INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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Chief, Appeals Office

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Year(s) Involved:
Date of Conferences:

LEGEND:

Taxpayer =
B =
C =
D =
E =
F =
G =
H =
Utility =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Date 1 =
Date 2 =

ISSUES:

1. Does the statutory language of the U.K. Windfall Tax (including the formula contained in Schedule 1 of the Finance (No. 2) Act 1997) on its face satisfy the net gain requirement of Treas. Reg. §1.901-2(b)?

2. If the answer to Issue # 1 is no, is it necessary to examine the nature and substance of the U.K. Windfall Tax by reference to evidence extrinsic to the text of the statutory language in determining its creditability under section 901 of the Code?

3. If the answer to Issue # 1 is no, can the requirements of Treas. Reg. §1.901-2(b) be satisfied by reference to an algebraic reformulation of the U.K. Windfall Tax Schedule 1 statutory formula?

4. If the answer to Issue # 3 is yes, is Taxpayer's proposed reformulation the mathematical equivalent of the U.K. Windfall Tax Schedule 1 statutory formula?

5. In analyzing the algebraic reformulation of the U.K. Windfall Tax, is it appropriate to compare the reformulation to U.S. excess profits taxes and other creditable foreign taxes?

6. If the answer to Issue # 4 is yes, does the U.K. Windfall Tax satisfy the requirements of Treas. Reg. §1.901-2(b)?

CONCLUSIONS:

ISSUE 1

No. The statutory language of the U.K. Windfall Tax (including the Schedule 1 formula) is clear and does not satisfy the net gain requirement of Treas. Reg. §1.901-2(b).

ISSUE 2

No. In determining the creditability of the U.K. Windfall Tax under section 901 of the Code, it is not necessary or permissible to consider evidence extrinsic to the text of the U.K. Windfall Tax statute, because the statute is unambiguous.

ISSUE 3

No. The requirements of Treas. Reg. §1.901-2(b) may not be satisfied by reference to an algebraic reformulation of the U.K. Windfall Tax Schedule 1 statutory formula.

ISSUE 4

Because the net gain requirement may not be satisfied by reference to an algebraic reformulation of the statute, this issue is moot. However, even if Taxpayer's proposed reformulation of the statute as a direct tax on book profits would result in an amount of tax liability numerically equal to that imposed under the actual U.K. Windfall Tax statute, because it does so by adjusting both the computation of the tax base and the statutory tax rate the algebraic restatement is not equivalent to the statutory formula.

ISSUE 5

No. In analyzing the creditability of the U.K. Windfall Tax, it is appropriate to compare the statute itself, not an algebraic reformulation of the statutory formula, to U.S. excess profits taxes and other creditable foreign taxes. The earnings multiplier in the U.K. Windfall Tax statutory formula, and its use of book profits rather than taxable income, distinguishes it from U.S. excess profits taxes and creditable foreign income and excess profits taxes.

ISSUE 6

Because the net gain requirement may not be satisfied by reference to an algebraic reformulation of the statute, and in any event the algebraic reformulation is not equivalent to the U.K. Windfall Tax statutory formula, this issue is moot. The U.K. Windfall Tax does not satisfy the requirements of Treas. Reg. §1.901-2(b).

SUMMARY:

Under the well-settled rule of statutory construction, if a statute has a plain meaning, then it is neither necessary nor appropriate to resort to secondary sources, or extrapolation, to elucidate what is already clear language on its face. The U.K. Windfall Tax unambiguously exacts a tax equal to 23 percent of the windfall excess of the value of a covered company in profit-making terms over its flotation value. By its express terms, the U.K. Windfall Tax, therefore, is a tax on the appreciation of the company above its flotation value. The statute utilizes the standard valuation technique of capitalizing book income by a price-to-earnings ratio to determine the appreciated value, from which to subtract the flotation value, for purposes of computing the windfall excess subject to tax. As explained below, such a windfall tax on appreciation in value does not satisfy the regulatory requirements for creditability under Treas. Reg. §1.901-2(b).

