US Outbound Tax Newsalert

A Washington National Tax Services (WNTS) Publication

June 21, 2012

Fifth Circuit splits circuits by holding that the UK Windfall Tax is creditable

Overview

On June 5, 2012, the Fifth Circuit Court of Appeals created a circuit split with the Third Circuit by holding in *Entergy Corp. v. Comr.*, 5th Cir. No. 10-60988 that the UK Windfall Tax is a creditable foreign income tax under section 901. On December 22, 2011, the Third Circuit had held in *PPL Corp. v. Comr.*, 3d Cir., No. 11-1069, that the UK Windfall Tax was not creditable on the same issue. See our *US Outbound Newsalert* issued January 17, 2012.

The Fifth Circuit distinguished its reasoning from the Third Circuit's more formalistic, text-based approach to section 901's creditability rules. The court found that the taxpayer met the three-part "predominant character" test under Treas. Reg. § 1.901-2(a) because the UK Windfall Tax was imposed on an amount derived from gross receipts, despite the UK tax statute's resemblance to an assets-based tax.

Though the UK Windfall Tax only affects 32 taxpayers directly, the *Entergy* Fifth Circuit decision has larger ramifications for the creditability of foreign taxes because of its emphasis, like the Tax Court's in this case, on a substance-based application of the test under Treas. Reg. § 1.901-2. Taxpayers should consider how both cases could impact their ability to claim foreign tax credits (FTCs).

Background

Entergy owns London Electricity, one of thirty-two companies that the UK privatized in the 1980s and 1990s. During that time, the UK government sold London Electricity and 31 other state-owned companies to private investors. Though privately

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owned, the utilities remained regulated and the UK government set the rates at which the utilities would sell electricity. The pricing scheme induced the new private owners to provide electricity more efficiently and most of the utilities, including London Electricity, increased efficiency more than the UK government had expected. As a result, the utilities' profits and their share prices increased. Executive compensation also increased.

The public was not happy with these high profits and compensation packages, and the Labour Party responded by introducing a one-time 23% tax on the difference between each company's "profit-making value" and its "flotation value." The latter is the price for which the UK government had sold the company. (The public believed that the government had sold the companies too cheaply, hence the "windfall.") The statute defined "profit-making value" as the company's average annual profit per day over an initial period (typically four years) multiplied by nine. The result was an imputed "price-to-earnings ratio."

London Electricity paid the Windfall Tax, and Entergy claimed a refund from the IRS seeking a FTC for Entergy's share of the Windfall Tax paid. The IRS denied Entergy's refund claim and issued a notice of deficiency. Entergy then petitioned the Tax Court, which concluded that Entergy was entitled to a FTC. The IRS Commissioner timely appealed to the Fifth Circuit, asserting that section 901 does not cover the Windfall Tax. Entergy and the Commissioner essentially disagreed on whether the Windfall Tax constituted a tax on excess profits, which would be creditable under section 901, or a tax on unrealized asset value, for which Entergy could not claim a FTC.

Fifth Circuit decision

The Fifth Circuit applied section 901(b)(1), which provides a tax credit for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year for any foreign country." This provision was clarified in a 1983 regulation, Treas. Reg. § 1.901-2, which governed this case.

Under this regulation, the terms "income, war profits, or excess profits tax" are combined into the single concept of an "income tax." Treas. Reg. § 1.901-2(a)(1). The regulation provides that a foreign levy is an "income tax" if and only if the predominant character of that tax is that of an income tax in the US sense. Treas. Reg. § 1.901-2(a)(1)(ii). A foreign tax's predominant character is that of an income tax in the US sense if it is "likely to reach net gain in the normal circumstances in which it applies." Treas. Reg. § 1.901-2(a)(3)(i). The regulation further states that:

> [a] foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements set forth ... in this section. Treas. Reg. § 1.901-2(b)(1).

The "realization" requirement generally provides that the tax must be imposed on or subsequent to the occurrence of events that would result in income realization under US tax law principles. Treas. Reg. § 1.901-2(b)(2). The "gross receipts" requirement generally provides that the tax must be imposed on gross receipts or an amount not greater than gross receipts. Treas. Reg. § 1.901-2(b)(3). The "net income" requirement generally provides that computing the tax requires deducting from gross receipts the costs and expenses incurred in earning those receipts. Treas. Reg. § 1.901-2(b)(4). The *Entergy* court imposed the "predominant character" standard in applying each of these three prongs of the test, and found that under this standard, the UK Windfall Tax satisfies all three prongs and is therefore a creditable tax under section 901.

