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This month's newsletter also features articles about a district court's decision to permit a corporation to take a business expense deduction for a portion of a double damages payment made to settle litigation brought under the False Claims Act, the Tax Court's decision in *Barnes Group v. Commissioner* applying the step-transaction doctrine to Barnes' corporate reinvestment plan, and sweeping changes to Switzerland's banking secrecy laws.

Supreme Court Holds in Favor of PPL in UK Windfall Profits Case

The Supreme Court held unanimously in favor of taxpayer PPL Corporation in the UK windfall profits tax case, reversing a decision by the US Court of Appeals for the Third Circuit that had held that the tax was not creditable for US tax purposes under section 901.¹ Rejecting the Third Circuit's formalistic interpretation of the meaning of a creditable tax, the Court determined that the windfall profits tax was a creditable excess profits tax for purposes of the foreign tax credit because its predominant character is that of an income tax in the US sense.

Background

PPL is a global energy company headquartered in Pennsylvania. The UK's Conservative Party privatized a number of government-owned companies between 1984 and 1996. Private parties purchased the utility companies through an initial sale of shares known as a "flotation." Taxpayer PPL became a part owner of one of the privatized companies. During their first four years of privatization, many of the companies were required to provide utility services at the same rates that they had offered when they were owned by the government. Many of the companies earned

¹ *PPL Corp. v. Commissioner*, No. 12-43 (May 20, 2013). All section references are to the Internal Revenue Code and all references to regulations are to the Treasury regulations issued thereunder, unless otherwise noted.

significant profits after privatization. In 1997, the Labor Party came to power in the UK and enacted a one-time “windfall tax” of 23 percent on utility companies.

The parties stipulated that the tax could be summarized by the following formula:

$$\text{Tax} = 23\% [(365 \times (P/D) \times 9) - \text{FV}]$$

In the equation, D is the number of days that a company was subject to rate regulation (the “initial period”), P is the total profits earned during the initial period, and FV equals the flotation value, or market capitalization value after sale. The Labor government characterized the tax as a 23 percent tax on the difference between what the companies’ flotation values should have been and what they actually were.

On its 1997 federal income tax return, PPL claimed a credit for its share of the windfall tax under section 901. The IRS rejected PPL’s characterization of the tax as a creditable tax, but the Tax Court disagreed with the IRS and held in favor of PPL. After the Third Circuit reversed the Tax Court, PPL petitioned the Supreme Court for certiorari.

Court’s Analysis and Holding

Under section 901, income, war profits, and excess profits taxes paid overseas are creditable against US income taxes. The Treasury Regulations provide that a foreign tax or levy is creditable if the “predominant character of that tax is that of an income tax in the US sense.”²

The Court laid out several related principles derived from the Regulations to establish that a foreign levy that taxes net income, or profits, is creditable.³ The “predominant character” of the tax is controlling. A foreign government’s characterization of its tax does not determine whether the tax is a creditable US tax, rather the “crucial inquiry is the tax’s economic effect.”⁴ “[F]oreign tax creditability depends on whether the tax, if enacted in the US, would be an income, war profits, or excess profits tax.”⁵ Further, the predominant character is that of a US income tax if the foreign tax reaches net gain, which it does if “judged on the basis of its predominant character, [it] satisfies each of the realization, gross receipts, and net income requirements” as outlined in the regulations.⁶ Net gain is the realized gross receipts less costs and expenses.

The Court identified the source of contention between the parties as how to characterize the tax: the Commissioner characterized the tax as a tax on the “difference

² Treas. Reg. 1.901-2(a)(1).

³ Slip op. at 5-7.

⁴ *Id.* at 5.

⁵ *Id.* at 6.

⁶ *Id.* citing Treas. Reg. 1.901-2(a)(3)(i).

between the price at which each company was sold and the price at which the Labour government believed each company should have been sold”⁷ and PPL argued that “the substance of the windfall tax is that of an income tax in the US sense.”⁸

The Court held in favor of PPL and “conclude[d] that the predominant character of the windfall tax is that of an excess profits tax, a category of income tax in the US sense.”⁹

The Court stated:

It is important to note that the Labour government’s conception of ‘profit-making value’ as a backward-looking analysis of historic profits is not a recognized valuation method; instead, it is a fictitious value calculated using an imputed price-to-earnings ratio. . . . [T]he windfall tax is a tax on realized net income disguised as a tax on the difference between two values, one of which is completely fictitious.¹⁰

Rejecting the IRS’s argument that any algebraic rearrangement of the stipulated mathematical formula representing the tax was improper, the Court readjusted the formula to “illustrate the economic substance of the tax and its interrelationship with net income.”¹¹ Thus, the Court held that the economic substance of the tax is that of an income tax in the US sense.

