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Appeals Court Rules Against the IRS and Affirms Refund for National Westminster Bank PLC

On January 15, 2008, the U.S. Court of Appeals for the Federal Circuit affirmed a decision of the Court of Federal Claims that National Westminster Bank PLC ("NatWest") was entitled to a refund of $65.7 million with interest for 1981-87.[1] The Appeals Court held that the application of Treas. Reg. § 1.882-5 (2006) to a permanent establishment ("PE") of an international bank and the use of the corporate yardstick to allocate interest expense violates the 1975 U.S.-UK income tax treaty (the "Treaty").

Background

NatWest operated in the United States through six U.S. branches (collectively, the "US Branch") during the years at issue. The US Branch was charged and paid interest on its loans with the UK parent corporation and with other NatWest branches as if they were unrelated entities. NatWest's accounts and its U.S. federal income tax returns reflected these transactions in the calculation of its interest expense deduction. The IRS disallowed this deduction and required the interest deduction for the US Branch to be determined using the formula in Treas. Reg. § 1.882-5, which disregards interbranch transactions in calculating U.S. income tax of foreign entities. This disallowance increased NatWest's income by approximately $155 million and resulted in the imposition of additional taxes. NatWest requested competent authority assistance under Article 24 of the Treaty but rejected the settlement offer by the United Kingdom. NatWest paid the additional taxes and filed suit in the U.S. Court of Federal Claims in 1995, arguing that application of Treas. Reg. § 1.882-5 by the IRS was inconsistent with Article 7 of the Treaty.

Three summary judgment opinions, all in favor of NatWest, were issued by the trial court. In the first opinion, issued in 1999 ("NatWest I")[2], the court ruled that the Treas. Reg. § 1.882-5 formula for determining deductible interest expense violated the "separate enterprise" principle in Article 7(2) of the Treaty, which provides that "…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." [Emphasis added] The court noted, however, that the interest shown on the US Branch's books is subject to adjustment to reflect the imputation of adequate capital and arm's length interest rates on intra-corporate loans.

In the second opinion, issued in 2003 ("NatWest II")[3], the court rejected the government's contention that Article 7(2) of the 1975 Treaty allows the imputation of capital to the US Branch based on regulatory and marketplace capital requirements as if the US Branch were a separately incorporated bank (the "corporate yardstick"). The court agreed with NatWest that the Treaty requires the government to use the US Branch's books to determine each item affecting the profits of the US Branch during the years at issue. Furthermore, the court held that the Treaty only allows the books and records of the US Branch to be adjusted if the interest payments on intra-company loans do not reflect an arm's length relationship.

In the third opinion, issued in 2005 ("NatWest III")[4], the court ruled that the US Branch kept adequate books and records, that it properly adjusted its interest expense deductions related to capital and that its six branches qualified as a single permanent establishment. The court also agreed with NatWest that it charged arm's length interest rates on money market transactions with non-U.S. branches and affiliates. On interest rates for clearing accounts, the parties later settled and final judgment in NatWest's favor was filed on October 6, 2006.[5]

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[1] *Nat'l Westminster Bank, PLC v. United States,* No. 2007-5028, 2008 WL 124227 (Fed.Cir. Jan 15, 2008).

[2] *Nat'l Westminster Bank, PLC v. United States,* 44 Fed. Cl. 120, 123 (1999), aff'd, No. 2007-5028, 2008 WL124227 (Fed.Cir. Jan 15, 2008).

[3] *Nat'l Westminster Bank, PLC v. United States,* 58 Fed. Cl. 491 (2003)aff'd, No. 2007-5028, 2008 WL124227 (Fed.Cir. Jan 15, 2008).

[4] *Nat'l Westminster Bank, PLC v. United States,* 69 Fed. Cl. 128 (2005).

[5] *Nat'l Westminster Bank, PLC v. United States,* 98 A.F.T.R.2d (RIA) 2006-7539 (Fed.C1. 2006).

