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U.S. Supreme Court Refines Interpretation of Foreign Tax Credit

A recent U.S. Supreme Court decision in a case involving the foreign tax credit reinforced the doctrine of substance over form and resolved conflicting interpretations of two lower courts.

Few tax provisions have generated more attention in recent years than the foreign tax credit. Fundamental issues, including who is entitled to take the credit, what amount is creditable against U.S. taxes, and how the credit should be calculated, were recently addressed by the U.S. Supreme Court in *PPL Corp. and Subsidiaries* v. *Commissioner of Internal Revenue* (133 S.Ct. 1897). This decision has significant policy implications reaching far beyond the specific factual content of the case. The Court addressed the doctrine of substance over form, analyzed whether foreign taxes that don't mirror U.S. income tax are creditable, and highlighted a philosophical conflict between decisions issued by the U.S. Courts of Appeal for the Third and Fifth Circuits.

The Foreign Tax Credit

Internal Revenue Code (IRC) §901(a) and §901(b)(1) state that a U.S. taxpayer may claim a foreign tax credit against its federal income tax liability for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." Further, Treasury Regulation §901-2(a)(3) states that a foreign tax must be "likely to reach net gain in the normal circumstances in which it applies." To meet the net gain criterion, the tax must meet the following three requirements:

- Realization requirement—a foreign tax 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 [Treas. Reg. §901-2(b)(2)].
- Gross receipts requirement—a foreign tax is imposed on gross receipts or an equivalent computed under a method that is likely to produce an amount that is not greater than fair market value [Treas. Reg. §901-2(b)(3)].
- Net income requirement—the base of the tax is computed by reducing gross receipts to allow for the recovery of the significant costs and expenses, including capital expenditures, attributable to such gross receipts [Treas. Reg. §901-2(b)(4)].

The Windfall Tax

The Supreme Court decision in *PPL Corp.* was the end result of a process that began after three U.S. energy companies—American Electric Power Co., Entergy Corporation, and PPL Corporation—paid a combined £296 million ($488 million) in taxes to the United Kingdom as part of the Windfall Tax, which was first assessed in 1997. The companies then claimed the equivalent amount in foreign tax credits on their U.S. federal income tax returns. Subsequently, the Internal Revenue Service (IRS) rejected all three requests for the foreign tax credit.

The Windfall Tax that these companies paid came about after the United Kingdom privatized more than 50 government-owned companies beginning in the late 1970s. The government's plan when privatizing the companies was to regulate prices rather than limit their maximum profit or rate of return. Following an initial period in which the companies would receive the benefits of any cost savings, the government planned a regulatory downward price adjustment that would result in ultimately passing along any cost savings to consumers. But a number of these corporations—including 12 regional electric utility monopolies—quickly experienced increased efficiencies and reduced operating costs following privatization that far exceeded expectations, leading to much greater profits than anticipated in the initial period.

Facing a loud public outcry that the utilities had been sold too cheaply based on the fact that their profits were excessive in relation to their initial stock valuation, Parliament enacted the one-time Windfall Tax, which taxed 23 companies that earned initial-period profits in excess relative to their initial stock valuation. The three U.S. companies had significant ownership interestes in the privatized companies and thus had to pay the tax.

The tax is calculated as 23% of the difference between the actual price for which each company was sold when privatized and the "notional price" at which each company should have been sold if the government had realized how profitable the companies would become once privatized. To determine the notional price, a formula was constructed that relied on the company's actual realized profits during the four-year fixed-price period immediately following privatization. The basic formula for the tax is as follows:

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

Where:

- 23% is the tax rate,
- 365 is the number of days in a year,
- P is the privatized company's total profit over the "initial period" as determined under U.K. financial accounting principles and standards and as shown in the company's income statement prepared in accordance with the U.K. Companies Act of 1985,
- D is the number of days of the initial period (usually 1,461 days = four years with one leap day),
- 9 is the statute-imposed price-to-earnings ratio, and
- FV is the privatized company's flotation value (i.e., the price at which the government sold the company).

IRS Disallows Credit for the Windfall Tax

The IRS rejected the companies' claims for the foreign tax credit because it believed the Windfall Tax wasn't computed based on U.K. company profits but rather on unrealized market value.

PPL was the first company to seek review by the U.S. Tax Court for the denial of its foreign tax credit. In its arguments, PPL asserted that the determination of whether a foreign tax meets the net gain requirement depends on the substance, rather than the form, of the tax. The IRS argued that the formula alone should be considered and not the rationale underlying the enactment of the tax. On September 9, 2010, the Tax Court decided in favor of the taxpayer (*PPL Corp. and Subsidiaries* v. *Commissioner*, 135 TC 304). The Tax Court agreed with PPL's argument that the Windfall Tax was a direct function of corporate income, reasoning that the excess stock value was based on income, and rejected the IRS's assertion that the tax wasn't creditable because it was based on stock value. Since the material facts of Entergy's case were identical to the facts of PPL, the Tax Court also held that the U.K. Windfall Tax imposed on Entergy constituted an excess profits tax creditable under §901.

In September 2011, the IRS appealed the decision of the Tax Court to the U.S. Court of Appeals for the Third Circuit. In its arguments to the Third Circuit, the IRS presented its own reformulation of the tax, stating that the "2.25 times gross receipts" portion of the IRS's reformulation violates the gross receipts requirement of §901, namely that the computed amount of gross receipts can't be greater than the fair market value of the gross receipts. On December 23, 2011, the Third Circuit reversed the decision of the Tax Court, disallowing the claimed foreign tax credit (665 F.3d 60). Fresh off its victory in the Third Circuit against PPL, the IRS appealed to the U.S. Court of Appeals for the Fifth Circuit the decision of the Tax Court that Entergy was also entitled to a foreign tax credit. The Fifth Circuit disagreed with the Third Circuit, noting, "We are always chary to create a circuit split, but we cannot engage in this sort of formalism in light of the predominant character standard. We therefore disagree with the Third Circuit's conclusion and hold that the Windfall Tax is a creditable foreign income tax under IRC §901" (*Entergy Corp. and Affilliated Subsidiaries* v. *Commissioner*, 683 F.3d 233). Given the different results reached by the Third and Fifth Circuit Courts of Appeal, the Supreme Court granted *certiorari* to the IRS, agreeing to resolve the split within the Circuit Courts.

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The Supreme Court's Ruling

On May 20, 2013, the U.S. Supreme Court ruled that the U.K. Windfall Tax is a creditable tax under §901. The Court ensured consistent application of the law by resolving the conflict in the Circuit Courts of Appeal, agreeing with the reasoning of the Tax Court and silently highlighting the stylistic differences between the Circuits. The Supreme Court decision also reinforced the doctrinal precedence of substance over form, specifically dismissing the IRS Commissioner's "rigid construction" (i.e., single focus on the form of the tax) as "unwarranted." If the substance of a foreign tax is imposed on income, then the tax should be creditable under §901, regardless of the form. Given the Supreme Court's ruling, a company that wants to claim the foreign tax credit may find the substance-over-form interpretation to be more inclusive, with more foreign taxes potentially meeting the definition of a creditable tax. Defending a claim of the foreign tax credit may become more difficult, however, given that proving substance usually requires a more sophisticated argument. **SF**

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