U.K. EXCESS PROFITS TAX UNDER U.S. FOREIGN TAX CREDIT

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Between 1984 and 1996, the government of the United Kingdom, under the control of the Conservative Party, privatized ownership of more than 50 state-owned companies by making public offerings of their stock. In December 1990, the government privatized twelve regional electric companies but immediately regulated the prices that the privatized utilities could charge the public.[1]

During the post-privatization period, the privatized utilities were able to increase efficiency and reduce operating costs to a greater degree than had been expected when the initial price controls were established, and accordingly the privatized utilities generated much higher profits than had been anticipated. The public came to believe that the utilities had been sold too cheaply and that their profits were excessive in relation to the price that had been paid for their stock. In the elections of 1996, the Labour Party promised to impose a special tax on the privatized utilities if it was elected to replace the Conservative Party government.

The Labour Party won the election and, as part of the Finance Act of 1997, enacted an "Excess Profits Tax" to recover the "windfall" profits of certain companies that had been privatized in the 1980s and 1990s, including the regional electric companies. For political and administrative reasons the Excess Profits Tax was not implemented as a straightforward tax on the "undeserved" profits of the privatized companies; rather, the tax was levied at the rate of 23% on the excess of (i) each company's estimated fair market value; over (ii) the price at which it had been sold by the Conservative government. The estimated fair market value of each company was set by a formula that capitalized (using a nine times earnings multiple) the company's earnings over its first four years as a private concern.

U.S. taxpayers[2] owned three of the U.K. companies subject to the Excess Profits Tax and, after their U.K. subsidiaries paid the tax to the United Kingdom, the U.S. parents claimed foreign tax credits for the tax on their U.S. federal income tax returns. The parents' claims have reignited arguments long thought to be settled and generated a conflict in the circuits that is now on its way to the U.S. Supreme Court.

The foreign tax credit

Section 901 permits U.S. taxpayers to take a "foreign tax credit" for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." The IRS disallowed the foreign tax credits claimed by the three U.S. parent corporations on the basis that the U.K Excess Profits Tax should be judged solely by its terms and, so judged, is a noncreditable tax on value. The government's position is that legislative purpose and how the tax operates are largely irrelevant and that a court's inquiry should be restricted to the text of the statute. The Third and Fifth Circuits, however, reached conflicting conclusions as to the creditability of the U.K. Excess Profits Tax and the U.S. Supreme Court has now agreed to step in and resolve the issue.

Definition of creditable tax before the regulations

To begin the discussion, it is useful to review the manner in which courts addressed the question of

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what taxes were creditable prior to the promulgation of regulations on the issue. The starting point is generally considered to be the *Biddle* case,[3] decided by the U.S. Supreme Court in 1938. In *Biddle*, the Supreme Court established the principle, that, in deciding whether a foreign tax is a creditable income tax for purposes of Section 901, the term "income tax" will be given meaning by referring to the U.S. income tax system and measuring the foreign tax against the essential features of that system.

The 1972 opinion of the Court of Claims in *Bank of America*[4] reflects the general consensus of the courts regarding what constitutes a creditable tax and established the standard for creditability that would ultimately be incorporated into the regulations. Bank of America conducted its general banking business through branch offices in Thailand; the Philippines; and Argentina. It was subject in each jurisdiction to a gross basis tax on income associated with its banking activities. The case addressed the issue of whether such taxes imposed on gross banking income are "income taxes" under Section 901.

The Court of Claims began by noting that "from 1913 on, Congress has always directed the [federal income tax] at some net gain or profit, and [that] for almost 60 years the concept that the income tax seeks out net gain has been inherent" in the U.S. system of taxation. The court stated that intent and application rather than labels and form are controlling for whether a foreign tax is creditable[5]—with the result that in certain situations a levy can in reality be a tax on net gain even though it is imposed squarely on gross income. The court went on to discuss earlier decisions and rulings establishing that a tax is creditable if it is highly likely or reasonably intended to reach some net gain. The court ultimately concluded that Bank of America was not entitled to foreign tax credits because none of the taxes involved permitted it to deduct the significant expenses it was certain to incur in generating its banking income—meaning that none of the taxes could be shown to tax only net gain.[6]

The Court of Claims returned to the question of what constitutes a creditable tax in the 1982 case of *Inland Steel Co.*[7] The taxpayer in that case, Inland Steel Company, owned a Canadian subsidiary, Caland Ore Company LTD, which operated an iron mine. Caland was subject to the Ontario Mining Tax Act (OMT), a provincial tax levied at a graduated rate on an amount determined by a statutory formula. The formula permitted the taxpayer to deduct from its sales revenues ten different categories of expenses and allowances but specifically prohibited deductions for royalty payments, interest expense, and depletion.

