



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224  
December 15, 2000

OFFICE OF  
CHIEF COUNSEL

Number: **200112011**  
Release Date: 3/23/2001  
CC:INTL:3  
WTA-N-115961-00  
UILC: 901.01-03; 461.00-00

INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR ASSOCIATE AREA COUNSEL, PHILADELPHIA  
CC:LM:MCT:PHI

ATTN: JAMES C. FEE

FROM: Anne O'Connell Devereaux  
Assistant to the Branch Chief, CC:INTL:3

SUBJECT:

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LEGEND

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Taxpayer=

B=

C=

X=

Y=

Year 1=

Year 2=

Month 1=

Date 1=

Date 2=

Date 3=

Date 4=

Date 5=

### ISSUES

1. Whether the United Kingdom Windfall Tax ("UKWT") enacted on July 2, 1997, and imposed on certain British utilities, is a creditable income tax within the meaning of Code sections 901(a) and 902(a)(1).
2. Whether the UKWT should be deducted from post-1986 undistributed earnings in the year paid or in the year accrued.

### CONCLUSIONS

1. The UKWT is not a creditable income tax within the meaning of Code sections 901(a) and 902(a)(1).
2. The UKWT should be deducted from post-1986 undistributed earnings in the year paid rather than in the year accrued.

### FACTS

Commencing in the 1980s, the United Kingdom Parliament enacted a series of statutory provisions "privatizing" certain government-owned public utilities by selling their shares to the public. A number of these utilities were acquired by U.S. utilities and, in Year 1, Taxpayer, a domestic corporation, acquired B percent of the shares of one of these British utilities ("the British Utility")

The British Utility declared and paid two distributions each in the amount of X British Pound Sterling ("BPS") in Month 1. The first distribution is not in issue here. The Taxpayer returned 99 percent of the amount of the second distribution to the British Utility on Date 2, after the distribution was declared.

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later, on Date 3, Taxpayer and the British Utility executed a rescission agreement (“Rescission Agreement”).<sup>1</sup>

The Rescission Agreement states that the British Utility distributed the sum of X BPS to its shareholders on Date 1 “even though it was not clear” whether the British Utility “would need the cash for its own projected purposes (including payment of the proposed UK windfall profits tax).” The Rescission Agreement further stated that it was made in the belief that the distribution would constitute a nontaxable return of capital, that after the UKWT had been announced, “it became clear” that the British Utility “would require” a return of the distribution, and that “shortly after the distribution,” “it was also determined” that the distribution would be taxable “if not rescinded or treated as a stock dividend.” Finally, the Rescission Agreement states that Taxpayer returned Y BPS to the British Utility on Date 2. The Rescission Agreement purports to rescind the distribution in question “to the extent of the returned funds.”

The UKWT was enacted on July 2, 1997, shortly after Date 1. The UKWT is based on 23 percent of the amount by which the “value of the company in profit making terms” exceeds the value placed on the company at the time of flotation (“flotation value”). The “flotation value” of a utility company is the price paid for the utility company’s stock by the public at the time the utility company was privatized. The value of a utility company in profit making terms is generally defined as 9 times the utility company’s average annual earnings, as reported for UK tax purposes, during the four years immediately following its flotation date (the “initial period”). The UKWT was a one-time tax on privatized UK utility companies.

Although not completely clear from the facts submitted, it appears that for U.S. tax purposes the British Utility’s taxable year is the fiscal year ending Date 4.<sup>2</sup> The first installment of the UKWT was due (and paid) on Date 5,<sup>3</sup> a date after the end of the British Utility’s 1997 tax year.

On its original 1997 U.S. federal income tax return, the Taxpayer did not claim a foreign tax credit for the UKWT paid by the British Utility under section 902 of the Code. Under examination, Taxpayer submitted a claim to the international

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<sup>1</sup> The issue of whether these events constituted a legal rescission of the distribution will be addressed in a separate response.

<sup>2</sup> If, on the other hand, the British Utility uses a calendar tax year for U.S. tax purposes, the issue of whether the tax should be deducted from post-1986 undistributed earnings when accrued or when paid is moot because, in that event, the British Utility’s UKWT liability was accrued and paid in the same taxable year.

