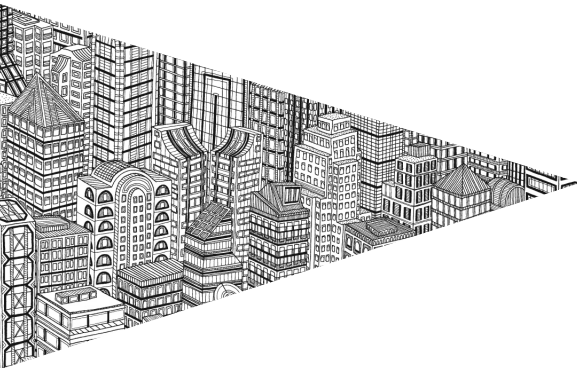


International Tax Alert



Third Circuit US Court of Appeals holds UK “windfall profits” tax not a creditable income tax for US foreign tax credit purposes

Executive summary

In *PPL Corporation, et al. v. Commissioner*,¹ the US Court of Appeals for the Third Circuit (Court of Appeals) reversed a US Tax Court (Tax Court) decision that allowed for a US foreign tax credit with respect to a UK “windfall profits tax” that was imposed on a number of state regulated utilities.² The Court of Appeals held that the windfall profits tax, computed on the basis of a formula whose primary variable referenced profits earned over a multi-year period, was not a creditable income tax for purposes of Section 901 (a creditable tax) because the tax did not meet the “gross receipts” test under Reg. Section 1.901-2(b)(1).

Discussion

Summary of facts

PPL (PPL), a Pennsylvania corporation, held a 25 percent stake in SWEB, a UK utility company. Between 1984 and 1996, the UK government privatized SWEB and 31 other utilities or state-controlled companies, most of which were state regulated monopolies (the utilities). Public opinion was that utilities were exploiting their monopoly position and were earning outsized returns. Further, based on the utilities’ profits, a newly elected UK government took the position that the original privatization of the utilities was for a price that was below the true fair market value of the utilities. The

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UK government enacted a one-time “windfall tax” designed to claw back a portion of the ostensible excess profits.

In form, the “tax” was structured to recapture all or a portion of the supposed discount represented by the difference between the initial sales price (flotation value) and the “true” fair market value of the utilities (the profit-making value), determined by applying a deemed price/earnings ratio multiple (based on subsequent actual earnings) to arrive at “true” fair market value. In practice, the formula, as applied to 29 out of 32 utilities, resulted in a charge to each utility that was primarily influenced by the cumulative profits of each such utility over the 4 year post privatization period (the Cumulative Profits).³ The Court of Appeals stated that PPL was taking the position that ultimately the tax was equal to 23% of Cumulative Profits multiplied by 2.25, which is the mathematical equivalent of Cumulative Profits multiplied by 51.75%.

PPL paid the windfall tax and filed for a refund claim with the IRS claiming a foreign tax credit for the windfall tax payment. The IRS denied the refund claim on the grounds that the windfall tax was not a creditable tax. PPL challenged the IRS’s position in the Tax Court. The Tax Court ruled in favor of PPL, holding that the windfall tax was a creditable tax. The Court of Appeals reversed the holding of the Tax Court and held that the windfall tax was not a creditable tax.

General principles and analysis

Treas. Reg. Section 1.901-2(a)(1) provides, in part, that a foreign levy will be considered an “income tax” (i.e., a creditable tax) if and only if (1) it is a tax, and (2) the predominant character of that tax is an income tax in the US sense. The predominant character of a foreign income tax is that of an income tax in the US sense if the foreign tax is likely to reach “net gain” in the normal circumstances in which it applies.⁴ 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 the regulations (the “three factor test”).⁵ In general, a foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of (A) gross receipts; or (B) gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.⁶ In general, a foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts to permit (A) recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or (B) recovery of such significant costs and expenses computed under a method that is likely to produce an amount that

approximates, or is greater than, recovery of such significant costs and expenses.⁷

The IRS’s position was that the tax base of the windfall tax was what the UK statute says it was: the difference between two imputed values of each affected company. Neither value was representative of a company’s gross receipts, nor did the tax base account for recognizable costs and expenses. Thus, the IRS argued that the windfall tax failed to meet either of the gross receipts or the net income requirement.

PPL argued that looking through the form of the windfall tax to its substance revealed that the tax was, in substance, a tax on profits, specifically on excess profits. PPL argued that, under the predominant character standard, so long as the tax ultimately could be distilled to a tax based on profits, the tax should be treated as an income tax in the US sense. Because the windfall tax could be reduced to a tax equal to 23% of Cumulative Profits multiplied by 2.25, which is the mathematical equivalent of approximately 51.75% of Cumulative Profits, the tax should be treated as a creditable tax.

The Court of Appeals, in a footnote, first articulated what it viewed to be the proper application of the predominant character standard as used in the regulations. The Court of Appeals rejected PPL’s contention that the predominant character standard, separate and independent from the three factor test, is sufficient to qualify a tax as

a creditable tax. To be a tax on net gain, the predominant character standard must be applied to each of the three factor test. That is, the predominant character of the foreign tax must generally be that it is only levied upon a realization event, reach gross receipts and net income.