The Court of Claims, relying on its earlier decision in *Bank of America*, emphasized that the relevant question is whether the foreign tax is designed to and does in fact reach net gain in the normal circumstances in which it applies.

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1 The prices were fixed for a five-year period. Prices would be reset at the start of the next regulatory period.

2 PPL Corporation; Entergy Corporation; and American Electric Power Company.

3 302 U.S. 573, 19 AFTR 1253 (1938). In Biddle, the Supreme Court stated that whether a person has paid foreign tax within the meaning of 26 U.S.C. 131 (1936), one of the forerunners to current Section 901, depends on the manner in which the foreign tax is laid and collected, what the taxpayer has done in conformity with the foreign law, and whether the taxpayer's act is the substantial equivalent of payment of a tax as that term is used in U.S. law.

4 459 F.2d 513, 29 AFTR 2d 72-1172 (Ct. Cl. 1972); Bank of America Nat'l, 61 TC 752 (1974). "The term 'income tax' in 901(b)(1) covers all foreign income taxes designed to fall on some net gain or profit, and includes a gross income tax if, but only if, that impost is almost sure, or very likely, to reach some net gain because costs or expenses will not be so high as to offset the net profit."

5 "We do not consider it all-decisive whether the foreign income tax is labeled a gross income or a net income tax, or whether it specifically allows the deduction or exclusion of the costs or expenses of realizing the profit. 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."

6 Seatrain Lines, Inc., 46 BTA 1076 (1942), held creditable a Cuban tax of 3% of the American company's gross income from its transportation business in Cuba. The tax was originally leveled at 6% tax on net profits and 3% of gross was viewed as a reasonable proxy for 6% of net. Santa Eulalia Mining Co., 2 TC 241 (1943), allowed foreign tax credits for a Mexican gross income tax on mining royalties where it seemed very clear that costs or expenses of the taxpayer in obtaining the royalties were minimal and thus unlikely to offset the gross income. See also Allstate Ins. Co. v. U.S., 190 Ct. Cl. 19, 24 AFTR 2d 69-6014 (1969).

7 677 F.2d 72, 49 AFTR 2d 82-1241 (Ct. Cl. 1982).

8 TD 7928, 10/12/83.

9 The regulations contain exceptions where the foreign jurisdiction may tax prior to realization in certain circumstances (but must not tax the unrealized income upon actual realization at a later time); where a tax may be based on the difference between the values of property at the beginning and end of a tax period; where a tax may be imposed to recapture a tax benefit previously claimed by the taxpayer; where a tax may be imposed at the time of the physical transfer, processing, or export of readily marketable property; and where a tax may be imposed on the receipt of deemed distributions of profits that have been realized by the distributing person.

10 172 F.3d 209, 83 AFTR 2d 99-1784 (CA-2, 1999).

11 The OMT imposed a graduated tax on Ontario mines to the extent that "profit," as defined for OMT purposes, exceeded a statutory exemption. In determining "profit" for OMT purposes, taxpayers were allowed to deduct some direct basic expenses and "an allowance for profit in respect of processing" in lieu of certain expenses that were attributable to OMT gross receipts but that were not recoverable under the tax.

12 113 TC 338 (1999).

In the court's view "to qualify as an income tax in the United States sense, the foreign country must have made an attempt always to reach some net gain in the normal circumstances in which the tax applies.... The label and form of the foreign tax is not determinative." The Court of Claims found that the form of OMT did not parallel a U.S. income tax but nonetheless reviewed whether the effect of the tax was to fall on some net gain. The court ultimately found, however, that, in view of the large-scale omission of deductions from the OMT, it could not be said that net gain of that business was sure, or very likely, to be reached by the tax.

