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LEGAL ALERT

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Supreme Court Unanimously Rules in Favor of Taxpayer, Holds U.K. Windfall Tax Creditable

The United States Supreme Court held Monday in *PPL Corporation v. Commissioner* (No. 12-43) that a U.S. taxpayer was entitled to claim a foreign tax credit on its share of a "windfall tax" imposed on the taxpayer's United Kingdom (U.K.) subsidiary. Applying a "commonsense approach that considers the substantive form of the tax," the Court found the windfall tax creditable because its "predominant character" "is that of an excess profits tax, a category of income tax in the U.S. sense." In so doing, the Court reaffirmed the principle that substance, not form, should determine the characterization of a given tax transaction, and provided some welcome clarity for taxpayers and practitioners. Sutherland lawyers along with other amici filed briefs urging the Court to review the case and address the applicability of the substance over form doctrine.

The *PPL* opinion conclusively resolves the creditability of the windfall tax at issue and reaffirms the substance over form doctrine, but the impact it will have on the broader creditability question is not clear. While the majority opinion reaffirms the role of substance, not form, in determining the predominant character of a tax, Justice Sotomayor's concurring opinion raises the question of whether the "predominant character" test requires that it have the same character for all taxpayers in order to satisfy the test. Whether this prompts the Treasury Department to consider clarifying amendments to its regulations on this point remains to be seen. The decision also raises the possibility that Treasury will promulgate new regulations specifically addressing excess profits taxes as a subset of income taxes.

Finally, the result in *PPL* will likely affect the IRS's position on the creditability of certain other foreign taxes commonly paid by U.S. taxpayers. Currently, the IRS is studying two such taxes: the Puerto Rican Excise Tax and the Mexican *impuesto empresarial a tasa única* (IETU) tax.

Background

The Labour-controlled British parliament enacted the windfall tax in 1997, imposing it on a class of former state-owned companies, including several public utilities, which were privatized in the late 1980s and early 1990s under the then-ruling Conservative Party. The government had privatized these companies through a public offering of shares, called a "flotation." For the first four years of operation, the newly privatized utilities were obligated to keep prices fixed at the same rates as the government had charged. During these first four years, many of the companies realized significant efficiencies that, when coupled with rate regulation, enabled them to reap large profits that advocates of the windfall tax perceived as out of proportion to the companies' flotation prices. The pertinent U.K. statute expressed the windfall tax as a mathematical formula that purported to tax the difference between a company's imputed value (calculated based on its actual profits during the initial period of rate regulation) and its flotation value (the price for which it had originally sold when privatized).

PPL Corporation (PPL) was a 25% owner of South Western Electricity plc, a U.K. utility company subject to the windfall tax. South Western Electricity paid the windfall tax, and PPL claimed a foreign tax credit for its share of the windfall tax under Internal Revenue Code Section 901(b)(1). The Commissioner of Internal Revenue denied the credit, but the U.S. Tax Court determined that the tax was creditable under Section 901. The U.S. Court of Appeals for the Third Circuit reversed the Tax Court, creating a split with

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the Fifth Circuit, which affirmed the Tax Court's holding in a separate case involving the same tax and a different taxpayer.
Section 901(b)(1) allows as a credit "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." Under the Treasury Regulations implementing Section 901 to be creditable a tax must be an "income tax," and to be an "income tax" the "predominant character of [the] tax [must be] that of an income tax in the U.S. sense." The regulations further provide that the "predominant character" of a tax is that of an income tax if the tax "is likely to reach net gain in the normal circumstances in which it applies."

Majority Opinion

Speaking for a unanimous Court, Justice Thomas evaluated the windfall tax as it applied to the majority of the companies subject to it, concluding that the windfall tax, as statutorily expressed, was the mathematical equivalent of a 51.71% tax on the difference between actual profit and a threshold amount of "acceptable" profit. As such, the windfall tax was "a classic excess profits tax," based on 'true net income.'" Because the Court found the "economic substance of the U.K. windfall tax is that of a U.S. income tax," the Court held the tax creditable under Section 901. The Court rejected the Commissioner's argument that the U.K. characterization of the windfall tax as a tax on imputed value should control the determination of the creditability of the tax. The Court also emphasized the fact that the windfall tax was based on actual profits, and not on any projection of future earning potential, making it more like a tax on income and less like a tax on value.

Concurring Opinion

Justice Sotomayor, writing separately and concurring in the Court's opinion, observed that the application of the windfall tax's statutory formula to certain outlier companies—i.e., the handful of companies that were subject to rate regulation for more or less than the four-year initial period—resulted in a different effective tax rate and a different excess profit threshold. In Justice Sotomayor's view, if these outliers were taken into consideration, the windfall tax could not be considered an income tax but rather "a tax on average profits," making its "predominant character" that of a "tax on a company's value." Perhaps most interestingly, Justice Sotomayor questioned whether Treas. Reg. § 1.901-2(a)(1)(ii), which provides that "a tax either is or is not an income tax, in its entirety, for all persons subject to the tax" means that the tax's "predominant character must be as an income tax for all taxpayers," or whether a tax need only be an income tax for a "substantial number of taxpayers." Justice Sotomayor's analysis suggested that she believed the former interpretation—advocated only by a number of tax professors appearing as amicus curiae—might well be correct. However, because the Commissioner had not advocated that interpretation, and had indeed rejected the notion that the outliers should be considered, Justice Sotomayor reserved the question and concurred in the Court's opinion.

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