The Court of Appeals noted that the preamble to the Treasury Decision that promulgated the current regulations under Section 901 (the Preamble) appears to adopt two conflicting approaches, i.e., the three factor test and also a broader application of the predominant character standard that is independent of the three factor test.⁸ The Court of Appeals resolves this tension in favor of the text of the regulations, which, the Court of Appeals notes, does not include the Preamble. The Court of Appeals held that the regulations are clear that in order for a tax to be a creditable tax, the tax must satisfy the three factor test. The language of the regulations is determinative as to what the law is. The regulations explicitly state that the predominant character standard must be met for each of the three factors.

The Court of Appeals assumed, for the sake of argument, that the windfall tax could be reduced to a tax that was levied on a tax base that was equal to an amount greater than actual gross receipts, i.e., the windfall tax could be reduced to a tax equal to 23% of Cumulative Profits multiplied by 2.25. The Court of Appeals, however, rejected PPL's final simplification, which adjusted

the tax base so that the tax was on actual gross receipts, i.e., 51.75% of Cumulative Profits. To do so, the court contended would be to read the gross receipts requirement out of the regulations. If the tax base could be adjusted by manipulating the effective tax rate imposed by foreign law, in most circumstances where the base of the tax was greater than 100% of gross receipts, the tax base could be reduced to actual gross receipts by increasing the foreign effective rate. The regulations do not allow for such manipulation.

In support of its view, the Court of Appeals pointed to Treas. Reg. Section 1.901-2(b)(3)(ii), Example 3, which illustrates the application of the gross receipts test. In the example, another country imposes a tax on the extraction of petroleum. The country deems "gross receipts" to equal 105% of the market value of the petroleum extracted. That is, the starting point for the tax base is 105% of each affected company's gross receipts from petroleum. The regulation disallows a credit for the tax because it "is designed to produce an amount that is greater than the fair market value of actual gross receipts."⁹

The Court of Appeals noted that a 20% tax levied on a base of income that is 105% of gross receipts is the mathematical equivalent of a 21% tax on 100% of gross receipts. The example however is unequivocal. So long as the foreign tax is levied on gross receipts that are in excess of actual gross receipts, none of the foreign tax will be treated as

a creditable tax. The fact that the economic effect of the tax is equivalent to a greater effective tax rate on a reduced gross receipts amount will not alter the fact that the tax is not an "income tax" in the US sense. An income tax in the US sense is not levied on a base of income that is in excess of actual income.¹⁰

It is worth noting that the Court of Appeals did not explicitly reject the IRS's analysis as to why the windfall tax was not a creditable tax. As noted above, the IRS argued that the windfall tax was based on the difference between two values and not a tax on gross receipts or on net income. The Court of Appeals did not discuss the IRS's position because it decided that even under PPL's interpretation of the windfall tax, the windfall tax still did not satisfy the gross receipts test.

Implications

The Court of Appeals' decision holding that the windfall tax is not a creditable tax, which reverses the Tax Court's decision the tax was a creditable tax, will likely impact those taxpayers that claimed foreign tax credits for windfall taxes paid in the UK. UK utilities companies which were privatized between 1984 and 1996 should consult with their advisors on the appropriate actions that they should be taking as a result of this decision.

The *PPL Corp.* decision provides helpful guidance for analyzing a foreign tax to determine whether the tax is a creditable foreign tax

for US tax purposes. The decision clarifies that in order for a foreign tax to be a creditable tax, the predominant character standard applies to each of the three factors relevant for determining creditability

of a foreign tax, the realization, gross receipts and net income tests. It is insufficient that the tax is the functional equivalent of a foreign tax that would satisfy the three factor test. If foreign law is levying a tax on

a tax base that is in excess of actual gross receipts, the tax will not be a creditable tax, regardless of whether the tax could have been expressed as a tax on actual gross income.

Endnotes

1. 2011 US App. LEXIS 25551 (3d Cir. 22 December 2011).
2. *PPL Corp. & Subsidiaries v. Comm’r*, 135 T.C. 304, 2010 US Tax Ct. LEXIS 31 (2010).
3. In actuality, the tax was further reduced by the actual amounts paid to the United Kingdom by the investors in the utilities. The Court of Appeals assumed that this further reduction was not relevant to determining whether or not the windfall tax was a creditable tax.
4. Treas. Reg. Section 1.901-2(a)(3)(i).
5. Treas. Reg. Section 1.901-2(b)(1).
6. Treas. Reg. Section 1.901-2(b)(3).
7. Treas. Reg. Section 1.901-2(b)(4).
8. The adoption of this broader approach results from the reference to the pre-1983 case law that applied that broader standard. 48 Fed. Reg. 46,272, 46,273 (12 October 1983). The Preamble stated the regulations are consistent with the cited case law.
9. Treas. Reg. Section 1.901-2(b)(3)(ii), Example 3.
10. In a footnote, the Court of Appeals noted that the windfall tax would likely fail the net income requirement as well as the gross receipts requirement.

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