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Economic and Legal Arguments in *PPL v. Commissioner*

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In late 2012, the U.S. Supreme Court granted *cert* in *PPL Corp. v. Commissioner*.[2] The Court took that case, which involves a claim by a U.S. corporation for a foreign tax credit for taxes paid under the 1997 U.K. Windfall Profit Tax Act,[3] in order to resolve a conflict between the Third Circuit, which denied the credit in *PPL*,[4] and the Fifth Circuit, which allowed the credit in *Entergy Corp. v. Commissioner*.[5]

Background

The United States taxes foreign persons on their U.S. source income, and it taxes U.S. persons, including U.S. corporations,[6] on their worldwide income. In order to mitigate the possibility of double taxation U.S. persons' foreign income, the Internal Revenue Code ("Code") grants U.S. persons a foreign tax credit for taxes paid on foreign source income.[7] In order to be creditable, the foreign levy has to be a tax on "income, war profits [or] excess profits."[8] Under the relevant Treasury Regulation, Treas. Reg. Sec. 901-2, which took effect in 1983, a "foreign levy is an income tax [and hence creditable] if and only if . . . [t]he predominant character of the tax is an income tax in the U.S. sense."[9]

In the 1980's, under Conservative Party rule, the British government privatized more than 50 state-run companies, mostly regulated utilities, by selling those companies to private investors at fixed, predetermined prices. In the years following, critics argued that those companies had been sold too cheaply and that those companies earned above market profits because of favorable regulatory policies in the form of lax price and return regulations. When the Labour Party took control in 1997, they enacted the Windfall Tax Act as a one-time tax on the recently privatized companies.

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[2] Sup. Ct. Dkt. No. 12-43.
[3] Finance (No. 2) Act, 1997, c. 58 (U.K.).
[4] The Third Circuit case is *PPL Corp. v. Comm.*, 665 F.3d 60 (3d Cir. 2011). The Tax Court case is *PPL Corp. v. Comm.*, 135 T.C. No. 15 (2010).
[5] 683 F.3d 233 (5th Cir. 2012)
[6] A U.S. corporation is a corporation incorporated under the laws of the United States or any of the states.
[7] Code, Sec. 901.
[8] Code, Sec. 901(b).
[9] Treas. Reg. Sec. 1.901-2(a).

Windfall Tax Act

The tax liability of a company subject to the Windfall Tax Act was calculated as 23 percent of the difference between a privatized company's value in profit-making terms and its flotation value. The flotation value is the price at which the company was sold by the government to its initial private investors. The value in profit-making terms is defined by the law as the difference between an imputed price-to-earnings ratio and the company's annualized average daily profits over an initial period. The imputed price-to-earnings ratio was arbitrarily set at 9, which represented the lowest average price-to-earnings ratio of the privatized companies (by sector) over the initial period. The initial period was defined as four years from the date the company was privatized unless the company was privatized after April 1, 1993, in which case it was the time from the date the company was privatized through March 30, 1997. Accordingly, if the company was privatized before April 1, 1993, the initial period was the full four years; but if the company was privatized after April 1, 1993, the initial period, which ran from the date the company was privatized through March 30, 1997, was less than four years.

Of the more than 50 privatized companies that were potentially subject to the Windfall Tax Act, only those companies whose value in profit-making terms exceeded their flotation value owed any tax. Of the 32 companies that owed tax, 27 had an initial period of a full four years. Of the 5 companies whose initial period was less than four years, 3 of those companies had initial periods just slightly shorter than 4 years,[10] but two companies had initial periods of less than one year.

The liability of a company subject to the Windfall Tax Act, denoted WT, is described in the statute by the following formula:

$$WT = 0.23 \times \left[\left\{ 365 \times \frac{P}{D} \times 9 \right\} - FV \right] (equation\ 1)$$

Where D denotes the number of days in the initial period, P denotes the total earnings of the company during its initial period, and FV denotes the flotation value. Thus, as expressed by the statute, the Windfall Tax Act imposes a 23 percent tax on the difference between the implied value of the company {the term in braces or curly brackets} and its flotation value, FV.

Three of the 32 companies subject to the Windfall Tax Act had sufficient U.S. ownership to claim the foreign tax credit. These included PPL, which claimed a foreign tax credit of $27 million, Entergy, which claimed a credit of $234 million, and a third company, whose case has not yet gone to trial.