Concurring Opinion

Justice Sotomayor wrote separately that the Government’s position that the predominant character inquiry should disregard five companies that had different initial periods rendered the Court (or some of its Justices) “reluctant” to consider an argument raised in an *amicus* brief that might have resulted in a different analysis.¹² Anne Alstott argued that if the predominant character inquiry is expanded to those five companies, it becomes clear that the windfall profits tax is functionally a tax on value, not an excess profits tax.¹³ Accordingly, Justice Sotomayor concurred with the Court’s opinion.

—Liz McGee

⁷ *Id.* at 7.

⁸ *Id.* at 7-8.

⁹ *Id.* at 8.

¹⁰ *Id.* at 8.

¹¹ *Id.* at 10.

¹² Dissent, slip op. at 7.

¹³ *Id.* at 1, 7.

US District Court Rejects *Talley* and Permits a Business Expense Deduction for Part of Double Damages Payment Under the False Claims Act

In a taxpayer-favorable decision earlier this month, the US District Court for the District of Massachusetts, following a jury verdict, entered judgment for a corporation in a tax refund suit permitting a business deduction for payments made to the government to resolve potential liability under the False Claims Act (“FCA”) (31 U.S.C. §§ 3729-3733), and other statutory and common law causes of action. In *Fresenius Medical Care Holdings, Inc. v. US*,¹⁴ Judge Douglas P. Woodlock upheld a jury verdict for Fresenius and awarded the taxpayer a refund of \$50,420,512.00 plus interest. The award reflected the jury’s finding that the majority of double damages payments that the IRS claimed were punitive and therefore ineligible for a deduction as ordinary and necessary under Internal Revenue Code § 162(a) were, in fact, compensatory and therefore deductible. In permitting the case to proceed to trial, the district court rejected the test to determine if payments constitute compensatory damages set forth in *Talley Indus., Inc. v. Comm’n*,¹⁵ and allowed Fresenius to present evidence beyond the terms of the settlement agreements to determine if all or some of the payments were made in settlement of non-punitive FCA liability.

Plaintiff Fresenius filed a tax refund suit against the United States in 2008 seeking recovery of \$126 million of a \$385 million payment to the government as part of a civil settlement, which resolved Fresenius potential liability under the FCA. Fresenius claimed that the entire settlement amount was tax deductible as an ordinary and necessary business expense under Internal Revenue Code § 162(a). The IRS had agreed that \$258 million was deductible as compensatory but viewed the remaining \$126 million at issue as a penalty ineligible for deduction under Code Section 162(f). Section 162(f) of the Code prohibits taxpayers from deducting settlement payments made to pay “a fine or similar penalty.”

Fresenius initially moved for summary judgment, but the motion was denied. Fresenius had asserted that the plain language of the civil settlement agreements identified the payments as non-punitive, and therefore, not a penalty within the meaning of Section 162(f). However the district court, applying federal common law to interpret the settlement agreements, found that the agreements contained conflicting language and concluded that the contracts were ambiguous. Fresenius’ argument was predicated on language in the agreement stating that “[Fresenius entities] further agree nothing in this agreement is punitive in purpose or effect.” The government argued that the agreement contained no provision governing how the US should allocate the

¹⁴ 2013 WL 1946216, Case No. 08-12118-DPW (D. Mass. May 9, 2013).

¹⁵ T.C. Memo 1999-200, aff’d 18 F. App’x 661 (9th Cir. 2001).

settlement funds. The settlement agreement provided, “Nothing in this agreement constitutes an agreement by the US concerning the characterization of the amounts paid hereunder for purposes of any proceeding under Title 26 of the Internal Revenue Code.” After the judge denied the summary judgment motion, the case proceeded to trial.

In a motion for judgment as a matter of law filed before the jury began deliberations, the government argued that Fresenius had not proven that the \$126 million represented compensatory payments. The government’s argument rested on US Supreme Court precedent and the *Talley* decision. The US Supreme Court held in *US v. Cook County*¹⁶ that the multiple damages provision of the FCA is both penal and compensatory. The government took the position that if the payment serves both purposes, the fact that one purpose is penal disqualifies it as a deduction under Section 162(f), unless the government agrees to strip the penal aspect from the payments. In reply and in support of its own motion for judgment as a matter of law, Fresenius argued that the Supreme Court in *US v. Bornstein*¹⁷ held that the compensatory purpose of the multiple damage provision of the FCA included the recovery of prejudgment interest, and that the Supreme Court’s ruling in *Cook County* held that triple damages under the FCA are both compensatory and punitive, but double damages (which Fresenius paid under the settlement agreements) are merely compensatory. The district court denied the parties’ motion for judgment as a matter of law and allowed the case to proceed to verdict.

