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Disputed attribution of profits to Irish and United Kingdom branches or permanent establishments

Jonathan Schwarz (Temple Tax Chambers; King's College London) · Wednesday, December 11th, 2019

Two cases, currently before different courts highlight long-standing questions around the attribution of profits to permanent establishments. Irish and United Kingdom law on the attribution of profits to branches of non-resident companies remined identical for decades until 2003. In each country, a non-resident company trading through a branch in that country was chargeable to corporation tax on trading income arising directly or indirectly through or from the branch (Ireland, Taxes Consolidation Act 1997 s 25; United Kingdom, Income and Corporation Taxes Act 1988 s 11).

In 2003, the UK enacted legislation to give effect in domestic law, to what was then called the OECD "working hypothesis". This ultimately became the "Authorised OECD Approach" when the OEDC produced its 2008, report entitled Attribution of Profit to Permanent Establishments. At the time of publication of the 2008 report, the OECD acknowledged that , although the report was intended to be an interpretation of article 7(2) of the Model treaty when the project was launched in 1998, it went beyond what article 7(2) permitted. As a result, article 7 was rewritten in the 2010 OECD Model with updated Commentary to fully reflect the Authorised OECD Approach.

Profits of Irish branches of non-resident companies

The rules for attribution of profits to Irish branches of non-resident companies remain unmodernised with no statutory guidance on when profits arise through a branch. The application of the Irish rules are under examination in the Commission investigation on alleged state aid granted to *Apple* (case SA.38373 (2014/C) on appeal to the EU General Court in *Ireland v Commission* (Case T-778/16); *Apple Sales International and Apple Operations Europe v Commission* (Case T-892/16). In its case, the Commission argues that rulings given by the Irish Revenue in 1991 and 2007 in respect of profits attributable to Irish branches of non-resident companies did not reflect arm's length pricing The Commission relies on, in particular, the 2010 *OECD Transfer Pricing Guidelines* and the *OECD 2010 Report on the Attribution of Profits to Permanent Establishments*. The Apple entities concerned were not resident in countries that have tax treaties with Ireland, so the attribution question is one of domestic law. The cases were heard by the General Court in September 2019.

Profits of UK permanent establishments

The attribution of profits to a UK permanent establishment of an Irish resident under the 1976 Ireland-United Kingdom double tax treaty and UK legislation introduced in 2003 has been before the UK tax tribunal in *Irish Bank Resolution Corporation Ltd (in special liquidation) and Irish Nationwide Building Society v Revenue and Customs* [2019] UKUT 277 (TCC).

Irish Bank Resolution Corporation Limited sought to deduct interest paid by the permanent establishment to its head office for borrowing from the head office by the permanent establishment. Intra-entity transactions do not exist as a matter of law since a person cannot transact with itself. Nonetheless, such notional transactions have long been recognised in relation to the banking industry (OECD Committee on Fiscal Affairs report: *Transfer Pricing and Multinational Enterprises*, *Three Taxation Issues* 1984) given the way in which banking business is conducted.

At stake was the compatibility of the UK 2003 legislation that requires an assumption that the permanent establishment, as a distinct and separate enterprise, has

- the same "credit rating as the non-resident company", and
- such equity and loan capital as it could reasonably be expected to have in the circumstances.

No deduction may be made in respect of costs in excess of those that would have been incurred on those assumptions. These assumptions, in effect, impose a thin-capitalisation limit on relief for interest expense by reference to a hypothetical equity capital that the permanent establishment would have.

Core issue

The core issue in the case was whether, in treating the permanent establishment as a separate enterprise, article 8(2) of the Ireland UK Treaty, corresponding to article 7(2) of the OECD Model until 2010, should have a hypothetical or notional capital (which it did not actually have), or whether the notionally enterprise should be determined only by reference to the capital that it actually has.

The First-tier Tribunal [2017] UKFTT 702 held that the assumption that the PE has the same credit rating as its parent, reflects the article [7(2)] assumption that the PE is trading "under the same or similar conditions"; and that it "has such equity and loan capital as it could reasonably be expected to have", reflects the article [7(2)] assumption that the PE is a "distinct and separate enterprise". On that basis the domestic law did no more than give effect to the article [7(2)] requirements.

On appeal, the Upper Tribunal decided that the language of art [7(2)] did not lay down any specific way in which the permanent establishment is to be treated as a sperate enterprise. In coming to this decision, the Upper Tribunal referred to two propositions in the 1963 OECD Commentary. First, construction of 'hypothetical profit figures in vacuo should not be constructed; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment. Second, in certain circumstances, it may be necessary to 'rectify' a permanent establishment?s books of account.

The real issue appears to be whether the attribution of notional capital involves the construction of hypothetical profit figures or whether, in these terms it is a necessary rectification of the permanent establishment's books of account. In other words, should the notionally distinct and separate enterprise be analysed on the basis of the assets it actually has, or, should it be analysed on the basis of the assets it would have if it were a distinct and separate enterprise.

An examination of the ordinary meaning of the treaty language in context would seem to support analysis on the basis of the assets the permanent establishment actually has. This is because article 7(2) refers to the profits of "*that* permanent establishment". *That establishment* is the establishment which is identified in article 7(1). It does not refer to "*a* permanent establishment" which would refer to a hypothetical permanent establishment. A hypothetical permanent establishment may well have assets different from those of the actual permanent establishment.

This analysis is supported by the decision of the United States Court of Appeals in *National Westminster Bank plc v United States of America* 512 F 3d 1347 (Fed Cir 2008) in relation to the United Kingdom-United States double tax treaty. The US Court of Claims (2003) 58 Fed Cl 491 said that "There is nothing in the plain words of the Treaty that allows the government to adjust the books and records of the branch to reflect 'hypothetical' infusions of capital based upon banking and market requirements that do not apply to the branch. In short, the government?s reading of article 7 goes too far …" The US Court of Appeal's upheld the decision saying that "In essence, the government would read the 'same or similar conditions' language out of the [UK-US] Treaty". The US decision has some additional piquancy because the United Kingdom intervened in the case in support of the taxpayer, arguing for this interpretation.

Permission to appeal to the Court of Appeal has been granted in the Irish bank case. It raises fundamental questions not only around attribution of profits but also the proper interpretation of treaties including the role of the OECD Commentary, particularly versions introduced decades after conclusion of the treaty and after the taxable events in question arose.

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