Taxpayer proceeds by several circuitous routes to reformulate the U.K. Windfall Tax in an attempt to lend some color to its argument that the U.K. Windfall Tax is a tax on windfall profits, rather than a tax on windfall appreciation. As indicated above, any

reformulation is unwarranted in light of the clear purport of the statute. Nevertheless, this memorandum also explains why Taxpayer's reformulation fails of its own weight.

FACTS:

Privatization of U.K. Utilities

Commencing in the 1980s, the U.K. Government privatized more than 50 government-owned enterprises using two basic methods: sale of publicly traded shares in the government-owned enterprises (which the U.K. Government referred to as a public flotation) or sales to private enterprises. Thirty-two of the privatized companies were subject to the U.K. Windfall Tax, each of which was a utility company that provided telephone, gas, electricity, water, sewer, airport or rail services (hereinafter referred collectively as the "Windfall Tax Companies"). The U.K. Government privatized each of the Windfall Tax Companies through a public flotation, at a fixed price offer.

The public flotation process involved the transfer of government-owned enterprises to new public limited companies ("PLCs"). The U.K. Government then sold shares of the new PLCs in public flotations, which were substantially similar to initial public offerings in the U.S. The newly-privatized companies became publicly traded companies listed on the London Stock Exchange. The U.K. National Audit Office reports relating to the privatization of the Windfall Tax Companies indicate that the U.K. Government set the initial share prices for the privatized companies at a level that it believed would maximize proceeds from the flotation, while concurrently generating an expectation that the shares would trade at a "modest premium" in the initial period. The U.K. Government realized substantial proceeds from the flotation of the Windfall Tax Companies. A number of these Windfall Tax Companies were acquired by U.S. utilities and, in Year 1, Taxpayer, a domestic corporation, acquired B percent of the shares of Utility from an unrelated domestic corporation. Taxpayer acquired the other C percent of the shares of Utility in two transactions, one in Year 2 and the other in Year 3.

Because each of the Windfall Tax Companies operates a business that is a natural monopoly, the U.K. Government, before privatization, established a new incentive regulatory regime called the "RPI (Retail Price Index) minus X system" to control the prices each company can charge. Under the "RPI minus X system," the prices that can be charged to customers increase by RPI minus X during the tenure of each price control period. RPI is a measure of inflation, and the X factor represents an annual efficiency factor. The regulator sets the factors in the formula for three to five years, depending on the industry. At the end of a regulatory period, the regulator resets rates for the next period based on the cost efficiencies the regulated companies achieved and establishes a new X factor following review.

The formula permits a regulated company, within a review period, to retain a portion of the additional revenues due to increased distribution of utility services and to retain all

increases in operating profit due to efficient operations and the reduction of expenses (including financing costs). Thus, the RPI minus X form of regulation controls the prices that a regulated company may charge its customers, rather than its profits. Because the U.K. Government established the initial rate structure for each of the Windfall Tax Companies before the flotation of the companies, the equity markets knew at the time of the privatizations exactly what level of price controls were to be in place for each of the privatized companies during the initial review period.

Taxpayer submitted a letter from , who advised the U.K. Government on the privatization and regulation of the industries and served as
from until . noted that, consistent with the incentive regulation system, the reductions in costs and improvements in efficiency initially benefited the utilities' shareholders and in due course their customers. However, this took time, and the initial price controls set by the Government at privatization did not fully anticipate the extent to which cost reductions would be possible. As a result, stated that customers and many other commentators took the view that the gains of privatization were not being shared equally between investors and customers. They saw excess profits, and were not convinced that regulators would in due course reset price controls to benefit customers. There was much public concern about this issue. Customer groups and others urged regulators to intervene to reset the price controls prematurely
explained that regulators were reluctant to do this, since it meant breaking, or at best undermining, the assumptions underlying the RPI minus X incentive mechanism, which relied on a pre-specified period within which companies would be encouraged to reduce costs without an adjustment to prices. As a result, despite later tightening of the price controls, there remained strong public sentiment that companies had obtained excess profits in the initial periods, and that customers had not shared equally in the gains from privatization.

