accompanying text.

will “consult together on a *continuing* basis,”¹⁵³ conducting studies and addressing issues as they arise.¹⁵⁴ When the two countries adopted the treaty, both were fully aware of the OECD’s operations and its commentaries and discussion drafts. It seems a stretch to say that the United States and the United Kingdom did not expect that the OECD would continue to release commentary to address new problems as they arose.

B. *In Violation of OECD Principles*

Favorable tax treatment for certain nations violates several principles of the OECD. As noted above, the United States plays host to over \$4.5 trillion in foreign-related bank assets.¹⁵⁵ Banking is a volatile industry, and attracting new business is essential.¹⁵⁶ For these reasons, among others, the United States has entered into several new treaties on the prevention of double taxation since 2000.¹⁵⁷ As noted below, the OECD was well aware of the need for uniformity in fiscal policies to prevent double taxation and foster cross-border businesses.

1. *OECD and Economic Development.*—One of the OECD’s chief aims as stated in its own Convention was “that the economically more advanced nations should co-operate in assisting to the best of their ability the countries in process of economic development.”¹⁵⁸ None of the countries that have formed a double taxation treaty with the United States since 2000 are one of the more “economically advanced” nations that belongs to the OECD.¹⁵⁹ The potential tax windfalls explained above would fall strictly on banks with a parent office in member countries because those countries adopted and ratified treaties well in advance of nonmember nations. Although U.K. banks could shift capital to other countries to dodge taxes—at least until the United States and United Kingdom ratified an updated treaty—countries with treaties ratified after the publication of the new commentary could not gain such benefits. Their tax assessment within the United States would be much higher because their U.S. PEs would be required to keep all U.S.-generated income on their books. Because NatWest’s home office and Hong Kong branches received the U.S. PEs’ profits via “loan”

¹⁵³ Convention on the Organisation for Economic Co-operation and Development art. 3(b), Dec. 14, 1960, 12 U.S.T. 1728, 888 U.N.T.S. 141 (emphasis added), available at http://www.oecd.org/document/7/0,3746,en_2649_201185_1915847_1_1_1_1,00.html.

¹⁵⁴ See *id.* art. 3 (cross-referencing Article 2’s enumerated undertakings).

¹⁵⁵ CARNELL, MACEY & MILLER, *supra* note 33, at 740.

¹⁵⁶ *Id.*

¹⁵⁷ See *United States Income Tax Treaties—A to Z*, *supra* note 17. These countries include Bangladesh, Bulgaria, and Sri Lanka. *Id.*

¹⁵⁸ See Convention on the Organisation for Economic Co-operation and Development, *supra* note 153, at pmbl.

¹⁵⁹ Bangladesh, Bulgaria, and Sri Lanka are not currently members of the OECD. See *Members and Partners*, *supra* note 58.

repayments, those PEs could reduce the income on their books even though the money stayed entirely within the control of NatWest. The branches could also deduct the interest expense “paid” on these loans. Banks without such an option would likely have to charge higher interest rates on loans or find some other means of making up the deficiencies in profits due to the worse tax treatment.

This OECD principle is also found in the introduction to the Model Treaty:

It has long been recognized among the Member countries of the Organisation for Economic Co-operation and Development that it is desirable to clarify, standardize, and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial, or any other activities in other countries through the application by *all* countries of common solutions to identical cases of double taxation.¹⁶⁰

The introduction to the Model Treaty does not state that it is desirable for “all *Member* countries” to find common solutions to double taxation problems but rather “all countries.” Yet the *NatWest* decisions would have the U.S. apply inconsistent solutions to different countries: U.K. banks can shift funds to allocate profits to PEs in jurisdictions with more desirable tax rates, but countries like Sri Lanka do not have such options.

2. *OECD and Economic Uniformity.*—The *NatWest* courts placed the IRS in a difficult situation. All future treaties relying on the Model Treaty will likely employ the language of the recently released discussion draft on Article 7.¹⁶¹ Under these future treaties, the IRS could apply the corporate yardstick approach and the *NatWest* courts’ methodology would find it acceptable.¹⁶² This interpretation gives a distinct business advantage to bank branches whose parent resides in a country with a preexisting tax treaty with the United States. Countries with weaker economies, which are unlikely to have long-standing tax treaties with the United States, suffer under such an interpretation, making it harder for them to compete with banks of more developed nations. Unless the United States starts rewriting tax treaties every time the OECD issues new commentary, the IRS has little room to maneuver under the *NatWest* ruling.