The calculation of the tax liability under the Windfall Tax Act can be illustrated using PPL as an example.[11] PPL owned a portion of South Western Electricity plc (SWEB), which was privatized in December 1990 for £295.9 million. SEWB's total profits over the 4-year interim period were £306.2

[10] According to the Tax Court, the taxpayer and the government stipulated to an interim period for one of the 5 companies of longer than 1461 days, which would be inconsistent with the law.
[11] The numbers, which are approximate, are derived from the flotation value and claimed tax credit.

million. Substituting SWEB's profits into equation 1 yields an estimated profit making value of £689 million. Accordingly, SWEB's tax liability was 23 percent of £393.1 million, or £90.4 million. PPL's share of SWEB's tax liability was £27 million, and so it claimed an indirect foreign tax credit in that amount.[12]

The other two U.S. companies' foreign tax credits were calculated similarly. In each case, the Treasury denied the credit and the taxpayers challenged the Service's ruling. The taxpayer challenged the Service's ruling that the tax imposed by the Windfall Tax Act is not a creditable tax on "income, war profits, [or] excess profits," because it does not satisfy the requirement that "[t]he predominant character of the tax is an income tax in the U.S. sense." In arguing that the tax is creditable, the taxpayer's sought to express the tax in a different, albeit mathematically and economically equivalent, manner than as it is described in the Windfall Tax Act.

For companies with an initial period covering the full four years, equation 1 can be rewritten after substituting 1460 for D as:[13]

$$WT = 0.23 \times \left[\left\{\frac{P}{4} \times 9\right\} - FV\right] (equation\ 2)$$

After further manipulation, equation (2) can be rewritten as:

$$WT = 0.5171 \times [P - 0.4448 \times FV] (equation\ 3)$$

Expressed in words, the Windfall Tax Act liability for firms operating throughout the full four-year interim period is the excess of 51.7 percent of their interim period profits over 44.5 percent of their flotation value. Expressed slightly differently, the tax liability under the Windfall Tax Act is 51.7 percent of the company's profits in excess of an annual return of 11.1 percent on the investment made at the time of flotation.

The Dispute

The two characterizations of the tax levied by the Windfall Tax Act described above frame the dispute in *PPL*. The government describes the levy as a 23 percent tax on the difference between the estimated value of the company and the price at which it was sold and argues that such a tax is not creditable. In contrast, the taxpayer characterizes the levy as a 51.7 percent tax on prior years' profits in excess of an 11.1 percent annual return and argues that such a tax is creditable.

With such sharp differences in how the parties characterize the U.K. windfall tax it is not surprising that *PPL* has generated substantial interest in the tax community, especially among academics. Two amicus briefs have been filed by groups of academics. The first to be filed was a brief filed by eight prominent

[12] PPL claimed an indirect or deemed paid foreign tax credit under Code Sec. 902, not a (direct) foreign tax credit under Code Sec. 901, because PPL did not pay the U.K. Windfall Tax, but rather because SWEB paid the tax and PPL owned more than 10 percent of SWEB.
[13] The one leap day is ignored in moving from equation 1 to equation 2.

economics professors (Academic Economists' Brief) urging the Court to grant cert and overturn the Third Circuit's opinion in *PPL* and allow the tax to be credited.[14] The second was a brief filed by nine prominent law professors (Legal Academics' Brief), after the Court granted cert, urging the Court to uphold the Third Circuit's opinion and not allow the tax to be credited.[15] The case has also produced an essay by Jacob Goldin in Tax Notes, arguing that the tax is not creditable.[16] The argument in that essay was incorporated into the Legal Academics' Brief.

The Statutory and Regulatory Framework

Section 901 of the Code allows U.S. persons a foreign tax credit for taxes paid to foreign governments on foreign source income. Section 901(b) provides in relevant part, that for domestic corporations the the amount of the credit is "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country."[17] The Code does not further describe the boundaries of creditable taxes. Accordingly, for many years, the Service and taxpayers would contest what foreign taxes were and were not creditable. The question was often phrased as whether the foreign tax was or was not an income tax in its predominant character. The result was uncertainty and a lack of clarity. In 1983, the Treasury sought to provide clearer and more definite guidance on the question by issuing a regulation determining what taxes are and are not creditable. That regulation is Treas. Reg. Sec. 1.901-2 (the Regulation). Although the Academic Economists' brief argues that that Regulation is inconsistent with the statute on the grounds that it would prevent war profits and excess income taxes from being creditable, the taxpayers have not challenged the Regulation and the issue has not been briefed since cert was granted.