<sup>3</sup> Based on the facts available, it appears this is merely the due date of the payment, and the liability for the tax was actually fixed on July 2, 1997.

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examiner to amend its 1997 U.S. tax return by changing the treatment of the UKWT paid by the British Utility as a creditable income tax instead of as a non-creditable tax.

## LAW AND ANALYSIS

### ISSUE 1:

Section 901(a) allows as a credit against the U.S. tax liability of a domestic corporation the amount provided in section 901(b)(1) and the amount of taxes deemed to be paid by a domestic corporation to a foreign country under section 902. Section 901(b)(1) provides that, subject to the limitations of section 904, a domestic corporation shall be allowed as a credit under section 901(a) the amount of “any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country”.<sup>4</sup> Section 902 deems a domestic corporation that owns 10 percent or more of the voting stock of a foreign corporation from which it receives a dividend to have paid the same proportion of the “foreign income taxes” paid by the foreign corporation as the amount of such dividend bears to the foreign corporation’s post-1986 undistributed earnings.

Section 902(c)(4) provides that:

The term “foreign income taxes” means any income, war profits, or excess profits taxes paid by the foreign corporation to any foreign country or possession of the United States.

Treas. Reg. § 1.902-1(a)(7) provides that foreign “income, war profits, and excess profits taxes” does not include amounts not included in the definition of those taxes in section 901 and the regulations thereunder. Treas. Reg. § 1.901-2 refers to “income, war profits, and excess profits taxes” as “income taxes.”

Under section 901 and the regulations thereunder, a payment to a foreign country is an income tax only if (1) it is a tax and (2) “the predominant character of that tax is that of an income tax in the U.S. sense.” Treas. Reg. § 1.901-2(a)(1). Treas. Reg. § 1.901-2(a)(2) provides that “a foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes.” It appears that the UKWT was imposed pursuant to the authority of the United Kingdom to

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<sup>4</sup> The UKWT is not an “in lieu of” tax under section 903 because it is in addition to the generally imposed corporate income tax, not in substitution therefor. Treas. Reg. §§ 1.903-1(a)(2), 1.903-1(b)(1).

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levy taxes. Further, based on the facts presented, the UKWT appears to be a compulsory payment.<sup>5</sup>

The predominant character of a 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, unless it is dependent on the availability of a credit against the income tax liability to another country (“no soak-up tax requirement”). Treas. Reg. § 1.901-2(a)(3).<sup>6</sup> A foreign tax is likely to reach net gain in the normal circumstances in which it applies only if it satisfies the realization, gross receipts, and net income requirements of the regulations. Treas. Reg. § 1.901-2(b)(1).

Treas. Reg. § 1.901-2(b)(2) provides in part:

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 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 consequences 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 a 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

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<sup>5</sup> Some commentators have suggested that the validity of the UKWT could be challenged under customary and treaty-based international law. The commentators suggest that the UKWT is “confiscatory” which could be regarded as tantamount to an expropriation or form of nationalization. Power Company International Tax Alert, Deloitte & Touche LLP, July 1997; 97 TNI 134-29. Further factual development would be needed to determine whether the UKWT does not qualify as a “tax” on the grounds that it was not validly imposed pursuant to the United Kingdom’s taxing authority.

<sup>6</sup> The UKWT is not dependent upon the availability of a credit against the income tax liability to another country, and thus the no soak-up tax requirement of the regulations is met.

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(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)....

Based on the facts presented, we do not believe the realization requirement of the regulations is met. First, we do not believe there is a realization event as required by Treas. Reg. § 1.901-2(b)(2)(A) because the base on which the UKWT is imposed is the difference between the value of a utility company in profit making terms and the "flotation value" of the utility company, indicating that the UKWT is a tax on the estimated appreciation in a utility company's value, rather than an additional direct tax on the utility company's income. This is supported by the fact that the UKWT is not imposed directly on the amount of the average earnings for the initial period, but instead that average is multiplied by 9 (the applicable price to earnings ratio) in order to reach the value of the utility company in profit making terms and the "flotation value" is then deducted from that value in order to determine the tax base.