In addition to public concern that the privatized utilities had obtained excess profits due to under-regulation, some commentators expressed the view that shares of the utility companies had been underpriced in the initial public flotation, resulting in windfall gains to the owners during the initial period.[1] The Labour Party, which was then the minority political party, strongly opposed the privatization, and indicated it would take action to recover the value lost by the government as the result of a perceived underpricing of the utilities by the then-majority Conservative Party. The Labour Party gained control of the U.K. Parliament in 1997, and implemented a one-off (one-time) lump-sum tax known as the "windfall tax" (sections 1-2 of the Finance (No. 2) Act 1997) that applied only to the privatized utility companies.

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[1] Lucy Chennells, *The Windfall Tax*, 18 Fiscal Studies (no. 3) 279, 280 (1997).

The U.K. Windfall Tax

Part I Section 1(1) of the Windfall Tax Statute provides as follows: "Every company which, on 2nd July 1997, was benefiting 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." Under Section 1(2), the statute provides that the "[w]indfall tax shall be charged at the rate of 23 per cent." Section 1(3) provides that "windfall" is quantified under Schedule 1 of the Act. Under Schedule 1, the amount of the "windfall" equals the excess (if any) of the value of a company "in profit-making terms" over its value "for privatisation purposes." Regulated companies not privatized by flotation were not subject to the tax.

Value in profit-making terms is defined in the Schedule as the annualized average daily profit for a company's initial period, multiplied by the applicable price-to-earnings ratio. "Initial period" encompasses the first four years after flotation, or the shorter period ending before April 1997.[2] The statute provides that nine is the only applicable price-to earnings ratio, so that all companies subject to the tax were to use this multiple in calculating their value in profit-making terms.[3] Value for privatisation purposes is the amount received for the company on flotation, "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." Institutional price is the price per share at which the shares were offered on flotation. Accordingly, the Windfall Tax was imposed at a rate of 23 percent of the excess of nine times the utility's annualized average profits for the initial flotation period over the total proceeds received by the government in the initial flotation offering. To the extent the government retained shares in the privatized company, Schedule 1, paragraph (4) provided for a proportionate reduction in the tax base.

The two-page U.K. Windfall Tax Return included a one-page calculation, on which each Windfall Tax Company reported the "Company value in profit making terms," "Value placed on company at flotation," and "Windfall Tax due." "Company value in profit making terms" is derived by adding "Profits after tax over an initial period of up to 4 financial years following privatization," dividing the total profits of the initial period by the number of days in the initial period and multiplying the result by 365 to determine average profits, and multiplying the result by the "price earnings ratio of 9." "Value placed on company at flotation" is derived by multiplying the "Total number of ordinary shares at flotation" by the "Highest fixed price at which ordinary shares offered at flotation (the 'institutional price')." The "Taxable amount" is the difference in these two figures. After multiplying the "Taxable amount" by the "percentage of ordinary share

[2] Three of the Windfall Tax Companies had initial periods of less than four years.

[3] According to the Chennells paper cited in note 1 above, the earnings multiple of nine was based on the lowest average price-to-earnings ratio for the affected industries, and actual trading prices were not used to value the privatized companies because wide price fluctuations during the post-privatization period were thought to make market prices an unreliable indicator of value. Id. at 286.

capital disposed of at flotation," if this percentage is 85% or less, the "Windfall Tax due" is computed by multiplying the "Taxable amount" by 23%.

