US Outbound Tax Newsalert

A Washington National Tax Services (WNTS) Publication

January 17, 2012

Third circuit holds that UK windfall tax is not a creditable tax under section 901

On December 22, 2011, in *PPL Corp. v. Comr*., 3d Cir., No. 11-1069, the Third Circuit held that PPL Corporation was not entitled to a foreign tax credit for the 1997 tax year with respect to amounts paid under the so-called UK "windfall tax," thus reversing a Tax Court decision that had found the tax creditable under Code section 901 (*PPL Corp*., 135 T.C. No. 15 (2010)).[1] The Third Circuit found that because the UK windfall tax is in substance a 23% tax on 2.25 times profits, the windfall tax fails to satisfy the requirement that a creditable tax under section 901 must be imposed on a tax base no greater than gross receipts. Treas. Reg. § 1.901-2(b)(3). Under application of the windfall tax, the calculation of the tax base begins with an amount greater than gross receipts and therefore the tax falls outside the definition of a creditable tax under section 901(b)(1) and Treas. Reg. § 1.901-2.

Though the UK windfall tax only affects 32 taxpayers directly, the *PPL Corp*. Third Circuit decision has larger ramifications regarding creditability of foreign taxes in its emphasis on a formalistic application of the test under Treas. Reg. § 1.901-2.

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[1] Note that on September 9, 2010 the Tax Court decided two cases that held the UK windfall tax was creditable: *PPL Corp*., 135 T.C. No. 15 (2010) and *Entergy Corp*., T.C. Memo 2010-197 (2010). *Entergy Corp*. is currently on appeal to the Fifth Circuit.

Background

PPL is a Pennsylvania corporation that in 1997 held a 25% stake in SWEB (formerly South Western Electricity Board), a utility in the United Kingdom. Between 1984 and 1996 the UK government sold SWEB and 31 other state-owned companies to private investors. Though privately owned, the utilities remained regulated and the UK government set the rates at which the utilities would sell electricity to customers. The pricing scheme induced the new private owners to provide electricity more efficiently and most of the utilities, including SWEB, increased efficiency to a greater degree than the UK Government had expected. As a result, the utilities' profits and their share prices increased. Executive compensation also increased. The public became unhappy with these high profits and compensation packages, and the Labour Party responded to public discontent by introducing a one-time 23% tax on the difference between each company's “profit-making value” and its “flotation value,” 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.”)

SWEB paid the windfall tax, and PPL filed with the IRS a claim for refund seeking a foreign tax credit for PPL's share of the windfall tax paid. In 2007, the IRS denied PPL's claim for refund and issued a notice of deficiency. PPL then filed a petition in the Tax Court, which agreed with PPL that it was entitled to a foreign tax credit. The Commissioner timely appealed to the Third Circuit, asserting that section 901 does not cover the windfall tax.

Third Circuit Decision

The Third 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 is clarified in a 1983 regulation, Treas. Reg. § 1.901-2, which governed the case. Under this regulation, the terms "income, war profits, [or] excess profits tax" are combined into the single concept of an "income tax." The court explained

> [The regulation] provides that a foreign assessment is an “income tax” if it has the “predominant character ... of an income tax in the U.S. sense.” Id. § 1.901-2(a)(1)(ii). ... The regulation then provides that a foreign assessment has a tax “character” if it is “likely to reach net gain in the normal circumstances in which it applies.” Id. § 1.901-2(a)(3)(i). And it is “likely to reach net gain ... if and only if the tax, judged on the basis of its predominant character,” satisfies each of three requirements: the “realization” requirement, the “gross receipts” requirement, and the “net income” requirement. Id. § 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 the realization of income under principles of U.S. tax law. 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 court imposed the "predominant character" standard in applying each of these three prongs of the test, and found that the UK windfall tax violates the gross receipts requirement because it is levied on a tax base greater than fair market value of gross receipts.

A levy need only fail one of the three requirements to be non-creditable - in *PPL Corp.*, the Third Circuit focused on the gross receipts requirement. Although the court did not discuss the other two requirements in the body of the opinion, it did discuss in Footnote 3 that the UK tax also fails the realization requirement. The court also noted in that footnote that it did not intend to discuss the net income requirement.

In arguing before the Third Circuit, PPL had asserted that looking through the form of the tax to its substance reveals that the tax is in substance a tax on profits, and specifically on excess profits. The court, however, called PPL's formulation of the UK windfall tax "a bridge too far" that still did not solve the fundamental problem that the tax base cannot be initial period profit alone unless the tax rate is rewritten. The court pointed out that this adjustment would essentially read the gross receipts requirement out of the regulation, because the tax rate could always be recalculated to bring the tax base to 100% of gross receipts.

Larger Implications for Creditability

Though the UK windfall tax only affects 32 taxpayers directly, the *PPL Corp*. Third Circuit decision has larger ramifications regarding creditability of foreign taxes. In 2010, the Tax Court's decision was unusual in its emphasis on substance and its willingness to algebraically restate the tax to meet the three key requirements under Treas. Reg. § 1.901-2. The Tax Court found that, although the tax was nominally imposed on changes in the value of the utilities over a certain period, it operated as an excess profits tax for the majority of the companies subject to it, because the amount of tax liability calculated under the windfall profits tax was never more than the companies' total profits over the period of measurement. The Tax Court thus looked to the actual effect of the tax to judge its creditability.

By contrast, the Third Circuit took a more formalistic approach, with its strict adherence to the mechanics set forth under Treas. Reg. § 1.901-2 to determine whether the realization, gross receipts and net income requirements are met. Although the court stated that "Our classification of a foreign tax hinges on its economic substance, not its form," the court in fact took a form approach by rejecting PPL's proposed simplifications. The decision focuses on the regulation's three key requirements, as compared to a circumstances based inquiry into whether the tax is likely to reach net gain. Taken together, the Tax Court and Third Circuit decisions highlight a largely unexplored tension between these two approaches.

The tension between the two decisions is also notable because the tax resembles an asset tax in its imposition of a 23% tax on the difference between each company's "profit-making value" and its "flotation value." Traditionally in IRS rulings, asset taxes have been noncreditable, with little if any disagreement by the courts. In *PPL Corp.*, the Tax Court explained that a tax on excess value in the utilities was in fact equivalent to a tax on excess profits. The court stated, "profits were considered excessive in relation to the prices at which the windfall tax companies were sold to the public, which, in turn, were deemed to be too low." Thus, according to the Tax Court, a tax to correct the undervaluation of the companies at flotation would also recoup the excess profits earned by the companies during the initial period. The court bolstered its argument with quotations from political speeches indicating that the UK windfall tax had always been intended to reach excess profits. The Tax Court's willingness to treat a tax formally imposed on value as a profits tax because (among other reasons) value was calculated as a profit multiple was novel. Income-producing assets typically derive their value from their profit-making history and potential, but courts have not generally treated asset taxes as profits taxes on that basis.

Conclusion

The *PPL* Tax Court decision remains good precedent outside of the Third Circuit, though it can be expected that the Tax Court in future cases and courts in other circuits will consider the Third Circuit's decision and its emphasis on formalism under Treas. Reg. § 1.901-2(b)(3). *PPL*'s companion case, *Entergy Corp*., T.C. Memo 2010-197 (2010), was decided for the taxpayer in the Tax Court and is currently on appeal to the Fifth Circuit, where the tension between a substance- vs. form-based approach to creditability may again play out on the appellate level.

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