No.

In the Supreme Court of the United States

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

ENTERGY CORPORATION AND AFFILIATED SUBSIDIARIES

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

PETITION FOR A WRIT OF CERTIORARI

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QUESTION PRESENTED

Whether the "windfall tax" set forth in the United Kingdom's Finance (No. 2) Act, 1997, c. 58 (U.K.), which imposed on privatized utilities a one-time 23% tax on the difference between a company's profit-making value and its privatization value, is an income tax for which a foreign tax credit is allowed under 26 U.S.C. 901.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

Statutes and regulations:

Statutes—Continued: Page

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PETITION FOR A WRIT OF CERTIORARI

The Solicitor General, on behalf of the Commissioner of Internal Revenue, respectfully petitions for a writ of certiorari to review the judgment of the United States Court of Appeals for the Fifth Circuit in this case.

OPINIONS BELOW

The opinion of the court of appeals (App., *infra*, 1a-13a) is reported at 683 F.3d 233. The opinion of the United States Tax Court (App., *infra*, 14a-15a) is not reported but is available at 2010 WL 3563098.

JURISDICTION

The judgment of the court of appeals was entered on June 5, 2012. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATUTORY AND REGULATORY PROVISIONS INVOLVED

The relevant statutory and regulatory provisions are reproduced in the appendix to this petition. App., *infra*, 74a-116a.

STATEMENT

1. Section 901 of the Internal Revenue Code allows a United States citizen or domestic corporation to claim a credit against its United States income tax liability for "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." 26 U.S.C. 901(a) and (b)(1). The goal of the foreign tax credit is to reduce double taxation of foreign-source income paid to U.S. taxpayers. *Burnet* v. *Chicago Portrait Co.*, 285 U.S. 1, 7 (1932).

In 1983, the Secretary of the Treasury issued a regulation that defines a creditable foreign tax under Section 901. See 26 C.F.R. 1.901-2. The regulation states that a foreign tax is creditable "if and only if * * * [t]he predominant character of that tax is that of an income tax in the U.S. sense." 26 C.F.R. 1.901-2(a)(1)(ii). That standard is met if "the foreign tax is likely to reach net gain in the normal circumstances in which it applies." 26 C.F.R. 1.901-2(a)(3)(i).

The regulation explains that a foreign tax is likely to reach net gain "if and only if the tax, judged on the basis of its predominant character," satisfies each of three tests: the realization test, the gross-receipts test, and the net-income test. 26 C.F.R. 1.901-2(b)(1). The realization test is satisfied if the foreign tax "is imposed [u]pon 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." 26 C.F.R. 1.901-2(b)(2)(i)(A). The gross-receipts test is satisfied if the foreign tax is imposed on the basis of

gross receipts or an equivalent thereof "computed under a method that is likely to produce an amount that is not greater than [the] fair market value." 26 C.F.R. 1.901-2(b)(3)(i). The net-income test is satisfied if "the base of the tax is computed by reducing gross receipts * * * to permit * * * [r]ecovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts." 26 C.F.R. 1.901-2(b)(4)(i)(A).

2. a. Between 1984 and 1996, the government of the United Kingdom, under the control of the Conservative Party, privatized ownership of more than 50 state-owned companies by "flotation" (*i.e.*, public offering) of their stock. C.A. J.A. 100-101, 108, *PPL Corp.* v. *Commissioner*, 665 F.3d 60 (3d Cir. 2011) (No. 11-1069). The flotation process involved the transfer of the companies' assets to newly created "public limited companies," followed by the offering of the new companies' shares to the public at a fixed price. 10-60988 C.A. R.E. Doc. 31, at 7 (5th Cir. Apr. 13, 2011) (Doc.). In December 1990, the U.K. Government privatized twelve regional electric companies, including London Electricity plc, which later became a subsidiary of respondent. *Id.* at 7-8.

The U.K. Government regulated the prices that the privatized utilities could charge the public. App., *infra*, 2a. Nevertheless, because the privatized utilities increased efficiency to a greater degree than had been expected when the initial price controls were established, the companies realized substantially higher profits than had been anticipated. *Ibid.* 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. Doc. 31, Ex. 17-P, para. 42.

b. In 1996, the Labour Party began to explore the possibility of imposing a "windfall tax" on the privatized utilities, which it promised to enact if restored to power. 4/7/08 Tr. 63, 2010 WL 3563098 (T.C.) (Tr.). Geoffrey Robinson, a member of Parliament and the Labour Party's Paymaster General, hired Arthur Andersen to assist the Labour Party's shadow treasury team in developing a proposal for the tax. Tr. 63-64, 71-74.

The Andersen team considered three "simple" and three "complex" solutions for structuring the tax. The three simple solutions were to tax gross receipts, assets, or profits. The three complex solutions were to tax excess profits, excess shareholder returns, or a "windfall" amount. Tr. 77-78. The team rejected all three simple solutions and the first two complex solutions. Robinson and the Anderson team settled on a one-time tax that would be charged on the "windfall" that the utilities were thought to have received at privatization. The windfall would be the amount by which an imputed value for each company at privatization (to be determined by applying a selected price-to-earnings ratio to each company's annual average profits over a multi-year period) exceeded the actual flotation price of the company. In other words, the proposal was to tax the difference between the price at which each company was actually sold and an estimated value at which it should have been sold. Tr. 84-87; Doc. 31, Ex. 27-R, at 73-74.

c. In 1997, the Labour Party regained control of the U.K. Government. As promised, in July 1997, Parliament enacted a "windfall tax" on the privatized utilities as part of the Finance (No. 2) Act, 1997, c. 58 (U.K.) (the Act). See App., *infra*, 95a-116a. The windfall tax was a one-time tax that was required to be paid in two install-

ments: one-half by December 1, 1997, and the other half by December 1, 1998. Act, Sch. 2, para. 3(1).

The Act provides that "[e]very company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation shall be charged with a tax (to be known as the 'windfall tax') on the amount of that windfall." App., *infra*, 95a-96a (Pt. I, para. 1(1)). The amount of the tax was 23% of the "windfall." *Id.* at 96a (Pt. I, para. 1(2)).

The "windfall" is defined as the difference between two values: (a) "the value in profit-making terms of the disposal made on the occasion of the company's flotation" minus (b) "the value which for privatisation purposes was put on that disposal." App., *infra*, 104a (Sch. 1, para. 2(1)). As the Board of Inland Revenue (the U.K. taxing authority) explained, "[t]he taxable amount is calculated by taking the value of the company in profit-making terms and deducting the value placed on the company at the time of flotation." Doc. 31, Ex. 17-P, cl. 1, para. 7.

i. The first of those two values (the profit-making value) is determined "by multiplying the average annual profit for the company's initial period by the applicable price-to-earnings ratio." App., *infra*, 104a (Sch. 1, para. 2(1)). A company's "initial period" is generally the first four years after flotation. *Id*. at 110a-111a (Sch. 1, para. 6(1)). The "average annual profit" during that initial period is equal to the company's total profits for the initial period divided by the number of days in the initial period, multiplied by 365. *Id.* at 104a-105a (Sch. 1, para. 2(2)).

That number is multiplied by the applicable price-to-earnings ratio, which is 9. App., *infra*, 105a (Sch. 1, pa-

ra. 2(3)). That figure represents the lowest average price-to-earnings ratio, during the relevant period, of the 32 companies that would be subject to the tax. Doc. 31, at 10, 12; *id.* Ex. 16-P, para. 4, *id.* Ex. 17-P, cl. 1, para. 11.

ii. The second of the two values (the flotation value) is determined by multiplying the highest price per share at which shares in the company were offered during flotation by the number of shares that were offered. App., *infra*, 105a (Sch. 1, para. 3(1)).

The windfall tax can thus be expressed by the following formula, where P is the total profits for the company's initial period,[1] D is the number of days in the initial period, and FV is the company's flotation value (the price for which the U.K. government sold the company):

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

App., *infra*, 104a-106a.

3. London Electricity paid a total windfall tax of £139,962,622. Doc. 31, at 4-5, 22. Respondent, a Delaware corporation with its principal place of business in New Orleans, Louisiana, is London Electricity's parent company. App., *infra*, 2a; Doc. 31, at 2, 4. Under 26 U.S.C. 902, if a U.S. corporation owns at least ten percent of the voting stock of a foreign corporation and receives a dividend from the foreign corporation, the U.S. corporation is deemed to have paid (for purposes of Section 901) a portion of any foreign income tax that the foreign corporation paid on the earnings and profits

[1] The company's "total profits" refers to the company's profit on ordinary activities after tax, as determined under U.K. financial accounting principles and as reflected in the company's profit and loss accounts prepared in accordance with the U.K. Companies Act 1985. App., *infra*, 106a-107a (Sch. 1, para. 5).

from which the dividend was paid. Accordingly, in an amended federal income tax return for 1998, respondent sought a foreign tax credit for the windfall tax paid by London Electricity. Doc. 31, at 5-6. The Internal Revenue Service disallowed the credit and issued a deficiency notice. *Id.* at 6; *id.* Ex. 9-R. Respondent contested the deficiency notice in the United States Tax Court.

4. In *PPL Corp.* v. *Commissioner*, 135 T.C. 304 (2010) (App., *infra*, 16a-73a), the Tax Court rejected the Commissioner's argument that the windfall tax was a tax based on value, *i.e.*, a tax on the undervaluation of the utilities at the time of flotation. App., *infra*, 66a. The court explained that "a foreign levy [can] be directed at net gain or income even though it is, by its terms, imposed squarely on the difference between two values." *Id.* at 67a-68a.

The Tax Court in *PPL* further explained that, as PPL had argued, the windfall tax could be reformulated as a 51.71% tax on a company's profits during the initial period, to the extent those profits exceeded an average annual return of approximately 11.1% of the company's flotation value. App., *infra*, 52a, 69a-70a. Without evaluating the windfall tax under the realization, gross-receipts, or net-income tests as required by 26 C.F.R. 1.901-2(b)(1) to (4), the court concluded that the tax "did, in fact, 'reach net gain,'" and was therefore creditable under Section 901. App., *infra*, 70a. The government appealed the Tax Court's ruling in *PPL* to the Third Circuit.

5. In the present case, the Tax Court likewise concluded that the windfall tax was creditable under Section 901. App., *infra*, 14a-15a. The court ruled summarily in favor of respondent based on its decision in *PPL*, which was issued on the same day. *Id*. at 15a.

6. The government appealed the Tax Court's decision in this case to the Fifth Circuit. The court of appeals affirmed. App., *infra*, 1a-13a. The court rejected the Commissioner's argument that the windfall tax was a tax on the undervaluation of London Electricity at flotation. *Id.* at 6a. The court invoked case law from before the 1983 adoption of the Treasury regulation to conclude that it was not required to rely "exclusively, or even chiefly, on the text of the Windfall Tax" to determine its predominant character. *Id.* at 6a-7a.

The court of appeals concluded that the U.K. windfall tax satisfied the realization test set forth in the regulation because the tax "is based on revenues from the ordinary operation of the utilities that accrued long before the design and implementation of the tax." App., *infra*, 7a. The court further held that the net-income test was satisfied because "the tax only reached—and only could reach—utilities that realized a profit in the relevant period." *Ibid.* (emphasis omitted). The court acknowledged that "[a] tax actually directed at corporate value would not, in the ordinary instance, be imposed on the basis of gross receipts." *Ibid.* But the court concluded that the "practical operation" of the tax was to "claw back" a portion of the utilities' "'excess profits' in light of their sale value," *id.* at 7a-8a, and that the gross-receipts test was satisfied because those initial-period profits were calculated as "gross receipts less expenses," *id.* at 8a. The court noted that, under the U.K. windfall tax statute, "each utility could only be subject to the Windfall Tax after making a profit exceeding approximately an 11% annual return on its initial flotation value, and the Windfall Tax liability increased linearly with additional profits past that point." *Id.* at 11a.

By the time the Fifth Circuit issued its decision in this case, the Third Circuit had ruled in the government's appeal in *PPL*. See *PPL Corp.* v. *Commissioner*, 665 F.3d 60 (2011), petition for cert. pending, No. 12-43 (filed July 9, 2012). The court of appeals in *PPL* held that a different taxpayer was not entitled to a foreign tax credit under Section 901 based on its payment of a windfall tax to the U.K. government. See *id.* at 63-68. In the present case, the court of appeals acknowledged (App., *infra*, 8a-12a) that its ruling was directly contrary to the Third Circuit's decision.

REASONS FOR GRANTING THE PETITION

The question whether the U.K. windfall tax is an income tax for which a foreign tax credit is allowed under 26 U.S.C. 901 is presented in another petition for a writ of certiorari that is currently pending before the Court. See *PPL Corp.* v. *Commissioner*, 665 F.3d 60 (3d Cir. 2011), petition for cert. pending, No. 12-43 (filed July 9, 2012). The Commissioner's response to the petition in *PPL* agrees that the petition should be granted. Br. for Respondent, *PPL Corp.* v. *Commissioner*, No. 12-43 (filed Sept. 4, 2012). If the Court grants the petition in *PPL* and concludes that the U.K. windfall tax is not an income tax that is creditable under Section 901, then respondent in this case would not be entitled to a foreign tax credit. Accordingly, the Court should hold this petition pending the disposition of *PPL*, including any subsequent proceedings on the merits, and then dispose of the petition in light of that decision.

CONCLUSION

The petition for a writ of certiorari should be held pending this Court's final disposition of *PPL Corp.* v. *Commissioner*, No. 12-43, and disposed of as appropriate in light of that decision.

Respectfully submitted.

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SEPTEMBER 2012

APPENDIX A

UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 10-60988

ENTERGY CORPORATION AND AFFILIATED SUBSIDIARIES, PETITIONER-APPELLEE

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT-APPELLANT

[Filed: June 5, 2012]

APPEAL FROM A DECISION OF THE UNITED STATES TAX COURT

Before: JONES, Chief Judge, and DAVIS and DEMOSS, Circuit Judges.

EDITH H. JONES, Chief Judge:

Appellant Commissioner of Internal Revenue ("Commissioner") seeks review of a United States Tax Court decision favoring Appellee Entergy Corp. ("Entergy") for the taxable years 1997 and 1998. By reference to a companion case, *PPL Corp. v. Comm'r*, 135 T.C. 304 (2010), *rev'd*, 665 F.3d 60 (3d Cir. 2011), the Tax Court concluded Entergy was entitled to a foreign income tax credit for its subsidiary's payment of the United Kingdom's Windfall Tax. The sole question on appeal is whether the Windfall Tax constitutes a creditable for-

eign income tax under I.R.C. § 901, 26 U.S.C. § 901. Notwithstanding the Third Circuit's contrary opinion, we AFFIRM.

BACKGROUND

The Tax Court and parties treat *PPL Corp.* as materially identical to this case; we do so as well. *See Entergy Corp. v. Comm'r*, 100 T.C.M. (CCH) 202 (2010). The Tax Court and Third Circuit ably detail the history of the Windfall Tax, and we briefly summarize the relevant facts.

Entergy owns London Electricity, one of thirty-two companies, generally utilities, the U.K. privatized through the 1980s and 1990s. The U.K. government set price controls on these utilities but not caps on profits; the newly privatized corporations quickly reduced costs beyond governmental expectations, reaping higher-than-expected profits, share prices, and executive compensation. This in turn led to a public backlash.

In response, the then-opposition Labour Party proposed a new tax on the utilities—a "windfall levy on the excess profits of the privatised utilities." Enlisting the accounting firm Arthur Andersen, the Labour Party designed a series of proposals, including gross receipts taxes and profits taxes, to recoup a desired proportion of the utilities' profits. Geoffrey Robinson, a Labour Member of Parliament, and Gordon Brown, Shadow Chancellor of the Exchequer, ultimately selected the Windfall Tax. Once in power, the Labour Party passed the tax.

The Windfall Tax was designed to address the public's concern that the utilities had been sold too cheaply in light of their profit potential. It imposed on each of the utilities a one-time 23% assessment on the difference

between: (1) a company's "profit-making value," defined as its average annual profit per day over an initial period (typically, as here, four years) multiplied by 9, an imputed "price-to-earnings ratio," and (2) its "flotation value," or the price for which it was privatized.

London Electricity timely paid slightly less than £140M as a result of the Windfall Tax, and Entergy filed an amended U.S. federal tax return in 1998 claiming an equivalent credit—approximately $234M. When the IRS disallowed the credit in a notice of deficiency, Entergy contested the notice by filing a petition with the Tax Court. Entergy and the Commissioner essentially disagreed on whether the Windfall Tax—on "profit-making value," calculated as explained above—constituted a tax on excess profits, creditable under I.R.C. § 901, or a tax on unrealized value for which Entergy could not claim a foreign income tax credit. Entergy demonstrated that the Windfall Tax could be mathematically re-expressed as a pure tax on profits; the Commissioner pointed to the statute's reference to "profit-making value" as conclusively demonstrating that the tax reached unrealized value rather than excess profits.

The Tax Court relied on its parallel decision in *PPL Corp. v. Comm'r*, 135 T.C. 304 (2010), applying the relevant Treasury regulation interpreting Section 901, 26 C.F.R. § 1.901-2(a). *Entergy*, 100 T.C.M. (CCH) 202. The Tax Court determined the Windfall Tax was based on excess profits, and that it therefore necessarily satisfied § 1.901-2(a)'s three-part "predominant character" test: namely, that the Windfall Tax (1) reached only realized income, (2) was imposed on the basis of gross receipts, and (3) targeted only net income. *PPL*, 135 T.C. at 337-39. The Tax Court therefore ruled Entergy enti-

tled to a tax credit. *Entergy*, 100 T.C.M. 202. The Commissioner appealed in both *PPL* and this case.

STANDARD OF REVIEW

This court applies the same standard of review to decisions of the Tax Court as we do to district court decisions: findings of fact are reviewed for clear error and issues of law are reviewed de novo. *Terrell v. Comm'r*, 625 F.3d 254, 258 (5th Cir. 2010).

DISCUSSION

The parties agree that 26 C.F.R. § 1.901-2(a) controls. It provides that "[a] foreign levy is an income tax if and only if[] . . . [t]he predominant character of that tax is an income tax in the U.S. sense." 26 C.F.R. §§ 1.901-2(a)(1), (a)(1)(ii). A foreign tax's predominant character "that tax is that of an income tax in the U.S. sense" if it "is likely to reach net gain in the normal circumstances in which it applies." *Id.* at §§ (a)(3), (a)(3)(i). "A foreign tax is likely to reach net gain in the normal circumstances 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" established by the regulation. *Id.* at § 1.901-2(b)(1).

The realization requirement tracks the American income tax principle that income is typically taxed only following a "realization event," usually "when property is sold or exchanged." BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES & GIFTS ¶ 72.4.3 (2011). The gross income requirement mandates that "[g]enerally, the starting point for calculating income subject to a creditable foreign income tax must be actual gross receipts." *Id.* And the net income

requirement only allows accreditation for taxes which "provid[e] for 'recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to [the] gross receipts included in the tax base.'" *Id.*

The Tax Court considered two competing interpretations of the Windfall Tax's reliance on "profit-making value." The Commissioner offered a "text-bound approach to determining" creditability, relying primarily on the fact that the Windfall Tax by its own terms levied the difference between two statutory values. *PPL Corp.*, 135 T.C. at 332, 334. The Commissioner further argued this ineluctable conclusion flowed directly from the Tax Court's obligation to examine the text of the Windfall Tax *alone*, to the exclusion of historical and mathematical sources. *Id.* at 333. PPL, by contrast, argued that both parliamentary history surrounding the Windfall Tax as well as algebraic reformulations demonstrated that the Windfall Tax was both intended as and actually acted as an excess profits tax. *Id.* at 326-27.

