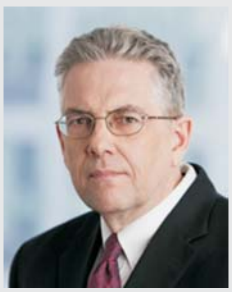
PPL: How to Determine Whether a Foreign Tax Is Creditable

By Patrick J. Smith



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PPL Corp. v. Commissioner presents the question whether the creditability of a foreign tax must be determined by applying the requirements of the section 901 regulations to the foreign statute's formula for the tax or by applying those requirements to an algebraic equivalent reformulation of the statutory formula. The decision will likely turn on whether the Supreme Court agrees with PPL that tax law's general substance-over-form principle authorizes reliance on an algebraic reformulation to determine whether a foreign tax is creditable for U.S. tax purposes. The author and his colleagues, Robert B. Stack and John D. Bates, filed an amicus brief in the Supreme Court in support of PPL.

Background

PPL Corp. v. Commissioner[1] involves the question of how to determine whether a foreign tax is the type of tax that is creditable against a taxpayer's U.S. income tax liability. Section 901(b)(1) says only that creditable taxes are "any income, war profits, and excess profits taxes paid or accrued" to any foreign country. There is no further statutory guidance on which taxes come within the category of creditable foreign taxes described in section 901(b)(1). However, regulations issued in 1983[2] provide that to be creditable, a foreign tax must satisfy a realization requirement, a gross receipts requirement, and a net income requirement.[3]

The tax at issue in *PPL* is the U.K. windfall tax on utilities that the United Kingdom had sold to private investors. A few of those utilities were owned partially or entirely by U.S. taxpayers when the tax was enacted in 1997.

The U.K. statute defined the windfall tax as 23 percent of the excess of the utility's profit-making value over its flotation value. Flotation value was the price at which the utility had been sold by the United Kingdom. Profit-making value was nine times the utility's average annual profit over the four-year period following that sale.

The Government's Position

The government contends that when the regulations' three requirements for creditability are applied to the U.K. statutory formula for the windfall tax, the tax satisfies none of them and thus is not creditable.

The realization requirement is unmet, according to the government, because the windfall tax is not 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."[4] The government argues that the triggering event for application of the windfall tax was the United Kingdom's sale of all stock in the utility — which was not a realization event for the utility.[5] It alternatively claims that even if the windfall tax were viewed as a tax on the increase in the utility's value during the four-year post-sale period, the tax would not satisfy the realization requirement because unrealized appreciation is not generally subject to tax under U.S. tax principles.[6]

The government ignores the fact that the United Kingdom's transfer of the utility business to a new entity, followed by the United Kingdom's sale of the stock in that new entity, was a realization event for the utility business even though the transfer did not result in recognition of gain for U.K. tax purposes.[7]

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[1]135 T.C. 304 (2010), *rev'd*, 665 F.3d 60 (3d Cir. 2011), *cert. granted*, 133 S. Ct. 571 (2012) (No. 12-43).

[2]T.D. 7918.

[3]Reg. section 1.901-2(b)(1).

[4]Reg. section 1.901-2(b)(2)(i)(A); Brief for the Respondent at 34-35, *PPL*, No. 12-43 (U.S. Jan. 14, 2013).

[5]Brief for the Respondent, *supra* note 4, at 35.

[6]*Id.*

[7]PPL made this argument in the Tax Court. *See* Reply Brief for Petitioner at 96-103, *PPL*, 135 T.C. 304 (2010) (No. 25393-07). In the Third Circuit, the government responded to that argument as follows: "While the transfer of the utilities' assets to the public companies may have been a realization event to the U.K.

(Footnote continued on next page.)

The government's position also ignores regulatory rules that provide alternative ways to satisfy the realization requirement — that is, other than through conventional realization events.

