



International Tax

## United States Tax Alert

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### Supreme Court finds UK windfall tax creditable under Code section 901

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On 20 May 2013, the Supreme Court, in a unanimous decision,<sup>1</sup> reversed the Third Circuit<sup>2</sup> and held that the UK “windfall tax” was a creditable foreign tax under Internal Revenue Code section 901 because the predominant character of the tax was that of an income tax.

#### Section 901 regulatory framework

Under Treas. Reg. §1.901-2(a)(1), a foreign levy is an income tax creditable under section 901 if and only if: 1) it is a “tax”; and 2) the predominant character of that tax is that of an income tax in the US sense. A foreign levy either is or is not an income tax for all persons subject to the tax. The predominant character of a foreign 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, but only to the extent that the liability for the tax is not dependent, by its terms or otherwise, on the availability of a credit for the tax against income tax liability to another country (i.e. a soak-up tax).<sup>3</sup> 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 Treas. Reg. §1.901-2(b)(2), (b)(3), and (b)(4), respectively.<sup>4</sup>

#### UK windfall tax

The UK windfall tax, enacted in 1997, imposed a one-time tax on what the government considered to be excess profits earned after the privatization of 32 formerly-public utility companies, including South Western Electricity plc, a subsidiary of PPL. As part of privatization, many of the companies were required to continue providing services at the same rate as they had charged under public ownership for a fixed period of time (the so-called “initial period”), typically their first four years of private operation. The UK Parliament adopted a tax (i.e. the windfall tax) that applied only to those regulated companies that were prohibited from raising their rates. The tax was characterized by the UK government as a tax

<sup>1</sup> *PPL Corp. v. Comm’r*, 569 U.S. \_\_\_ (2013). Justice Sotomayor issued a concurrence (see additional note below).

<sup>2</sup> *PPL Corp. v. Comm’r*, 665 F.3d 60 (3rd. Cir. 2011), *rev’g* 135 T.C. 304 (2010).

<sup>3</sup> Treas. Reg. §1.901-2(a)(3).

<sup>4</sup> Treas. Reg. §1.901-2(b)(1).

on the difference in value of the privatized companies between the companies' respective flotation values at the time of privatization and their respective "profit-making values" at the end of the initial period, determined using a complex formula that included an imputed price-to-earnings ratio of 9.<sup>5</sup> For 27 of the 32 companies subject to the tax, the number of days in the initial period was the same (i.e. a full four years, or 1,461 days).<sup>6</sup>

## PPL litigation

In *PPL Corp. v. Commissioner*,<sup>7</sup> the Tax Court held that the UK windfall tax was creditable since the intent of Parliament (as determined by the Tax Court) was to tax "excessive profits" that were the result of the privatization of UK utility companies. The court found that the actual effect of the tax for most taxpayers was to levy an amount on what was determined to be excess profits at an effective tax rate of 51.71%. The Tax Court found that the predominant character of the tax was that of an income tax, rejecting the Commissioner's argument that the creditability issue should be decided by looking only at the characterization of the tax by the UK government and the formula set forth in the statute. By examining the windfall tax's design and actual effect, the Tax Court found that the U.K windfall tax was enacted to, and did in fact operate as, an excess profits tax for the vast majority of companies subject to the tax.

On appeal, the Third Circuit reversed the Tax Court's decision in PPL, accepting the Service's formalistic position that since the language of the statute imposed a tax based on the difference between two values, the intent and actual effect of the law were immaterial. Subsequently, in *Entergy v. Commissioner*<sup>8</sup> (a case involving the same UK tax), the Fifth Circuit adopted the Tax Court's approach in PPL, finding the UK windfall tax to be a creditable income tax based on the tax's substance. To resolve this split in the Circuits, the Supreme Court granted *certiorari* to review the Third Circuit's PPL decision.

## Supreme Court opinion

Consistent with the reasoning of the Tax Court in PPL and the Fifth Circuit in *Entergy*, the Supreme Court adopted what it characterized as a "common sense approach that considers the substantive effect of the tax" and concluded that the windfall tax was creditable. Rejecting the Third Circuit's approach, the Supreme Court stated that the "crucial inquiry is the tax's economic effect" on taxpayers and not the manner in which the foreign government characterizes the tax (e.g. label, arrangement of the formula, etc.).

The Court found that the tax was in fact a tax on realized net income "disguised as a tax on the difference between two values...." Rearranging the tax formula set forth in the UK statute, the Supreme Court noted that for the 27 of 32 companies that had identical 1,461 day initial periods, the substantive effect of the tax formula was to impose an excess profits tax on profits above a certain threshold at a rate of 51.71%. Accordingly, the "economic substance" of the tax was found to be a creditable income tax.<sup>9</sup>

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<sup>5</sup> The formula was as follows: Windfall Tax = 23% [(365 x (P/D) x 9) – FV]. D equals the number of days a company was subject to rate regulation; P equals the total profits earned during the initial period; FV equals the flotation value/market capitalization of the company after privatization.

<sup>6</sup> Three of the remaining five companies had initial periods very close to four years (1,463, 1,456 and 1,380 days), while another had an initial period of only 316 days. The initial period of the final company was not disclosed in the opinion.

<sup>7</sup> 135 T.C. 304 (2010).

<sup>8</sup> 683 F.3d 233 (5<sup>th</sup> Cir. 2012).

<sup>9</sup> Two of the five companies with shorter initial periods were potentially subject to effective tax rates exceeding 200% of net income. The unanimous opinion of the Court did not consider whether this fact should impact the creditability analysis because the Commissioner

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conceded that the government had not preserved this argument in the *PPL* litigation. The opinion noted, however, that under the "predominant character" test, a tax that operates as an income tax for most taxpayers is creditable "even if it may affect a handful of taxpayers differently." In a concurrence, Justice Sotomayor questioned whether the windfall tax's impact on these two companies should have been disregarded in determining the tax's predominant character, but she joined the Court's unanimous opinion because the Commissioner did not pursue this argument.