The Tax Court agreed with the latter view, refusing the Commissioner's argument that "the words of the . . . statute *are* the 'substance'" of the tax and affirming the propriety of resorting to extra-statutory sources under the predominant character standard. *Id.* at 331, 334-35. The Tax Court concluded that the Windfall Tax acted as an excess profits tax despite its imposition on "profit-making value," specifically noting that:

> The architects and drafters of the tax knew (1) exactly which companies the tax would target, (2) the publicly reported after-tax financial profits of those companies, which were a crucial component of the tax base, AND (3) [the ta]rget amount of revenue the tax

> would raise. [T]herefore, it cannot have been an unintentional or fortuitous result that, (1) for 29 of the 31 windfall tax companies that paid tax, the effective rate of tax on deemed annual excess profits was at or near 51.7 percent, and (2) for none of the 31 companies did the tax exceed initial total period gains. What respondent refers to as "petitioner's algebraic reformulations of the Windfall Tax statute" do not, as respondent argues, constitute an impermissible "hypothetical rewrite of the Windfall Tax statute[.]"[ ] Rather, they represent a legitimate means of demonstrating that Parliament did, in fact, enact a tax that operated as an excess profits tax for the vast majority of the windfall tax companies. The design of the windfall tax formula made certain that the tax would, in fact, operate as an excess profits tax for the vast majority of companies subject to it.

Id. at 339-341. The Tax Court concluded the Windfall Tax, a tax on excess profits, satisfied each of the net gain test's three requirements, and that it was therefore a creditable foreign income tax.

The Commissioner reiterates his insistence on the primacy of the Windfall Tax's text, which uses the term "profit-making value" to describe the base for calculation of the tax. This argument is easy to dispatch. The case law from which 26 C.F.R. § 1.901-2 is derived refutes the Commissioner's assertion that we should rely exclusively, or even chiefly, on the text of the Windfall Tax in determining the tax's "predominant character." "The label and form of [a] foreign tax is not determinative." *Inland Steel Co. v. U.S.*, 677 F.2d 72, 80 (Ct. Cl. 1982). "We do not . . . consider it alldecisive [sic] whether the foreign income tax is labeled a gross income or a net income tax . . . . The important thing is

whether the other country is attempting to reach some net gain, *not the form in which it shapes the income tax or the name it gives*." *Bank of Am. Nat. Trust & Sav. Ass'n v. U.S.*, 459 F.2d 513, 519 (Ct. Cl. 1972) (emphasis added).

Viewed in practical terms, the Windfall Tax clearly satisfies the realization and net income requirements. The Windfall Tax is based on revenues from the ordinary operation of the utilities that accrued long before the design and implementation of the tax. Revenues from earlier ordinary operation are clearly "realized;" indeed, the Labour Party accurately estimated the amount the Windfall Tax would raise, as the earnings of each of the utilities were publicly available when the Labour Party drafted the tax. Furthermore, the tax *only* reached—and only *could* reach—utilities that realized a profit in the relevant period, calculating profit in the ordinary sense (*e.g.* by subtracting operating expenses associated with generating the utilities' income). This satisfies the net income requirement.

The Commissioner's formalistic argument applies with somewhat greater force to the gross receipts requirement. A tax actually directed at corporate value would not, in the ordinary instance, be imposed on the basis of gross receipts. The Commissioner essentially urges that because Parliament computed the Windfall Tax based on "profit-making value," calculated according to average profits over an initial period, the tax is not designed to reach gross receipts, even though the tax may be based on gross receipts in some indirect way. But we are persuaded by the Tax Court's astute observations as to the Windfall Tax's predominant character: the tax's history and practical operation were to "claw back" a substantial portion of privatized utilities' "ex-

cess profits" in light of their sale value. These initial profits were the difference between the utilities' income from all sources less their business expenses—in other words, gross receipts less expenses from those receipts, or net income. The tax rose in direct proportion to additional profits above a fixed (and carefully calculated) floor. That Parliament termed this aggregated but entirely profit-driven figure a "profit-making value" must not obscure the history and actual effect of the tax, that is, its predominant character.

Following oral argument in this case, however, the Third Circuit concluded to the contrary: that the Windfall Tax fails at least the gross receipts requirement of the governing regulation, 26 C.F.R. § 1.901-2(a), and is therefore not a creditable foreign income tax. *PPL Corp. v. Comm'r*, 665 F.3d 60, 65-66 (3d Cir. 2011). It regarded the Appellee taxpayer's mathematical reformulation, demonstrating the Windfall Tax equated to a 51.75% tax on initial period profits, as a "bridge too far," requiring that court to "rewrite the tax rate" to find the Windfall Tax creditable. *PPL*, 665 F.3d at 65. The Third Circuit accepted that perhaps the Windfall Tax reached 23% of 2.25 times the companies' initial period profits, but it viewed this as fatal to the gross receipts requirement. *Id*. Since a tax must be established on the basis of no more than 100% of gross receipts, the Third Circuit reasoned, a tax imposed on 23% of 225% of profits could not satisfy the regulatory requirement. *Id.* at 67. The Third Circuit viewed Example 3 of 26 C.F.R. § 1.901-2(b)(3)(ii), disallowing a theoretical credit for a tax based on 105% the value of extracted petroleum, as bolstering its conclusion: "[i]f 105% of gross receipts (barely more than actual receipts) does not satisfy the requirement, then 225% is in the same boat but another

ocean." *Id.* That court reversed the Tax Court's judgment. *Id.* at 68.

This reasoning exemplifies the form-over-substance methodology that the governing regulation and case law eschew. The gross receipts requirement ensures a creditable income tax is usually computed "begin[ning] from actual gross receipts, rather than notional amounts." BITTKER & LOKKEN at ¶ 72.1. This distinction between "actual receipts" and "notional amounts" reflects a core requirement in Section 1.901-2 that creditable foreign taxes must be based on either actual income *or* an imputed value *not* intended to reach *more* than actual gross receipts.

This policy arises from a common foreign response to the attempt to avoid double taxation. Foreign countries would use imputed, rather than actual, income formulas for income tax purposes "structured to tax artificial or fictitious income" in order to increase domestic tax receipts. The taxed corporation, entitled to a dollar-for-dollar foreign tax credit, acted as a conduit from the tax-accrediting nation (*e.g.* the U.S.) to the nation imposing the tax on fictitious imputed income instead of actual income. *See, e.g.*, *Foreign Tax Credit; Libya & Saudi Arabia*, 1978-1 C.B. 228. The gross receipts requirement therefore serves as one mechanism to prevent foreign nations from "soaking up" American tax revenue by levying an income tax on an imputed amount deliberately calculated to reach some amount greater than the business's actual gross receipts.

Nevertheless, not all methods of imputing income fail to satisfy the gross receipts requirement. Section 1.901-2(b)(3)(i) indicates that a foreign tax satisfies the gross receipts requirement if it is imposed either on *actual*

gross receipts or *imputed* gross receipts "computed under a method that is likely to produce an amount that is not greater than fair market value." Either of these reflects "actual gross receipts." Treas. Reg. § 1.901-2(b)(3)(i)(A), (B). A fictitious calculation likely to produce an amount greater than the fair market value of *actual* gross receipts is instead a forbidden fictitious "notional amount."

A close reading of *all* of the examples following the subsection establishing the gross receipts requirement indicates they do not illustrate the meaning of "actual gross receipts," but instead differentiate between permissible *imputed* actual gross receipts and impermissible notional amounts. Example 1 considers a "headquarters company tax" where "arm's length gross receipts" for a hypothetical foreign regional headquarters of a nonresident company would be difficult to actually calculate, and are thus deemed 110% of the business expenses of the foreign branch. *Id.* at § 1.901-2(b)(3)(ii) Ex. 1. Because this formula is designed to produce an amount that is likely not greater than the fair market value of arm's-length gross receipts from such transactions with affiliates, the example concludes that the headquarters company tax satisfies the gross receipts requirement. Example 2 posits a specific circumstance in which the headquarters tax actually produces an amount much greater than actual gross receipts' value. Because a tax either is or is not creditable for all entities subject to the tax, however, it remains creditable under either Example 1 or 2. Example 3 hypothesizes a tax on the extraction of petroleum where the income value of the petroleum is deemed to be 105% of the fair market value of the petroleum: *i.e.* deliberately greater than actual gross receipts. The petroleum extraction tax is

obviously a method for computing an impermissible notional amount greater than actual gross receipts. Because this imputation is fictionally exaggerated, inflating the amount subject to foreign taxation, it is not creditable.

The Windfall Tax relies on no Example 3-type imputed amount, nor indeed on any imputation, for calculating gross receipts. Instead, the Windfall Tax begins by taking 23% of the daily average of profit based on *actual gross receipts*, multiplied by a statutory constant of nine (deemed a "price-to-earnings ratio"), less each company's flotation value. No more and no less. The Windfall Tax at no point imputes gross receipts against the utilities as difficult to calculate or impractical to know; in fact, by all accounts, the Labour Party forecasted the estimated revenue from the Windfall Tax with extreme accuracy, because the various utilities' earnings information was long since public before the Windfall Tax was even proposed. There was no need to calculate imputed gross receipts; gross receipts were actually known. And thus, an example detailing an impermissible method for calculating *imputed* gross receipts (based on historical practices by OPEC countries) is facially irrelevant.

In fact, as the record indicates, each utility could only be subject to the Windfall Tax after making a profit exceeding approximately an 11% annual return on its initial flotation value, and the Windfall Tax liability increased linearly with additional profits past that point. Moreover, the Third Circuit opinion seems to overlook that a tax based on actual financial profits in the U.K. sense necessarily begins with gross receipts, as, again, the record here indicates. London Electricity's profit for purpose of the Windfall Tax was calculated by com-

puting gross receipts less operating expenses. The Windfall Tax was designed to reach a *subset* of this left-over amount by beginning with an amount predicated on *actual gross receipts* minus flotation value.

Furthermore, an examination of the origins of the 2.25 multiplier, which the Third Circuit asserts as "proof" that the tax was computed on amounts exceeding gross receipts, illustrates that it had nothing to do with inflating the utilities' profits into notional amounts. *But see PPL Corp. v. Comm'r*, 665 F.3d 60, 65-66 (3d. Cir. 2011). The 2.25 multiplier resulted from dividing the number of days in a year by approximately the number of days in four years—or, simplified, one-quarter. This number was multiplied by nine—the price-to-earnings ratio—to result in 2.25 (times profits). By the Third Circuit's logic, had the Windfall Tax applied to the first *nine* years after flotation, rendering the initial period approximately 3,285 days (and the divisor one-ninth), the "multiplier" would have been (approximately) 1, and the Windfall Tax would suddenly qualify for dollar-for-dollar credit under Internal Revenue Code § 901. But the Third Circuit illogically holds that a Windfall Tax for eight years, or four, as in this case, is in entirely "another ocean" and may not be credited. We are always chary to create a circuit split, *Wheeler v. Pilgrim's Pride Corp.*, 591 F.3d 355, 363 (5th Cir. 2009), 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 I.R.C. § 901.

CONCLUSION

We conclude that when judged on its predominant character, the Windfall Tax is based on excess profits—realized income derived from gross receipts less deductions for substantial business expenses incurred in earning those receipts. This satisfies the three-part net gain requirement, as the Tax Court accurately noted. We therefore **AFFIRM** the judgment of the Tax Court.

AFFIRMED.

APPENDIX B

UNITED STATES TAX COURT

T.C. Memo. 2010-197
Docket No. 25132-06

ENTERGY CORPORATION & AFFILIATED SUBSIDIARIES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

[Filed: Sept. 9, 2010]

MEMORANDUM OPINION

HALPERN, *Judge*: Entergy Corp. (petitioner) is the common parent of an affiliated group of corporations (the group) making a consolidated return of income. By notice of deficiency respondent determined deficiencies of $17,341,254 and $61,729,798 in the group's Federal income tax for its 1997 and 1998 taxable (calendar) years, respectively. The only issue remaining for decision is whether respondent properly denied a foreign tax credit for the United Kingdom (U.K.) windfall tax paid by petitioner's indirect U.K. subsidiary.[1] That issue is identical to the issue in *PPL Corp. & Subs. v. Commissioner*, 135 T.C. __ (2010), which we also decide today. Moreover,

[1] We decided a separate issue in *Entergy Corp. v. Commissioner*, T.C. Memo. 2010-166.

the material facts with respect to that issue are identical to the corresponding facts in *PPL*.

Unless otherwise stated, all section references are to the Internal Revenue Code in effect for 1997 and 1998.

The parties have stipulated that, in 1997, petitioner's indirect U.K. subsidiary, London Electricity plc, became liable for the U.K. windfall tax, a "one-off" (i.e., one-time) tax of £139,962,622, which it timely paid in two equal installments on December 2, 1997 and 1998. The sole issue is whether the U.K. windfall tax constituted an income or excess profits tax under section 901(b)(1), thereby entitling petitioner to a foreign tax credit under section 901(a) for London Electricity's payment of that tax. In *PPL*, we answer that question in the affirmative. Respondent makes no argument that leads us to believe we have erred in *PPL*. We rely on *PPL* in holding for petitioner on the windfall tax issue.

An appropriate order and decision will be issued.

APPENDIX C

UNITED STATES TAX COURT

Docket No. 25393-07

PPL CORPORATION & SUBSIDIARIES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Filed: Sept. 9, 2010

HALPERN, *Judge*: PPL Corp. (petitioner) is the common parent of an affiliated group of corporations (the group) making a consolidated return of income. By notice of deficiency, respondent determined a deficiency of $10,196,874 in the group's Federal income tax for its 1997 taxable (calendar) year and also denied a claim for refund of $786,804. The issues for decision are whether respondent properly (1) denied the claim for the refund, which is related to the creditability of the United Kingdom (U.K.) windfall tax paid by petitioner's indirect U.K. subsidiary (the windfall tax issue), (2) included as dividend income a distribution that petitioner received from the same indirect U.K. subsidiary, but which, within a few days, the subsidiary rescinded and petitioner repaid (the dividend rescission issue), and (3) denied depreciation deductions that petitioner's U.S. subsidiary claimed for street and area lighting assets. We disposed of the third issue in a previous report, *PPL Corp. & Subs. v. Commissioner*, 135 T.C. ___ (2010), and we dispose of the remaining issues here.

Unless otherwise stated, all section references are to the Internal Revenue Code in effect for 1997, and all Rule references are to the Tax Court Rules of Practice and Procedure. With respect to the two issues before us here, petitioner bears the burden of proof. See Rule 142(a).[1]

FINDINGS OF FACT

Stipulations

The parties have entered into a first, second, and third stipulation of facts. The facts stipulated are so found. The stipulations, with accompanying exhibits, are incorporated herein by this reference.

Petitioner's Business and Its U.K. Operation

Petitioner is a Pennsylvania corporation that was known during 1997 as PP&L Resources, Inc. It is a global energy company. Through its subsidiaries, it produces electricity, sells wholesale and retail electricity, and delivers electricity to customers. It provides energy services in the United States (in the Mid-Atlantic and the Northeast) and in the United Kingdom. During 1997, South Western Electricity plc (SWEB), a U.K. private limited liability company, was petitioner's indirect subsidiary.[2] Its principal activities at the time included the distribution of electricity. It delivered electricity to

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[1] Petitioner has not raised the issue of sec. 7491(a), which shifts the burden of proof to the Commissioner in certain situations. We conclude that sec. 7491(a) does not apply because petitioner has not produced any evidence that it has satisfied the preconditions for its application. See sec. 7491(a)(2).

[2] SWEB was originally incorporated as a U.K. public limited liability company in 1987, but, as described *infra*, it was privatized in 1990. The appendix shows SWEB's relationship to petitioner in 1997.

approximately 1.5 million customers in its 5,560-square-mile service area from Bristol and Bath to Land's End in Cornwall. SWEB also owned electricity-generating assets.

Privatization of U.K. Companies

The Conservative Party won control of the U.K. Parliament in the 1979 elections. It retained control through May 1997, under the leadership of Margaret Thatcher and John Major.

Between 1979 and 1983, the Conservatives privatized mostly companies that were not monopolies (e.g., manufacturing companies) and, for that reason, did not require specific economic regulation. Between 1984 and 1996, however, the U.K. Government privatized more than 50 Government-owned companies, many of which were monopolies.

The U.K. Government privatized those companies largely through public flotations (share offerings) at fixed price offers, which involved the transfer of those Government-owned enterprises to new public limited companies (plcs), followed by what was essentially a sale of all or some of the shares in the new plcs to the public.[3]

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[3] The U.K. Government hired investment banks and other advisers to assist it in setting the initial share prices, structuring the offers, and marketing the shares to investors. The new plcs were not subject to a gains tax on transfers of stock to the general public, a result made possible by an amendment to the then-existing U.K. law.

Under sec. 171 of the U.K. Taxation of Chargeable Gains Act, 1992 (TCGA), companies within a group (generally, a parent and its 75-percent-owned subsidiaries) may transfer assets between members of the group without incurring a capital gains charge. The effect of TCGA sec. 171 is to defer the chargeable gain on asset appreciation until a group member transfers the asset outside the group, at which

The plcs then became publicly traded companies listed on the London Stock Exchange. In most cases, the floated shares opened for trading at a substantial premium over the price the flotation investors paid for the shares.

In December 1990, the U.K. Government privatized 12 regional electric companies (RECs), including SWEB. The ordinary shares of each REC were offered to the public at £2.40 per share in connection with the flotation of those shares.

The 32 U.K. Government-owned companies that were privatized and that ultimately became liable for the windfall tax (the privatized utilities or windfall tax companies) and the years in which they were privatized are as follows:

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point the gain becomes chargeable to that transferor. Under the TCGA as originally enacted, however, the transfer outside the group of the *stock* of a group member holding an appreciated asset would not trigger any capital gains charge to the transferor. (The nongroup transferee, meanwhile, would receive a basis in the stock that would reflect the value of the underlying asset.) TCGA sec. 179 was enacted to make the tax consequences of the stock transfer similar to those of the asset transfer, although only if the transfer of the stock of the group member holding the asset occurred within 6 years of that member's acquisition of the asset. Because the transfers of the stock of the privatized utilities to the general public pursuant to the flotations of that stock would have triggered the application of TCGA sec. 179 and taxation of the appreciation inherent in the assets the companies received from the various U.K. Government-owned enterprises, Parliament specifically exempted the privatization share transfers from the application of that provision.