The government maintains that the windfall tax fails the gross receipts test for creditability because the tax was imposed not on gross receipts but on the difference between the utility's profit-making value and its flotation value. That tax base, the government argues, "is a company value that is divorced from the traditional concept of gross receipts."[8]

The government acknowledges that a utility's gross receipts over the four-year post-sale period played a role in the calculation of its profit-making value. That is because the formula used to determine profit-making value was based on the utility's profits over that four-year period, and gross receipts were a necessary component in computing those profits. Nevertheless, the government argues that the role played by gross receipts in the U.K. statutory formula is too indirect to satisfy the gross receipts requirement.[9] However, as discussed below, that position fails to recognize an alternative regulatory rule that allows the gross receipts requirement to be satisfied by a tax based on fair market value.

The government contends that the windfall tax also fails the net income requirement for creditability because it is imposed on the difference between profit-making value and flotation value. The net income requirement is satisfied if the base of the tax is computed by reducing gross receipts to permit recovery of the significant costs and expenses (including significant capital expenditures) attributable to those gross receipts.[10] As discussed below, the government's position ignores the fact that in determining the tax base by reducing the utility's profit-making value by its flotation value, the windfall tax provides precisely the recovery of cost the net income requirement demands.

PPL's Position

PPL does not argue that the regulations' three requirements for creditability are satisfied if the requirements are applied to the U.K. statutory formula for the windfall tax. Instead, PPL maintains that the creditability of a foreign tax must be evaluated based on its substance rather than the form given to it by the foreign tax statute.[11] The company contends that the substance of the windfall tax is revealed by an algebraically equivalent reformulation of the U.K. statutory formula.[12]

Under that reformulation, the windfall tax is equal to 51.75 percent of the amount by which the utility's profits exceed 11 percent of its flotation value, measured for each of the four years following the United Kingdom's sale of the utility.[13] Eleven percent is the profit rate that corresponds to the multiple of nine-times-average-profits that is used in the U.K. statutory formula to determine the utility's profit-making value.

PPL argues that this algebraically equivalent reformulation reveals that the windfall tax is in substance an excess profits tax: The tax is imposed on the utility's excess profits over an allowed annual profit of 11 percent of flotation value for the four-year post-sale period. Because the algebraically equivalent reformulation corresponds to a conventional formula for an excess profits tax and section 901(b)(1) explicitly allows a credit for excess profits taxes, the windfall tax is creditable, PPL reasons.

If PPL is correct that the creditability of the windfall tax should be determined by applying the three regulatory requirements to the algebraically equivalent reformulation of the windfall tax into an excess profits tax, the three requirements are satisfied. The annual profits over the four-year post-sale period clearly meet the realization requirement, the gross receipts requirement, and the net income requirement. Those profits are realized, they are determined based on the utility's gross receipts, and they allow the recovery of the costs attributable to the gross receipts.

Thus, a central (although not necessarily determinative) question in the case is whether the creditability of the windfall tax should be determined by applying the three regulatory requirements to PPL's algebraically equivalent reformulation or instead by applying the three requirements to the U.K. statutory formula for the tax. The government's position,

government, neither the receipt of these assets nor the flotation of the stock was a realization event to the public companies as to the built-in gain in these assets." Opening Brief for the Appellant at 29, n.4, *PPL*, 665 F.3d 60 (3d Cir. 2011) (No. 11-1069). The government did not explain why it apparently believed the fact that the transfer was a realization event for the U.K. government was insufficient to satisfy the realization requirement. In the Supreme Court, the government repeats its contention that the U.K. government's sale of the utilities' stock was not a realization event for the utility companies; however, it does not repeat its acknowledgment that the transfer of assets to the public companies was a realization event for the U.K. government.

[8]Brief for the Respondent, *supra* note 4, at 37.

[9]*Id.* at 36-37.

[10]Reg. section 1.901-2(b)(4)(i)(A); Brief for the Respondent, *supra* note 4, at 38.

[11]Brief for Petitioners at 19-20, 23-36, *PPL*, No. 12-43 (U.S. Dec. 13, 2012).

[12]*Id.* at 10, 12, 20, 21, 37-38, 43-44, and 46.

[13]*See PPL*, 135 T.C. at 328; Brief for the Respondent, *supra* note 4, at 8.

according to PPL, is that the creditability of a foreign tax must be determined based on its form, not its substance. Given the pervasive principle that substance, not form, controls in determining tax consequences, it is not surprising that the government's merits brief in the Supreme Court does not explicitly endorse PPL's framing of the issue.