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Appeals Court Decision

The appeals court agreed with the trial court's opinions in NatWest I and NatWest II[6] and denied the government's appeal of the *Order Denying Reconsideration* arguing that it be allowed to take discovery of NatWest's home office books to determine the capital actually allotted to the US Branch.

The appeals court agreed with the trial court's analysis of the "separate enterprise" principle in Article 7(2) of the Treaty and found that under the plain language of the Treaty, disregard of interbranch transactions that are recorded on the branch's books in determining the business profits of the branch is prohibited but that such transactions may be adjusted to reflect arm's length terms. The court also found that the Commentary to Article 7 of the Organization for Economic Co-Operation and Development ("OECD") 1963 Draft Double Taxation Convention on Income and Capital ("1963 Draft Convention"), on which the Treaty was modeled, indicates that Treas. Reg. § 1.882-5's disregard of interbranch transactions is inconsistent with the 1963 Draft Convention. Furthermore, the court found no evidence that prior to 1984, the parties to the Treaty understood the "separate enterprise" principle as allowing a method of calculating the interest expense of the U.S. branch that disregards interbranch transactions.

The appeals court also upheld the trial court's decision in NatWest II that the application of the "corporate yardstick" to tax the US Branch as if it were subject to regulatory and market capital requirements is inconsistent with Article 7(2), which provides that the US Branch be taxed as a separate enterprise engaged in activities that are "same or similar" to the activities in which the US Branch is engaged under "same or similar" conditions. In addition, the court cited the Commentary to Article 7 of the 1963 OECD Draft Convention, which states that "… there is no justification for tax administrations to construct hypothetical profit figures *in vacuo*; it is always necessary to start with the real facts of the situation as they appear in the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce." The court concluded that the real facts of the case are that the US Branch is not required to maintain any minimal amount of capital and therefore, the use of the corporate yardstick violates the Treaty.

Finally, the government's appeal of the *Order Denying Reconsideration* was denied because the interest expense deduction for the US Branch is determined according to the properly maintained books of the branch, making discovery of NatWest's home office books unnecessary.

Conclusion

Treas. Reg. § 1.882-5, originally issued in 1960, was amended by the 1996 Final Regulations (T.D. 8658), which stated that Treas. Reg. § 1.882-5 provided the exclusive rule for calculating interest expense attributable to business profits of a U.S. PE under a U.S. income tax treaty. U.S. Treasury Technical Explanations of U.S. income tax treaties with the United Kingdom (signed July 2001) and Japan (signed November 2003), however, state that Treas. Reg. § 1.882-5 may produce inappropriate results in some cases and provides for an alternative approach based on the 1995 OECD Transfer Pricing Guidelines. On July 14, 2005, the IRS issued Notice 2005-53, 2005-32 C.B. 263, which states that the exclusivity provision in Treas. Reg. § 1.882-5 is no longer accurate in light of the renegotiated UK and Japanese treaties and that the provision will be eliminated by amendments to the regulations. However, the Notice goes on to state that the Treasury and the IRS "continue to believe that application of [Treas. Reg.] § 1.882-5 results in a sufficient allocation of equity capital to a Permanent Establishment, and is simpler to apply than an alternative approach under the [UK and Japan] treaties."

In August 2006, temporary regulations were issued (T.D. 9281). The temporary regulations permit an alternative approach for calculating interest expense attributable to business profits of a permanent establishment under a US income tax treaty but only if a treaty or the accompanying documents expressly provide for such alternative approach. The effect of the temporary regulations is limited and the formula in Treas. Reg. § 1.882-5T remains the only option under older treaties that have not been renegotiated. However, there is a question as to whether the IRS will enforce the application of Treas. Reg. § 1.882-5T or the "corporate yardstick" in similar cases in light of its most recent defeat in *NatWest*.

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[6] The government agreed not to appeal the trial court's decision in NatWest III if NatWest I and II were affirmed.

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