Year	Company
1984	50.2 percent of British Telecommunications plc (British Telecom)
1986	British Gas plc
1987	British Airports Authority
1989	10 water and sewerage companies (the WASCs)
1990	The 12 RECs
1991	60 percent of National Power plc and Powergen plc (the generating companies)
1991	Scottish Power plc and Scottish Hydro–Electric plc (the Scottish electricity companies)
1993	Northern Ireland Electricity (NIE)
1996	Railtrack plc (Railtrack)
1996	88.5 percent of British Energy plc (British Energy) (which owned U.K. nuclear generating stations)

Regulation of the Windfall Tax Companies

The Electricity Act of 1989, c. 29, sec. 1, created the position of U.K. Director General of Electricity Supply, a position that Professor Stephen C. Littlechild (Professor Littlechild) held from its creation in 1989 through 1998.[4]

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[4] Professor Littlechild was professor of commerce and head of the Department of Industrial Economics and Business Studies, University of Birmingham (on leave, 1989 to 1994) from 1975 to 1994 (and honorary professor from 1994 until 2004).

Before that appointment, in 1983, the U.K. Secretary of State asked Professor Littlechild for his advice on how to regulate British Telecom in the light of its impending privatization. Professor Littlechild recommended a regulatory scheme which regulated prices rather than, as in the United States, maximum profits or rates of return. The premise of the scheme, which became known as "RPI - X",[5] was that, if the Government fixed prices (but not profits) for a set number of years, the privatized companies would have an incentive to reduce costs to maximize profits during that period. Prices would be reset (presumably downward) at the start of the next regulatory period, to garner for consumers the fruits of the prior period's cost reductions. Profits might in a sense become excessive during any regulatory period (because a company achieved greater-than-anticipated savings and there was no mechanism for mid-period correction), but balance would be reestablished at the start of the next period. The goal was to increase efficiency, encourage competition, and protect consumers. Under RPI - X, prices were not allowed to increase during the regulatory period, except to allow for inflation (i.e., increases in RPI) less an amount (the X factor, which did not vary during the period) intended to reflect expected, increasing efficiency.

The U.K. Government set the X factors for the first regulatory periods, just before the initial privatization, to be effective for what was, in most cases, the 5-year period after privatization. Industry regulators subsequently reset the X factors, typically every 4 or 5 years.

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[5] RPI, which stands for retail price index, is comparable to the CPI (consumer price index) used for various purposes in the United States.

In some cases, particularly where investment requirements were high (e.g., in the case of companies that had underinvested while under public ownership), the X factor might be positive (RPI + X). That was the case for most of the RECs and WASCs.

Each of the regulatory bodies for the privatized utilities followed the RPI - X regulatory method, which was adopted for 29 of the 32 windfall tax companies, the exceptions being the generating companies. On March 31, 1990, the RPI - X methodology as applied to the RECs came into effect for the 5-year period ending March 31, 1995. As noted *supra*, because the RECs were in need of large capital expenditures during the initial 5-year period, the U.K. Government set price controls for the RECs in the form of RPI + X; i.e., it provided for annual increases in electricity distribution charges above the rate of inflation rather than reductions in those charges.

Utility Profits, Share Prices, and Executive Compensation During the Initial Postprivatization Period

During the initial postprivatization period (the initial period), the privatized utilities were able to increase efficiency and reduce operating costs to a greater degree than had been expected when the initial price controls were established. That ability led to higher-than-anticipated profits,[6] which, in turn, led to higher-than-anticipated dividends and share price increases for the privatized utilities. The large profits, dividends, and share price increases resulted in sharply increased com-

[6] Among the privatized utilities, the RECs and the WASCs were particularly profitable during the initial period in that they recovered nearly all (over 90 percent for the WASCs and over 80 percent for the RECs) of their shareholders' initial investment at flotation within the first 4 years.

pensation for utility directors and executives, which, in some cases, arose through their share ownership and through bonus schemes. The popular press referred to those executives as "fat cats".

The public viewed the privatized utilities' initial period profits as excessive in relation to their flotation values. It also viewed the initial period compensation paid to the directors and executives of those companies as excessive. Those concerns, as well as the increases in dividends and share prices, resulted in considerable public pressure on the utility industry regulators to intervene and take action that would result immediately in lower prices, before the expiration of the initial 5-year period. But because the incentive for increased efficiency (and, ultimately, lower prices) depended on the regulators' not intervening until the end of the defined price control period, the regulators resisted that pressure and did not act until the end of the initial period, at which point they did tighten price controls and thereby transfer the benefit of reduced prices to utility customers. Despite those price adjustments, the public retained a strong feeling that the privatized utilities had unduly profited from privatization and that customers had not shared equally in the gains therefrom.

Development of the Windfall Tax

Although the Labour Party had been fundamentally opposed to privatization, particularly with respect to the utilities, by 1992 the party reasoned that, because it would be costly and, given that much of the voting public had embraced share ownership, potentially unpopular, renationalization of those companies (when the party regained control of the Government) was unrealistic.

The issue, then, was how the party might best channel the public concerns into developing policy.

As early as 1992, the British press reported that the policy of an incoming Labour Party might include "a 'windfall' tax on the profits of privatized utilities such as gas and electricity." By 1994 the idea of a windfall tax had become a regular feature in all Labour Party speeches and programs, and, in 1997, the party campaigned on a platform promising that it would (1) impose a windfall tax on the previously privatized utilities and (2) implement a welfare-to-work youth employment training program that the windfall tax would fund. Specifically, the Labour Party's 1997 Election Manifesto contained the following promise:

> We will introduce a Budget * * * to begin the task of equipping the British economy and reforming the welfare state to get young people and the long-term unemployed back to work. This welfare-to-work programme will be funded by a windfall levy on the excess profits of the privatised utilities * * * .

In May 1996, before the issuance of that manifesto, certain members of the Labour Party's shadow treasury team, which included Geoffrey Robinson (Mr. Robinson), a Member of Parliament, began designing the U.K. windfall tax legislation that the party would introduce to Parliament in the likely event that it won the 1997 election. To that end, Mr. Robinson commissioned members of the tax consulting firm Arthur Andersen (the Andersen team) to assist the Labour Party's shadow treasury team in developing the tax. The Andersen team consisted principally of Stephen Hailey, Christopher Osborne (Mr. Osborne), and Christopher Wales (Dr. Wales). The tax that the Andersen team devised was essentially the

windfall tax that Parliament enacted in July 1997. Mr. Osborne and Dr. Wales were the most involved members of the Andersen team.

During their initial consideration of the design of the windfall tax, the Andersen team proposed three "simple" and three "complex" solutions for structuring the tax. The "simple" solutions were to tax either (1) turnover (gross receipts), (2) assets, or (3) profits. The "complex" solutions were to tax (1) excess profits, (2) excess shareholder returns, or (3) a "windfall" amount. The team members rejected the three "simple" solutions and the first two "complex" solutions for a variety of reasons. For example, they considered that a straightforward tax on profits, if prospective, would pose a risk of financial manipulation by the target companies (and, therefore, uncertainty as to its yield), a risk of public perception that it would compromise existing corporate tax reliefs, and, if retrospective, a risk of criticism that it constituted a second tax on the same profits. And although Mr. Robinson and the Andersen team considered that there was ample rationale for a straightforward tax on either excess profits or excess shareholder returns, they concluded that the negative aspects (e.g., the difficulty in computing the "excess" amounts, the need for a retrospective tax to be assured of raising a target amount, and, in the case of a tax on excess shareholder returns, the likelihood of taxing the wrong shareholders, i.e., shareholders who did not realize those returns) outweighed the positive ones.

As a result of the perceived difficulties with the other approaches, Mr. Robinson and the Andersen team settled on the idea of a tax that would be a one-time (or, in U.K. parlance, a "one-off") tax on the "windfall" to the privatized utilities on privatization. The approach would

be to impute a value to each company at privatization, using an appropriate price-to-earnings ratio for each company's profits during the first 5 years after flotation, recognize the "windfall" (the difference between the imputed value and the flotation price) as value forgone by taxpayers, and tax the privatized utilities on that "windfall" using established principles from capital gains tax legislation.[7] They reasoned that such a tax would factor in the privatized utilities' "excess" profitability, the discount on privatization, the unanticipated efficiency gains, and the perceived weakness of the initial regulatory regime.

In November 1996, the foregoing proposal was reviewed and approved by Gordon Brown (who became Chancellor of the Exchequer when Labour returned to power in 1997) and the Labour Party's shadow treasury team, and, after the Labour Party regained power in 1997, by the U.K. Treasury Department, Inland Revenue, and the Parliamentary drafters (who drafted the actual legislative language), after which the draft legis-

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[7] In November 1996, in a presentation to Gordon Brown (Labour's next Chancellor of the Exchequer) and the Labour Party's shadow treasury team, the Andersen team set forth the average price-to-earnings ratios for the various privatized utility groups during the first 5 years after privatization, which ranged from a high of 12.7 after-tax and 9.4 pre-tax (both for the Scottish Electricity companies) to a low of 9.4 after-tax (for the WASCs) and 7.3 pre-tax (for the RECs). The presentation also set forth the potential revenue yield from using price-to-pre-tax earnings ratios of 6 through 8 to ascertain the imputed values of the companies and showed that a potential revenue yield of £6.4 billion could be achieved by using for that purpose either a pre-tax ratio of 6 or an after-tax ratio of 8.25 coupled with a 33-percent windfall tax rate on the excess of the imputed value over the flotation price.

lation was disseminated to members of Parliament and enacted in July 1997.

Description of the Windfall Tax

On July 31, 1997, Parliament enacted the windfall tax. It constituted part I of chapter 58, Finance (No. 2) Act 1997 (the Act), and provided, in clause 1, as follows:

> 1.—(1) Every company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation shall be charged with a tax (to be known as the "windfall tax") on the amount of that windfall.
>
> (2) Windfall tax shall be charged at the rate of 23 per cent.
>
> (3) Schedule 1 to this Act (which sets out how to quantify the windfall from which a company was benefitting on 2nd July 1997) shall have effect.

Clause 2 makes clear that the windfall tax is to apply to the 32 privatized utilities, clause 3 provides for the administration of the tax by the Commissioners of Inland Revenue, clause 4 covers the relationship between the windfall tax and profit-related pay schemes under the then-existing U.K. law, and clause 5 sets forth the definitions of terms used in part I.

Paragraphs 1 and 2 of schedule 1, referred to in clause 1(3), provide in pertinent part as follows:

> 1.—(1) * * * where a company was benefitting on 2nd July 1997 from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation, the amount of that windfall shall be taken for the purposes of this Part

to be the excess (if any) of the amount specified in sub-paragraph (2)(a) below over the amount specified in sub-paragraph (2)(b) below.

(2) Those amounts are the following amounts * * * , that is to say—

(a) the value in profit-making terms of the disposal made on the occasion of the company's flotation; and

(b) the value which for privatisation purposes was put on that disposal.

Value of a disposal in profit-making terms

2.—(1) * * * the value in profit-making terms of the disposal made on the occasion of a company's flotation is the amount produced by multiplying the average annual profit for the company's initial period by the applicable price-to-earnings ratio.

(2) For the purposes of this paragraph the average annual profit for a company's initial period is the amount produced by the following formula—

$$A = 365 \times P/D$$

Where—

A is the average annual profit for the company's initial period;

P is the amount * * * of the total profits for the company's initial period; and

D is the number of days in the company's initial period.

(3) For the purposes of this paragraph the applicable price-to-earnings ratio is 9.

Paragraph 3 defines "value put on a disposal for privatisation purposes"; i.e., the flotation value. Paragraph 4 provides for an appropriate percentage reduction of a company's "value in profit-making terms" and its flotation value where less than 85 percent of the company's ordinary share capital was "offered for disposal on the occasion of the company's flotation." Paragraph 5 sets forth the criteria for determining a company's "total profits for a company's initial period" and generally provides that those profits are its after-tax profits for financial reporting purposes as determined under relevant provisions of the U.K. Companies Act 1985.[8] Paragraph 6 defines the term "initial period" in relation to a company as the period encompassing the company's 4 financial years after flotation or such lesser period of existence for companies operating for less than 4 financial years after privatization and before April 1, 1997.[9] Paragraph 7 provides for the apportionment of the windfall amount subject to tax between companies that previously had been a single privatized company. Lastly, paragraph 8 defines the term "financial year" and other terms for purposes of the windfall tax legislation.

The Act required that affected companies pay the windfall tax in two installments: one-half on or before

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[8] The parties stipulate that profit for a windfall tax company's initial period was equal to the company's "profit on ordinary activities after tax" as determined under U.K. financial accounting principles and standards and as shown in the company's profit and loss accounts prepared in accordance with the U.K. Companies Act of 1985, as amended.

[9] From this point forward, the term "initial period" refers to the 4–year windfall tax initial period rather than the 5–year initial postprivatization period under the RPI - X regulatory regime.

December 1, 1997, and the other half on or before December 1, 1998.

Public Statements Regarding the Windfall Tax

On July 2, 1997, Gordon Brown, then Chancellor of the Exchequer, gave the Budget Speech announcing the windfall tax, and he described the windfall tax as follows:

> Our reform to the welfare state—and the programme to move the unemployed from welfare to work—is funded by a new and one-off windfall tax on the excess profits of the privatised utilities.
>
> * * * * *
>
> In determining the details of the tax, I believe I have struck a fair balance between recognising the position of the utilities today and their undervaluation and under-regulation at the time of privatisation.
>
> The windfall tax will be related to the excessively high profits made under the initial regime.
>
> A company's tax bill will be based on the difference between the value that was placed on it at privatisation, and a more realistic market valuation based on its after-tax profits for up to the first 4 full accounting years following privatisation.

Also on July 2, 1997, Inland Revenue issued an announcement describing the tax as follows:

> The Chancellor today announced the introduction of the proposed windfall tax on the excess profits of the privatised utilities. The one-off tax will apply to companies privatised by flotation and regulated by stat-

> ute. The tax will be charged at a rate of 23 per cent on the difference between company value, calculated by reference to profits over a period of up to four years following privatisation, and the value placed on the company at the time of flotation. The expected yield is around 5.2 billion Pounds.

The Inland Revenue announcement also stated that the price-to-earnings ratio of 9 "approximates to the lowest average price/earnings ratio of the taxpaying companies during the relevant periods, grouped by sector."

Around that same time, Her Majesty's Treasury issued a publication entitled "Explanatory Notes: Summer Finance Bill 1997", which describes in detail the various clauses of the windfall tax, and which contains a section entitled "Background", stating:

> The introduction of the windfall tax is in accordance with the commitment in the Government's Election Manifesto to raise a tax on the excess profits of the privatised utilities.
>
> The profits made by these companies in the years following privatisation were excessive when considered as a return on the value placed on the companies at the time of their privatisation by flotation. This is because the companies were sold too cheaply and regulation in the relevant periods was too lax.
>
> The windfall tax will raise around £5.2 billion and fund the Government's welfare to work programme.

Parliamentary Debate Preceding Enactment of the Windfall Tax

Mr. Robinson, in opening the debate in the House of Commons on the windfall tax legislation, offered the following introductory observations:

> Clause 1 heads a group of provisions that together introduce the windfall tax, thus meeting the commitment that we made in our election manifesto to introduce a windfall levy on the excess profits of the privatised utilities. Those companies were sold too cheaply, so the taxpayer got a bad deal. Their initial regulation in the period immediately following privatisation was too lax, so the customer got a bad deal.
>
> As a result, the companies were able to make profits that represented an excessive return on the value placed on them at the time of their flotation. We are now putting right the failures of the past by levying a one-off tax. The yield of around £5.2 billion will fund our welfare-to-work programme, and the new deal that we have announced for the young long-term unemployed and schools.
>
> Clause 1 provides a one-off charge, set at a rate of 23 per cent. It also gives effect to schedule 1, which will be debated in Standing Committee. It may be helpful if I set the clause in context by explaining briefly how the windfall tax works.
>
> Windfall tax is charged on the difference between the value of the company, calculated by reference to the profits made in the initial period after privatisation, and the value placed on the company at the time of privatisation. The value of the company is calculated by multiplying the average annual profit after tax for, normally, the first four financial years after flotation, by a price-to-earnings ratio of nine. That ratio approximates to the lowest average * * * sectoral

> price-to-earnings ratio of the companies liable to the tax. * * *

The Conservative Party Shadow Chancellor of the Exchequer, Peter Lilley, MP (Mr. Lilley), summarized his party's opposition to the windfall tax, and, in particular, clause 1 imposing the tax, as follows:

> We have four major criticisms of the clause and the windfall tax that it initiates. First, the clause makes it clear that the tax will not be borne by the so-called fat cats and speculators, criticisms of whom justified its introduction. Secondly, it makes no meaningful attempt to define what is a windfall and should therefore bear the tax. Thirdly, it increases instead of reduces cost to customers; any improved profitability should be passed on to customers in the form of lower prices. Finally, it is retrospective, arbitrary and symptomatic of the Government's belief in arbitrary government, rather than in government by known and predictable rules.

Mr. Lilley's comments during the debate illustrate his understanding of how the tax would affect the privatized utilities:

> They [the government] have taken average profits over four years after flotation. If those profits exceed one ninth of the flotation value, the company will pay windfall tax on the excess. * * *

And further:

> Essentially, the windfall tax boils down to a tax on success. Companies that failed to improve their profitability over the said period will pay much less or even no windfall tax. * * *

Other members of the Conservative Party repeated the idea that the windfall tax was a tax on profits or on success.

Several Labour Party members defended the tax as a legitimate method of recouping the difference between what should have been charged for the privatized utilities at the time of the various privatizations and the actual flotation prices. For example, one such member, Mr. Hancock, observed:

> The overwhelming majority of people have embraced the tax because most think that they were ripped off in the first place when the companies were sold. The companies were sold at hopelessly undervalued prices at a time when most people felt that the companies were better and safer in the hands of the public sector. The legitimacy of the tax among the general public is that they feel that they are getting back what they should have had in the first place.

Another, Mr. Stevenson, echoed Mr. Hancock's remarks:

> I asked the Library to do some research on the difference between the proceeds from privatization of the utilities, not including the railways, and their stock market share price the minute they were floated. I asked the Library to tot up the difference. It was almost £6 billion at the outset of privatisation and it has increased over the years. So the snapshot figure of £6 billion by which the Government undersold public assets, and therefore robbed the public, is a conservative estimate.

Overall Effect of the Windfall Tax on the Windfall Tax Companies

Thirty-one of the thirty-two windfall tax companies had a windfall tax liability. None of the 31 companies that paid windfall tax had a windfall tax liability that exceeded its total profits over its initial period. Twenty-nine of those thirty-two companies had initial periods of 4 full financial years. Twenty-seven of those twenty-nine companies had initial periods consisting of 1,461 days, i.e., three 365-day years and one 366-day (leap) year. The other 2 of those 29 companies had initial periods of 1,456 days and 1,463 days,[10] respectively. The remaining three companies had initial periods of less than 4 full financial years, consisting of 1,380 days, 316 days, and (in the case of British Energy, which because of low initial profits, paid no windfall tax) 260 days, respectively.

Effect of the Windfall Tax on SWEB

Before the enactment of the windfall tax, SWEB met with members of the shadow treasury team (which included Mr. Robinson) and the Andersen team in an effort to influence the development of the windfall tax. SWEB's then treasurer, Charl Oösthuizen (Mr. Oösthuizen), was the SWEB officer principally engaged in that effort. Upon the announcement of the windfall tax, SWEB realized that its liability for the tax would greatly exceed its prior estimates thereof, and it investigated ways of reducing that liability. SWEB determined that it could reduce its windfall tax liability if it could reduce

[10] The parties stipulated an initial period of 1,463 days, although that would seem to exceed 4 years, even taking into account a leap year.

its earnings for the 4-year initial period. To that end, SWEB identified a theretofore unidentified liability of £12 million for tree-trimming costs (trees interfered with its distribution network) that SWEB should have taken account of in determining its earnings for its fiscal year ended March 31, 1995. SWEB's outside auditor approved a restatement of its 1995 earnings and, after an initial objection, Inland Revenue did as well.