Because the United States relies on the Model Treaty language when formulating its own tax treaties with other nations, any treaties it now enters

¹⁶⁰ 2008 MODEL TREATY, *supra* note 65, at 7 (emphasis added).

¹⁶¹ The OECD issued the Discussion Draft of Article 7 in July of 2008, *see* ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 144, and finalized and formally incorporated the new language into its Model Treaty. *See* Mary Bennett & Raffaele Russo, *Discussion Draft on a New Art. 7 of the OECD Model Convention*, 2009 INT’L TRANSFER PRICING J. 73, 73–80.

¹⁶² *See infra* Part IV.A for a discussion of the recent OECD commentary as it relates to the corporate yardstick method.

into will very likely incorporate the new language of Article 7.¹⁶³ As a result, some U.S. treaties will embody the new language whereas others will predate it. If new signatory countries must adhere to this new language but others are free to ignore it, then inconsistency will enter the banking marketplace.

For example, imagine that the United States enters into a tax treaty with Bhutan based on the Model Treaty next week. As a result, Bhutanese PEs within the United States would be required to comply with the new Article 7 language, and under the logic of the *NatWest* decisions,¹⁶⁴ the nations would implicitly have relied on the recent commentary approving the corporate yardstick method. The IRS could attribute hypothetical capital to the Bhutanese PE under the corporate yardstick method, thus precluding the PE from shifting its income to foreign branches to dodge the U.S. tax rates. However, under the *NatWest* decisions, PEs with home offices in countries like Japan could amend their prior tax returns and ignore the new Article 7 language and any recent commentary.¹⁶⁵ A Japanese bank could shift funds from its U.S. PEs to its PEs in countries like Hong Kong, where the corporate tax rates are much lower, by having its Hong Kong branches “loan” the money and the U.S. branches “repay” the loans—deducting the interest expense to boot. Bhutanese PEs in the above hypothetical would not have such an option. The United States would prefer that Bhutanese PEs not have that option, but it does give greater advantage to countries with stronger economies because those are the countries that created the OECD.¹⁶⁶ Application of the approach taken by the *NatWest* courts would thus create dramatically different tax consequences for two different banks competing in the same economic environment. Further, the United States could conceivably lose billions of dollars in tax revenue because a bank with a PE in a country with lower corporate tax rates would have an incentive to shift funds away from its U.S. PE even if only for accounting, rather than operational, purposes.

¹⁶³ The new Article 7 slightly alters the first two paragraphs of the old Article 7 and completely eliminates paragraphs 3, 4, 5, and 6. Compare MODEL TAX CONVENTION ON INCOME AND CAPITAL: CONDENSED VERSION 27–28, art. 7 (Org. for Econ. Co-operation & Dev. 2010), with MODEL TREATY, *supra* note 14, at 46–46, art. 7.

¹⁶⁴ See *NatWest II*, 58 Fed. Cl. 491, 503 (2003) (rejecting the use of later commentary as not reflective of the signatory parties’ understanding in 1975).

¹⁶⁵ Japan and the United States entered into a new treaty in November 2003, which the Senate ratified in March 2004. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, *supra* note 146. Although the new treaty will prevent future shifting of funds such as that in the *NatWest* situation, it does not stop banks from amending prior tax returns to do what *NatWest* did. Further, any future issues that might arise could only be addressed by new commentary, none of which would be relevant to the earlier understanding of the signatory parties under the *NatWest* decisions.

¹⁶⁶ Convention on the Organisation for Economic Co-operation and Development, *supra* note 153, at pmb1. (referring to member nations as “the economically more advanced nations”).

IV. THE CORPORATE YARDSTICK METHOD

By restricting their focus to the 1963 OECD Commentary and then looking solely at the commentary on Article 7, the *NatWest* courts ignored myriad subsequent commentary supplementing the original Model Treaty. When courts rely on OECD commentary, they should interpret the commentary more consistently. The *NatWest* methodology would encourage inconsistency, however, by applying different rules to banks from different countries, depending on the date of the treaty. This Part explains both the need for and logic behind looking to subsequent commentary because this was indeed part of the shared expectations of parties entering into a double taxation treaty. It then argues for a specific approach: the corporate yardstick.

The corporate yardstick approach, which would have the IRS look to similarly situated bank branches to determine the meaning of “arm’s length,” is a method the OECD has found to more accurately assess the attribution of profits, as expressed in the commentary.¹⁶⁷ Because a bank dealing with its own branch does not offer the same interest rate that it would to an actually independent party, the corporate yardstick approach attempts to replicate what an independent transaction would resemble. Although the corporate yardstick approach has its flaws, it is a far more economically realistic means of handling the attribution of profits to PEs than relying on a bank branch to honestly report the amount of capital it actually requires.