The Government's Tax Court Position

The government has at no point in the litigation conceded that the creditability determination is a form-versus-substance issue. In the Tax Court, the government clearly contended that the determination must be based exclusively on the foreign tax's statutory form, without regard to the tax's substance. And while the government's Supreme Court brief superficially retreats from that extreme rhetorical position, the essence of the government's position has not changed. Thus, PPL is accurate in characterizing the government's position as being that form rather than substance controls in determining whether a foreign tax is creditable.

In the Tax Court, the government argued that "there is no authority to rely on extrinsic evidence of *any* type to evaluate whether the Windfall Tax satisfies the section 901 net gain requirements."[14] That includes evidence concerning the tax's purported purpose, design, and substance as revealed through PPL's algebraic reformulation.[15] The government reasoned:

> The "substance" underlying the foreign tax, or its economic incidence, are not relevant to the "net gain" analysis under the section 901 regulations. The regulation provides three specific tests, all of which a foreign tax must satisfy to be deemed an income tax in the U.S. sense, and therefore creditable. These regulatory tests neither permit nor require the application of these tests to the "substance" of the tax. Instead, they apply to the base of the foreign tax as defined in the foreign statute.[16]

The government concluded:

> The "substance" of the tax is revealed on the face of the Windfall Tax statute itself. The words of the U.K. statute *are* the "substance" of this tax.[17]

The government's Supreme Court brief does not repeat the broad assertions that the creditability of a foreign tax must be determined based exclusively on the text of the foreign statute that imposes the tax. Nevertheless, the government's position in the Supreme Court regarding the nature of the creditability determination is really no different from what it was in the Tax Court: "That the regulation requires the base of a foreign tax to be net income does not mean that the Commissioner's position turns on 'labels' and 'form.'"[18]

> The "labels" and "form" that a foreign government uses to formulate a tax are relevant, even if they are not determinative of how the tax should be classified. The "base" of the windfall tax could not be described as net income unless both the tax base and the tax rate are rewritten, which is what petitioner has done to characterize the tax as a 51.75 percent tax on excess profits. There are infinite ways to express the algebraic formula that is the windfall tax, but the classification of the tax should be based on the iteration selected by Parliament.[19]
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> . . . .
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> If the text of the U.K. Act is taken at face value, the tax is in substance a tax on excess value (i.e., the difference between the actual value of the privatized companies and the amounts the U.K. received for them at flotation) rather than a tax on income as such.[20]

In the Tax Court, the government contended that case law predating the 1983 regulations — including decisions clearly supporting PPL's position that the purpose, operation, and effect of the foreign tax are relevant in determining whether the tax is creditable — had been superseded by the tests in the regulations and thus was obsolete and irrelevant in determining whether a tax is creditable under the regulations.[21] In its Supreme Court brief, however, the government instead argues that the cases cited by PPL do not support the company's position.

The government is correct that none of the pre-1983 case law relied on by PPL involved the type of algebraic reformulation at the core of the company's position. The decision likely will turn on whether

[14]Reply Brief for Respondent at 102, *PPL*, 135 T.C. 304 (2010) (No. 25393-07) (emphasis in original).

[15]Opening Brief for Respondent at 99, *PPL*, 135 T.C. 304 (2010) (No. 25393-07).

[16]*Id.* at 93 and 95.

[17]*Id.* at 114 (emphasis in original).

[18]Brief for the Respondent, *supra* note 4, at 41.

[19]*Id.* at 42.

[20]*Id.* at 43.

[21]Opening Brief for Respondent, *supra* note 15, at 89 ("The Regulations largely incorporated, but legally superseded, the criteria for creditability set forth in the prior case law"); *id.* at 92 ("The principles articulated in this obsolete case law were either subsumed within or superseded by the Regulations"); Reply Brief for Respondent, *supra* note 14, at 92 ("Petitioner incorrectly relies on case law predating the effective date of the section 901 regulations").

the Supreme Court agrees with PPL that an algebraic reformulation is authorized by the principle that taxation is based on substance rather than form.