SWEB filed its windfall tax return with Inland Revenue on November 7, 1997, and paid its £90,419,265 windfall tax liability (which was based on 4 full financial years totaling 1,461 days), as required, in two installments, on December 1, 1997 and 1998. The first installment was paid 1 day after the close of SWEB's tax year (for U.S. Federal income tax purposes) ending November 30, 1997.

OPINION

I. The Windfall Tax Issue

A. Principles of Creditability

Pursuant to section 901(a) and (b)(1), a domestic corporation 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". We must decide whether the windfall tax constitutes a creditable income or excess profits tax under section 901.

In *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256, 283–284 (1995), we described the background, purpose, and function of the foreign tax credit provisions of the Internal Revenue Code as follows:

The foreign tax credit provisions were enacted primarily to mitigate the heavy burden of double taxation for U.S. corporations operating abroad who were subject to taxation in both the United States and foreign countries. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 9 (1932); *F.W. Woolworth Co. v. Commissioner*, 54 T.C. 1233, 1257 (1970). These provisions were originally designed to produce uniformity of tax burdens among U.S. taxpayers, irrespective of whether they were engaged in business abroad or in the United States. H. Rept. 1337, 83d Cong., 2d Sess. 76 (1954). A secondary objective of the foreign tax credit provisions was to encourage, or at least not to discourage, American foreign trade. H.R. Rept. 767, 65th Cong., 2d Sess. (1918), 1939–1 C.B. (Part 2) 86, 93; *Commissioner v. American Metal Co.*, 221 F.2d 134, 136 (2d Cir. 1955), affg. 19 T.C. 879 (1953).

Taxes imposed by the government of any foreign country were initially fully deductible in computing net taxable income, pursuant to our income tax law of 1913. Revenue Act of 1913, ch. 16, 38 Stat. 114. Specific foreign taxes became creditable pursuant to the Revenue Act of 1918. The foreign taxes that are presently creditable pursuant to section 901, specifically, income, war profits, and excess profits taxes, have remained unchanged and are the same taxes that were creditable in 1918. Revenue Act of 1918, ch. 18, sec. 222(a)(1), 40 Stat. 1073.

The definition of income, war profits, and excess profits taxes has evolved case by case. The temporary and final regulations, adopted relatively recently, outline the guiding principles established by prior case law. * * *

The Supreme Court in *Biddle v. Commissioner*, 302 U.S. 573, 579 (1938), established the principle, uniformly followed in subsequent caselaw and enshrined in the regulations, that, in deciding whether a foreign tax is an "income tax" for purposes of section 901, the term "income tax" will be given meaning by referring to the U.S. income tax system and measuring the foreign tax against the essential features of that system:

> The phrase "income taxes paid," as used in our own revenue laws, has for most practical purposes a well understood meaning * * * . It is that meaning which must be attributed to it * * * .

The final regulations referred to in *Phillips Petroleum* are the regulations that were issued in 1983, were in effect in 1997 (the year in issue), and remain in effect today (sometimes, the 1983 regulations).

Section 1.901–2, Income Tax Regs., is entitled "Income, war profits, or excess profits tax paid or accrued." Paragraph (a) thereof is entitled "*Definition of income, war profits, or excess profits tax*", and, in pertinent part, it provides as follows (adopting the term "income tax" to refer to an "income", "war", or "excess profits" tax):

> (1) *In general.* * * * 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.

Paragraph (a) further provides that, with exceptions not relevant to this case, "a tax either is or is not an income tax, in its entirety, for all persons subject to the tax."

In pertinent part, section 1.901–2(a)(3), Income Tax Regs., defines the term "predominant character" as follows: "The predominant character of a foreign tax is that of an income tax in the U.S. sense * * * [i]f, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies".

In pertinent part, section 1.901–2(b)(1), Income Tax Regs., provides:

> A foreign tax is likely to reach net gain in the normal circumstances 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 set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

Pursuant to section 1.901–2(b)(2)(i), Income Tax Regs. (as pertinent to this case), a foreign tax satisfies the realization requirement:

> if, judged on the basis of its predominant character, it is imposed * * * [u]pon 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 * * *

Pursuant to section 1.901–2(b)(3)(i), Income Tax Regs. (as pertinent to this case), a foreign tax satisfies the gross receipts requirement "if, judged on the basis of its predominant character, it is imposed on the basis of * * * [g]ross receipts".

Pursuant to section 1.901–2(b)(4)(i), Income Tax Regs., 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 * * * attributable * * * to such gross receipts; or
>
> (B) Recovery of such significant costs and expenses computed under a method that is likely to * * * [approximate or be greater than] recovery of such significant costs and expenses.

Section 1.901–2(b)(4)(i), Income Tax Regs., further provides:

> 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,[11] 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 that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. * * * A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is

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[11] E.g., items deductible under the Internal Revenue Code and capitalized and amortized under the foreign tax system.

> paid persons subject to the tax are almost certain to have net gain. * * *

The Secretary first adopted the "predominant character" standard in the 1983 regulations. In the preamble to those regulations (the preamble), the Secretary stated that the standard:

> adopts the criterion for creditability set forth in *Inland Steel Company v. U.S.*, 677 F.2d 72 (Ct. Cl. 1982), *Bank of America National Trust and Savings Association v. U.S.*, 459 F.2d 513 (Ct. Cl. 1972), and *Bank of America National Trust and Savings Association v. Commissioner*, 61 T.C. 752 (1974). [T.D. 7918, 1983–2 C.B. 113, 114.]

In the cases the Secretary cited in the preamble and in other, more recent, cases, the issue or test regarding the status of a foreign tax as a creditable income tax appears to be whether the foreign tax in question is designed to and does in fact reach net gain in the normal circumstances in which it applies. Thus, in *Bank of Am. Natl. Trust & Sav. Association v. United States*, 198 Ct. Cl. 263, 274, 459 F.2d 513, 519 (1972) (Bank of America I), which the Secretary cites in the preamble, the Court of Claims, in considering the creditability of a gross income tax that, on its face, was not a tax on net income or gain, concluded that such a tax could be creditable under certain circumstances:

> We do not, however, consider it all-decisive whether the foreign income tax is labeled a gross income or a net income tax, or whether it specifically allows the deduction or exclusion of the costs or expenses of realizing the profit. The important thing is whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the

> name it gives. In certain situations a levy can in reality be directed at net gain even though it is imposed squarely on gross income. That would be the case if it were clear that the costs, expenses, or losses incurred in making the gain would, in all probability, always (or almost so) be the lesser part of the gross income. In that situation there would always (or almost so) be some net gain remaining, and the assessment would fall ultimately upon that profit.[12]

In *Inland Steel Co. v. United States*, 230 Ct. Cl. 314, 325, 677 F.2d 72, 80 (1982), also cited in the preamble, the Court of Claims, relying on its earlier decision in Bank of America I, emphasized the purpose of the foreign country in designing the tax to reach net gain:[13]

> To qualify as an income tax in the United States sense, the foreign country must have made an attempt always to reach some net gain in the normal circumstances in which the tax applies. * * * The

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[12] The test the Court of Claims adopted for the creditability of a foreign gross income tax (the virtual certainty of net gain) is specifically incorporated in the regulations. *See* sec. 1.901-2(b)(4)(i), Income Tax Regs., quoted *supra*.

[13] As the Court of Appeals for the Second Circuit stated in *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209, 216 (2d Cir. 1999) (Texasgulf II), affg. 107 T.C. 51 (1996) (Texasgulf I), the preamble to the 1983 regulations "reaffirms *Inland Steel's* general focus upon the extent to which a tax reaches net gain". In Texasgulf II, the Court of Appeals found creditable under the predominant character standard in the 1983 regulations a tax, the Ontario Mining Tax, that the Court of Claims, in *Inland Steel Co. v. United States*, 230 Ct. Cl. 314, 677 F.2d 72 (1982), had found noncreditable before the promulgation of those regulations. See discussion *infra*.

label and form of the foreign tax is not determinative.
* * *

In *Bank of Am. Natl. Trust & Sav. Association v. Commissioner*, 61 T.C. 752, 760 (1974), affd. without published opinion 538 F.2d 334 (9th Cir. 1976), the third case the Secretary cites in the preamble, we described the analysis of the Court of Claims in Bank of America I as "[distilling]" the governing test to determine whether a foreign income tax qualifies as a creditable income tax within the meaning of section 901(b)(1); i.e., whether the tax was "designed to fall on some net gain or profit". That test, we added, "is the proper one to apply". *Id.*

Moreover, courts have construed the 1983 regulations in a manner consistent with the analysis in Bank of America I. For example, the Court of Appeals for the Second Circuit, in *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209 (2d Cir. 1999) (Texasgulf II), affg. 107 T.C. 51 (1996) (Texasgulf I), considered the creditability of the Ontario Mining Tax (OMT), which imposed a graduated tax on Ontario mines to the extent that "profit", as defined for OMT purposes, exceeded a statutory exemption. In determining "profit" for OMT purposes, taxpayers were allowed to deduct "an allowance for profit in respect of processing" (processing allowance) in lieu of certain expenses that were attributable to OMT gross receipts but that were not recoverable under the tax (nonrecoverable expenses). The taxpayer had presented empirical evidence to show that, across the industry, the processing allowance was likely to exceed nonrecoverable expenses for the tax years at issue. In answer to the Commissioner's objection that the taxpayer had not shown anything more than an accidental relationship between the processing allowance and the nonrecoverable expenses, the Court of Appeals stated:

> At bottom, the Commissioner's argument is that the type of quantitative, empirical evidence presented in this case is not relevant to the creditability inquiry. However, the language of § 1.901–2—specifically, "effectively compensate" and "approximates, or is greater than"—suggests that quantitative empirical evidence may be just as appropriate as qualitative analytic evidence in determining whether a foreign tax meets the net income requirement. We therefore hold that empirical evidence of the type presented in this case may be used to establish that an allowance effectively compensates for nonrecoverable expenses within the meaning of § 1.901–2(b)(4).

Id. at 216 (fn. ref. omitted). The Court of Appeals concluded:

> Given the large size and representative nature of the sample considered, these statistics suffice to show that the Tax Court did not clearly err in finding that the processing allowance was likely to exceed nonrecoverable expenses for the tax years at issue. Texasgulf has therefore met its burden of proving that the predominant character of the OMT * * * is such that the processing allowance effectively compensates for any nonrecoverable costs.

Id. at 215–216.

In reaching their decisions, both the Court of Appeals and this Court distinguished *Inland Steel Co. v. United States*, *supra* (which held the same OMT to be noncreditable). The former distinguished that case on the ground that it was decided before the promulgation of section 1.901–2, Income Tax Regs., and, in particular, before the adoption of the rule that a foreign tax law that "provides allowances that effectively compensate

for non-recovery of * * * significant costs or expenses * * * is considered to permit recovery of such costs and expenses." Texasgulf II, 172 F.3d at 216–217. We distinguished *Inland Steel* not only on that ground but also on the ground that the case was governed by the "predominant character" test, which replaced the "substantial equivalence" test under which *Inland Steel* was decided. Texasgulf I, 107 T.C. at 69–70. In reaching that conclusion we stated that use of the "predominant character" and "effectively compensates" tests represented "a change from the history and purpose approach used in cases decided before the 1983 regulations applied a factual, quantitative approach." *Id.* at 70.

In *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999), we considered the creditability of the U.K. petroleum revenue tax (PRT) under section 901 and the 1983 regulations. We found that a purpose of the PRT was "to tax extraordinary profits of oil and gas companies relating to the North Sea." *Id.* at 344. With limited exceptions, the tax base subject to PRT was gross income relating to oil and gas recovery activities less "all significant costs and expenses, except interest expense".[14] *Id.* at 345. In lieu of an interest expense deduction, the law provided a deduction for "uplift"; i.e., "amounts equal to 35 percent of most capital expenditures relating to a North Sea field". *Id.* at 347.

With respect to the predominant character of the tax, we found: "The purpose, administration, and structure of PRT indicate that PRT constitutes an income or excess profits tax in the U.S. sense." *Id.* at 356. We stated

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[14] The denial of a deduction for interest was designed to prevent the use of intercompany debt to avoid or minimize liability for the tax. *Exxon Corp. v. Commissioner*, 113 T.C. 338, 345 (1999).

that the evidence at trial showed "that special allowances and reliefs under PRT significantly exceed the amount of disallowed interest expense for Exxon and other oil companies", and we quoted the testimony of the U.K. Government official who first presented PRT to the U.K. House of Lords for formal consideration that "'of course, this tax [PRT] represents an excess profits tax.'" *Id.* at 357. We rejected as irrelevant the Commissioner's contention that a company-by-company analysis showed that most of the companies operating in the North Sea did not have uplift allowance greater than or equal to the disallowed interest expense, and we agreed with Exxon that the "PRT was designed to tax excess profits from North Sea oil and gas production[,] which generally were earned by major oil and gas companies[,] which owned the largest and most profitable fields in the North Sea." *Id.* at 359. We then noted that the vast majority of those companies "had uplift allowance in excess of nonallowed interest expense."[15] *Exxon Corp. v. Commissioner*, *supra* at 359. Finally, we concluded that "the predominant character of PRT constitutes an ex-

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[15] Earlier in *Exxon Corp. v. Commissioner*, *supra* at 352, in discussing the predominant character standard, we made the following observation regarding sec. 1.901–2, Income Tax Regs.:

> The regulations * * * provide that taxes either are or are not to be regarded as income taxes in their entirety for all persons subject to the taxes. *See* sec. 1.901–2(a), Income Tax Regs. Respondent does not interpret this provision as requiring that, in order to qualify as an income tax, a tax in question must satisfy the predominant character test in its application to all taxpayers. Rather, respondent interprets this provision as requiring that in order to qualify as an income tax a tax must satisfy the predominant character test in its application to a substantial number of taxpayers.

cess profits or income tax in the U.S. sense" creditable under section 901. *Id.*

B. Arguments of the Parties

1. Petitioner's Arguments

Petitioner argues that, given the historical development, design, and actual operation of the windfall tax, it constitutes a creditable tax on excess profits.

Petitioner rejects respondent's view that, in determining the creditability of the windfall tax, we are constrained by the text of the statute. Rather, petitioner argues that we may consider extrinsic evidence of the purpose and effect of the tax as applied to the windfall tax companies. As petitioner states: "The determination of whether a foreign tax is designed to fall on some net gain or profit depends on the substance, and not the form or label, of the tax." In support of its position, petitioner relies, in large part, on the decisions of this Court in *Exxon Corp. v. Commissioner*, *supra*, Texasgulf I, and *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995), in each of which we considered evidence of the purpose, design, and operation of the foreign tax in question in considering creditability.

With respect to the development and design of the tax, petitioner offers the trial testimony of Professor Littlechild, two members of the Andersen team (Mr. Osborne and Dr. Wales), and an exhibit constituting Mr. Robinson's trial testimony in *Entergy Corp. v. Commissioner*, T.C. Memo. 2010–197, filed today, which also involves the creditability of the windfall tax. Petitioner notes that Professor Littlechild's testimony establishes that he designed the regulatory system (RPI - X) that allowed the privatized utilities to realize the higher-

than-anticipated profits during the initial period after flotation. Petitioner also notes that both Mr. Osborne and Dr. Wales (members of the Andersen team who testified as experts regarding the regulatory and political concerns that led to enactment of the windfall tax) stated that (1) the rationale for the tax was the perceived excess profits the privatized utilities earned during the initial period and (2) the actual form of the tax was adopted for "presentational" reasons.[16] Mr. Robinson's testimony in *Entergy* is consistent with that of Mr. Osborne and Dr. Wales, and it reaches the same principal conclusion: The intent was to tax the excess profits of the privatized utilities.

Petitioner also offers the testimony of Mark Ballamy (Mr. Ballamy) and Edward Maydew (Professor Maydew), both experts in accounting, the former the founder of a U.K. accounting firm, the latter a professor of accounting at the University of North Carolina. Petitioner claims that the sum and substance of Mr. Ballamy's testimony (which dealt with U.K. financial accounting concepts under the windfall profits tax statute) "establishes that the windfall tax fell on the excess profits of the Windfall Tax Companies during their initial periods and that all of these profits represented realized profits". Professor Maydew testified regarding U.K. and U.S. financial accounting concepts and that the windfall tax was, in substance, a tax on income, similar in operation to prior U.S. and U.K. excess profits taxes. Petitioner

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[16] Dr. Wales testified that, during a Nov. 6, 1996, meeting with Gordon Brown, the Andersen team "demonstrated the presentational linkage that could be made between the mechanics of the tax, * * * the underlying rationale for the tax [i.e., a tax on the privatized utilities' initial period excess profits] and the popular notion of undervalue at privatisation."

claims that Professor Maydew's testimony confirms that of Mr. Ballamy that the U.K. and U.S. concepts of realization are fundamentally the same, thereby satisfying the regulations' realization requirement.

Petitioner's final expert witness was Stewart C. Myers (Professor Myers), professor of finance at MIT's Sloan School of Management. Professor Myers' research and teaching focus is, in part, on the valuation of real and financial assets. Petitioner points to Professor Myers' testimony that the differences in windfall tax payments by the privatized companies cannot be explained by differences in flotation value or by changes in value after flotation and that the tax "operated as an excess-profits tax, not as a tax on value, change in value or undervaluation."[17]

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[17] As part of his testimony, Professor Myers employed a series of scatter plot diagrams to demonstrate that there was, at best, a very loose relationship between the windfall tax the privatized utilities paid and changes in their actual market values after privatization, but very tight and direct relationships between (1) the windfall tax payments and the cumulative initial period earnings of those companies and (2) the windfall tax payments and what Professor Myers determined to be the cumulative initial period excess profits of the RECs and the WASCs.

Professor Myers also testified that the term "value in profit-making terms", as defined in the windfall tax statute, is not a standard economic term or concept and it has no meaning in any other context. Moreover, he believes that it does not represent a true economic value of any of the privatized utilities; rather, he believes that it constituted "a one-off device created to determine tax liability." He further testified:

> The privatized companies were valued daily on the London Stock Exchange. The designers of the Windfall Tax could have used stock-market values to identify (with hindsight) the "undervaluation" of the companies on or after their IPO dates. Instead

Petitioner also offered the fact testimony of Mr. Oösthuizen, SWEB's treasurer during the period leading up to the enactment of the windfall tax in 1997 and, before that, SWEB's tax manager. Mr. Oösthuizen recognized that, under the windfall tax formula, for every pound that profits were reduced in an initial period year, SWEB received 51 percent of that amount back as a reduction in its windfall tax liability. He also was involved in SWEB's decision to act on that knowledge by obtaining permission from its auditors (and, after an initial objection, Inland Revenue) to restate its accounts for its 1994–95 fiscal year (the final year of SWEB's initial period) by expensing (as a reserve) £12 million of projected tree-trimming costs, which saved SWEB over £6 million of projected windfall tax.[18] Petitioner also notes Mr. Oösthuizen's recognition that the windfall tax operated as an excess profits tax. In that regard, Mr. Oösthuizen testified as follows:

> In effect, the way the tax works is to say that the amount of profits you're allowed in any year before you're subject to tax is equal to one-ninth of the flotation price. After that, profits are deemed excess, and

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they settled on a formula in which the chief moving part was not value but profits.