The *Entergy* court first addressed the "realization" and "net income" prongs of the predominant character test. Taking a substance-based approach for which the court cited prior section 901 case law, the *Entergy* court quoted the *Inland Steel* cases, stating, "The label and form of [a] foreign tax is not determinative." (*Inland Steel Co. v. U.S.*, 677 F.2d 72, 80 (Ct. Cl. 1982). It also quoted the *Bank of America* case, stating "...The important thing is whether the other country is attempting to reach some net gain, ***not the form in which it shapes the income tax or the name it gives***." (*Bank of Am. Nat. Trust & Sav. Ass'n v. U.S.*, 459 F.2d 513, 519 (Ct. Cl. 1972).) (Emphasis added.) The *Entergy* court then stated briefly that "the Windfall Tax clearly satisfies the realization and net income requirements" because the tax is based on revenues that accrued long before the tax was designed and implemented, and because the tax only reached utilities that realized a profit in the relevant period.

The Fifth Circuit primarily focused its discussion on the "gross receipts" prong, since the Third Circuit had decided *PPL* exclusively on that prong to find the Windfall Tax was not creditable. The Fifth Circuit found that "the tax's history and practical operation were to 'claw back' a substantial portion of privatized utilities' 'excess profits' in light of their sale value," and explained that while the tax was calculated based on average annual profit per day over an initial period to arrive at a "profit-making ***value***," the profits themselves were the difference between gross receipts and expenses from those receipts. Therefore, the actual effect of the tax, i.e., its predominant character, is that of a tax derived from gross receipts.

The Third Circuit had called the taxpayer's mathematical reformulation of the Windfall Tax to a 51.75% tax on initial period profits a "bridge too far," requiring that the court "rewrite the tax rate" to find the Windfall Tax creditable. *PPL*, 665 F.3d at 65. The Third Circuit had reasoned that since a tax must be established on the basis of no more than 100% of gross receipts, a tax imposed on 23% of 225% of profits could not satisfy the regulatory requirement. Id. at 67. The Fifth Circuit criticized the Third Circuit's formalistic reasoning, emphasizing that the "gross receipts" prong provides that the tax must be imposed on gross receipts ***or*** an amount not greater than gross receipts. Treas. Reg. § 1.901-2(b)(3). The regulation's examples "do not illustrate the meaning of 'actual gross receipts,' but instead differentiate between permissible imputed actual gross receipts and impermissible notional amounts." Because the Windfall Tax calculation was based on ***actual*** gross receipts and not an impermissible notional amount, the calculation's 2.25 multiplier should not affect qualification under the test's gross receipts prong.

The Fifth Circuit reluctantly created a circuit split, but stated that "we cannot engage in this sort of formalism in light of the predominant character standard. We therefore disagree with the Third Circuit's conclusion and hold that the Windfall Tax is a creditable foreign income tax under I.R.C. § 901."

Broader creditability implications

Although the UK Windfall Tax only affects 32 taxpayers directly, the *PPL* and *Entergy* cases are important in gauging possible court approaches in examining the creditability of taxes that resemble income taxes in certain respects but may arguably not satisfy the three-prong test under Treas. Reg. § 1.901-2(a) when applied mechanically. The two courts took very different approaches to the problem: The Third Circuit had a form-driven approach, with strict adherence to the mechanics set forth under Treas. Reg. § 1.901-2 and a literal reading of the Windfall Tax statute to determine whether the taxpayer met the realization, gross receipts and net income requirements. By contrast, in its *Entergy* decision, the Fifth Circuit emphasized the tax's history and practical operation over its mechanical application. The court found

that the Windfall Tax's parliamentary history showed that the tax was intended as and actually acted as an excess profits tax rather than a tax on enterprise value.

The *PPL* Third Circuit decision remains good precedent in the Third Circuit, though the Fifth Circuit's decision may signal a more general return to a substantive approach in future creditability cases.

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