The Government's Response to PPL

One of the principal arguments made by the government in its Supreme Court brief responds to PPL's position that the substance of the windfall tax is revealed by the fact that the U.K. statutory formula for the tax is algebraically equivalent to a tax on a utility's excess profits during its initial four-year post-sale period. The government does not dispute that PPL's reformulation is algebraically equivalent to the U.K. statutory formula. Rather, it notes that for many taxes imposed on the value of property, the value is determined through a formula that applies a multiplier to the annual income produced from the property, as the U.K. statutory formula for the windfall tax did.[22]

Continuing, the government argues that whenever a tax on the value of property determines the property's value as a multiple of the income produced by the property, it will be possible to determine an algebraically equivalent reformulation of the tax in the form of a different tax rate applied directly to the income used in the statutory formula.[23] As a result, according to the government, PPL's algebraic reformulation approach would improperly extend creditability to many such taxes based on value.

Although this argument has some superficial appeal, it has at least two significant shortcomings. The first is that PPL's algebraic reformulation of the windfall tax does not simply reformulate a tax based on value into a tax based on income. Instead, it reformulates a tax that is nominally based on the difference between two values of a business into a tax based on the business's profits over a four-year period in excess of a specified rate of return on the utility's flotation value. The government's contention that it will frequently be possible to perform precisely the same sort of algebraic reformulation that is relied on by PPL clearly is incorrect when PPL's reformulation is described in this more accurate and more detailed way.

The second shortcoming with the government's argument is that even for taxes whose statutory formula is based on a single value rather than the difference between two values, an algebraic reformulation of the tax into a tax based on the income that is used in the statutory formula to determine value would not ordinarily result in the reformulated tax being creditable. That is because the reformulated tax rate would usually exceed 100 percent. For example, if the formula for determining value were based on a single year's income and used the same price-earnings multiple of nine that is used in the U.K. windfall tax to determine profit-making value, a nominal tax rate of 25 percent applied to the value so determined would be reformulated as a tax rate of 225 percent (9 times 25 percent) applied to the income that was used in the valuation formula, and a tax imposed on income at such a high rate would clearly not be creditable.[24]

The government also disputes PPL's contention that the algebraically equivalent reformulation of the U.K. windfall tax has the form of a conventional excess profits tax. However, the government's argument on this point is essentially frivolous.

Under PPL's algebraic reformulation of the U.K. windfall tax as a tax on excess profits over a four-year period, the utility's flotation value serves as the base for determining the amount of excess profits. Under that reformulation, the amount of excess profits for each of the four years is equal to the amount by which the actual profits reported for that year exceeded 11 percent (one-ninth) of flotation value. As noted earlier, that 11 percent rate for determining the amount of excess profits corresponds to the statutory formula's use of a price-earnings ratio of nine applied to the average annual profits for the four-year period to determine the utility's profit-making value.

The government's response regarding the role played by flotation value under PPL's reformulation of the windfall tax as a tax on excess profits is entirely inadequate. The government acknowledges that in excess profits taxes, one of the conventional approaches used to calculate the amount of excess profits is to multiply a specified rate of return by the amount of the taxpayer's invested capital. That determines the amount of allowable profits. Profits over that amount are considered taxable excess

[22]Brief for the Respondent, *supra* note 4, at 11-12 and 16-23.
[23]*Id.* at 12 and 23-24.

[24]An amicus curiae brief filed by several tax professors in support of the government uses a similar example to argue that the windfall tax should not be creditable because it could be reformulated as a tax at a rate of 207 percent (9 times 23 percent) on the utility's *average* annual profits over the four-year period after the United Kingdom's sale of the utility. Brief of Anne Alstott et al. as *Amici Curiae* in Support of Respondent at 22, *PPL*, No. 12-43 (U.S. Jan. 18, 2013). This argument is not persuasive because it requires reformulating the windfall tax as a one-year tax on average annual profits over a multiyear period to arrive at the inflated and non-creditable tax rate of 207 percent. A one-year tax on average annual profits over a multiyear period is not something that is seen in the real world, in contrast to PPL's reformulation of the windfall tax as a tax on excess profits over a four-year period.