Professor Myers rejects respondent's argument (discussed *infra*) that value in profit-making terms, because it is calculated using a reasonable price-to-earnings multiple, is the product of an acceptable valuation technique. In Professor Myers' view, "9 is not an accurate P/E multiple, and it is not applied to current or expected future earnings * * * [Therefore,] 'value-in-profit-making terms' cannot measure the economic value that companies could, would, or should have had."

[18] Mr. Oösthuizen testified that a Government press release describing the windfall tax prompted SWEB to restate its accounts for its 1994–95 fiscal year.

there is a tax. That's how the tax works. It has a definition of what is allowable profit and what is excess profits, and it taxes the excess.

Lastly, petitioner notes that it is possible to restate the windfall tax formula algebraically to make clear that it operates as an excess profits tax imposed (on 27 of the 32 windfall tax companies) at an approximately 51.7–percent rate.[19] In that regard, petitioner points to a series of stipulations in which the parties agree that that is in fact the case.[20] In particular, petitioner points to the parties' stipulation that the windfall tax formula (for companies with a full 1,461–day initial period) can be rewritten pursuant to the following steps (where P is the total initial period profits and FV is the flotation value).

Statutory Windfall Tax Formula

Tax = 23% x [{(365 x (P/1,461)) x 9} - FV]

Windfall Tax Formula—Modification (1)

Tax = 23% x [{(P/4[21]) x 9} - FV)]

Windfall Tax Formula—Modification (2)

Tax = 51.71% x {P - (44.47% x FV)}[22]

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[19] Mr. Oösthuizen and Professors Maydew and Myers make the same point.

[20] Respondent objects to certain of those stipulations on the ground that the reformulations are neither (1) "the statutory equivalent of the equation set forth in the [Windfall Tax] Act" nor (2) "an appropriate application of the equation in the Act", and on the further ground that the stipulations are "irrelevant and immaterial." Respondent does not object to the mathematical equivalence of the reformulations.

[21] For the sake of simplicity here and in modification (2), 1,461 days divided by 365 days is deemed to equal 4 rather than the more accurate 4.0027397.

Petitioner also points out that, instead of a cumulative reformulation of the windfall tax for the entire initial period, the tax can be reformulated by showing its application with respect to each year of that period as follows (where P_1, P_2, etc. represent profits for year 1, year 2, etc.).

$$\begin{aligned}\text{Tax} = \quad & 51.71\% \times \{P_1 - (11.11\% \times FV)\} \\ & + 51.71\% \times \{P_2 - (11.11\% \times FV)\} \\ & + 51.71\% \times \{P_3 - (11.11\% \times FV)\} \\ & + 51.71\% \times \{P_4 - (11.14\% \times FV)\}\end{aligned}$$ [23]

Petitioner argues that the foregoing mathematical and algebraic reformulations of the windfall tax as enacted show that, in substance, it was a tax imposed at a 51.71–percent rate "on the profits for each Windfall Tax company's initial period to the extent those profits exceeded an average annual return of approximately 11.1 percent of [the company's flotation value]."

Petitioner acknowledges, and the parties have stipulated (with respondent lodging the same objections regarding lack of statutory equivalency, appropriateness, relevancy, and materiality), that 5 of the 32 windfall tax

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[22] Again, for the sake of simplicity, 44.47 percent represents (1,461/365)/9 or approximately 0.4447489 (which is approximately 4/9), and the 51.71 percent represents {9/(1,461/365)} x 23 percent or approximately 0.5171458 (which is approximately 9/4 of the 23-percent windfall tax rate). As Professor Myers points out, to get from modification (1) to modification (2), one need only multiply all terms inside the brackets (in modification (1)) by 4/9 and the 23 percent tax rate by 9/4 with the windfall tax amount remaining unchanged, because (4/9) x (9/4) = 1.

[23] The 11.14 percent reflects the multiplier for the leap year of 366 days, assumed, for demonstrative purposes, to be year 4.

companies had initial periods longer or shorter than 1,461 days and that, for those companies, the reformulated rates are different. For two of those companies, because the number of days in the initial period was very close to 1,461 days, the rate of the reformulated windfall tax was very close to 51.71 percent, and the 4–year return on flotation value to be exceeded for there to be a tax was very close to 44.47 percent. For NIE, which had an initial period of 1,380 days, those two rates were 54.75 percent and 42.01 percent, respectively. As noted *supra*, British Energy had no windfall tax liability because of insufficient profits during the initial period. The fifth company, Railtrack, had an initial period of only 316 days, with the result that the effective tax rate on its excess profits (determined pursuant to the stipulated reformulation of the tax) was 239.10 percent, and the cumulative 4–year return on flotation value to be exceeded for there to be a tax was only 9.62 percent. Petitioner dismisses any concerns regarding the effect of the reformulated windfall tax on those 5 companies as compared to its uniform effect on the other 27 companies on several grounds: (1) For 2 of the companies, the differences are negligible; (2) any differences in effective rates "are not significant or material in evaluating the overall incidence of the Windfall Tax" because the 5 companies are outliers and, therefore, must be ignored for purposes of determining creditability under the section 901 regulations as applied by the Court of Appeals for the Second Circuit in Texasgulf II and this Court in Texasgulf I; (3) as Mr. Osborne explained, the payment of relatively large amounts of windfall tax by companies with initial periods of substantially less than 1,461 days (i.e., NIE and Railtrack) was not a problem because profits earned over the balance of what would have been

a full 1,461–day period (referred to by Mr. Osborne as "out performance") would not be subject to the tax; and (4) the tax did not exceed the realized, after-tax profits of any of the windfall tax companies.

2. Respondent's Arguments

Respondent argues that the 1983 regulations alone control the creditability of the windfall tax because those regulations subsume or supersede prior caselaw and "neither require nor permit inquiry into the purpose underlying the enactment of a foreign tax or the history of a foreign taxing statute." Applying those regulations to this case, respondent concludes that, according to the actual terms of the windfall tax statute, the windfall tax failed to satisfy any of the tests that a foreign tax must satisfy to be considered "likely to reach net gain in the normal circumstances in which it applies"; i.e., the realization, gross receipts, and net income tests. Therefore, the windfall tax did not have the predominant character of an income tax in the U.S. sense. In essence, respondent's position is that, pursuant to the terms of the statute, the windfall tax "was not imposed upon or after the occurrence of a realization event for U.S. tax purposes because the * * * tax was not a direct additional tax on previously-realized earnings. Rather, the tax was imposed on the difference between two company values." As a tax imposed on a base equal to the unrealized difference between two defined values, rather than directly on realized gross receipts reduced by deductible expenses, respondent argues that it necessarily fails to satisfy any of the three tests.

Respondent flatly rejects petitioner's claim that, under the 1983 regulations, we may rely on extrinsic evidence "relating to * * * [the Windfall Tax's] purported

purpose, design, and 'substance' revealed through petitioner's so-called 'algebraic reformulation' of the tax." Respondent argues that Texasgulf II, Texasgulf I, and *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999), which did admit extrinsic evidence to demonstrate the creditability of foreign taxes, should be limited to their facts; i.e., a finding that the alternative cost allowances under consideration in those cases "effectively compensated" for the nondeductibility of certain actual expenses pursuant to the requirements of section 1.901-2(b)(4)(i)(B), Income Tax Regs., and "do not support the use of extrinsic evidence to satisfy a requirement not found in the regulations."

Respondent also argues that we should disregard petitioner's algebraic reformulations of the windfall tax statute as merely "a hypothetical rewrite" of the statute, which does not constitute " 'quantitative' or 'empirical' evidence" that the tax actually touched net gain, "as contemplated by this Court in *Texasgulf I* or *Exxon*." That argument, like his argument that we may not consider extrinsic evidence that the actual incidence of the tax was on net income or excess profits, follows from what appears to be the crux of respondent's position: The windfall tax is unambiguously imposed on the difference between two values and, therefore, it cannot be a tax on income or profit.[24]

Because for respondent "the 'substance' of the tax is revealed on the face of the Windfall Tax statute itself"—

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[24] Respondent makes the point on brief as follows: "The key evidence in this case—the Windfall Tax statute itself—explicitly provides that the Windfall Tax is imposed on a base of the difference between two values, and such formulation fails to satisfy the section 901 regulations."

i.e., "[t]he words of the U.K. statute *are* the 'substance' of this tax"—he believes that it is not necessary to look beyond those words to give them meaning. Nevertheless, he argues that, even assuming the intent of the Andersen team and members of Parliament might be relevant in characterizing the nature of the windfall tax, their intent is as consistent with the statute as written (i.e., a tax on value in excess of flotation proceeds) as it is with petitioner's view that the windfall tax was intended as a tax on excess profits. In support of that argument, respondent refers to Mr. Robinson's 2000 book describing his life as a member of the Labour Party, entitled "The Unconventional Minister", and quotes the following portion of chapter 6, which describes the development and enactment of the windfall tax:

> Then in October 1996 Chris Wales had a stroke of inspiration. Chris simply turned the whole argument on its head: the problem was not that the companies had made too much profit, nor that they had paid out too much to shareholders and fat-cat directors, nor that they had been treated with kid gloves by the regulators. That was all true of course: but the genesis of the problem was that they had been sold too cheaply in the first place. Why not then, argued Chris, tax the loss to the taxpayer which arose from the sale of these companies at what was a knock-down price.

In further support of his position that the windfall tax was indeed a tax on the difference between two defined values, respondent offers the expert testimony of Peter K. Ashton (Mr. Ashton), a consultant who was qualified as an expert in economics and valuation methodologies, and Philip Baker QC (Queens Counsel; Mr. Baker), a

U.K. tax lawyer offered as an expert in U.K. tax legislation and the U.K. tax system.

Mr. Ashton viewed the method of computing the statutory value in profit-making terms for each of the windfall tax companies as a generally accepted valuation methodology, which he referred to as the "market value multiples method for computing the equity value of a company." Although Mr. Ashton agreed that, in general, "valuation is a forward-looking proposition", he reasoned that the windfall tax methodology of fixing value retroactively was acceptable because the draftsmen selected a valuation date with respect to which they had "perfect foresight of what the income is going to be for * * * [the windfall tax companies] that you can plug in to the valuation formula."

The substance of Mr. Baker's testimony was that, by its terms, the windfall tax was for each windfall tax company a tax on a tax base equal to the difference between two defined values, and that, as such, it was distinguishable from prior or existing U.K. taxes on excess profits or capital gains.

Respondent echoes Mr. Baker's view that the windfall tax was intentionally imposed on a tax base measured, in part, by a value (the "value in profit-making terms") derived (retrospectively) from known initial period earnings and, for that reason, criticizes Professor Myers' reliance on "equity value or market capitalization value" as his standard for concluding that, in relying on "value in profit-making terms", the windfall tax was not a tax on value, as that term is conventionally understood. In respondent's view, we "need not determine whether the Profit–Making Value formula resulted in a 'realistic' valuation of the Windfall Tax Companies in order to de-

termine whether the Windfall Tax is a creditable tax." That is because, in respondent's view, profit-making value "represented a reasonable approximation of how the Windfall Tax Companies might have been valued at the time of flotation if subsequent earnings could have been known at that time." [25]

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[25] Relying on a point that the Andersen team made in a November 1996 presentation to Gordon Brown, respondent also argues, presumably as an alternative ground for denying a foreign tax credit for the windfall tax, that the tax was, in substance, a reenactment of TCGA sec. 179 (see the discussion of that provision in note 3 of this report); i.e., a retroactive tax on the unrealized appreciation of the windfall tax companies at the time of privatization. Respondent argues that, because the tax necessarily fails the realization test of the 1983 regulations, it is noncreditable. We find respondent's arguments unpersuasive for two reasons. First, respondent's own expert, Mr. Baker, specifically disavowed those arguments by flatly stating that the windfall tax "was not corporation tax. It was a separate tax and it was at the rate of 23 percent instead [of the 33 percent corporate tax rate]." Second, we agree with petitioner that, even if the windfall tax had been intended as (in substance) a reenactment of TCGA sec. 179, it would not be a tax on unrealized appreciation; rather it would be a tax on previously realized but unrecognized gain and, therefore, creditable. As petitioner points out: "the operation of section 171 TCGA and section 179 TCGA is substantively similar to the gain deferral and recognition rules relating to intercompany transfers in our consolidated return regulations, section 1.1502–13, Income Tax Regs." Petitioner argues, however, that "[t]he Windfall Tax statute was not designed on the basis of Section 179 TCGA. Respondent's argument on this basis is unfounded." We accept what is, in effect, petitioner's concession that the windfall tax should not be considered an income tax because it resembled, or was a reinstatement of, TCGA sec. 179. Therefore, we do not decide the windfall tax issue on that ground.

C. Analysis

1. Introduction

The parties fundamentally disagree as to what we may consider in determining whether the windfall tax is a creditable tax for purposes of section 901. Respondent's view is that we need not (indeed, may not) consider anything other than the text of the windfall tax statute in determining whether that tax is an "income tax" within the meaning of section 1.901–2(a), Income Tax Regs. "[B]ased on * * * the simple formula employed to levy the tax", respondent argues, the windfall tax falls on the difference between two values—"Flotation Value" and "Profit–Making Value". It is, respondent continues, therefore a tax on value (and not on income). "Petitioner", respondent concludes, "cannot escape from the plain language of the [windfall tax] statute."[26]

Petitioner, points out that, under the cited regulation, it is the "predominant character" of the foreign tax in question that counts. To determine the predominant character of the windfall tax, petitioner argues that we may consider evidence beyond the text of the statute; viz, evidence of the design of the tax and its actual eco-

[26] "In construing a statute", respondent argues, "the 'preeminent canon of statutory interpretation requires a court to "presume that [the] legislature says in a statute what it means and means in a statute what it says there."'" (quoting *BedRoc Ltd., LLC v. United States*, 541 U.S. 176, 183 (2004) (quoting *Conn. Natl. Bank v. Germain*, 503 U.S. 249, 253-254 (1992))). Respondent insists that "'when the statute's language is plain, "the sole function of the courts"—at least where the disposition required by the text is not absurd—"is to enforce it according to its terms."'" (quoting *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) (quoting *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241 (1989)).

nomic and financial effect as it applies to the majority of the taxpayers subject to it. In support of that argument, petitioner principally relies on three cases this Court has decided since the promulgation of the 1983 regulations: *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999), Texasgulf I, and *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995).

For the reasons that follow, we think that petitioner has the better argument, and we find that the windfall tax is a creditable income tax under section 901.

2. Nature of the Predominant Character Standard

Respondent's text-bound approach to determining the creditability of the windfall tax is inconsistent with the 1983 regulations' description of the predominant character standard for creditability under which "the predominant character of a foreign tax is that of an income tax in the U.S. sense * * * [i]f * * * the foreign tax is likely to reach net gain in the normal circumstances in which it applies". Sec. 1.901–2(a)(3)(i), Income Tax Regs. By implicating the circumstances of application in the determination of the predominant character of a foreign tax, the drafters of the 1983 regulations clearly signaled their intent that factors extrinsic to the text of the foreign tax statute play a role in the determination of the tax's character. In determining the predominant character of a foreign tax, we may look to the actual effect of the foreign tax on taxpayers subject to it, the inquiry being whether the tax is designed to and does, in fact, reach net gain "in the normal circumstances in which it applies", regardless of the form of the foreign tax as reflected in the statute.

That interpretation of the regulations' predominant character standard is consistent with caselaw preceding

the issuance of the 1983 regulations and, in particular, two of the cases cited in the preamble to those regulations as providing the "criterion for creditability" embodied in that standard: *Inland Steel Co. v. United States*, 230 Ct. Cl. 314, 677 F.2d 72 (1982), and Bank of America I (*see supra* p. 27 of this report). In the former case, the Court of Claims stated that a foreign tax will qualify as an income tax in the U.S. sense if the foreign country has "made an attempt always to reach some net gain in the normal circumstances in which the tax applies. * * * The label *and form* of the foreign tax is not determinative." *Inland Steel Co. v. United States, supra* at 325, 677 F.2d at 80 (emphasis added). The court noted that the issue, as framed under its analysis in Bank of America I, is "whether taxation of net gain is the ultimate objective *or effect* of * * * [the foreign] tax." *Inland Steel Co. v. United States, supra* at 326, 677 F.2d at 80 (emphasis added). In Bank of America I, 198 Ct. Cl. at 274, 459 F.2d at 519 (emphasis added), the Court of Claims stated: "The important thing is whether the other country is attempting to reach some net gain, *not the form in which it shapes the income tax or the name it gives*."

The facts and analysis of the Court of Claims in Bank of America I nicely illustrate the prevailing pre-1983 standard. The case involved in part the creditability of foreign taxes on the taxpayer's gross income from the banking business its branch conducted in each of certain foreign countries. Clearly, a gross income tax is not, by its terms, a net income tax. Had the Court of Claims focused solely on the statutory language, which, in each case, levied a tax on the taxpayer's "gross takings" or "gross receipts" before deduction of any expenses, it would have been compelled to hold, on that ground

alone, that none of the taxes under consideration constituted a creditable net income tax. The focus of the court's inquiry, however, was not on the text of the statute per se, but on the question of whether the tax was "attempting to reach some net gain". *Id.* The court specifically noted that "a levy can in reality be directed at net gain even though it is imposed squarely on gross income." *Id.* Relying on prior judicial decisions, Internal Revenue Service rulings, and gross income tax levies under Federal law (e.g., sections 871 and 1441), the court concluded that an income tax under section 901 "covers all foreign income taxes designed to fall on some net gain or profit, and includes a gross income tax if, but only if, that impost is almost sure, or very likely, to reach some net gain because costs or expenses will not be so high as to offset the net profit." *Id.* at 281, 459 F.2d at 523.[27] Because the gross income taxes in Bank of America I failed to meet that test, the court held that they were noncreditable. *Id.* at 283, 459 F.2d at 524-525.

Also, as noted *supra*, the cases that have applied the 1983 regulations' predominant character standard are consistent with the Court of Claims' approach to creditability in *Inland Steel* and Bank of America I. Thus, in Texasgulf I, and in *Exxon Corp. v. Commissioner, supra*, we relied on quantitative, empirical evidence of the actual effect of the foreign tax on a majority of the taxpayers at whom it was directed and found that, in each case, the tax was designed to, and did, in fact, reach net gain and, therefore, constituted a creditable income or excess profits tax. In Texasgulf I, we distinguished the

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[27] As noted *supra* note 12, the Court of Claims' test for the creditability of a gross income tax is incorporated into the 1983 regulations. See sec. 1.901–2(b)(4)(i), Income Tax Regs.

result in *Inland Steel Co. v. United States, supra*, which had held the tax under consideration (the Ontario Mining Tax) to be noncreditable, stating: "The use of the 'predominant character' and 'effectively compensates' tests in section 1.901–2(b)(4), Income Tax Regs., is a change from the history and purpose approach used in the cases decided before *the 1983 regulations applied a factual, quantitative approach*." Texasgulf I, 107 T.C. at 70 (emphasis added).