The Regulation begins as follows:

> "Section 901 allows a credit for the amount of income, war profits or excess profits tax (referred to as "income tax" for purposes of this section . . .) paid to any foreign country. Whether a foreign levy is an income tax is determined independently for each separate foreign levy. A foreign levy is an income tax if and only if—
>
> (i) It is a tax; and
> (ii) The predominant character of that tax is that of an income tax in the U.S. sense.

[14] Brief for Amici Curiae Roseanne Altshuler, Richard M. Bird, Malcolm Gillis, Arnold C. Harberger, Gary C. Hufbauer, Charles F. McClure Jr., Jack Mintz, and George R. Zodrow in Support of Petitioners, *PPL*, No. 12-43 (Aug. 10, 2012) (Academic Economists' brief).

[15] Brief for Amici Curiae Anne Alsott, Marvin Chirelstein, Mihir Desai, Michael Graetz, Daniel Halperin, Mitchell Kane, Lawrence Lokken, Robert Peroni and Alvin Warren in Support of Respondent, *PPL*, No. 12-43 (Jan. 13, 2013) (Legal Academics' Brief).

[16] Jacob Goldin, Reconsidering Substance over Form in PPL, Tax Notes 1229 (Dec. 10, 2012).

[17] Code Sec. 901(b)(1). Code Sec. 902 extends the foreign tax credit to subsidiary corporations where the domestic corporation owns 10 percent or more of the stock. The credit received under Sec. 902 is referred to as the indirect or deemed paid foreign tax credit.

[Except for exceptions not relevant here], a tax either is or is not an income, in its entirety, for all persons subject to tax."[18]

The Regulation goes on to explain both what a tax is[19] and what is meant by the phrase "the predominant character of that tax is that of an income tax in the U.S. sense." The former is not an issue in the case except for being raised by the Legal Academics' Brief, whereas the latter is the central issue in the case. Thus, the Regulation provides:

> "The predominant character of a foreign tax is that of an income tax in the U.S. sense—
>
> (i) If . . . the foreign tax is likely to reach net gain [in] the normal circumstances in which it applies."[20]

The regulation then continues by explaining what it means for a tax to reach net gain in the normal circumstance in which it applies:

> "A foreign tax is likely to reach net gain in the normal circumstance 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[.]"[21]

The Regulation continues by covering these three requirements in turn. Starting with the realization requirement:

> "A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed—
>
> (A) upon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the Internal Revenue Code.
>
> (C) Upon the occurrence of a prerealization event . . ., but only if the foreign country does not upon the occurrence of a later event . . . impose tax ("second tax") with respect to the income on which tax is imposed by reason of such prerealization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the prerealization event) and –
>
> (1) The imposition of the tax upon such prerealization event is based on the difference in the values of property at the beginning and end of a period.

[18] Treas. Reg. Sec. 1.901-2(a)(1).
[19] Treas. Reg. Sec. 1.901-2(a)(2).
[20] Treas. Reg. Sec. 1.901-2(a)(3).
[21] Treas. Reg. Sec. 1.901-2(b).

> A foreign tax that, judged on the basis of its predominant character, is imposed on the occurrence of events described in this paragraph . . . satisfies the realization requirement even if it is also imposed in some situations upon the occurrence of events not described in this paragraph[.]"[22]

The Regulation next addresses the gross receipts requirement:

> "A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of—
>
> (A) Gross receipts; or
> (B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.
>
> A foreign tax that, judged on the basis of its predominant character, is imposed on the basis of amounts described in this paragraph . . . satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph[.]"[23]

Finally, the Regulation describes the net income requirement:

> "A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts (. . .) to permit—
>
> (A) Recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles, to such gross receipts; or
> (B) Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, the recovery of such significant costs and expenses.
>
> A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be if the Internal Revenue Code applied, unless the time of recovery is such that under the circumstances, there is effectively a denial of such recovery. . . . A foreign tax law that does not permit recovery of one or more significant costs or expenses, but provides allowances that effectively compensate for nonrecovery of such costs or expenses, is considered to permit recovery of such costs or expenses. Principles used in the foreign tax law to

[22] Treas. Reg. Sec. 1.901-2(b)(2)(i).
[23] Treas. Reg. Sec. 1.901-2(b)(3).

> attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Internal Revenue Code."[24]

<u>The Parties' Arguments</u>

With the exception of the brief filed by the academic economists, the parties do not challenge the validity of the Regulation. Thus, the dispute is framed by the differing characterizations of the tax imposed by the U.K. Windfall Tax Act and the Regulation described above. In addition, with the exception of the brief filed by the legal academics, no one challenges the claim that the levy is a tax, and not a payment for a benefit, as required by the Regulation for creditability. [25] With those exceptions, the issue in *PPL* is whether the predominant character of the tax imposed by the Windfall Tax Act is that of an income tax in the U.S. sense.

The taxpayer and the academic economists have cast the argument as one of substance versus form. Their major argument is that the tax is mathematically and economically equivalent to a tax on profits over the interim period and as such the predominant character of the tax is that of an income tax in the U.S. sense. The taxpayer further argues that the levy imposed by the Windfall Tax Act and understood as a tax on profits over the interim period satisfies the three-part test set out in the Regulation for creditability.[26]

The government has largely accepted the taxpayer's statement and characterization of the case. The government's central argument is that mathematical reformulations are irrelevant for the purpose of ascertaining whether or not a tax is an income tax in the sense of the Regulation. In other words, the government argues that the form of the tax is controlling. The government argues, as do the legal

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[24] Treas. Reg. Sec. 1.901-2(b)(4).

[25] The Regulation, however, looks to U.S. law to ascertain whether a levy is a tax or a payment for a specific payment, and U.S. law does not consider taxes on regulated industries as payments for specific economic benefits. See Treas. Reg. Sec. 1.901-2(a)(2) ("[w]hether a foreign levy requires a compulsory payment pursuant to the foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law in the foreign country[]"). In addition, the Regulation requires the payment to be made before or at the time of the benefit, not after. See. Treas. Reg. Sec. 1.901-2(a)(2)(i) ("a foreign levy is not pursuant to a foreign country's authority to levy taxes, and thus is not a tax, to the extent a person subject to the levy receives (or will receive), directly or indirectly, a specific economic benefit . . . from the foreign country in exchange for payment pursuant to the levy."). The legal academics argue that there is no difference with a later payment, but there is. The payment here was assessed years later. In some cases as long as as 14 years after privatization, and it was highly uncertain at the time many of the companies were privatized that there would ever be such a tax imposed. There was no wink and a nod here. The tax was vigorously debated in public, and it was a significant issue in a contentious election cycle. The legal academics are surely right in that it is possible to have a tax that operates as a disguised payment. However, such payments have long been a problem for the tax credit mechanism. They are treated as payments when determined to be so (Treas. Reg. Sec. 1.901-2(a)). Such payments can readily be part of a very ordinary looking income tax. It is not necessary for the tax to resemble the levy imposed by the Windfall Tax Act for such a concern to arise.

[26] The academic economists also argue that the Regulation is drawn too narrowly to be a reasonable interpretation of the statute and that there are important policy reasons for interpreting (and if necessary extending) the foreign tax credit to cover this and other taxes.

academics, that the tax is not creditable because it is a tax not on income, but rather is a tax on a difference in values. In addition to arguing that the tax is not an income tax in the U.S. sense and hence not creditable, the government also argues that the tax does not meet the three-part test set forth in the regulation and so is not creditable. The legal academics also offer additional reasons for not allowing a credit. They further argue that expressing the tax as in equation 3 does not resolve the issue because the tax can be expressed in a variety of different ways some of which would not support creditability.[27] They also argue that an income tax in the U.S. sense requires prospective and annual taxation, which the Windfall Tax Act fails to do. And they take issue with the claim that the tax is substantially equivalent to a tax on income because it taxes average rather than annual profits.[28]

Valuation

In order to understand and evaluate the arguments of the parties in *PPL*, it is helpful to look more closely at the levy imposed by the Windfall Tax Act from a valuation perspective. The taxpayer, especially its experts, and the government, in its Supreme Court brief, spent substantial time and space arguing whether the tax formula is or is not attempting to value the privatized companies. The government argues that the formula is trying to value the companies and so is not creditable. The taxpayer argues that the formula is not trying to value the companies, but rather is attempting to tax previously realized income, and so is creditable. One of the difficulties in evaluating such arguments is that prior years' earnings can be used both as a basis for taxation as well as a means to estimate future years' earnings and hence as part of a formula to calculate value.