profits. As described by the government, the invested capital standard ''is based on the assumption that 'normal' profits are measured by a return on capital invested in the business.''[25]

As the government notes, the principal alternative to the invested capital approach is to use the taxpayer's actual profits during a specified period preceding the period to which the excess profits tax applies to determine the amount of excess profits:

> Within the United States, excess-profits taxes thus have historically been imposed on a base of net income over a floor, with the floor being determined by either historical net income during a base period, or a specified percentage of return on the company's capital investment.[26]

It is indisputable that under PPL's reformulation of the windfall tax as an excess profits tax, the utility's flotation value plays the role of invested capital under the invested capital approach. That makes sense because flotation value was the amount investors paid the United Kingdom for the utilities, and imposition of the windfall tax was justified by the argument that the amount investors paid for the utilities was too low.[27]

The government's response on this point ignores the approach under which excess profits is determined by applying a specified rate of return to the amount of invested capital:

> Under the formula established by the U.K. Act, however, a company could make far higher initial-period profits than it did during any historical base period and pay no windfall tax, so long as the U.K. government was properly compensated for the value of the company at flotation. The U.K. Act requires that initial-period profits be compared, not to any measure of ''normal'' profits, but to the value that was placed on the company when it was sold. That difference between the windfall tax and historic excess-profits taxes reinforces the conclusion that the windfall tax is a tax on value.[28]

The government's assertion that ''a company could make far higher initial-period profits than it did during any historical base period and pay no windfall tax'' assumes an excess profits tax that is based on comparing profits during the period the excess profits tax is in effect to normal profits over a historical base period. Because that assertion disregards the invested capital approach — an approach the government acknowledges earlier in its brief — the government's argument is unpersuasive.

Oral Argument

The oral argument in *PPL* was unusually revealing as to the thinking of several of the justices. Justices Sonia Sotomayor and Elena Kagan seemed to find persuasive an argument made in the amicus brief filed by several tax professors in support of the government.[29] That brief posits that PPL's reformulation is not algebraically equivalent to the U.K. statutory formula for some of the utilities, which had been sold by the United Kingdom less than four years before the effective date of the windfall tax.[30]

For those companies, the profit that was used in the U.K. statutory formula for determining profit-making value was not the utility's profit over the full initial four-year period following the United Kingdom's sale of the company. Instead, the statutory formula used the utility's profit over the shorter period between the date of the sale and the effective date of the windfall tax. That profit was then divided by the length of that shorter time period to determine the utility's average annual profit over that period, an amount that was then multiplied by nine to determine the utility's profit-making value. Thus, while the total four-year profit for a utility with a full four-year period was divided by four to determine that utility's average annual profit, a utility whose tax period was only one year, for example, would determine its annual average profit simply as an amount that was equal to its actual one-year profit. So for that utility, there would be no division by four under the statutory formula for the windfall tax to determine profit-making value.

The consequence of this aspect of the windfall tax formula was that for utilities with a full four-year tax period, PPL's algebraic reformulation produced an effective annual tax rate of 51.75 percent (the nominal 23 percent tax rate times nine divided by four), whereas for a company with a single-year tax

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[25]Brief for the Respondent, *supra* note 4, at 25.

[26]*Id.* at 26.

[27]*Id.* at 4 (''It was thus widely believed in the U.K. that the utilities had been sold too cheaply and that their profits were excessive in relation to their flotation value'').

[28]*Id.* at 26. The government does not argue that flotation value cannot be equated to invested capital because flotation value was the amount paid for the utility stock by the shareholders rather than the amount invested by the utility itself. Presumably the reason the government does not make this argument is that it would conflict with the government's position that the windfall tax was a tax on the windfall supposedly received by the utilities' shareholders as a result of buying the utility shares at too low a price, even though the tax was imposed on the utilities themselves rather than the shareholders who bought their stock from the U.K. government.

[29]Brief of Alstott et al., *supra* note 24, at 14-18.