We reject respondent's argument that this Court, in Texasgulf I and *Exxon*, and the Court of Appeals for the Second Circuit, in Texasgulf II, "strictly limit the use of empirical data to an analysis under the alternative cost recovery method of the net income requirement of * * * [section 1.901–2(b)(4)(i)(B), Income Tax Regs.]." It is true that Texasgulf I, Texasgulf II, and *Exxon* involved the creditability of foreign taxes that started with a statutory tax base consisting of gross income, and that all three relied on extrinsic evidence to show that the foreign law's allowances in lieu of deductions for expenses actually incurred would "effectively compensate for nonrecovery of * * * significant costs or expenses", as required by section 1.901–2(b)(4)(i), Income Tax Regs. We disagree, however, with respondent's conclusion that those cases "do not support the use of extrinsic evidence to satisfy a requirement not found in the regulations." Nothing in those cases would so limit a taxpayer's right to rely on extrinsic evidence to demonstrate the creditability of a foreign tax and, specifically, that it satisfied the predominant character standard. In Texasgulf I, Texasgulf II, and *Exxon*, the narrow issue was whether the statutory allowances in question did, in fact, "effectively compensate" for the nondeductibility of "significant costs or expenses" within the meaning of

section 1.901–2(b)(4)(i), Income Tax Regs. But the overall issue for decision in those cases, as in this case, was whether the foreign tax was designed to and did, in fact, reach net gain. The only limitation on reliance on extrinsic evidence in any of the three opinions in those cases is the following observation by the Court of Appeals for the Second Circuit in Texasgulf II, 172 F.3d at 216 n. 11:

> We note, however, that this case is exceptional, in that the relatively small number of taxpayers subject to the OMT made it practicable to compile and present broadly representative industry data spanning a lengthy period. We do not suggest that the reliance that we place on empirical evidence would be appropriate in cases where such comprehensive data is unavailable.

Far fewer taxpayers were subject to the windfall tax than were subject to OMT in Texasgulf II, and the data (after-tax financial profits)[28] for the taxpayers subject to the windfall tax were readily available in the published financial reports of those taxpayers.

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[28] Although respondent states that "[t]he use of financial book earnings, rather than 'taxable income,' in determining the Windfall Tax Companies['] Profit–Making Value further distinguishes the Windfall Tax from a U.S. excess profits tax", he does not argue that a foreign tax on financial profits is noncreditable for that reason alone. That argument would appear to be invalid, in any event, in the light of our own corporate alternative minimum tax, which at one time was calculated, in part, using financial or book earnings. *See* sec. 56(f), repealed in 1990 by the Omnibus Budget Reconciliation Act of 1990, Pub. L. 101–508, sec. 11801(a)(3), 104 Stat. 1388– 520. Moreover, differences between book and taxable income are, with rare exception, attributable to timing differences, which are generally disregarded under the 1983 regulations. *See* sec. 1.901–2(b)(4)(i), Income Tax Regs.

Respondent's argument that we should restrict our inquiry to the text of the windfall tax to determine its predominant character is unpersuasive.

3. The Predominant Character Standard as Applied to the Windfall Tax

The term "value" may mean, among other things, either "Monetary or material worth" or, in mathematics, "An assigned or calculated numerical quantity." The American Heritage Dictionary of the English Language 1900 (4th ed. 2000). The parties do not disagree that the amount of the windfall for purposes of determining the windfall tax is, in mathematical terms, the excess (if any) of one value (value in profit-making terms) over another (flotation value). Nor do they disagree that flotation value is real or actual value (a value in the first sense). They do disagree as to whether value in profit-making terms is a real or actual value. Relying on its experts' testimony, petitioner argues that it is not "a real economic value".[29] We need not settle that dispute because, even were we to agree with respondent that value in profit-making terms is a real or actual value, that would not necessarily be determinative since our inquiry as to the predominant character of the windfall tax is not text bound. Indeed, however we describe the form of the windfall tax base, our inquiry as to the design and incidence of the tax convinces us that its predominant character is that of a tax on excess profits. As an initial

[29] Mr. Osborne, one of petitioner's expert witnesses and a member of the Andersen team involved in designing the windfall tax, testified that value in profit-making terms "is not a real value: it is rather a construct based on realised profits that would not have been known at the date of privatisation, and a mechanism by which additional taxes on profits could be levied."

matter, we note that the parties have stipulated that none of the 31 companies that paid windfall tax had a windfall tax liability in excess of its total profits over its initial period.

With respect to design, respondent reorders the usual notion (at least in architecture) that form follows function to argue, in essence, that form determines function; i.e., that the design of the tax base (the excess of one value over another) demonstrates Parliament's decision to enact a tax based on value (i.e., "to tax undervaluation on flotation of the Windfall Tax Companies") "rather than a tax based on income or excess profits." We disagree.

Gordon Brown's public statements in his July 2, 1997, Budget Speech, the Inland Revenue and U.K. Treasury announcements, and the debate in Parliament preceding enactment of the windfall tax make clear that the tax was justified for two essentially equivalent reasons: (1) It would recoup excessive profits earned by the privatized utilities during the initial period, and (2) it would correct for the undervaluation of those companies at flotation. The reasons are equivalent because each subsumes the other. That is the essence of the explanation of the windfall tax by Her Majesty's Treasury in its 1997 publication entitled "Explanatory Notes: Summer Finance Bill 1997":

> The profits made by these companies in the years following privatisation were excessive when considered as a return on the value placed on the companies at the time of their privatisation by flotation. This is because the companies were sold too cheaply and regulation in the relevant periods was too lax.

Thus, profits were considered excessive in relation to the prices at which the windfall tax companies were sold to the public, which, in turn, were deemed to be too low.[30] One explanation implies the other. It follows, then, that both parties may be said to be correct in their assessment of the political motivation for the windfall tax.

Of greater significance, in terms of the creditability of the windfall tax, is the fact that the members of Parliament understood that they were enacting a tax that, by its terms, represented one of two equivalent explanations. That understanding is evidenced by the Conservative Party Shadow Chancellor of the Exchequer's, Mr. Lilley's, recognition that the Government had "taken average profits over four years after flotation" and "[i]f those profits exceed one ninth of the flotation value, the company will pay windfall tax on the excess." Mr. Lilly's understanding that the windfall tax could be characterized as a tax on excess profits is further indicated by his recognition that privatized utilities "that failed to improve their profitability over * * * [the initial period] will pay much less or even no windfall tax."

Just as "a levy can in reality be directed at net gain even though it is imposed squarely on gross income", Bank of America I, 198 Ct. Cl. at 274, 459 F.2d at 519, so too can a foreign levy be directed at net gain or income

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[30] That rather obvious point was also made by Mr. Osborne:

> The rationale for the tax was rooted in * * * [the] initial period during which excessive profits were made, as judged against the companies' flotation values.
>
> The nature of the judgment means that there is a logical symmetry between the two available ways of describing the rationale for the tax—that profits were high in relation to the flotation value, or that the flotation value was low in relation to profits. * * *

even through it is, by its terms, imposed squarely on the difference between two values.[31] And that is what we conclude in the case of the windfall tax. The architects and drafters of the tax knew (1) exactly which companies the tax would target, (2) the publicly reported after-tax financial profits of those companies, which were a crucial component of the tax base,[32] and (3) the target amount of revenue the tax would raise. Therefore, it cannot have been an unintentional or fortuitous result

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[31] A classic definition of income from the economic literature is squarely so based: "Income is the money value of the net accretion to one's economic power between two points of time." Haig, "The Concept of Income–Economic and Legal Aspects", The Federal Income Tax 7 (Columbia University Press 1921).

Robert M. Haig's definition was subsequently expressed by another economist, Henry C. Simons, in a way that explicitly included consumption: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period in questions." Simons, Personal Income Taxation 50 (1938). The Simons refinement has come to be known as the Haig–Simons definition of income and is widely accepted by lawyers and economists. Graetz & Schenk, Federal Income Taxation, Principles and Policies 97 (6th ed. 2009).

A foreign tax imposed on a base conforming to the Haig–Simons definition of income, viz, (1) the value of savings at the end of the period plus consumption during the period minus (2) the value of savings at the beginning of the period, would seem to qualify as a tax on net gain under the 1983 regulations. That the tax base includes unrealized appreciation in property is no bar to such qualification. See sec. 1.901-2(b)(2)(i)(C), (iv) *Example* (*2*), Income Tax Regs.

[32] SWEB's ability to reduce retroactively its reported profits for one of its initial period years appears to have been a solitary aberration among the windfall tax companies and does not detract from the general conclusion that the initial period financial profits of the windfall tax companies were known before enactment.

that, (1) for 29 of the 31 windfall tax companies that paid tax, the effective rate of tax on deemed annual excess profits was at or near 51.7 percent,[33] and (2) for none of the 31 companies did the tax exceed total initial period profits. What respondent refers to as "petitioner's algebraic reformulations of the Windfall Tax statute" do not, as respondent argues, constitute an impermissible "hypothetical rewrite of the Windfall Tax statute". Rather they represent a legitimate means of demonstrating that Parliament did, in fact, enact a tax that operated as an excess profits tax for the vast majority of the windfall tax companies.[34] The design of the windfall tax

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[33] Because it had an initial period of only 316 days, Railtrack presents the sole exception to the overall conclusion that the windfall tax, viewed as a tax on excess profits, affected the targeted companies in a reasonable manner. As noted *supra*, the effective tax rate on Railtrack's excess profits was 239.10 percent and the cumulative 4-year return on flotation value to be exceeded for there to be a tax was only 9.62 percent. It is clear, however, that neither the regulations nor the cases interpreting them require that the foreign tax mimic the U.S. income tax for all taxpayers to achieve creditability under sec. 901, only that it satisfy that standard "in the normal circumstances in which it applies". See sec. 1.901-2(a)(3)(i), Income Tax Regs. *See also Exxon Corp. v. Commissioner*, 113 T.C. at 352, in which we noted the Commissioner's acknowledgment that, "to qualify as an income tax a tax must satisfy the predominant character test in its application to a substantial number of taxpayers." In that case we found that the U.K. Petroleum Revenue Tax (PRT) provided a sufficient allowance in lieu of a deduction for interest expense where, for the 34 companies responsible for 91 percent of the PRT payments, the allowance exceeded nonallowed interest expense.

[34] Respondent describes petitioner's algebraic reformulation of the windfall tax as an attempt "to rewrite the value-based Windfall Tax to convert it into a profit-based tax." Presumably, respondent would agree that, had the tax been enacted as a "profit-based tax" instead of as a tax on the difference between two values, it would have been creditable. Under that approach, the same tax is either creditable or

formula made certain that the tax would, in fact, operate as an excess profits tax for the vast majority of the companies subject to it.[35]

Because both the design and effect of the windfall tax was to tax an amount that, under U.S. tax principles, may be considered excess profits realized by the vast majority of the windfall tax companies, we find that it did, in fact, "reach net gain in the normal circumstances in which it [applied]", and, therefore, that its "predominant character" was "that of an income tax in the U.S. sense." See sec. 1.901-2(a)(1), (3), Income Tax Regs.

We recognize that, in the cases that have either provided the foundation for the predominant character standard (e.g., *Inland Steel Co. v. United States*, 230 Ct.

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noncreditable, depending on the form in which it is enacted, a result at odds with the predominant character standard set forth in the regulations and applied in the caselaw.

[35] If, as respondent suggests, the real goal of the windfall tax was to recoup, on behalf of the public, the windfall to the initial investors that arose by virtue of flotation prices well below actual value (as perceived with hindsight), why did the Labour Party majority not try to recoup the entire windfall or at least a substantial portion of it; i.e., why was the tax rate not 100 percent or something closer to it than the 23-percent rate actually imposed? Although there is no evidence in the record that would provide a direct answer to that question, we find the enactment of the relatively low 23-percent rate to be consistent with an awareness of the Labour Party that it was taxing the companies, not the investors who actually benefited from the allegedly low flotation prices, and a decision, on its part, that a tax on the companies, being, in effect, a second tax on their initial period profits, should be imposed at a reasonable, nonconfiscatory rate, which would be sufficient to raise the desired revenue. That view is, of course, consistent with petitioner's argument that the form of the tax was adopted for "presentational" reasons.

Cl. 314, 677 F.2d 72 (1982), and Bank of America I), or applied that standard (e.g., Texasgulf I, Texasgulf II, and *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999)), the tax base, pursuant to the statute, was a gross amount or a gross amount less expenses comprising, in part, allowances in lieu of actual costs or expenses, and the issue was whether the statutory tax base represented net gain for the majority of taxpayers subject to the foreign tax. Nevertheless, the analysis that led the courts in those cases (with the exception of *Inland Steel*)[36] to determine creditability or noncreditability of the foreign tax in issue is equally applicable in determining the creditability of the windfall tax, the question being whether, according to an empirical or quantitative analysis, the tax was likely reach net gain in the normal circumstances in which it applied. Because the facts of this case provide an affirmative answer to that question, we find the windfall tax to be creditable.

D. Conclusion

The windfall tax paid by petitioner's indirect U.K. subsidiary, SWEB, constituted an excess profits tax creditable under section 901.

II. The Dividend Rescission Issue

The parties submitted the dividend rescission issue fully stipulated. On brief, petitioner states that, if we

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[36] As we noted in Texasgulf I, 107 T.C. at 71, the Court of Claims in *Inland Steel Co. v. United States*, 230 Ct .Cl. 314, 677 F.2d 72 (1982) "did not have industry-wide data to consider, and the Secretary had not yet promulgated regulations using a quantitative approach", and it held the Ontario Mining Tax to be noncreditable because it was not the "substantial equivalent" of an income tax, a standard for creditability that was modified by the 1983 regulations' adoption of the predominant character standard.

resolve the windfall tax issue in its favor, then petitioner concedes the dividend rescission issue. Because we have done so, we need not address the dividend rescission issue. We accept petitioner's concession.[37]

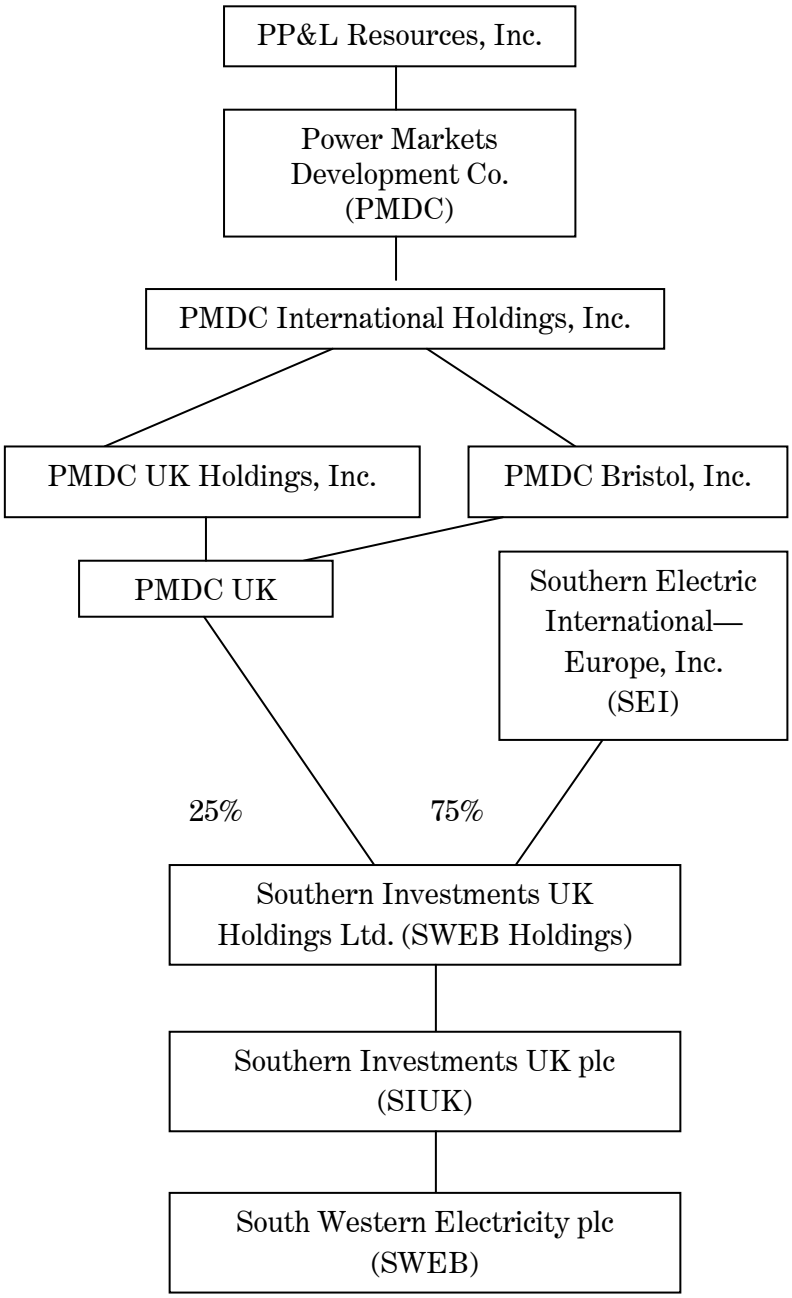
III. Conclusion

Taking into account our prior Opinion in *PPL Corp. & Subs. v. Commissioner*, 135 T.C. ___ (2010),

Decision will be entered under Rule 155.

[37] Petitioner argues that if we resolve the windfall tax issue in its favor, then SWEB Holdings would not have had sufficient earnings and profits to pay a taxable dividend. Any distribution by SWEB Holdings would thus constitute a nontaxable return of capital. On brief, petitioner states that the "tax consequences [of such a nontaxable return of capital] would not, in petitioner's judgment, be material." For that reason, "[i]n the interest of judicial economy", petitioner does not ask that we decide the dividend rescission issue in its favor if we decide the windfall tax issue in its favor.

APPENDIX


PP&L Resources, Inc.
Power Markets Development Co. (PMDC)
PMDC International Holdings, Inc.
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PMDC Bristol, Inc.
PMDC UK
Southern Electric International—Europe, Inc. (SEI)
25%
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Southern Investments UK Holdings Ltd. (SWEB Holdings)
Southern Investments UK plc (SIUK)
South Western Electricity plc (SWEB)

APPENDIX D

26 U.S.C. 901 provides in pertinent part:

Taxes of foreign countries and of possessions of United States

(a) Allowance of credit

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).

(b) Amount allowed

Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) Citizens and domestic corporations

In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

(2) Resident of the United States or Puerto Rico

In the case of a resident of the United States and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and

(3) Alien resident of the United States or Puerto Rico

In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any foreign country; and

(4) Nonresident alien individuals and foreign corporations

In the case of any nonresident alien individual not described in section 876 and in the case of any foreign corporation, the amount determined pursuant to section 906; and

(5) Partnerships and estates

In the case of any person described in paragraph (1), (2), (3), or (4), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be. Under rules or regulations prescribed by the Secretary, in the case of any foreign trust of which the settlor or another person

would be treated as owner of any portion of the trust under subpart E but for section 672(f), the allocable amount of any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the settlor or such other person in respect of trust income.