Had the *NatWest* courts looked to the commentary that followed the 1975 ratification of the U.S.–U.K. Treaty, they would have realized that the OECD had addressed and resolved this specific problem. The OECD had not only addressed the issue of attribution of profits but had also endorsed the corporate yardstick approach.

A. Recent OECD Commentary: An Evolving View

Following its release of the Model Treaty in 1963, the OECD published commentary to assist and guide nations that relied on the Model Treaty when drafting their own treaties on the avoidance of double taxation. The OECD often revises and updates such commentary, or even releases entirely new commentary when an unanticipated situation confronts a number of member nations.¹⁶⁸ After releasing a discussion draft, the OECD ac-

¹⁶⁷ See MODEL TREATY REPORT, *supra* note 14, at 82–83, art. 7, cmts. 11–12..

¹⁶⁸ See *Centre for Tax Policy and Administration: Publications & Documents*, ORG. FOR ECON. CO-OPERATION & DEV., http://www.oecd.org/findDocument/0,3770,en_2649_34897_1_1_1_1_1,00.html (last visited Nov. 20, 2011). This website maintains numerous OECD reports, guidelines, commentaries, news releases, and other publications.

cepts suggestions and comments from member nations before drafting and issuing the final version of the commentary.¹⁶⁹

The 2007 commentary on Article 7 begins by noting that Article 7 is “not particularly detailed” and does not contain any “precise rules” for implementing its general directive, thus allowing a variety of permissible methods to implement the separate-enterprise approach.¹⁷⁰ In 2004, the OECD’s discussion draft emphasized the total lack of “a consensus amongst Member countries as to the correct interpretation of Article 7.”¹⁷¹ It also noted the “considerable variation in the domestic laws” of the various member countries as to the proper means of taxing PEs.¹⁷² The International Fiscal Association (IFA), which each year chooses a monetary topic at loggerheads in the international community, chose the attribution of profits to PEs for its 2006 convention.¹⁷³ After receiving branch reports from members on the status of the topic in their respective countries, the IFA reporters concluded that “there is hardly a single point, be it in the application of domestic law or in the interpretation of article 7, on which every branch report agrees.”¹⁷⁴

The OECD revisited these issues in 2001, 2003, and 2007. Although it still found no consensus among member nations on how best to attribute profits to a PE, the OECD offered three possible methods for attributing hypothetical capital to a branch that would satisfy Article 7’s separate-enterprise principle: the “capital allocation” approach, the “quasi-thin capitalization” approach, and the “thin capitalization” approach.

The capital allocation approach “allocate[s] the bank’s actual ‘free’ capital . . . in accordance with the attribution of financial assets and risks,” thus leading to an attribution of capital to a PE.¹⁷⁵ Under the quasi-thin capitalization approach, a PE is attributed at least the same amount of “free” capital as would be “required for regulatory purposes . . . [for] an independent banking enterprise operating in the host country.”¹⁷⁶ This approach

¹⁶⁹ See, e.g., *Discussion Draft Release of a New Article 7 (Business Profits) of Its Model Tax Convention (Revised)*, ORG. FOR ECON. CO-OPERATION & DEV., http://www.oecd.org/document/27/0,3343,en_2649_33747_44117467_1_1_1_1,00.html (last visited Nov. 20, 2011).

¹⁷⁰ See ORG. FOR ECON. CO-OPERATION & DEV., REVISED COMMENTARY ON ARTICLE 7 OF THE OECD MODEL TAX CONVENTION 3 (2007), available at <http://www.oecd.org/dataoecd/0/2/38361711.pdf> (discussion draft).

¹⁷¹ ORG. FOR ECON. CO-OPERATION & DEV., DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENT—PART I (GENERAL CONSIDERATIONS) 6 (2004), available at <http://www.oecd.org/dataoecd/22/51/33637685.pdf>.

¹⁷² *Id.* at 4.

¹⁷³ See Philip Baker & Richard S. Collier, *General Report*, 91b CAHIERS DE DROIT FISCAL INTERNATIONAL (2006).

¹⁷⁴ *Id.* at 34.

¹⁷⁵ ORG. FOR ECON. CO-OPERATION & DEV., DISCUSSION DRAFT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS (PES): PART II (BANKS) 23 (2003) (emphasis omitted), available at <http://www.oecd.org/dataoecd/13/48/2497776.pdf>.