[30]*Id.*

period, the effective annual tax rate under PPL's algebraic reformulation would be 207 percent (23 percent times 9 but with no division by 4). The tax professors' amicus brief argued that this result for utilities with a short tax period showed the windfall tax is not creditable, since a foreign tax imposed on income at such a high rate would not be creditable. Sotomayor and Kagan seemed to agree.[31]

In questioning PPL's attorney, Kagan framed the argument as being that a utility with a single-year tax period would pay the same total amount of windfall tax as a utility with a full four-year tax period if the utility with the longer tax period had profits for each of the four years that were equal to the single-year profit of the utility with the single-year tax period.[32] The two utilities would pay the same amount of windfall tax, even though the utility with the full four-year tax period had four times the total profits of the utility with the single-year tax period. That result, Kagan concluded, supported the position that the windfall tax was in substance a tax on value rather than a tax on income because, despite the difference in total profits over the tax period, both companies would have the same profit-making value under the U.K. statutory formula. Thus, under Kagan's reasoning, it would be appropriate for the two utilities to pay the same amount of tax when the tax is viewed as a tax on value rather than as a tax on income.

However, as Chief Justice John G. Roberts Jr. pointed out in his questioning of the government's attorney, the significant problem with that argument is that the government had not taken the position that the creditability of the windfall tax should be determined based on the tax's effect on those so-called outlier companies.[33] The reason the government did not make that argument is that the regulations provide that the creditability of a foreign tax is determined based on the predominant character of the tax[34] and how the tax operates ''in the normal circumstances in which it applies.''[35] The way the windfall tax applied to the outlier companies was not how the tax applied ''in the normal circumstances.''

In response to Roberts's questions, the government's attorney acknowledged that the government actually disagreed with the argument made by the amicus brief that Sotomayor and Kagan seemed to find persuasive:

> That particular aspect of the amicus brief that says if it's bad for one, it's bad for all, yes, that is not our position. . . . So I think we are in general agreement with PPL that if there are outliers where net gain would be totally confiscated, you'd look at it in the — in the normal circumstances in which it applies. That's what the regulation says.[36]

In light of the considerable emphasis given by Sotomayor and Kagan to the tax professors' argument, the government's concession that the argument is contrary to the regulations could well be significant to the outcome in the case.[37]

The other significant aspect of oral argument was the questioning by Justice Stephen Breyer, which made clear that he agreed with PPL that the windfall tax was in substance a tax on a utility's excess profits for a four-year period at a rate of approximately 50 percent. His approach was to conclude that the combined effect of the nominal tax rate of 23 percent and the multiplication of the utility's average annual profits by nine to determine the utility's profit-making value produced a total tax that was equal to approximately two years of the utility's excess profits out of the total four years' excess profits during the four-year tax period, representing an effective tax rate of approximately 50 percent, consistent with PPL's position.[38]

Although Justice Antonin Scalia was not nearly as active in his questioning as Roberts, Breyer, Sotomayor, or Kagan, one of his questions suggested that he favored PPL's position that because the windfall tax used the utility's actual profits to determine its profit-making value, even though the market price of each utility's stock immediately after flotation was readily available and would have provided a much more reliable measure of each utility's value on that date, the windfall tax was in substance a tax on excess profits over the period used in the formula for determining profit-making value.[39] The relatively few questions from Justice

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[31]Transcript of Oral Argument at 5-6, 11-15, 17-19, and 36-38, *PPL*, No. 12-43 (U.S. Feb. 20, 2013). References to the ''D variable'' or the ''D element'' in the questions by Sotomayor and Kagan refer to the U.K. statutory formula's measurement of the tax period in days rather than years.

[32]*Id.* at 12-15, 17-19, and 36-38.

[33]*Id.* at 34-37.

[34]*See* reg. section 1.901-2(a)(1)(ii), (a)(3), (b)(1), (b)(2)(i), (b)(3)(i), and (b)(4)(i).

[35]Reg. sections 1.901-2(a)(3)(i) and (b)(1).

[36]Transcript, *supra* note 31, at 37.