* * * * *

APPENDIX E

1. 26 C.F.R. 1.901–2 provides:

Income, war profits, or excess profits tax paid or accrued.

(a) *Definition of income, war profits, or excess profits tax*—(1) *In general.* 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 and §§ 1.901–2A and 1.903–1) 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.

Except to the extent otherwise provided in paragraphs (a)(3)(ii) and (c) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Paragraphs (a), (b) and (c) of this section define an income tax for purposes of section 901. Paragraph (d) of this section contains rules describing what constitutes a separate foreign levy. Paragraph (e) of this section contains rules for determining the amount of tax paid by a person. Paragraph (f) of this section contains rules for determining by whom foreign tax is paid. Paragraph (g) of this section contains definitions of the terms "paid by," "foreign country," and "foreign levy." Paragraph (h) of this section states the effective date of this section.

(2) *Tax*—(i) *In general.* A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax, nor is a customs

duty a tax. Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto. Notwithstanding any assertion of a foreign country to the contrary, 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 (as defined in paragraph (a)(2)(ii)(B) of this section) from the foreign country in exchange for payment pursuant to the levy. Rather, to that extent, such levy requires a compulsory payment in exchange for such specific economic benefit. If, applying U.S. principles, a foreign levy requires a compulsory payment pursuant to the authority of a foreign country to levy taxes and also requires a compulsory payment in exchange for a specific economic benefit, the levy is considered to have two distinct elements: A tax and a requirement of compulsory payment in exchange for such specific economic benefit. In such a situation, these two distinct elements of the foreign levy (and the amount paid pursuant to each such element) must be separated. No credit is allowable for a payment pursuant to a foreign levy by a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) unless the person claiming such credit establishes the amount that is paid pursuant to the distinct element of the foreign levy that is a tax. See paragraph (a)(2)(ii) of this section and § 1.901–2A.

(ii) *Dual capacity taxpayers*—(A) *In general.* For purposes of this section and §§ 1.901–2A and 1.903–1, a person who is subject to a levy of a foreign state or of a possession of the United States or of a political subdivision of such a state or possession and who also, directly or indirectly (within the meaning of paragraph (a)(2)(ii)(E) of this section) receives (or will receive) a specific economic benefit from the state or possession or from a political subdivision of such state or possession or from an agency or instrumentality of any of the foregoing is referred to as a "dual capacity taxpayer." Dual capacity taxpayers are subject to the special rules of § 1.901–2A.

(B) *Specific economic benefit.* For purposes of this section and §§ 1.901–2A and 1.903–1, the term "specific economic benefit" means an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general. Thus, a concession to extract government-owned petroleum is a specific economic benefit, but the right to travel or to ship freight on a government-owned airline is not, because the latter, but not the former, is made generally available on substantially the same terms. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls (within the meaning of paragraph (a)(2)(ii)(D) of this section); or a reduction or discharge of a contractual obligation. It does not include the right

or privilege merely to engage in business generally or to engage in business in a particular form.

(C) *Pension, unemployment, and disability fund payments.* A foreign levy imposed on individuals to finance retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for some substantially similar purpose, is not a requirement of compulsory payment in exchange for a specific economic benefit, as long as the amounts required to be paid by the individuals subject to the levy are not computed on a basis reflecting the respective ages, life expectancies or similar characteristics of such individuals.

(D) *Control of property.* A foreign country controls property that it does not own if the country exhibits substantial indicia of ownership with respect to the property, for example, by both regulating the quantity of property that may be extracted and establishing the minimum price at which it may be disposed of.

(E) *Indirect receipt of a benefit.* A person is considered to receive a specific economic benefit indirectly if another person receives a specific economic benefit and that other person—

(*1*) Owns or controls, directly or indirectly, the first person or is owned or controlled, directly or indirectly, by the first person or by the same persons that own or control, directly or indirectly, the first person; or

(*2*) Engages in a transaction with the first person under terms and conditions such that the first person receives, directly or indirectly, all or part of the value of the specific economic benefit.

(3) *Predominant character.* The predominant character of a foreign tax is that of an income tax in the U.S. sense—

(i) If, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies,

(ii) But only to the extent that liability for the tax is not dependent, within the meaning of paragraph (c) of this section, by its terms or otherwise, on the availability of a credit for the tax against income tax liability to another country.

(b) *Net gain*—(1) *In general.* A foreign tax is likely to reach net gain in the normal circumstances 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 set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

(2) *Realization*—(i) *In general.* 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;

(B) Upon the occurrence of an event prior to a realization event (a "prerealization event") provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer; or

(C) Upon the occurrence of a prerealization event, other than one described in paragraph (b)(2)(i)(B) of this section, but only if the foreign country does not, upon the occurrence of a later event (other than a distribution or a deemed distribution of the income), 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; or

(*2*) The prerealization event is the physical transfer, processing, or export of readily marketable property (as defined in paragraph (b)(2)(iii) of this section).

A foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even if it is also imposed in some situations upon the occurrence of events not described in this paragraph (b)(2)(i). For example, a foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even though the base of that tax also includes imputed rental income from a personal residence used by the owner and receipt of stock dividends of a type described in section 305(a) of the Internal Revenue Code. As provided in paragraph (a)(1) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax; therefore, a foreign tax described in

the immediately preceding sentence satisfies the realization requirement even though some persons subject to the tax will on some occasions not be subject to the tax except with respect to such imputed rental income and such stock dividends. However, a foreign tax based only or predominantly on such imputed rental income or only or predominantly on receipt of such stock dividends does not satisfy the realization requirement.

(ii) *Certain deemed distributions.* A foreign tax that does not satisfy the realization requirement under paragraph (b)(2)(i) of this section is nevertheless considered to meet the realization requirement if it is imposed with respect to a deemed distribution (*e.g.,* by a corporation to a shareholder) of amounts that meet the realization requirement in the hands of the person that, under foreign law, is deemed to distribute such amount, but only if the foreign country does not, upon the occurrence of a later event (*e.g.,* an actual distribution), impose tax ("second tax") with respect to the income on which tax was imposed by reason of such deemed distribution (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 with respect to the deemed distribution).

(iii) *Readily marketable property.* Property is readily marketable if—

(A) It is stock in trade or other property of a kind that properly would be included in inventory if on hand at the close of the taxable year or if it is held primarily for sale to customers in the ordinary course of business, and

(B) It can be sold on the open market without further processing or it is exported from the foreign country.

(iv) *Examples.* The provisions of paragraph (b)(2) of this section may be illustrated by the following examples:

Example 1. Residents of country X are subject to a tax of 10 percent on the aggregate net appreciation in fair market value during the calendar year of all shares of stock held by them at the end of the year. In addition, all such residents are subject to a country X tax that qualifies as an income tax within the meaning of paragraph (a)(1) of this section. Included in the base of the income tax are gains and losses realized on the sale of stock, and the basis of stock for purposes of determining such gain or loss is its cost. The operation of the stock appreciation tax and the income tax as applied to sales of stock is exemplified as follows: *A,* a resident of country X, purchases stock in June, 1983 for 100u (units of country X currency) and sells it in May, 1985 for 160u. On December 31, 1983, the stock is worth 120u and on December 31, 1984, it is worth 155u. Pursuant to the stock appreciation tax, *A* pays 2u for 1983 (10 percent of (120u – 100u)), 3.5u for 1984 (10 percent of (155u - 120u)), and nothing in 1985 because no stock was held at the end of that year. For purposes of the income tax, *A* must include 60u (160u – 100u) in his income for 1985, the year of sale. Pursuant to paragraph (b)(2)(i)(C) of this section, the stock appreciation tax does not satisfy the realization requirement because country X imposes a second tax upon the occurrence of a later event (*i.e.,* the sale of stock) with respect to the income that was taxed by the stock appreciation tax and no credit or

comparable relief is available against such second tax for the stock appreciation tax paid.

Example 2. The facts are the same as in example 1 except that if stock was held on the December 31 last preceding the date of its sale, the basis of such stock for purposes of computing gain or loss under the income tax is the value of the stock on such December 31. Thus, in 1985, *A* includes only 5u (160u – 155u) as income from the sale for purposes of the income tax. Because the income tax imposed upon the occurrence of a later event (the sale) does not impose a tax with respect to the income that was taxed by the stock appreciation tax, the stock appreciation tax satisfies the realization requirement. The result would be the same if, instead of a basis adjustment to reflect taxation pursuant to the stock appreciation tax, the country X income tax allowed a credit (or other comparable relief) to take account of the stock appreciation tax. If a credit mechanism is used, see also paragraph (e)(4)(i) of this section.

Example 3. Country X imposes a tax on the realized net income of corporations that do business in country X. Country X also imposes a branch profits tax on corporations organized under the law of a country other than country X that do business in country X. The branch profits tax is imposed when realized net income is remitted or deemed to be remitted by branches in country X to home offices outside of country X. The branch profits tax is imposed subsequent to the occurrence of events that would result in realization of income (*i.e.,* by corporations subject to such tax) under the income tax provisions of the Internal Revenue Code; thus, in accordance with paragraph (b)(2)(i)(A) of this section, the branch profits tax satisfies the realization requirement.

Example 4. Country X imposes a tax on the realized net income of corporations that do business in country X (the "country X corporate tax"). Country X also imposes a separate tax on shareholders of such corporations (the "country X shareholder tax"). The country X shareholder tax is imposed on the sum of the actual distributions received during the taxable year by such a shareholder from the corporation's realized net income for that year (*i.e.,* income from past years is not taxed in a later year when it is actually distributed) plus the distributions deemed to be received by such a shareholder. Deemed distributions are defined as (A) a shareholder's pro rata share of the corporation's realized net income for the taxable year, less (B) such shareholder's pro rata share of the corporation's country X corporate tax for that year, less (C) actual distributions made by such corporation to such shareholder from such net income. A shareholder's receipt of actual distributions is a realization event within the meaning of paragraph (b)(2)(i)(A) of this section. The deemed distributions are not realization events, but they are described in paragraph (b)(2)(ii) of this section. Accordingly, the country X shareholder tax satisfies the realization requirement.

(3) *Gross receipts*—(i) *In general.* 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 de-

scribed in this paragraph (b)(3)(i) satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph (b)(3)(i).

(ii) *Examples.* The provisions of paragraph (b)(3)(i) of this section may be illustrated by the following examples:

Example 1. Country X imposes a "headquarters company tax" on country X corporations that serve as regional headquarters for affiliated nonresident corporations, and this tax is a separate tax within the meaning of paragraph (d) of this section. A headquarters company for purposes of this tax is a corporation that performs administrative, management or coordination functions solely for nonresident affiliated entities. Due to the difficulty of determining on a case-by-case basis the arm's length gross receipts that headquarters companies would charge affiliates for such services, gross receipts of a headquarters company are deemed, for purposes of this tax, to equal 110 percent of the business expenses incurred by the headquarters company. It is established that this formula is likely to produce an amount that is not greater than the fair market value of arm's length gross receipts from such transactions with affiliates. Pursuant to paragraph (b)(3)(i)(B) of this section, the headquarters company tax satisfies the gross receipts requirement.

Example 2. The facts are the same as in Example 1, with the added fact that in the case of a particular taxpayer, *A,* the formula actually produces an amount that is substantially greater than the fair market value of arm's length gross receipts from transactions with affiliates. As provided in paragraph (a)(1) of this section,

the headquarters company tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Accordingly, the result is the same as in example 1 for all persons subject to the headquarters company tax, including *A*.

Example 3. Country X imposes a separate tax (within the meaning of paragraph (d) of this section) on income from the extraction of petroleum. Under that tax, gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted. This computation is designed to produce an amount that is greater than the fair market value of actual gross receipts; therefore, the tax on extraction income is not likely to produce an amount that is not greater than fair market value. Accordingly, the tax on extraction income does not satisfy the gross receipts requirement. However, if the tax satisfies the criteria of § 1.903–1(a), it is a tax in lieu of an income tax.

(4) *Net income*—(i) *In general.* 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 (including gross receipts as computed under paragraph (b)(3)(i)(B) of this section) 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, 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. For example, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery, the net income requirement is satisfied where items deductible under the Internal Revenue Code are capitalized under the foreign tax system and recovered either on a recurring basis over time or upon the occurrence of some future event or where the recovery of items capitalized under the Internal Revenue Code occurs less rapidly under the foreign tax system. A foreign tax law that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Internal Revenue Code (e.g., principles that apply under section 265, 465 or 861(b) of the Internal Revenue Code). A foreign tax whose base, judged on the basis of its predominant character, is computed by reducing gross receipts by items described in paragraph (b)(4)(i)(A) or (B) of this section satisfies the net income requirement even if gross receipts are not reduced by some such items. A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost

never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax). In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether gross receipts are reduced, in the base of the tax, by another tax, provided that other tax satisfies the realization, gross receipts and net income requirements.

(ii) *Consolidation of profits and losses.* In determining whether a foreign tax satisfies the net income requirement, one of the factors to be taken into account is whether, in computing the base of the tax, a loss incurred in one activity (e.g., a contract area in the case of oil and gas exploration) in a trade or business is allowed to offset profit earned by the same person in another activity (e.g., a separate contract area) in the same trade or business. If such an offset is allowed, it is immaterial whether the offset may be made in the taxable period in which the loss is incurred or only in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset the loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial that no such offset is allowed if a loss incurred in one such activity may be applied to offset profit earned in that activity in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset such loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial

whether a person's profits and losses from one trade or business (*e.g.,* oil and gas extraction) are allowed to offset its profits and losses from another trade or business (*e.g.,* oil and gas refining and processing), or whether a person's business profits and losses and its passive investment profits and losses are allowed to offset each other in computing the base of the foreign tax. Moreover, it is immaterial whether foreign law permits or prohibits consolidation of profits and losses of related persons, unless foreign law requires separate entities to be used to carry on separate activities in the same trade or business. If foreign law requires that separate entities carry on such separate activities, the determination whether the net income requirement is satisfied is made by applying the same considerations as if such separate activities were carried on by a single entity.

(iii) *Carryovers.* In determining whether a foreign tax satisfies the net income requirement, it is immaterial, except as otherwise provided in paragraph (b)(4)(ii) of this section, whether losses incurred during one taxable period may be carried over to offset profits incurred in different taxable periods.

(iv) *Examples.* The provisions of this paragraph (b)(4) may be illustrated by the following examples:

Example 1. Country X imposes an income tax on corporations engaged in business in country X; however, that income tax is not applicable to banks. Country X also imposes a tax (the "bank tax") of 1 percent on the gross amount of interest income derived by banks from branches in country X; no deductions are allowed. Banks doing business in country X incur very substantial costs and expenses (e.g., interest expense) attributable to their interest income. The bank tax neither pro-

vides for recovery of significant costs and expenses nor provides any allowance that significantly compensates for the lack of such recovery. Since such banks are not almost certain never to incur a loss on their interest income from branches in country X, the bank tax does not satisfy the net income requirement. However, if the tax on corporations is generally imposed, the bank tax satisfies the criteria of § 1.903–1(a) and therefore is a tax in lieu of an income tax.

Example 2. Country X law imposes an income tax on persons engaged in business in country X. The base of that tax is realized net income attributable under reasonable principles to such business. Under the tax law of country X, a bank is not considered to be engaged in business in country X unless it has a branch in country X and interest income earned by a bank from a loan to a resident of country X is not considered attributable to business conducted by the bank in country X unless a branch of the bank in country X performs certain significant enumerated activities, such as negotiating the loan. Country X also imposes a tax (the "bank tax") of 1 percent on the gross amount of interest income earned by banks from loans to residents of country X if such banks do not engage in business in country X or if such interest income is not considered attributable to business conducted in country X. For the same reasons as are set forth in example 1, the bank tax does not satisfy the net income requirement. However, if the tax on persons engaged in business in country X is generally imposed, the bank tax satisfies the criteria of § 1.903–1(a) and therefore is a tax in lieu of an income tax.

Example 3. A foreign tax is imposed at the rate of 40 percent on the amount of gross wages realized by an employee; no deductions are allowed. Thus, the tax law

neither provides for recovery of costs and expenses nor provides any allowance that effectively compensates for the lack of such recovery. Because costs and expenses of employees attributable to wage income are almost always insignificant compared to the gross wages realized, such costs and expenses will almost always not be so high as to offset the gross wages and the rate of the tax is such that, under the circumstances, after the tax is paid, employees subject to the tax are almost certain to have net gain.

Accordingly, the tax satisfies the net income requirement.

Example 4. Country X imposes a tax at the rate of 48 percent of the "taxable income" of nonresidents of country X who furnish specified types of services to customers who are residents of country X. "Taxable income" for purposes of the tax is defined as gross receipts received from residents of country X (regardless of whether the services to which the receipts relate are performed within or outside country X) less deductions that permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X tax satisfies the net income requirement.

Example 5. Each of country X and province Y (a political subdivision of country X) imposes a tax on corporations, called the "country X income tax" and the "province Y income tax," respectively. Each tax has an identical base, which is computed by reducing a corporation's gross receipts by deductions that, based on the predominant character of the tax, permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable princi-

ples to such gross receipts. The country X income tax does not allow a deduction for the province Y income tax for which a taxpayer is liable, nor does the province Y income tax allow a deduction for the country X income tax for which a taxpayer is liable. As provided in paragraph (d)(1) of this section, each of the country X income tax and the province Y income tax is a separate levy. Both of these levies satisfy the net income requirement; the fact that neither levy's base allows a deduction for the other levy is immaterial in reaching that determination.

APPENDIX F

ELIXABETH II

[LOGO OMITTED]

Finance (No. 2) Act 1997

1997 CHAPTER 58

An Act to grant certain duties, to alter other duties, and to amend the law relating to the National Debt and the Public Revenue, and to make further provision in connection with Finance. [31st July 1997]

Most Gracious Sovereign,

WE, Your Majesty's most dutiful and loyal subjects, the Commons of the United Kingdom in Parliament assembled, towards raising the necessary supplies to defray Your Majesty's public expenses, and making an addition to the public revenue, have freely and voluntarily resolved to give and grant unto Your Majesty the several duties hereinafter mentioned; and do therefore most humbly beseech Your Majesty that it may be enacted, and be it enacted by the Queen's most Excellent Majesty, by and with the advice and consent of the Lords Spiritual and Temporal, and Commons, in this present Parliament assembled, and by the authority of the same, as follows:—

PART I
THE WINDFALL TAX

1.—(1) Every company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation shall be charged with a tax (to be

known as the "windfall tax") on the amount of that windfall.

(2) Windfall tax shall be charged at the rate of 23 percent.

(3) Schedule 1 to this Act (which sets out how to quantify the windfall from which a company was benefitting on 2nd July 1997) shall have effect.

2.—(1) For the purposes of this Part a company in existence on 2nd July 1997 was benefitting on that date from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation if—

(a) that company, or a company of which it was on that date a demerged successor, had before that date been privatised by means of a flotation;

(b) there had, before that flotation, been a statutory transfer of property, rights and liabilities from a public corporation to the floated company or to a company which, at the time of the flotation, was a subsidiary undertaking of the floated company; and

(c) at the time of the flotation, the floated company was carrying on an undertaking whose privatisation involved the imposition of economic regulation.