As the government states clearly and correctly in its brief, there are a variety of different techniques that can be used to value an asset. One method commonly used with publicly traded property is to rely on market prices. For example, stock market prices can be used to value public companies.[29] A second method that is often used to value assets is to rely on recent sales price of comparable assets. For example, real estate (especially owner-occupied residential real estate) is often valued using the price of comparable real estate assets (called "comps" for short) and extrapolating. Some companies, especially those with customers who hold long-term contracts, can be valued this way. For example, cable or cell phone companies might be valued on the basis of the number of customers they have under active contract. The estimated value of such a company is the product of the number of active customers and the value per customer. A third and very common way to value an asset is by estimating the present value of the future cash flow stream. That method is often referred to as discounted cash flow analysis. The standard formulation of this principle is that the value of a cash-flow generating asset is the discounted present value of its future net cash flows. Thus, in a full-blown discounted cash flow

[27] The legal academics argue that there is a close relationship between value and income, that the Regulation only credits income taxes, not taxes on differences in value, and that allowing credits for taxes on differences in values on the grounds that such taxes would often track differences in income would permit credits for taxes that are not in substance income taxes.

[28] This last argument incorporates the argument from Goldin's essay in Tax Notes.

[29] There can be administrative reasons for not using market prices to impose taxes because market prices can be affected by actions and statements of managers.

analysis, one estimates future cash flows into an indefinite future and selects a discount rate that is then used to discount those projected cash flows back to present value.

As described above, discounted cash flow valuation is a forward looking exercise. It is also difficult to do accurately because it is much harder to predict the future than the past. The problem of prediction is compounded when the parties have adverse interests, such as in a legal dispute. Accordingly, financial economists have developed techniques, many of which are widely used in the context of valuing businesses, intended to reduce the subjectivity and variability in discounted cash flow valuations and to provide more consistent results across practitioners. Admittedly, these techniques are imperfect, but they survive because they are better than simply guessing or deferring to authority.

One commonly used technique goes by the name of capitalizing or capitalization. Shannon Pratt and Roger Grabowski describe capitalizing and distinguish it from as discounting as follows:

> "In discounting we project *all* expected economic income (cash flows or other measures of economic income) from the subject investment to the respective class or classes of capital over the life of the investment. Thus, the percentage return that we call the discount rate represents the total compound rate of return that an investor in that class of investment requires over the life of the investment.
>
> There is a related processing for estimating present value, which we call *capitalizing*. In capitalizing, instead of projecting all future economic income to the respective class(es) of capital, we focus on the economic income of just one single period, usually the economic income expected in the first year immediately following the valuation date. That amount represents the long-term sustainable base level of economic income or a base from which the level of economic income is expected to grow or decline at a more or less constant rate. We then divide the single-year economic income by a divisor called the *capitalization* rate.
>
> As we will see, the process of capitalizing is really just a shorthand form of discounting."[30]

The reciprocal of the capitalization rate is often called a multiplier. When a multiplier is used, the estimated present value is the product of the estimated base period income and the multiplier. There are various techniques that can be used to establish both the multiplier and the base year earnings. The multiplier can be developed through a sophisticated financial exercise that seeks to determine the risk-free interest rate, the proper risk premium, and the expected income growth rate. Alternatively, the multiplier can be drawn from other similar firms. This approach addresses implicitly what the direct approach tries to handle explicitly. The capitalization rate (or its reciprocal) the multiplier is intended to capture an independent (often called the market) assessment of the likely path of future earnings and the riskiness of such earnings going forward. Much of the disagreement in valuation disputes (some of which arise in tax cases, but not only in tax cases) revolves around the selection of a multiplier.

[30] Shannon P. Pratt and Roger J. Grabowski, Cost of Capital: Applications and Examples 26-27 (4th ed. 2010).

The calculation of the base-period earnings to which the multiplier is applied can also be done in a variety of different ways. Among the techniques used are analysts' estimates of next year's earnings, current year's earnings, an average of prior years' earnings, or an estimate of next year's earnings based on drawing a trend line through prior years' earnings. The point – and it is central to understanding the argument in *PPL* – is that valuation while essentially a forward looking exercise is often done by drawing on historical earnings data. In contrast, income taxes commonly, although not always, are backward looking. It is thus the use by the U.K. tax authorities of historical earnings as inputs into forward looking valuation techniques that has brought the case to where it is today.