[37]The tax professors' brief also argues that the windfall tax should not be considered a creditable tax on income or excess profits because the profits that were used in the formula for the tax relate to time periods that preceded enactment of the tax. Brief of Alstott et al., *supra* note 24, at 24-26. However, as with the argument based on the effect of the windfall tax on the outlier companies, the government does not make this argument.

[38]Transcript, *supra* note 31, at 20-23, 27-34, and 44-48.

[39]*Id.* at 27 (''I don't know that anybody values a company that — that is sold on the market by saying how much money

(Footnote continued on next page.)

Anthony M. Kennedy[40] and Justice Ruth Bader Ginsburg[41] did not suggest a clear preference for either side's position. There were no questions from Justice Clarence Thomas or Justice Samuel Alito.

Based on the evidence provided at oral argument, it appears that PPL's likelihood of prevailing is considerably better than the government's. Breyer clearly favored PPL's position, and Roberts and Scalia also seemed to favor PPL's position, while Sotomayor and Kagan clearly favored the government's position. This suggests the ultimate voting lineup might be similar to that in *United States v. Home Concrete & Supply, LLC*.[42] In *Home Concrete*, Breyer wrote the opinion for the Court in favor of the taxpayer, joined in full by Roberts, Thomas, and Alito, and in part by Scalia. Kennedy, Ginsburg, Sotomayor, and Kagan dissented. To the extent the voting lineup in *PPL* may differ, there might be more votes in favor of PPL than favored the taxpayer in *Home Concrete*.

Alternative Approach

As noted above, if PPL persuades the Supreme Court that creditability should be determined by applying the regulations' requirements to PPL's algebraically equivalent reformulation of the windfall tax as a tax on excess profits, the company should prevail in its position that the windfall tax is creditable. However, PPL could still prevail even if the government persuades the Court that the three creditability requirements should be applied to the U.K. statutory formula.

That's the position two of my colleagues and I take in our amicus curiae brief supporting PPL's position that the windfall tax is creditable.[43] Our analysis is based in part on an alternative position the government had taken in the Tax Court regarding the nature of the tax.

Under that alternative position, the government contended that if the creditability of the windfall tax were evaluated based on considerations other than the U.K. statutory formula, the tax should be viewed as a recapture of the U.K. tax that would have applied to the appreciation in each utility's assets at the time it was sold by the United Kingdom, if Parliament had not specifically exempted the privatization transactions from that tax.[44] From that perspective, the government argued that the windfall tax is non-creditable because a tax on unrealized appreciation can satisfy the regulations' realization requirement only if the same appreciation is not taxed a second time when the appreciation is realized.[45]

In the Tax Court the government maintained that because the U.K. statute does not exempt the appreciation from being taxed a second time when it is realized, the windfall tax does not satisfy the realization requirement's provision concerning taxes on unrealized appreciation. In contrast, the government's brief in the Supreme Court completely ignores the regulatory provision that taxes on unrealized appreciation can satisfy the realization requirement for creditability. It instead presents the misleading and clearly incorrect position that taxes on unrealized appreciation can never under any circumstances satisfy the realization requirement.[46] Thus, under that view, even if the windfall tax were considered a tax on unrealized appreciation, the tax could not possibly satisfy the realization requirement.

Our brief points out that under the government's alternative position in the Tax Court, the windfall tax satisfies the realization requirement because another rule in the regulations provides that the recapture of a tax allowance previously enjoyed by the taxpayer satisfies the realization requirement.[47] That rule contains no requirement parallel to the provision concerning taxes on unrealized appreciation to the effect that the foreign jurisdiction must not tax the same amount a second time.[48]

Our brief also argues that when the gross receipts requirement is applied to the U.K. statutory formula, the windfall tax satisfies that requirement.[49] The regulations provide that the gross receipts requirement is satisfied if the tax is based on FMV.[50] That provision was clearly intended in part to work together with the provision stating that a tax on unrealized appreciation can satisfy the realization requirement.

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did they make in the last 2 years and we are going to multiply that by 9. You look at what people were paying you in the market'').

[40]*Id.* at 7-8.

[41]*Id.* at 9, 40, and 49.

[42]132 S. Ct. 1836 (2012).