In each of these cases, the foreign tax statute did not allow the taxpayer to deduct all of its expenses in computing its taxable income. In assessing the taxes, however, the court looked beyond the strict labeling and form of the tax and sought to evaluate the actual effect of the foreign tax. If form were strictly controlling, there would have been no additional inquiry necessary.

Foreign tax credit regulations

In 1983, the Treasury issued Reg. 1.901-2 to provide greater clarity as to what constitutes a creditable foreign tax.[8] The Treasury combined the three types of taxes specified in the statute into a single concept of "income tax," which it stated would be a creditable tax only if it is both: (i) a tax; and (ii) a tax whose predominant character is that of an income tax in the U.S. sense. The preamble to the regulations cites *Bank of America* and *Inland Steel* for the standard that the predominant character of a foreign tax is that of an income tax in the U.S sense, if the foreign tax is likely to reach net gain in the normal circumstances in which it applies.

The regulations established a three-part test to judge whether a foreign tax satisfies the predominant character requirement. The regulations explain that a foreign tax is likely to reach net gain "if and only if the tax, judged on the basis of its predominant character," satisfies each of three tests: the realization test, the gross-receipts test, and the net-income test. The three requirements concern the timing and the base of the foreign tax. The realization requirement, one of timing, ensures that the taxpayer has received income before being obligated to pay taxes on it. The gross receipts and net income requirements present questions about the tax base, the amount on which the tax is levied.

Realization. The realization requirement means, essentially, that the tax should be imposed upon income as distinct from capital, consumption, or some other non-income amount. A foreign tax satisfies the realization test if "it is imposed upon or subsequent to the occurrence of events that would result in the realization of income under the income tax provisions of the Internal Revenue Code."[9]

Gross receipts. The gross receipts requirement provides that a tax, when judged on the basis of its predominant character, must be imposed either on actual gross receipts or on formulary gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.

Net income. A foreign tax satisfies the net income requirement if the base of the tax is computed by reducing gross receipts to permit recovery of the significant costs and expenses attributable, under reasonable principles, to such gross receipts; or by allowing recovery of significant costs and expenses computed under a method likely to produce an amount that approximates recovery. A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies.

Case law after the regulations

Following the promulgation of the regulations, courts addressing whether a foreign tax was an "income tax" continued to look beyond the strict form and label of the tax and focused both on the manner in which the tax operated and on its intended purpose.

In *Texasgulf Inc.*,[10] the Second Circuit addressed the creditability of the Ontario Mining Tax—the identical tax that was found noncreditable in *Inland Steel*.[11] The court focused on how the OMT operated with respect to the entire industry. The taxpayer cited empirical evidence that the processing allowance effectively compensated for the expenses the taxpayer was not allowed to deduct. The court reviewed return-by-return industry data and noted that only 15.9% of taxpayers with OMT liability indicated nonrecoverable expenses that exceeded the processing allowance claim. This statistical information on the incidence of the tax was sufficient for the court to find that the OMT was likely to reach net gain, and therefore was a creditable tax.

In *Exxon Corp.*,[12] the U.S. Tax Court considered the creditability of the U.K. petroleum revenue tax, a special tax targeted at oil and gas activities in the North Sea enacted by the United Kingdom in response to increases in oil prices during the Arab oil embargo. The tax did not allow deductions for certain significant expenses, including notably interest expense, but it did grant a special deduction for "uplift, oil, safeguard, and tariff receipts."[13] The Tax Court considered the practical application of the special deduction and its relationship to the amount of actual expenses that could not be deducted. The court also cited the statute's legislative history, in which a government official said the tax "represents an excess profits tax." The Tax Court found that "the purpose, administration, and structure" of the tax indicated that this special tax constituted an income or excess profits tax in the U.S. sense and was creditable.

Thus, in applying the regulations' three-part test, courts continued the pre-regulation method of evaluating the purpose and the actual effect of the foreign tax.