The jury returned a verdict for Fresenius, finding that \$95 million of the \$126 million in disputed settlement payments were compensatory and therefore deductible. In concluding that it was reasonable for the jury to conclude that the vast majority of the settlement payments were compensatory, the court referenced the large amount of pre-judgment interest necessary to make the government whole on losses incurred by the fraud. The court also noted that the global settlement included a criminal plea agreement imposing a fine on Fresenius of \$101 million, which the jury reasonably might have concluded was intended to cover the punitive damages against Fresenius for fraud.

The court’s opinion rejected the analysis in *Talley*. Judge Woodlock noted that throughout the litigation, the government relied heavily on *Talley* for the proposition that the parties must agree on the purpose of the settlement payment in order to characterize the payment as compensatory for tax purposes. In *Talley*, the Tax Court held that the tax characterization of a settlement payment was ambiguous under the agreement. After a hearing in *Talley*, the Tax Court found that “[the record show[ed]

¹⁶ 538 U.S. 119 (2003).

¹⁷ 423 U.S. 303 (1976).

that the parties did not agree whether the portion of the settlement in excess of the Government's 'single' damages would constitute compensation to the Government for its losses," and thus the taxpayer "failed to establish entitlement to a deduction for the disputed portion of the settlement." Judge Woodlock concluded "that a manifest agreement is not necessary for Fresenius to establish that all or some portion of the payments at issue were made in settlement of non-punitive FCA liability."

Fresenius opens the door for corporations to seek deductions for the double damages portion of FCA awards. Care in documenting settlement negotiations with the government should be taken to improve one's chances of sustaining award deductions.

—*Lawrence M. Hill, Richard A. Nessler, and Liz McGee*

Tax Court Applies Step Transaction Doctrine to Corporate Reinvestment Plan, Sustains Accuracy-Related Penalties in *Barnes Group v. Commissioner*

The Tax Court rejected the Barnes Group's characterization of a series of transfers and loans among related entities as a "reinvestment plan" and held that the transfers were dividends to the parent company that should have been included in gross income under section 301.¹⁸ The court also held the taxpayers liable for the section 6662 accuracy-related penalty.¹⁹

Barnes is a US corporation with a number of foreign subsidiaries. In 1999 and 2000 it made three significant acquisitions as part of a strategic objective to expand the company. Barnes assumed approximately \$200 million in new debt in relation to those acquisitions. Some of the loan rates on the debt were in excess of 7 percent. At the same time, Barnes and its subsidiaries had \$45.2 million in cash worldwide, on which Barnes was earning only 3 percent. According to the court, Barnes understood that a dividend or loan from one of the foreign subsidiaries to Barnes would result in a Federal tax liability. Barnes then sought advice from three major accounting firms to assist it in addressing the situation.

Ultimately Barnes and one of the accounting firms developed a reinvestment plan between Barnes and its subsidiaries. Barnes formed Bermuda and Delaware subsidiaries in 2000 as part of the plan. The plan was then divided into two phases. The first phase consisted of three parts. Initially a Singapore subsidiary and Barnes transferred foreign currency to the Bermuda subsidiary for its common stock. The

¹⁸ T.C. Memo. 2013-109.

¹⁹ The court also held in favor of the IRS on a third issue: whether the fair market value of "clean rooms" transferred to Barnes in 2001 should be excluded from its income under section 109.

Bermuda subsidiary and Barnes transferred foreign currency and Bermuda common stock to the Delaware subsidiary in exchange for its stock, and Barnes and Bermuda received preferred stock in return. Finally the Delaware subsidiary converted the foreign currencies into US dollars and lent the funds to Barnes. In the second phase, the Singapore subsidiary borrowed money from a Singapore bank and then engaged in a transaction similar to the one that occurred in the first phase. Ultimately Barnes received over \$65 million in loans from the Delaware subsidiary.

The accounting firm provided an opinion letter that focused on the transactions between the Bermuda and Delaware subsidiaries. The opinion letter stated that the Delaware preferred stock held by the Bermuda subsidiary should constitute an investment in US property within the meaning of section 956(c)(1), but the Bermuda subsidiary should have a zero basis in the Delaware preferred stock, no amount should be included in Barnes' income as a result of the Bermuda subsidiary's investment in the Delaware preferred stock, section 269 should not apply to the investment plan, the transaction should not result in a deemed repatriation of the funds under section 301, and the conclusions of the opinion letter should not be altered by step transaction principles.

The IRS sent Barnes a Notice of Deficiency, which increased Barnes' taxable income to reflect, in part, the transfers to Barnes that resulted from the reinvestment plan.