Analysis

In the taxpayer's view, the use of prior years' earnings was a deliberate choice by the U.K. tax authorities. The taxpayer, through its experts, argues that a proper valuation should not use historical earnings, but rather such a valuation should use current or expected earnings. In the taxpayer's view, the U.K. authorities chose to use 4 years' of earnings because they wanted to tax those earnings. Thus, in the taxpayer's view, the tax is a backward looking tax imposed at an effective rate of 51.7 percent on four prior years' earnings (over a floor). Moreover, the taxpayer argues that the levy imposed by the Windfall Tax Act when viewed as a 51.7 percent tax on those years' earnings over a floor satisfies the three-pronged test set out in the Regulation. According to the taxpayer, the tax, so understood, passes the realization prong because the tax is imposed on realized income over the interim period. It also satisfies the gross revenue and net income prongs because profitability is a net concept that is calculated by subtracting expenses from gross revenue.[31]

Viewed from the perspective of an outsider to the dispute, it seems a reasonably fortuitous coincidence for the taxpayer that the U.K. government used four years' earnings as the basis for which to calculate average earnings before applying the multiplier to that average. The U.K. government could have chosen one year's earnings, or prospective earnings,[32] or some other earnings measure that drew on less than four years of earning history. In such a case, the taxpayer would have had a more difficult time plausibly asserting that the levy imposed by the Windfall Tax Act was a tax on prior years' income. For example, if the average income was calculated over only one year, the effective tax rate (at the margin) would have been 217 percent on that one year's earnings.[33] Alternatively, the U.K. government could have made the taxpayer's argument easier by choosing 9 years' average earnings, in which case the effective tax rate would equal the statutory rate of 23 percent.[34] Although no one seems to have put it

[31] The taxpayer, through its experts, also makes much of the fact that the term used in the U.K. statute, "value in profit-making terms" is not an accepted term in valuation. Nonetheless, it is clear that the law is calling for a discounted cash flow valuation with the tax.
[32] Analysts might have produced estimates of earnings.
[33] The effective tax rate of 217 percent is the product of 23 percent and 9.
[34] The effective tax rate is the statutory tax rate, 23 percent, times the multiplier (9 under the U.K. law), and divided the number of years' earnings used to calculate the average annual earnings (4 under the U.K. law). For the Windfall Tax Act as enacted, this produces an effective tax rate of 51.7 percent. If, however, the multiplier and

precisely this way, it seems odd and not at all intellectually satisfying that the credibility of the levy imposed by the Windfall Tax Act should depend upon the number of years of earnings used to calculate average earnings relative to the choice of multiplier. That might not bother the taxpayers, which would get their credit if the argument is accepted, but it does give pause to the government and the legal academics.

Thus, the legal academics and Goldin argue that the tax is not creditable, even if it is conceptualized as a 51.7 percent tax on income, because for some firms (specifically, those firms with an initial period of less than 4 years), the tax operates very differently. For the two firms with interim periods of less than one year, the effective (marginal) tax rate on income is over 200 percent. A 200 percent tax is not a tax, or at least no ordinary tax. Under the Regulation, this line of argument, if dispositive, calls upon the Court to draw a line. Because a levy either is or is not an income tax in the U.S. sense for all affected taxpayers, the question becomes whether such different treatment of two of the 32 covered firms is sufficient to render the tax not creditable because it prevents the tax from being an income tax in its predominant character or whether that variation is not enough to do so. That question could go either way.

Accordingly, the government has sought to avoid getting into that argument or any argument about many of the details of the Windfall Tax Act and their significance, such as the number of years of earnings that are averaged and the choice of the multiplier, by arguing that the Act's levy does not have the predominant character of an income tax in the U.S. sense based simply on its form. That is to say, the government argues that the levy is a tax on the difference in values, not income. The legal academics amicus brief supports this argument and extends it by arguing that the tax does not have the character of an income tax because it is neither annual nor prospective, but is rather a one-time retrospective tax on profits earned before the enactment of the tax. That the tax be prospective (in the sense of applying to profits earned after enactment) and imposed at least annually is not required by the Regulation. The Regulation does not invite an open-ended discussion and debate over whether the predominant character of a tax is that of an income tax in the U.S. sense. Indeed, the purpose behind the Regulation was to foreclose such debates. Accordingly, the Regulation sets out a three-prong test for ascertaining whether the predominant character of a foreign tax is an income tax in the U.S. sense.[35] If a foreign tax meets the test, the tax is creditable; if it does not, then it is not creditable. Nowhere does the Regulation in general (or in the three-part test in particular) say anything about annual taxation nor does it prohibit retrospective taxation.[36]

As the parties and the amici all recognize, value and cash flow are closely related. The government's argument takes the form that a tax cannot simultaneously be a tax on a difference in values and a tax on

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the number of years of earnings used to calculate an average are equal (say 9 and 9), then the statutory rate equals the effective rate.