The Windfall Tax Statute provided that the profit figures used in calculating the Windfall Tax were to be taken from the accounts that the Windfall Tax Companies filed pursuant to Section 242 of the U.K. Companies Act 1985 (the "Companies Act"). Section 242 of the Companies Act requires publicly-held U.K. companies to file annual reports with the U.K. Registrar of Companies. Section 226 of the Companies Act requires that individual companies prepare balance sheets and profit and loss accounts in compliance with the provisions of Schedule 4 of the Companies Act, and Section 227 of the Companies Act requires that parent and subsidiary companies prepare group accounts in compliance with the provisions of Schedule 4A of the Companies Act. Schedule 4 of the Companies Act provides the basic rules for preparing the accounts that companies file with the Registrar of Companies, and Schedule 4A of the Companies Act sets out the basic rules for preparing the accounts of a parent/subsidiary group. Schedule 4A requires the preparation of individual accounts for each related company and the subsequent aggregation of the accounts of the individual companies. A parent/subsidiary group generally adds the amounts for revenue and expenses in the individual financial statements on a line-by-line basis to form the group accounts, with some exceptions for items such as those resulting from intra-group transactions and minority interests.

Schedule 4 of the Companies Act specifies the form and content for a company's profit and loss accounts. Under Part I of Schedule 4, companies may choose one of several formats for profit and loss accounts. Although the order of the individual line items in the accounts varies under the different formats, calculation of income under all formats begins with turnover. Turnover is a revenue concept analogous to gross sales in the United States. Section 262 of the Companies Act defines turnover as "the amounts derived from the provision of goods and services falling within the company's ordinary activities, after deduction of -- (i) trade discounts, (ii) value added tax, and (iii) any other taxes based on the amounts so derived." Although turnover is the principal source of reportable receipts under the Companies Act, the profit and loss formats under Schedule 4 also recognize other sources of revenue including other operating income, income from shares in group undertakings, income from participating interests, income from other fixed-asset investments, other interest receivable and similar income, and extraordinary income.

Part II of Schedule 4 provides certain accounting principles and rules to be followed in preparing company accounts. Paragraph 12(a) specifically requires that "only profits realised at the balance sheet date shall be included in the profit and loss account." Section 262 of the Companies Act explains that references to "realised profits ... in relation to a company's accounts, are to such profits or losses of the company as fall to be treated as realised in accordance with principles generally accepted, at the time when the accounts are prepared, with respect to the determination for accounting

purposes of realised profits." In discussing this language, the U.K.'s Consultative Committee on Accountancy Bodies noted that "a profit which is required by statements of standard accounting practice to be recognised in the profit and loss account should normally be treated as a realised profit." *The Determination of Realised Profits and Disclosure of Distributable Profits in the Context of the Companies Acts 1948 to 1981*, TR 481 (Consultative Committee of Accountancy Bodies 1982). In Statements of Standard Accounting Practice 2, the U.K.'s Accounting Standards Committee (the predecessor to the Accounting Standards Board) explained that "revenue and profits ... are recognised by inclusion in the profit and loss account when realised in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty."

In the early 1990s, the U.K. Accounting Standards Board began work on a comprehensive statement of the U.K. accounting rules, which was to be called the Statement of Principles. In 1992, the Accounting Standards Board issued a Discussion Draft for Chapter 4 of the Statement of Principles. The Accounting Standards Board stated that an item should be recognised in the financial statements if: (a) the item meets the definition of an element of financial statements; (b) there is sufficient evidence that the change in assets or liabilities inherent in the item has occurred (including, where appropriate, evidence that a future inflow or outflow of benefit will occur); and (c) the item can be measured at a monetary amount with sufficient reliability. The guidance further provided that for gains to be recognised in the profit and loss account, the following criteria must also be satisfied:

(a) the gain must be earned -- that is, there is no material transaction, contract or other event that must occur before the change in the assets and liabilities of the entity inherent in the gain will have occurred; and

(b) the gain must be realised -- that is, one of the following is met:

   (i) a transaction whose value is measurable with sufficient reliability has occurred. In addition, for a transaction involving an exchange, the assets or liabilities exchanged must be dissimilar or monetary; or

   (ii) the gain results from a change in the asset or liability of a type not held for continuing use in the business, and the resultant asset or liability is readily convertible to known amounts of cash or cash equivalents; or

   (iii) the gain results from a liability expiring, being cancelled or otherwise ceasing to exist. Mike Davies, *UK GAAP: Generally Accepted Accounting Practice in the United Kingdom*, p. 132-133 (Ernst & Young 1994).