Before the Tax Court, the taxpayers argued that they had reasonably relied upon Revenue Ruling 74-503, 1974-2 C.B. 117 and that Revenue Ruling 2006-2, 2006-1 C.B. 261 precluded the IRS from challenging situations in which the taxpayer had reasonably relied upon Revenue Ruling 74-503. The court, distinguishing the facts at issue in the *Barnes* case from the facts at issue in the Revenue Ruling, dismissed this argument and applied the "interdependence test" of the step transaction doctrine to the transfers and loans at issue finding that the substance of the plan was actually a dividend from the Singapore subsidiary to Barnes.

—Liz McGee

Switzerland's Secrecy Law Cracks Under US Pressure

On May 29, 2013, Switzerland announced a landmark decision that it has accepted a settlement with the US over alleged Swiss bank complicity in abetting tax evasion by US taxpayers. The details of the settlement remain confidential, but if accepted by the Swiss parliament, Swiss banks would be permitted to provide customer information to US authorities without violating Swiss secrecy laws. The agreement is the result of nearly two years of negotiations between US and Swiss government officials. Once adopted by the Swiss government, it is expected that the US will make a unilateral amnesty offer to Swiss banks to hand over client information without violating Swiss law. The amnesty offer is expected to last only 12 months.

In support of the agreement, the Swiss Finance Minister stated that Switzerland “wants to create the legal basis for resolving the tax dispute with the US.” However, the proposed agreement does not provide a universal deal between the US and Swiss banks; each bank will have to make its own agreement with the US. Moreover, the Swiss government has denied reports that it will pay billions of dollars to the US to cover the fines the Swiss banks can expect to receive. It is not yet known how much money Swiss banks will have to pay the US, but according to Swiss officials, the US will distinguish between what banks did prior to 2009, when the US investigated UBS AG, and those that continued to aid American tax evaders afterwards.

Switzerland’s willingness to agree to a US deal is to save its banks from the fate suffered by Switzerland’s oldest bank, Wegelin & Co., which recently plead guilty in the US to aiding American tax evaders and is now closing. More than a dozen Swiss banks have been the focus of the US’s broad tax evasion probe. This development clearly places more pressure on US taxpayers with Swiss accounts to voluntarily disclose their accounts to the Internal Revenue Service before the agency finds them or face draconian fines, penalties and criminal charges. Under the current offshore voluntary disclosure program, taxpayers must file original and amended tax returns, pay back-taxes, and interest for up to eight years and pay accuracy-related or delinquency penalties as high as 27.5 percent.

—Richard A. Nessler

IRS Announces Agreement with United Kingdom and Australia to Identify Tax Evaders

On May 9, 2013, the IRS announced (IR 2013-48) a coordinate effort with tax administrations from Australia and the United Kingdom to share tax information involving complex offshore structures, trusts, and companies holding assets on behalf of residents in jurisdictions throughout the world. Tax administrators believe that these offshore structures are being used to conceal assets by wealthy individuals and companies. The unprecedented international cooperation “is part of a wider effort by the IRS and other tax administrations to pursue international tax evasion,” said IRS Acting Commissioner Steven T. Miller.²⁰

²⁰ See IRS News Release 2013-48.

Tax administrations from the three nations have acquired a substantial amount of data (the UK reporting nearly 400 gigabytes of data is still being analyzed), revealing the use of companies and trusts in a number of jurisdictions including Singapore, the British Virgin Islands, the Cayman Islands, and the Cook Islands. The three countries are reportedly reviewing the collection of data to identify those who may own such companies or trusts as well as the advisors who helped to establish the offshore entities. The three countries have developed a plan for sharing the data, as well as their preliminary advice, if requested by those other tax administrators. The IRS has not announced any preliminary findings from the data analysis; however, UK officials have reported that it has identified over 100 taxpayers who benefit from these offshore structures, many now under investigation, and more than 200 UK accountants and advisors who advised on setting up these offshore structures.²¹ Advisors may be subject to civil penalties or criminal prosecution for promoting such arrangements.

The goal of the cooperation and coordinated effort is to allow countries to efficiently process the tax information and effectively enforce any laws that may have been violated – obviously with the desire to clamp down on tax avoidance and evasion. The collaborative effort between the US, UK and Australian tax authorities is seen as an extension of a recently announced pilot tax information exchange program agreed to in April by the UK, France, Germany, Italy and Spain.

US taxpayers holding assets through offshore entities are encouraged to review their tax obligations with respect to these offshore entities. In January 2012, the IRS reopened its offshore voluntary disclosure program by which taxpayers can disclose hidden offshore accounts to the IRS in exchange for reduced penalties. The IRS's 2009 and 2011 offshore disclosure program resulted in over 33,000 disclosures and in the collection of over \$4.4 billion. Failure to disclose may result in significant penalties and possibly criminal prosecution.

—*Richard A. Nessler*

²¹ See "UK Agency working with US and Australia to Counter Offshore Tax Evasion", Tax Notes, May 9, 2013.

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