U.K. windfall tax

The Labour Party commissioned Arthur Anderson to assist in developing its new tax on the privatized electric utilities. The Anderson team proposed several possibilities, including taxes on (1) gross receipts; (2) assets; (3) profits; (4) excess profits; and (5) excess shareholder returns. The Party rejected a number of these due to questions of administrative feasibility and accuracy. The Party also feared that a straight forward tax on profits would give the target companies opportunities for financial manipulation while creating a public perception that the new tax compromised existing corporate tax reliefs—and, if retrospective, constituted a second tax on the same profits.

The Labour Party settled on the idea of a tax on the "windfall" received by the privatized utilities at the time of their privatization, with the new Chancellor of the Exchequer, Gordon Brown, stating that the "tax will be related to the excessively high profits made under the initial [privatized] regime" and the U.K. Inland Revenue stating that the tax would constitute a "windfall tax on excess profits … calculated by reference to profits over a period of up to four years following privatization." As enacted by Parliament on 7/31/97, the new tax was a one-time tax on the companies themselves that was required to be paid in two installments. The details of the tax included the following:

- The amount of tax was set at 23% of the "windfall."
- The "windfall" was defined as the excess of: (a) the value of the company in profit making terms; over (b) the value at which it was sold to investors.
- The value of the company in profit making terms was defined as the amount produced by multiplying: (i) the average annual profit earned by the company during its first four years after privatization; by (ii) a price-to-earnings ratio of 9.[14]

As noted above, the new tax was imposed on the companies directly, rather than on their shareholders. London Electricity, a U.K. company partially owned by Entergy Corporation (Entergy), and South Western Electricity Board (SWEB), a U.K. company owned by PPL Corporation (PPL), paid tax in the amounts of approximately £140 million[15] and £90 million,[16] respectively. Entergy and PPL were both U.S. corporations and, following receipt of dividends from their U.K. subsidiaries, the two U.S. taxpayers claimed foreign tax credits under Section 902 and Section 901 for amounts of the new U.K. tax paid.

Litigation

The IRS disallowed the foreign tax credits claimed by Entergy and PPL and both companies filed petitions seeking review of the IRS disallowances by the U.S. Tax Court.[17]

Taxpayer arguments. Entergy and PPL presented essentially identical arguments before the Tax Court. Both taxpayers relied principally on a substance over form argument, namely, that the creditability of the windfall tax could be established by examining the actual operation and effect of the tax. Following on this principal, both taxpayers argued that, given the historical development, design, and actual operation of the windfall tax, it should be treated as, in effect, a creditable tax on excess profits because it did—and was clearly intended to—reach net gain actually realized by the U.K. utilities in the normal circumstances to which the tax applied.

The external evidence submitted by the taxpayers included testimony of the designers of the tax that indicated: first, that the rationale for the tax was to tax excess profits realized by the privatized utilities earned during the initial four-year period; and second, that the actual form of the tax was adopted for "presentational reasons." The taxpayers also submitted testimony of a professor of finance that indicated: first, that there was a very loose relationship between the windfall tax paid and changes in the companies' actual market values after privatization; but that, second, there was a very tight and direct relationship between the windfall tax paid and the cumulative initial period earnings of the companies.

Beyond these evidentiary allegations, the taxpayers made a simple algebraic argument, namely, that the windfall tax could be simply restated as a 51.7% tax on the companies "excess" earnings over their first four years.[18] This clearly showed, according to the taxpayers, that the predominant character of the windfall tax was that of an excess profits tax in the U.S. sense.

Government arguments. The government argued that the 1983 regulations neither require nor permit inquiry into the purpose underlying the enactment of a foreign tax or the history of a foreign taxing statute—that, to the contrary, creditability of the windfall tax must be evaluated only by reference to the specific statutory language.[19] The government distinguished cases such as *Texasgulf*, where external evidence on the actual incidence of the tax was admitted, on the basis that such cases were addressing only the limited question of whether, under the regulations, the cost allowances in question "effectively compensated" the taxpayer for being denied certain other deductions, with the result that the net income requirement in the regulations was satisfied.

The government further argued that the windfall tax was not a creditable foreign tax because it did not, *on its face*, satisfy any of the requisite factors set forth in the regulations.