The Accounting Standards Board published a final version of the Statement of Principles in 1999. The 1999 version continues to base recognition on sufficient

evidence of a change in assets or liabilities and sufficient reliability for the measurement of monetary amounts. Chapter 5 of the 1999 Statement provides that "[i]n a transaction involving the provision of services or goods for a net gain, the recognition criteria ... will be met on the occurrence of the critical event in the operating cycle involved." Chapter 5 explains that in many cases, the critical event in the operating cycle is synonymous with full performance and that "[t]he critical event is the point in an operating cycle at which there will usually be sufficient evidence that the gain exists and it will usually be possible to measure that gain with sufficient reliability."

As in the U.S., all of the profit and loss formats described under Schedule 4 require the deduction of expenses, including allowances for certain capitalized costs, attributable to the receipts described above. As an offset to turnover, the most prominent deduction under each format is for cost of sales. Although not specifically defined by the Companies Act, cost of sales is comparable to cost of goods sold. With subtle variations in categorization, the different formats provide deductions for administrative and staff expenses, depreciation and other amounts written off of tangible and intangible fixed assets, distribution costs, taxes, interest payable, amounts written off of investments, extraordinary charges, and other operating expenses.

Utility’s Payment of the U.K. Windfall Tax

Following enactment of the Windfall Tax in 1997, Utility reviewed its financial profit and loss accounts for the first four full years following its Date 1 flotation. Utility initially determined that its aggregate reported book profits for that four-year period, based on the profit and loss accounts that it had filed with the U.K. Registrar of Companies, were D and that, based on those reported profits, its Windfall Tax liability would be about E. Utility considered whether there was any basis for restating its published book profits and thereby reducing its Windfall Tax liability. Utility discovered that it had failed to accrue on its profit and loss account certain tree-cutting expenses for its year ended Date 2, with the result that Utility’s profit account overstated book profits by about F. (Utility's year ended Date 2, hereinafter Year 4, was the final year included in Utility’s four-year period for purposes of computing its Windfall Tax liability.)

Utility then restated its published profit account for Year 4. That undertaking required filing a restated profit account with the U.K. Registrar of Companies and mailing to each person who was a shareholder of Utility during Year 4 a copy of that restated profit account. The U.K. Inland Revenue Service (Inland Revenue) challenged Utility’s ability to restate its Year 4 reported profits. Inland Revenue initially concluded that Utility was not permitted to restate its book profit account for Year 4 and correspondingly to reduce its Windfall Tax liability. Inland Revenue then referred the matter to the Financial Reporting Review Panel, which is an independent regulatory body responsible for ensuring compliance with relevant accounting requirements, for further consideration. Ultimately, the Financial Reporting Review Panel concluded that Utility could restate its Year 4 book profit account. As a result, Utility reduced its total profits for the four-year

Windfall Tax period to G and its corresponding total Windfall Tax liability from about E to H. The disputed expense was not allowable in computing taxable income under U.K. law and so had no effect on Utility's U.K. corporate income tax liability.

Taxpayer's Treatment of the U.K. Windfall Tax as a Creditable Tax

Taxpayer treated the U.K. Windfall Tax as a non-creditable tax on its U.S. federal income tax return for Year 5 as originally filed. Taxpayer subsequently filed a refund claim with the I.R.S. for Year 5 seeking a tax refund based on treatment of the U.K. Windfall Tax as a creditable tax under section 901 of the Code. The refund claim shows a reduction of Taxpayer's Year 5 tax liability as a result of treating the U.K. Windfall Tax as a creditable tax under section 901 that accrued and reduced Utility's earnings and profits as of the end of Utility's 1997 tax year, rather than the later year in which the tax was paid. See Treas. Reg. §1.461-4(g)(6), providing that creditable foreign taxes are deemed to accrue when the all events test is met, whereas other taxes accrue only upon economic performance, when the tax is paid. For Year 5, Taxpayer claims that the additional reduction in Utility's earnings and profits converted a distribution by Utility to Taxpayer from a dividend to a non-taxable distribution and eliminated Utility's reported subpart F income for Year 5.