[43]*See* Brief of Patrick J. Smith et al. as *Amici Curiae* in Support of Petitioner, *PPL*, No. 12-43 (U.S. Dec. 14, 2012).

[44]Opening Brief for Respondent, *supra* note 15, at 21 and 103-106. As discussed earlier, the government's brief in the

(Footnote continued in next column.)

Supreme Court ignores the fact that this appreciation was realized when the United Kingdom transferred the utility business to a newly formed entity before selling the shares in the new entity. The realization requirement for creditability was therefore satisfied without regard to the rule providing that taxes on unrealized appreciation can satisfy the realization requirement.

[45]Reg. section 1.901-2(b)(2)(i)(C); Opening Brief for Respondent, *supra* note 15, at 106.

[46]Brief for the Respondent, *supra* note 4, at 35-36.

[47]Reg. section 1.901-2(b)(2)(i)(B); Brief of Smith et al., *supra* note 43, at 3, 22, and 24.

[48]Brief of Smith et al., *supra* note 43, at 3 and 23-24.

[49]*Id.* at 3-4 and 29-34.

[50]Reg. section 1.901-2(b)(3)(i)(B).

Without some special rule relating to the gross receipts requirement, taxes on unrealized appreciation would never satisfy that requirement and thus never be creditable. But such a result would make no sense in light of the specific provision in the regulations permitting taxes on unrealized appreciation to satisfy the realization requirement. The provision that a tax based on FMV satisfies the gross receipts requirement resolves the anomaly that would otherwise exist for taxes on unrealized appreciation.[51]

Based on that provision for FMV-based taxes, the windfall tax should satisfy the gross receipts requirement under the government's position that under the U.K. statutory formula the tax is a tax on the value of the utility. The government's Supreme Court brief ignores the fact that when the windfall tax is viewed as a tax on value, as the government contends the tax must be viewed, the windfall tax satisfies this aspect of the gross receipts requirement for creditability.

Our brief also argues that when the creditability of the windfall tax is evaluated based on the U.K. statutory formula, the tax satisfies the net income requirement for the same reason that any tax on unrealized appreciation satisfies that requirement.[52] The fact that the property's appreciated value is reduced by its initial value to determine the tax base necessarily satisfies the net income requirement's demand for a cost recovery allowance. Otherwise, a tax on unrealized appreciation would never satisfy the net income requirement and thus would never be creditable — an outcome that is inconsistent with the rule in the regulations that a tax on unrealized appreciation can satisfy the realization requirement.

[51]Brief of Smith et al., *supra* note 43, at 29 and 32-34.

[52]*Id.* at 4 and 37-38.

Because the windfall tax base is the difference between the utility's profit-making value and its flotation value, the net income requirement is satisfied the same way that the reduction of appreciated value by an initial value satisfies the net income requirement for a tax on unrealized appreciation. The government's brief in the Supreme Court ignores that reason why the windfall tax satisfies the net income requirement when it is viewed as a tax on the difference between two values.[53]

Thus, even if the government prevails in its position that the creditability of the windfall tax must be determined by applying the three requirements for creditability in the regulations to the U.K. statutory formula for the tax, the tax is still creditable because it satisfies each of the three requirements.

Conclusion

If the Supreme Court accepts PPL's substance-over-form justification for using an algebraically equivalent reformulation of a foreign tax to determine its creditability, PPL should win. Based on the oral argument, it appears that PPL's likelihood of prevailing is considerably better than the government's.

[53]Our brief also argues that both the realization requirement and the gross receipts requirement, as formulated in the regulations, are subject to challenge under the arbitrary and capricious standard in the Administrative Procedure Act, 5. U.S.C. section 706(2)(A), as that standard has been interpreted in *Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983). We contend that these requirements are subject to challenge because the IRS did not explain when the regulations were issued why it was appropriate to impose a realization requirement when the regulations explicitly provide that taxes on unrealized appreciation can satisfy this requirement, or why it was appropriate to impose a gross receipts requirement when a tax based on the value of appreciated property can satisfy this requirement. Brief of Smith et al., *supra* note 43, at 25-28 and 35-36.