First, the government argued that the base of the windfall tax, as set forth in the statute, was the difference between two values, and that the tax therefore was not imposed upon or after the occurrence of events that would result in the realization of income under U.S. tax principles—with the result that the realization requirement of the regulations was not satisfied. The fact that the taxable value in question was determined by reference to past profits actually realized did not, in the government's view, convert the windfall tax into a tax on realized income. To the contrary, the government argued that a tax on income producing property does not become an income tax simply because the property's value is calculated for tax purposes by reference to the amount of income the property generates.

Next, the government argued that the tax was not imposed on the basis of gross receipts or net income because the windfall-tax base was simply the difference between two values—indeed, the windfall tax statute makes no mention of gross receipts or gross income at all. The government stressed that, under the statutory formula, the windfall tax base of London Electricity and SWEB in each case exceeded the company's four-year profits.[20]

Tax Court.[21] The Tax Court began by noting the taxpayer and the government "fundamentally disagree as to what [the court] may consider in determining whether the windfall tax is a creditable tax." The court rejected the government's text-bound approach as inconsistent with the 1983 regulations, which state that the "predominant character of a foreign tax is that of an income tax in the U.S. sense * ** [i]f*** the foreign tax is likely to reach net gain in the normal circumstances in

[13] The U.K. ring-fenced North Sea oil and gas activities and subjected these activities to a separate corporate income tax. Deductions were not allowed for interest expense, costs of acquiring licenses from private parties, or royalties.

[14] The actual formula was: Tax = 23% x [(365 x (P/D) x 9) – Floatation Value], where P represented aggregate profits over the four-year period and D represented the precise number of days in the four-year period, and where Floatation Value represented the value at which the company was sold to investors.

[15] London Electricity's total profits for the initial period amounted to £503.3 million, making its average annual profit £125,763,860. London Electricity's profit-making value was £1,131,874,760 (i.e., its average annual profit x 9). London Electricity's floatation value was £523,341,600. Its windfall was thus £608,533,140. This resulted in a windfall tax liability of £139,962,622.

[16] SWEB total profits for the initial period amounted to £306.2 million, making its average annual profit £76,497,604. SWEB's profit-making value was £688,478,439. SWEB's floatation value was £295,351,200. Its windfall was thus £393,127,239. This resulted in a windfall tax liability of £90,419,265.

[17] American Electric Power Company (AEP) owned, indirectly, a 50% interest in Yorkshire Electricity Group, another U.K. company that paid the new windfall tax. AEP is currently disputing the IRS' disallowance of its foreign tax credits in administrative proceedings before the IRS.

[18] Tax = 23% x [(365 x (P/D) x 9) – Floatation Value]
Tax = 23% x [(365 x (P/1,461) x 9) – Floatation Value], given that D = 1461
Tax = 23% x [((P/4) x 9) – Floatation Value], given that 1461 days equals 4 years
Tax = 23% x [(2.25 x P) – Floatation Value]
Tax = 51.7% x [P – (44.47% x Floatation Value)]

[19] The government distinguished the substance versus form approach taken for transactions and the approach that should be taken for duly enacted legislation. In the context of duly enacted legislation, the legislature "must be taken at its word."

[20] The government argued that this fact brought the case within the scope of Example 3 of the applicable regulations. See Reg. 1.901-2(b)(3)(ii), Example 3.

which it applies." The court found that by implicating "circumstances of application" the regulations signaled their intent for factors extrinsic to the text of the foreign statute to play a role in the determination of the tax's character. The court concluded that the ultimate inquiry is whether the tax is designed to and does, in fact, reach net gain, regardless of the form of the foreign tax as reflected in the statute.

The court found that the design and incidence of the windfall tax was that of a tax on excess profits. The court noted the public statements by government officials that the tax would recoup "excessive profits" and Parliament's understanding that the tax was a tax on excess profits. Citing *Bank of America*, the court found that "just as 'a levy can in reality be directed at net gain even though it is imposed squarely on gross income,' . . so too can a foreign levy be directed at net gain or income even though it is, by its terms, imposed squarely on the difference between two values."