U.S. tax principles apply in determining whether a realization event has occurred. See Biddle v. Commissioner, 302 U.S. 573 (1938). Under U.S. tax principles, mere appreciation in the value of assets without a disposition of such assets is not a realization event. See Eisner v. Macomber, 252 U.S. 189, 194-195 (1920). Therefore, although the value of the utility company is calculated as 9 times average annual earnings during the initial period, and those earnings have been realized in the U.S. sense, the UKWT is not imposed upon the occurrence of a realization event for U.S. tax purposes because the UKWT is not an additional tax on such earnings, but rather is a tax on the estimated appreciation in value of the utility corporation. Earnings for the initial period is merely used indirectly as a valuation method to estimate that unrealized increase in the utility corporation's value. In fact, the UKWT is imposed on an amount that could exceed the actual realized earnings and profits of a utility company, if the flotation value of the utility company was low and the earnings for the initial period was high. The income of the utility company is averaged and multiplied by 9 merely in order to approximate the utility company's value, not in order to calculate the utility company's income.

The requirements of Treas. Reg. § 1.901-2(b)(2)(B) are not met because the UKWT is not triggered by prerealization events resulting in the recapture of previously allowed amounts.

Finally, the requirements of Treas. Reg. § 1.901-2(b)(2)(C) are also not met. As discussed above, we do not believe a realization event has occurred and, therefore, the UKWT was imposed upon the occurrence of a prerealization event. Although the UKWT appears to be imposed on a utility company based on the estimated increase in the utility company's value, there is no provision in the UKWT that prohibits a second tax from being imposed on the utility company's future realized income. Further, there is no credit or comparable relief available for the UKWT paid with respect to the estimated appreciation in the utility company's value, the

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prerealization event. Thus, none of the exceptions listed in Treas. Reg. § 1.901-2(b)(2) is met.

The gross receipts and net income tests are also not met. The gross receipts test requires that “judged on the basis of its predominant character, [the tax] 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.” Treas. Reg. § 1.901-2(b)(3). Here, because there is no realization, there are no gross receipts. Accordingly, the requirements of Treas. Reg. § 1.901-2(b)(3)(A) are not met. Further, because the UKWT is not based on a computation of gross receipts, the requirements of Treas. Reg. § 1.901-2(b)(3)(B) are also not met.

The net income test requires that:

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....”

Since the gross receipts test is not met in this case, by definition the net income test is also not met.

Under the section 901 regulations, the realization, gross receipts, net income and no soak-up tax requirements must all be met in order for the UKWT to be an “income tax”. Thus, the absence of any single one of those requirements will prevent the UKWT from being an “income tax” for purposes of section 901. Based on the above analysis, the realization, gross receipts, and net income test are all not met in this case and, therefore, the UKWT is not an “income tax” under section 901. Accordingly, Taxpayer may not claim a foreign tax credit under section 902 for the UKWT paid to the United Kingdom by the British Utility.

## ISSUE 2:

Under U.S. tax principles, corporations are required to use the accrual method of accounting. Under that method, a liability is taken into account when all events have occurred that establish the fact of the liability (the “all events test”), the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. Treas. Reg. § 1.461-1(a)(2). In this case, the all events test was satisfied and the amount of the liability could be determined with reasonable accuracy at the time of the enactment of the UKWT.

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With respect to taxes, except in certain cases, economic performance occurs when the tax is paid to the government authority imposing the tax. Treas. Reg. § 1.461-4(g)(6). The exception to the foregoing rule is in Treas. Reg. § 1.461-4(g)(6)(iii)(B), which provides that, in the case of a tax imposed on income, war profits or excess profits that is creditable under Code section 901 or 903, economic performance takes place when all the requirements of the all events test other than economic performance are met. Thus, if a tax is creditable, it is taken into account when the liability for the tax accrues. If a tax is not a creditable income tax, it is taken into account when it is paid under the all events test of the regulations under section 461, including economic performance.

As discussed above, the UKWT is not a creditable tax under section 901 or 903. Accordingly, pursuant to the regulations under Code section 461, the UKWT should be deducted from the British Utility's post-1986 undistributed earnings in the year paid rather than in the year accrued.

Please call (202) 622-3850 if you have any further questions.

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