[35] The efficacy of the Regulation in distinguishing an income tax from other taxes is subject to debate. The realization and gross income requirements are especially problematic.

[36] On two separate occasions the regulation uses the formulation "if and only if." See Treas. Reg. Secs. 1.901-2(a)(1), (b) That expression equates the clauses before and after the expression and leaves no other way to satisfy or fail the test. The one requirement for creditability outside this language is the requirement that the levy be a tax, not a payment for a specific economic benefit. Treas. Reg. Sec. 1.901-2(a)(1)(i)

income at least under the Regulation. Such a sharp dichotomy is questionable and has not been demonstrated. It is possible for a tax to be simultaneously both on a difference in values and on (prospective) income. The Windfall Tax Act would seem to do both.

The Windfall Tax Act imposes a levy on covered corporations of 23 percent of the difference between the value in profit-making terms and the flotation value. The taxpayer argues that the phrase "value in profit-making terms" is not a well-articulated concept, but the government argues, and correctly so, that it is the estimated net present value (NPV) of the corporation's future earnings calculated by applying a (conservative) market-based multiplier to each corporation's average earnings over the interim period. In this view, the earnings be taxed under the Windfall Tax Act are not retrospective earnings (or are at least not limited to the earnings over the interim period), but are (or at least include) anticipated future earnings. Those earnings are implicitly adjusted for deferral, for risk, and for the possibility of growth or decline through the multiplier. In other words, the calculation of value is an estimate (perhaps not a very sophisticated one, but still an estimate) of the expected value of earnings after privatization (including earnings after the imposition of the Windfall Tax Act).[37] In other words, the levy is simultaneously a tax on a difference in values and on income.[38]

Returning to the Regulation, the Windfall Tax Act would arguably fits within the definition of an income tax in the U.S. sense. The first prong of the three-prong test is realization. The Regulation states that the test is met if the tax "is imposed upon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the [Code]."[39] That requirement is met for all of the companies as all of them have realized some income between the date of privatization and imposition of the tax.[40] It is also possible to satisfy the realization requirement even if the tax is imposed before realization as long as the tax does not impose a second tax and the imposition of the tax is based on differences in value of property at the beginning and end of a period.[41] That would seem to be the case here. There is no second tax because the Windfall Tax Act is analyzed as a separate levy from the general U.K. income tax. The tax is imposed on a difference in value, a situation which the Regulation explicitly permits. The tougher question is whether the tax is imposed on the difference in value of *property*. Arguably, the tax is imposed on the difference in value of the privatized company's stock. That is not property of the privatized company, but it is property in the hands of its owners, including the petitioner, PPL.

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[37] With this formulation, the firms with short interim periods do not present a problem because earnings are estimated and discounted into the indefinite future.

[38] The argument does not imply that all taxes on differences in value are taxes on income, which the government describes as the fatal flaw in the taxpayer's argument (p. 15). For example, a tax on a difference in value where the market value is determined by using market prices, comparable assets, or by valuing an asset on a different basis, such as value per customer, need not be an income tax.

[39] Treas. Reg. Sec. 1.901-2(b)(2). Note that the language does not require that all of the income to be taxed have been realized, but only says that one or more realization events have occurred.

[40] When the levy is viewed as imposed on the indefinite earnings of the covered firms, then some of the taxed income has been recognized not all of it. The language of the Regulation, however, does not require that all of the income be realized.

[41] Treas. Reg. Sec. 1.901-2(b)(2).

The second prong, gross receipts, is satisfied "if, judged on the basis of its predominant character, [the tax] is imposed on gross receipts; or gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value." [42] The second prong would appear to be met. Average earnings over the interim period are calculated starting with gross receipts and subtracting expenses. Those earnings are then used as an estimate of current earnings and capitalized into an estimate of fair value by applying the multiplier of 9.[43] And the choice of a conservative multiplier implies that the calculation is not likely to produce an amount greater than fair market value.[44]

The third prong, net income, is satisfied if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts . . . to permit recovery of significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates or is greater than, recovery of such significant costs and expenses." [45] Arguably, the third prong is also satisfied because the estimate approximates the significant costs and expenses that are incurred after privatization, including the cost of capital. Accordingly, because the three prongs are arguably met, the tax imposed by the Windfall Tax Act can be upheld without going through the legerdemain of describing the tax as a levy on earnings over the interim period at a tax rate other than the statutory rate. Instead, the tax is a one-time tax on the present value of an indefinite stream of earnings earned after privatization. Such a tax seems conceptually similar to an income tax and more important seems to fit within the Regulation's definition as well.