After reviewing the extrinsic evidence of purpose and implementation, the Tax Court found that because both the design and effect of the windfall tax was to tax an amount that, under U.S. tax principles, may be considered excess profits realized, the tax did, in fact, "reach net gain in the normal circumstances in which it applied, and therefore, that its 'predominant character' was 'that of an income tax in the U.S. sense.' "

Third Circuit.[22] The government appealed the *PPL* decision to the Third Circuit. The Third Circuit opinion began by clarifying that "predominant character" is not an independent standard and that all three requirements in the regulations must be satisfied. The Third Circuit then adopted the view of the Tax Court that "classification of a foreign tax depends on its economic substance and not its form" but reversed the Tax Court on the ground that it did not properly consider all three requirements of the pertinent regulations.

First, the Third Circuit rejected PPL's argument that the windfall profits tax should be appropriately viewed as a 51.75% tax on profits above the level of "normal profits,"[23] and held instead that the windfall tax failed the gross receipts test of the regulations because the tax base specified by the statute (2.25 times actual four-year profits) exceeded the utilities' actual four-year profits. The Third Circuit was simply not willing to restate a tax at 23% on 2.25 times excess profits as a tax at 51.75% on actual excess profits.

Second, the Third Circuit found that the tax failed the realization requirement. To meet that test, the tax must be imposed upon the occurrence of events that would result in the realization of income. The court found the U.K. windfall tax did not ensure that the companies had actually realized the amounts of profits being taxed.

Fifth Circuit.[24] The government appealed the *Entergy* decision to the Fifth Circuit. The Fifth Circuit began by citing *Inland Steel* for the premise that label and form of a foreign tax are not determinative. In the court's view, the important thing is whether the other country is attempting to reach some net gain.

The court found that viewed in practical terms, the windfall tax clearly satisfied the realization and net income requirements. The tax was based on revenues from the ordinary operation of utilities that accrued long before the design and implementation of the tax. The court reviewed the legislative history of the windfall tax and found the "tax's history and practical operation" were to "claw back" a substantial portion of the privatized utilities' excess profits. These initial profits were the difference between the utilities' income from all sources less their business expenses—in other words, their net income.

Much of the Fifth Circuit's opinion was spent critiquing the Third Circuit's approach in *PPL*. The Fifth Circuit rejected the Third Circuit's argument that a tax on 2.25 × profits violates gross receipts as logically flawed. In the Fifth Circuit's view, the windfall tax begins by taking 23% of the daily average of profit based on actual gross receipts. The windfall tax at no point imputes gross receipts against utilities. The Third Circuit opinion seems to overlook that a tax based on actual financial profits in the U.K. sense necessarily begins with gross receipts. By the Third Circuit's logic, had the Windfall Tax applied to the first nine years after floatation, the multiplier would have been 1 and the Windfall Tax would suddenly qualify for dollar-for-dollar credit.

Supreme Court review

PPL petitioned the Supreme Court for review of the Third Circuit decision and the government ac-

[21] PPL, 135 TC 304 (2010); Entergy, TCM 2010-166. The Tax Court issued a full opinion in PPL and issued a short opinion in Entergy, in which it expressly relied on its opinion in PPL.

[22] PPL, 665 F.3d 60, 108 AFTR 2d 2011-7571 (CA-3, 2011).

[23] 51.7% is based on the formula Tax = 23% x [2.25 x P]. See footnote 18.

[24] Entergy Corp., 109 AFTR 2d 2012-2425 (CA-5, 2012).

quiesced on the theory that the court should resolve the split with the Fifth Circuit. The government once again argued that, by its terms, the Windfall Tax is a tax on value and, under U.S. tax law, a tax on value or unrealized appreciation is not a tax on realized income.

The Supreme Court has granted cert and agreed to hear the case. In our view, the government's reliance on the form and label of a tax is inconsistent with both the core notion of the U.S. tax system that substance not form is generally controlling *and* the express mandate of the foreign tax credit regulations that a tax should be treated as an income tax if "it is likely to reach net gain in the normal circumstances in which it would apply." The legislative history indicates that while the Labour Party had a variety of options, its target was always to recapture the perceived excessive profits earned by privatized utilities in the years immediately following privatization. Moreover, the formula for determining the windfall profits tax starts with profits actually realized by the company in the first four years after its privatization. A company can only incur a windfall tax liability if it had net profits, and net profits in excess of an 11% annualized return on its floatation value. This sounds to us like an income tax in the U.S. sense. ■