¹⁷⁶ *Id.* at 24.

would require attributing to a PE the amount of capital required already as a pledge of assets—in the case of the United States, a 5% ratio.¹⁷⁷ Finally, the OECD discussed the thin capitalization approach, under which a PE has attributed to it “the same amount of ‘free’ capital as would independent banking enterprises carrying on the same or similar activities under the same or similar conditions in the jurisdiction of the PE.”¹⁷⁸ In other words, a determination would consider how much capital an independent PE would require to operate. The thin capitalization approach is the corporate yardstick approach by another name—the same approach the *NatWest* courts rejected.

Noting that each of the three proposals had its strengths and weaknesses, the OECD determined that each was permissible under Article 7(2) of the Model Treaty.¹⁷⁹ All three proposals support the idea that a bank’s capital should be attributed to its PE by reference to the risks arising from the PE’s activity.¹⁸⁰ None of the approaches looks solely at the branch’s books to make the determination. Under this more recent commentary, the IRS would certainly be able to increase *NatWest*’s taxable income by adjusting its interest expense deduction. Both the OECD’s worldwide determination in *NatWest I* as well as the Regulation and the IRS’s corporate yardstick approach in *NatWest II* conform to the OECD’s evolving views.

In 2008, the OECD formalized the discussion draft as a *Report on the Attribution of Profits to Permanent Establishments*, Part II of which addressed attributing profits to banks. The report observed a “consensus amongst governments and business on the principle that a bank PE . . . should have sufficient capital to support” its operations.¹⁸¹ The report then listed the “authorized approaches” for attributing that capital to a PE: specifically, the “capital allocation” and “thin capitalization” approaches.¹⁸² It still considered the “quasi-thin capitalization” approach to be acceptable but only as an alternative safe harbor.¹⁸³

The *NatWest* appellate court did not once mention the vast amount of commentary released subsequent to the 1975 signing of the U.S.–U.K. Treaty. Yet it is clear from the various subsequent Commentaries and Drafts that interpreting Article 7 to allow for a corporate yardstick approach is not inconsistent with the language of the U.S.–U.K. Treaty.

¹⁷⁷ Pledge of Assets, 12 C.F.R. § 347.209 (2011).

¹⁷⁸ ORG. FOR ECON. CO-OPERATION & DEV., *supra* note 175, at 25.

¹⁷⁹ *Id.* at 27.

¹⁸⁰ *See id.* at 20.

¹⁸¹ ORG. FOR ECON. CO-OPERATION & DEV., REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS 103 (2008), available at <http://www.oecd.org/dataoecd/20/36/41031455.pdf>.

¹⁸² *Id.* at 96–97.

¹⁸³ *Id.* at 98.

B. Hypothesizing Assets and Risks

Having lost the litigation battle, the IRS and the Treasury Department needed to determine an acceptable way to both comply with the U.S.–U.K. Treaty, as the courts understood it, and properly tax PEs. When the Treasury Department released Treasury Decision 9465 in September of 2009, it failed to solve any of the problems resulting from the *NatWest* litigation. Treasury Decision 9465 amended Regulation 1.882-5, rejected in the *NatWest* decisions as inconsistent with the U.S.–U.K. Treaty.¹⁸⁴ But the underlying factors making the Regulation incompatible with the U.S.–U.K. Treaty are still present in the Regulation. Although the Treasury altered some of the Regulation's language, the Treasury did not remove or significantly change parts of the Regulation that involve the determination of worldwide assets and liabilities.

The Regulation retains the complicated formula for allocating interest based on a company's worldwide assets, one of the factors explicitly rejected by the *NatWest I* court.¹⁸⁵ Although the Treasury did make minor adjustments to the method of determination, the actual ratio computation remained the company's total worldwide liabilities divided by the total value of its worldwide assets.¹⁸⁶ When amending the Regulation, the Treasury addressed this aspect but did not resolve the issue. Rather, the Treasury amended the Regulation to return to the fixed-ratio amount, which a branch can opt for instead of using its actual ratio, to 95%.¹⁸⁷ By decreasing the ratio amount and allowing companies to claim only 5% capital, the Treasury provided an incentive for some companies to choose the fixed amount. A 7% capital ratio is higher than a branch is likely to have, given that it does not require actual capitalization.¹⁸⁸ Five percent, though still high, makes the default option more attractive. However, banks like NatWest, whose branches span the globe, will not choose any fixed ratio amount if they can shift funds to locations in more favorable tax jurisdictions.¹⁸⁹

¹⁸⁴ T.D. 9465, 2009-43 I.R.B. 542.