Policy and Other Arguments

The taxpayer and the government have steered clear of raising explicit policy arguments in their briefs. The academics, however, have raised several policy arguments. The academic economists argue that the range of foreign taxes that are creditable should be significantly expanded beyond taxes that are income taxes in the U.S. sense. In the economists' view, the foreign tax credit is intended to equalize

[42] Treas. Reg. Sec. 1.901-2(b)(3).
[43] As the government acknowledges, such a valuation method is a familiar practice under U.S. law. Respondent's brief, at 20-21.
[44] In arguing that the gross receipts test is not met, the government argues as follows:
"The windfall tax was not imposed on the basis of gross receipts. Although gross receipts were used to compute a company's average annual profits, which was one variable in the windfall-tax formula, the windfall tax was not imposed on the basis of those receipts. The receipts figured into a larger formula that produced a company value *divorced* from the concept of gross receipts."
Brief for Respondent at 13-14 (emphasis added). The value, however, is not divorced from gross receipts, but derived from it.
[45] Treas. Reg. Sec. 1.901-2(b)(3).

the tax burden on corporations (and U.S. individuals as well) operating domestically and abroad.[46] The form a foreign levy takes is a policy choice that can be affected by many factors, administrative, political and economic, that should not affect credibility. The academic economists, thus, suggest expanding the range of creditable foreign taxes markedly, and they argue for treating the levy imposed by the Windfall Tax Act as creditable.

The legal academics also raise a policy issue. They argue that the tax imposed by the Windfall Tax Act should not be credited because it is not a tax, but rather a payment in exchange for a specific economic benefit that is not otherwise available to the general public. In addition, the legal academics argue that allowing the credit would provide foreign countries privatizing companies with a roadmap to convert purchase price into foreign tax credits. That would seem to be an exaggeration as the issue whether a levy is a tax or a payment has arisen many times in the past, and the Treasury has tools to battle such actions readily available, including the Regulation.[47]

Conclusion

The taxpayer in *PPL* argues that the Windfall Tax Act although nominally a tax on a difference in values is mathematically equivalent to a tax on prior years' realized income and as such should be creditable for the foreign tax credit. The government, in contrast, argues that the levy imposed by the Windfall Tax Act is, by its own terms, not a tax on income, but rather a tax on a difference in values, and as such should not be creditable. Both parties seem to accept the idea that the levy is either a tax on income or a tax on a difference in value and that it cannot simultaneously be both a tax on income and a tax on a difference in value. Both parties also proceed as if they accept the idea that the levy would not be creditable unless the mathematical reformulation was accepted and the levy was analyzed on the basis of that reformulation. Nonetheless, it is possible for a tax to be both an income tax and a tax on a difference in values when the tax measures value as discounted future income, which is what the Windfall Tax Act does.[48] Moreover, the levy as imposed by the Windfall Tax Act, and without resorting to any mathematical reformulations, arguably satisfies the three-prong test for creditability set forth in the Regulation. Thus, the levy as described might well be a creditable foreign tax under the Regulation. Moreover, whether or not the levy imposed by the Windfall Tax Act is creditable, the proper way to make that determination is by recognizing that the levy taxes estimated future earnings capitalized to a present value and by evaluating whether the levy understood in that form satisfies the three-prong test contained in the Regulation.

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[46] The academic economists argue that the foreign tax credit should surely apply to cash flow taxes. The economists refer to an experience two of them had some years ago seeking to encourage Bolivia to adopt cash flow taxation. According to the economists, Bolivia was ready to go forward with the tax and would have done so had not an official of the U.S. Treasury told them such a tax would not be creditable. Such a tax should be creditable under the Regulation as it is written. The only substantial difference between a cash flow tax and income tax is in the timing of expenses, which the Regulation acknowledges can be recovered at a different time than with the Code without rendering the tax not creditable. See Treas. Reg. Sec. 1.901-2(b)(4)(i).

[47] Treas. Reg. Sec. 1.901-2(a).

[48] The argument in the text does not imply that every tax on a difference in values is also a tax on income.