LAW AND ANALYSIS:

Section 901(a) of the Code 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 or to any possession of the United States".

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) further provides that the term "foreign income taxes" means foreign "income, war profits, and excess profits taxes as defined in §1.901-2(a)" and taxes included in that term by reason of section 903.

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 a creditable 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." 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).[4] Treas. Reg. §1.901-2(a)(3). 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 of the regulations. Treas. Reg. §1.901-2(b)(1). All of these tests must be met in order for the predominant character of the foreign tax to be that of an income tax in the U.S. sense.

Taxpayer and the Field agree that the U.K. Windfall Tax must satisfy the net gain test of the section 901 regulations in order to be a creditable tax. However, Taxpayer and the Field disagree as to whether the tax meets the regulatory requirements.

Issue (1) Does the statutory language of the U.K. Windfall Tax (including the formula contained in Schedule 1 of the Finance (No. 2) Act 1997) on its face satisfy the net gain requirement of Treas. Reg. §1.901-2(b)?

The U.K. Windfall Tax statutory formula outlined in Schedule 1 of the Finance (No. 2) Act of 1987 calls for multiplying the "average annual profit for a company's initial period" by the "applicable price-to-earnings ratio" (nine), and calls this calculated value the "value in profit making terms." This calculated value is compared to the company's "value for privatization purposes" (flotation value). The difference, if any, is subject to the 23% U.K. Windfall Tax rate.

Paragraph (2) of Schedule 1 algebraically defines the "average annual profit for the company's initial period" (denoted as A) as follows:

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

where P represents the profits earned by the company during its "initial period" and D is equal to the number of days in that initial period.[5] The complete U.K. Windfall Tax statutory formula, as outlined in Schedule 1, in algebraic equation form is as follows:

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[4] Although not addressed by either party to this request for technical advice, for purposes of this memorandum we assume that the U.K. Windfall Tax levy (1) satisfies the "tax" requirement of Treas. Reg. §1.901-2(a)(2) as it was imposed pursuant to the authority of the U.K. to levy taxes and was a compulsory payment, and (2) satisfies the "no soak-up tax" requirement of Treas. Reg. §1.901-2(a)(3) as the U.K. Windfall Tax was not dependent upon the availability of a credit against the income tax liability to another country.

[5] The initial period in calculating the average annual profits is the number of days in the first four financial years after privatization. A special rule is provided in Schedule 1 where a company's first four financial

U.K. Windfall Tax = 23% x [(365 x P/D x 9) – Flotation Value].

Determining whether the U.K. Windfall Tax satisfies the "net gain" requirement of Treas. Reg. §1.901-2(b) requires analyzing whether or not the Schedule 1 statutory formula, on its face, meets the realization, gross receipts, and net income tests of the section 901 regulations.

Under Treas. Reg. §1.901-2(b)(2)(i), 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
>
> (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)....

On its face, the U.K. Windfall Tax Schedule 1 statutory formula does not satisfy the realization requirement. First, the tax is not imposed on or after the occurrence of a realization event as required by Treas. Reg. §1.901-2(b)(2)(i)(A). Under the Schedule 1 formula, the base on which the U.K. Windfall Tax was imposed was the difference between the calculated value of the company in profit making terms (i.e., average daily book earnings for the initial period, annualized and multiplied by nine (the applicable price–to-earnings ratio)) and the value for privatization purposes (i.e., "flotation value").

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years after privatization ended on or after April 1, 1997. In such cases, the initial period is re-defined as a shorter period that ends as of the last day of the last financial year to end prior to April 1, 1997.

By its terms, this tax base comprises a portion of the company's value, rather than a portion of the company's previously-realized net profits.