¹⁸⁵ Treas. Reg. § 1.882-5(c)(2)(i) (as amended by T.D. 9465, 2009-43 I.R.B. 542).

¹⁸⁶ *Id.* In the three-part formula to determine the interest expense deduction, the Treasury increased the fixed ratio amount allowed for banks in the second step. *Id.* t § 1.882-5(c)(4).

¹⁸⁷ T.D. 9465, 2009-43 I.R.B. 542, at 546. The Treasury changed the original amount of 95% to 93% in 2006. *See* Treas. Reg. § 1.882-5(c)(4) (2006).

¹⁸⁸ NatWest's branches, for example, had a ratio of between 0.76% and 1.75% (although this ratio is much lower than the required pledge of assets for a branch). *See NatWest II*, 58 Fed. Cl. 491, 495 (2003). By contrast, NatWest's U.S. subsidiary, subject to capitalization requirements, regularly had a capital ratio from 6.03% to 7.19%. *Id.*

¹⁸⁹ For example, consider NatWest's operations. Between 1981 and 1987, the amount of capital on its U.S. branches' books ranged from 0.76% to 1.75%. *Id.* Thus, according to its books, NatWest's liabilities to assets ratio is anywhere from 98.25% to 99.24%. This is far more favorable to NatWest than a fixed ratio of 95% (or 96%, 97%, or even 98%) would be. When a company can shift funds to avoid claiming capital at a PE, it has every tax incentive to do so.

The IRS and the Treasury probably did not alter the language of the Regulation because the *NatWest* courts rejected all of their other options. Rather, knowing that any subsequent treaties would incorporate the evolving views of the OECD, the Treasury probably kept the Regulation intact because it is acceptable under the more recent OECD commentary. The *NatWest II* court rejected the corporate yardstick approach as an “evolving view[]” that “does not reflect the understanding of the 1975 Treaty partners.”¹⁹⁰ The plain language of the subsequent commentary makes clear that a corporate yardstick approach is perfectly acceptable under the Model Treaty. To prevent companies from shifting funds that should be attributed to a U.S. PE to countries like Hong Kong, the IRS will likely employ this formula with any country whose treaty does not predate the most recent commentary.

But why should banks based in countries with treaties predating certain commentary be given more favorable (or less favorable) tax treatment than those countries with treaties postdating such commentary? If two different banks from two different countries are to compete in the same market, a treaty interpretation favoring one bank over another gives the favored bank an unwarranted economic advantage. This is especially true when the language of the countries’ respective treaties is identical. The Regulation’s worldwide determination is only inconsistent with the U.S.–U.K. Treaty to the extent that a court looks only to commentary available at the time of ratification.

C. Subsequent Commentary: Shared Expectations?

The *NatWest* courts explicitly rejected the idea of relying on any of this subsequent commentary.¹⁹¹ It is beyond dispute that the information contained in a discussion draft or subsequent commentary is itself a determination of the drafters. The *NatWest II* court referred to the more recent discussion drafts as representing the “continued thinking of the OECD on attributing capital to branches and its post-1995 evolving views on arm’s length principles.”¹⁹² Under traditional treaty interpretation—or contract interpretation, for that matter—only the commentary available at the time of treaty ratification should govern a court’s decision. But as noted above,¹⁹³ although the Model Treaty’s drafters did not anticipate the specific issues and the resulting commentary, they certainly anticipated that problems would arise and that commentary would address them. It is for this reason that, if courts are going to look to OECD commentary at all, they should look to it in its entirety.

¹⁹⁰ *Id.* at 503.

¹⁹¹ *Id.* at 501 (“[T]here can be no doubt that the 2001 Discussion Draft could not and does not reflect the understandings of the Treaty partners in 1975.”).

¹⁹² *Id.* at 503.

¹⁹³ See *supra* Part IV.A.

CONCLUSION

Global commerce has greatly evolved since 1975, when the United States and the United Kingdom signed their treaty on the avoidance of double taxation. The *NatWest* courts placed both parties inside an economic bubble, strictly adhering to the language of the Model Treaty and commentary available in 1975. This decision ignored years of subsequent OECD studies and resolutions of problems unforeseeable in 1975. Yet countries without tax treaties prior to the 1984, 2003, or 2007 commentaries and drafts would, upon entering into a tax treaty with the United States, face significantly different tax consequences than countries with treaties predating such issuances. The result is economic inconsistency among banks, burdening those from countries whose economies the OECD vowed to help improve. Future courts should look to the OECD commentary in its entirety, if they intend to rely on it at all. Courts should give the Model Treaty the very consistency it requires and provide contracting parties with a level economic playing field.