(2) For the purposes of this Part a company was privatised by means of a flotation if—

(a) an offer of shares in that company was at any time made to the public in the United Kingdom;

(b) the shares which were the subject-matter of the offer were publicly-owned at the time of the offer;

(c) the offer was or included an offer of shares for disposal at a fixed price; and

(d) shares in that company were first admitted to listing on the Official List of the Stock Exchange in pursuance of an application made in connection with the offer.

(3) In this Part references, in relation to a company privatised by means of a flotation, to the time of the company's flotation are references to the time when shares in the floated company were first admitted to listing on the Official List of the Stock Exchange.

(4) For the purposes of this Part a company in existence on 2nd July 1997 ("the relevant company") was on that date a demerged successor of a company privatised by means of a flotation if—

(a) after the flotation of the floated company but before 2nd July 1997, there had been a statutory transfer of property, rights and liabilities from the floated company to a company ("the transferee company") which was a subsidiary undertaking of the floated company at the time of the transfer;

(b) the transferee company was not a subsidiary undertaking of the floated company on 2nd July 1997 but was, on that date, a subsidiary undertaking of the relevant company; and

(c) before 2nd July 1997 shares in the relevant company had been admitted to listing on the

Official List of the Stock Exchange in pursuance of an application made in connection with the transaction, or series of transactions, by virtue of which the transferee company ceased to be a subsidiary undertaking of the floated company.

(5) For the purposes of this section a company was, at the time of its flotation, carrying on an undertaking whose privatisation involved the imposition of economic regulation if that company, or a company which at that time was a subsidiary undertaking of that company, was at that time—

(a) a public telecommunications operator, within the meaning of the Telecommunications Act 1984;

(b) an airport operator in relation to an airport subject to economic regulation under Part IV of the Airports Act 1986;

(c) the holder of an authorisation granted under section 7 of the Gas Act 1986, as originally enacted (public gas suppliers);

(d) the holder of an appointment under section 11 of the Water Act 1989 as the water undertaker for any area of England and Wales;

(e) the holder of a licence granted under section 6 of the Electricity Act 1989 or Article 10 of the Electricity (Northern Ireland) Order 1992 (licences authorising generation, transmission and supply of electricity); or

(f) a company authorised by a licence under section 8 of the Railways Act 1993 to be the operator of a railway asset.

(6) In subsection (5) above "airport operator" has the same meaning as in the Airports Act 1986.

3.—(1) The windfall tax shall be under the care and management of the Commissioners of Inland Revenue.

(2) Schedule 2 to this Act (which makes provision with respect to the management and collection of the windfall tax) shall have effect.

(3) Subject to paragraph 19(5) of Schedule 8 to the Taxes Act 1988 (which is the provision about profit-related pay schemes that is amended by section 4 below), nothing in this Act or the Tax Acts shall have the effect of allowing or requiring any amount of windfall tax to be deducted in computing income, profits or losses for any of the purposes of the Tax Acts.

4.—(1) In paragraph 19 of Schedule 8 to the Taxes Act 1988 (ascertainment of profits for the purposes of profit-related pay schemes)—

(a) in sub-paragraph (5)(b), after "1985" there shall be inserted "or section 3(3) of the Finance (No. 2) Act 1997"; and

(b) after paragraph (ff) of sub-paragraph (6) there shall be inserted the following paragraph—

"(fg) windfall tax charged under Part I of the Finance (No. 2) Act 1997;".

(2) Subsection (1) above has effect in relation to the preparation, for the purposes of any scheme, of a profit

and loss account for any period ending on or after 2nd July 1997.

(3) Subsection (1) above shall not have effect in relation to an existing scheme unless, before the end of the period of six months beginning with the day on which this Act is passed, the scheme is altered, with effect for all periods ending on or after 2nd July 1997, to take account of that subsection.

(4) Provision made, in compliance with paragraph 20(1) of Schedule 8 to the Taxes Act 1988 (consistency in preparation of accounts), by any existing scheme that is altered to take account of subsection (1) above shall not prevent a profit and loss account from being prepared in accordance with the alteration.

(5) An alteration of an existing scheme to take account of subsection (1) above shall be treated as being within section 177B of the Taxes Act 1988 (alterations which are registrable and which, when registered, cannot give rise to the Board's power of cancellation).

(6) In this section "existing scheme" means a scheme which at any time in the period beginning with 2nd July 1997 and ending immediately before the day on which this Act is passed was a registered scheme under Chapter III of Part V of the Taxes Act 1988.

(7) The preceding provisions of this section shall cease to have effect, in accordance with the notes to Part VI(3) of Schedule 18 to the Finance Act 1997, as if they were included in the repeal of Schedule 8 to the Taxes Act 1988.

5.—(1) In this Part—

"company" means a company within the meaning of the Companies Act 1985 or the Companies (Northern Ireland) Order 1986;

"fixed price", in relation to any offer of publicly-owned shares in a company, means—

(a) a price set out in the offer; or

(b) a price subsequently fixed by a Minister of the Crown in a case in which the amount of a first instalment of the price was fixed by the offer;

"the floated company", in relation to the privatisation of a company by means of a flotation, means the company so privatised;

"public corporation", in relation to a statutory transfer, means any body corporate in existence at the time of the transfer which—

(a) had been established by or in accord ance with the provisions of any enactment; and

(b) had a membership consisting of, or in cluding, persons appointed as members by a Minister of the Crown;

"publicly-owned", in relation to any shares, means held by—

(a) a Minister of the Crown or the Treasury; or

(b) a nominee for a Minister of the Crown or for the Treasury;

"share" includes any right to require the issue of a share;

"statutory transfer" means a transfer under a transferring enactment or by or in accordance with a statutory scheme;

"subsidiary undertaking"—

(a) except in relation to a company formed and registered in Northern Ireland, means a subsidiary undertaking within the meaning of Part VII of the Companies Act 1985; and

(b) in relation to a company so formed and registered, means a subsidiary undertaking within the meaning of Part VIII of the Companies (Northern Ireland) Order 1986.

(2) In this section—

"enactment" means an enactment contained in a public general Act or any provision of Northern Ireland legislation;

"Minister of the Crown" includes a Northern Ireland department or the head of such a department;

"statutory scheme" means any scheme which

(a) has been made in exercise of any power or duty conferred or imposed by any enactment;

(b) contains provision for the division of property, rights and liabilities between different persons, or for the transfer of property, rights and liabilities to a company; and

(c) would not have taken effect or come into force but for having been approved by a Minister of the Crown;

"transferring enactment" means an enactment under which property, rights and liabilities of a person specified in the enactment became, by virtue of that enactment, the property, rights or liabilities of a company nominated under that enactment.

(3) In subsection (2) above the reference, in relation to a scheme, to its having been approved by a Minister of the Crown includes a reference to its having been made by a Minister of the Crown.

(4) The reference in subsection (1) above to Part VII of the Companies Act 1985 shall be construed, in relation to times in relation to which that Part had effect without the amendments made by the Companies Act 1989, as if those amendments did have effect in relation to those times.

* * * * *

SCHEDULE 1

QUANTIFICATION OF A PRIVATISATION WINDFALL

The basic rule

1.—(1) Subject to paragraph 7 below, where a company was benefitting on 2nd July 1997 from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation, the amount of that windfall shall be taken for the purposes of this Part to be the excess (if any) of the amount specified in sub-paragraph (2)(a) below over the amount specified in sub-paragraph (2)(b) below.

(2) Those amounts are the following amounts (determined in accordance with paragraphs 2 to 6 below), that is to say—

(a) the value in profit-making terms of the disposal made on the occasion of the company's flotation; and

(b) the value which for privatisation purposes was put on that disposal.

Value of a disposal in profit-making terms

2.—(1) Subject to paragraph 4 below, the value in profit-making terms of the disposal made on the occasion of a company's flotation is the amount produced by multiplying the average annual profit for the company's initial period by the applicable price-to-earnings ratio.

(2) For the purposes of this paragraph the average annual profit for a company's initial period is the amount produced by the following formula—

$$A = 365 \times \frac{P}{D}$$

Where—

A is the average annual profit for the company's initial period;

P is the amount, ascertained in accordance with paragraph 5 below, of the total profits for the company's initial period; and

D is the number of days in the company's initial period.

(3) For the purposes of this paragraph the applicable price-to-earnings ratio is 9.

Value put on a disposal for privatisation purposes

3.—(1) Subject to paragraph 4 below, the value which for privatisation purposes was put on the disposal made on the occasion of a company's flotation is the amount produced by multiplying the institutional price by the number of shares comprised in the ordinary share capital of the company at the time of its flotation.

(2) In this paragraph "the institutional price", in relation to a company, means the highest fixed price per share at which publicly-owned shares in the company were offered for disposal on the occasion of the company's flotation.

(3) Subject to sub-paragraph (4) below, where publicly-owned shares in a company were offered for disposal in accordance with any arrangements for the payment of the price in two or more instalments, the price per share at which those shares were offered shall be ascertained by aggregating the instalments.

(4) Where the arrangements under which any publicly-owned shares in a company were offered for

disposal provided for any discount on the payment of the whole or any part of the price for those shares, that discount shall be disregarded for the purposes of this paragraph in determining the price per share at which those shares were offered.

Cases where company privatised in stages

4.—(1) For the purposes of this Schedule, where the disposal percentage in the case of any company was 85 per cent. or less—

(a) the value in profit-making terms of the disposal made on the occasion of the company's flotation, and

(b) the value which for privatisation purposes was put on that disposal,

shall each be taken to be the disposal percentage of the amount which, under paragraph 2 or 3 above, would be the amount of that value but for this paragraph.

(2) For the purposes of this paragraph "the disposal percentage", in relation to any company, means the percentage which expresses (in terms of nominal value) how much of the ordinary share capital of the company at the time of its flotation was represented by the publicly-owned shares in the company offered for disposal on the occasion of the company's flotation.

Total profits for the initial period

5.—(1) For the purposes of paragraph 2 above the amount of the total profits for a company's initial period is the sum of the amounts falling within sub-paragraph (2) below.

(2) Subject to sub-paragraph (3) and paragraph 6(3) below, those amounts are every amount which, for a financial year of the company ending in or at the end of its initial period, is shown in the relevant accounts for that year—

(a) where those accounts are prepared in accordance with section 227 of the Companies Act 1985 (group accounts), as the profit of that company and its subsidiary undertakings for that year; and

(b) in any other case, as the profit of that company for that year.

(3) Where—

(a) any profit shown in the relevant accounts of a company for any financial year has been computed using a current cost accounting method, but

(b) the information which was contained in those accounts, or which was provided to the registrar together with those accounts, included information from which it can be ascertained what that profit would have been if an historical cost accounting method had been used,

the amount shown as that profit in those accounts shall be deemed to be the amount (as ascertained from that information) which would have been so shown if that historical cost accounting method had been used.

(4) In this paragraph references, in relation to any financial year of a company, to the relevant accounts are references to any such accounts for that year as have

been or are delivered to the registrar under section 242 of the Companies Act 1985 and consist—

(a) in the case of a financial year at the end of which the company was a parent undertaking, in consolidated group accounts prepared in accordance with section 227 of that Act (group accounts); and

(b) in any other case, in accounts prepared in accordance with section 226 of that Act (individual accounts).

(5) Subject to sub-paragraph (6) below, references in this paragraph to the amount shown in any accounts as the profit for any financial year are references to the amount of the profit (if any) for that year which is set out in the profit and loss account comprised in those accounts as the item which is, or is the equivalent of, the final item of the statutory format which for that year was used for that profit and loss account.

(6) Where any amount shown in any accounts is less than it would have been if no provision or other deduction had been made—

(a) in relation to the windfall tax, or

(b) in anticipation of the imposition of a charge with characteristics similar to those of the windfall tax,

this Schedule shall have effect as if the amount shown were the amount it would have been if that provision or deduction had not been made.

(7) Nothing in this paragraph shall, in the case of any company—

(a) prevent any charge to windfall tax from being treated as having arisen on 2nd July 1997 by reference to accounts delivered to the registrar after that date; or

(b) prevent any requirement to pay an instalment of windfall tax, or any other liability under Schedule 2 to this Act, from arising before the delivery to the registrar of the accounts by reference to which the amount of that charge is computed;

and any power of the Board under that Schedule to make an assessment shall include power to make an assessment on the basis that accounts will be delivered to the registrar showing such amounts as may, to the best of their judgement, be determined by the Board.

(8) Subject to sub-paragraph (9) below, this paragraph shall have effect in relation to any time at which the Companies Act 1985 had effect without the amendments made by the Companies Act 1989—

(a) as if the references in sub-paragraphs (2) and (4) above to sections 226, 227 and 242 of the Companies Act 1985 were references, respectively, to sections 227, 229 and 241 of that Act, as it had effect without those amendments;

(b) as if the reference in sub-paragraph (2) above to a company's subsidiary undertakings were a reference to its subsidiaries (within the meaning of that Act as it so had effect); and

(c) as if the reference in sub-paragraph (4)(a) above to a company's being a parent undertaking were a reference to its having such subsidiaries.

(9) In relation to a company formed and registered in Northern Ireland, this paragraph shall have effect as if the references in sub-paragraphs (2) and (4) above to sections 226, 227 and 242 of the Companies Act 1985 were references, respectively, to Articles 234, 235 and 250 of the Companies (Northern Ireland) Order 1986.

(10) In this paragraph—

"the registrar" means—

(a) except in relation to a company formed and registered in Northern Ireland, the registrar within the meaning of the Companies Act of 1985; and

(b) in relation to a company so formed and registered, the registrar within the meaning of the Companies (Northern Ireland) Order 1986;

and

"statutory format", in relation to a profit and loss account, means a format set out in the provisions (as they had effect in relation to that account) of Schedule 4 to the Companies Act 1985 or Schedule 4 to the Companies (Northern Ireland) Order 1986.

Meaning of the initial period etc

6.—(1) In this Schedule "initial period", in relation to a company privatised by means of a flotation, means (subject to sub-paragraph (2) below) the period which—

(a) begins with the first day of the first financial year of the company to begin after the time of its flotation; and

(b) ends with the end of the fourth financial year of the company to begin after the time of its flotation.

(2) Where the initial period of a company privatised by means of a flotation would (but for this sub-paragraph) include any time on or after 1st April 1997, sub-paragraph (1) above shall not apply and the initial period of that company shall be taken, instead, to be the period which—

(a) begins with the day on which the time of its flotation falls; and

(b) ends with the end of the last financial year of the company to end before 1st April 1997.

(3) Where—

(a) sub-paragraph (2) above applies for determining a company's initial period, and

(b) there is a financial year of that company beginning before but ending after the beginning of that initial period,

the amount which for that year is shown as mentioned in paragraph 5(2) above shall be included in the sums added together for the purposes of paragraph 5(1) above to the extent only that that amount is attributable, on an apportionment made in accordance with the following provisions of this paragraph, to the part of that year falling within the company's initial period.

(4) Except in a case where sub-paragraph (5) below applies, an apportionment for the purposes of sub-paragraph (3) above shall be made on a time basis according to the respective lengths of—

(a) the part of the financial year falling before the beginning of the company's initial period; and

(b) the remainder of that financial year.

(5) Where the circumstances of a particular case are such that—

(a) the making of an apportionment on the basis mentioned in sub-paragraph (4) above would work in a manner that would be unjust or unreasonable, but

(b) it would be just and reasonable to make the apportionment on the alternative basis,

the apportionment shall be made, instead, on the alternative basis.

(6) For the purposes of this paragraph an apportionment in the case of any company of the amount shown for any financial year as a profit for that year is made on the alternative basis where it is made according to how much of that profit accrued in each of the two parts of that financial year that are mentioned in sub-paragraph (4) above.

Apportionment between demerged successors and predecessors

7.—(1) This paragraph applies where—

(a) a company ("the predecessor company") was benefitting on 2nd July 1997 from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation; and

(b) another company which on that date was a demerged successor of the predecessor company is also taken for the purposes of this Part to have been benefitting from such a windfall on that date.

(2) Where this paragraph applies—

(a) the amount of the windfall from which the predecessor company was benefitting on 2nd July 1997 shall be equal to only the appropriate fraction of the amount ("the total windfall") which (but for this paragraph) would have been the amount of that windfall under paragraphs 1 to 6 above; and

(b) the amount of the windfall from which the demerged successor shall be taken to have been benefitting on that date shall be equal to the remainder of the total windfall.

(3) In this paragraph "the appropriate fraction" means the following fraction—

$$\frac{P}{P+S}$$

Where—

P is the amount produced by multiplying the number of shares comprised at the end of the relevant day in the ordinary share capital of the predecessor company by the market price on that day of an ordinary share in that company; and

S is the amount produced by multiplying the number of shares comprised at the end of the relevant day in the ordinary share capital of the

demerged successor by the market price on that day of an ordinary share in the demerged successor.

(4) For the purposes of this paragraph references to the market price of shares on any day are references to the sum of—

(a) the lower of the two prices shown in the Stock Exchange Daily Official List for that day as the closing prices for the shares on that day; and

(b) one half of the difference between those two prices.

(5) In this paragraph "the relevant day" means the day on which shares in the demerged successor were first listed on the Official List of the Stock Exchange.

General interpretation of the Schedule

8.—(1) In this Schedule "financial year", in relation to a company, means (subject to sub-paragraph (2) below)—

(a) a financial year of that company within the meaning of Part VII of the Companies Act 1985; or

(b) any period which—

(i) began before the coming into force of section 3 of the Companies Act 1989 (new definition of financial year); and

(ii) was a financial year of that company for the purposes of that Part, as it had ef-

fect without the amendments made by that section.

(2) Sub-paragraph (1) above does not apply to a company formed and registered in Northern Ireland; and in relation to such a company, references in this Schedule to a financial year are references to a financial year within the meaning of Part VIII of the Companies (Northern Ireland) Order 1986.

(3) In this Schedule references, in relation to a company privatised by means of a flotation, to the shares offered for disposal on the occasion of the company's flotation are references to the following shares in that company, that is to say—

(a) those that were the subject-matter of the offer to the public in respect of which that company is regarded for the purposes of this Part as having been so privatised; and

(b) any publicly-owned shares not falling within paragraph (a) above that were the subject-matter of an offer for disposal made on the same occasion as the offer mentioned in that paragraph.

(4) References in this Schedule to an offer for the disposal of shares in a company include references to any offer to transfer or confer an immediate or contingent right to or interest in any such shares, whether or not for a consideration; and (subject to sub-paragraph (5) below) references to the shares that are the subject-matter of such an offer shall be construed accordingly.

(5) For the purposes of sub-paragraph (3) above where—

(a) an offer for the disposal of publicly-owned shares in a company contained provision for a person to become entitled to further shares in that company if he satisfied conditions specified in the offer, and

(b) those conditions included a condition as to the period for which shares in that company continued to be held by that person,

shares which (apart from this sub-paragraph) would fall to be treated as the subject-matter of the offer by virtue only of that provision shall be treated as the subject-matter of the offer to the extent only that persons did in fact become entitled to them before 2nd July 1997 as a result of having satisfied the conditions in question.

(6) In this Schedule a reference, in relation to any time, to the ordinary share capital of a company is a reference to the following, taken together, that is to say—

(a) the shares comprised in the ordinary share capital of the company (within the meaning of the Tax Acts); and

(b) any shares that would have been so comprised at that time if the issued share capital of the company at that time had included any shares in the company that had been allotted but not issued.

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