United States 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). The valuation methodology used in the U.K. Windfall Tax used nine times the annualized average daily book earnings during the initial period to calculate value, and we assume for purposes of this memorandum that those earnings had been realized in the U.S. sense. However, the U.K. Windfall Tax was not imposed upon or after the occurrence of a realization event for U.S. tax purposes because the U.K. Windfall Tax was not a direct additional tax on previously-realized earnings. Rather, the tax was imposed on the estimated appreciation in value of the company, using standard valuation techniques based on a specified price-to-earnings ratio. Average book earnings for the initial period were used indirectly as an element of a valuation method to estimate that unrealized increase in the company's value, not to define the tax base. The book profits of the company over the base period were averaged, annualized, and multiplied by nine as a device to approximate the utility company's value, rather than as a measurement of actual realized net income.

Second, the U.K. Windfall Tax does not meet the requirements of Treas. Reg. §1.901-2(b)(2)(i)(B). While the U.K. Windfall Tax was imposed upon the occurrence of a prerealization event, the consequences of such event did not involve the recapture of previously-allowed deductions.

Finally, the U.K. Windfall Tax also fails to meet the requirements of Treas. Reg. §1.901-2(b)(2)(i)(C). As discussed above, while the U.K. Windfall Tax was imposed upon the occurrence of a prerealization event, the estimated excess of the company's value over its flotation value, nothing in the U.K. tax law would have operated to preclude the imposition of a second tax on future realized gain. Moreover, it is clear that the U.K. Windfall Tax was not creditable or deductible by the Windfall Tax Companies for purposes of determining their liability for the U.K. corporate income tax on their realized net income. Thus, the U.K. Windfall Tax met none of the conditions listed in Treas. Reg. §1.901-2(b)(2).

The U.K. Windfall Tax Schedule 1 formula also fails to satisfy the gross receipts and net income tests. The gross receipts test of Treas. Reg. §1.901-2(b)(3)(i) 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." Here, because the determination of the amount of each company's U.K. Windfall Tax liability was based on the excess of *nine times* the annualized average daily book earnings over flotation value, rather than on net income, the tax clearly was not imposed on the basis of gross

receipts. Accordingly, the requirements of Treas. Reg. §1.901-2(b)(3)(i)(A) are not met. Further, because the U.K. Windfall Tax is not based on an alternative computation of gross receipts, the requirements of Treas. Reg. §1.901-2(b)(3)(i)(B) are also not met. The net income test of Treas. Reg. §1.901-2(b)(4)(i) 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 was not met in this case, by definition the net income test was also not met. Accordingly, the U.K. Windfall Tax statutory language (including the Schedule 1 formula) on its face does not satisfy the net gain requirement of Treas. Reg. §1.901-2(b).

The text of the statute plainly provides that the tax base that is subject to the 23 percent U.K. Windfall Tax rate is the difference between what the statute refers to as the "value in profit-making terms," which is determined by multiplying the company's average profits for the "initial period" by nine (the applicable price-to-earnings ratio), and the "value for privatization purposes" (flotation value). On its face, the U.K. Windfall Tax is an ad-valorem tax: a tax levied on the equity value of a company in excess of a specified level; in this case, flotation value. Book profits is used not to define the tax base, but as an element in the statutory formula for determining value. A prominent commentator confirmed the view that the role of the profit measure in the statutory formula "is to establish an alternative equity value for the companies, to compare with their equity value at flotation." Lucy Chennells, *The Windfall Tax,* 18 Fiscal Studies (no. 3) 279, 286 (1997). Use of a price-to-earnings ratio to establish equity values (i.e., "value in profit-making terms") is a standard valuation technique.[6]

Taxpayer acknowledges that, on its face, the U.K. Windfall Tax is a 23 percent tax on the excess of (i) the company's annualized average daily profits for the four-year (or shorter) period immediately after privatization, multiplied by nine, over (ii) the company's initial public offering price. Taxpayer argues, however, that the "substance" of this statutory formula is to tax a subset of the profits realized by the Windfall Tax Companies

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[6] See, e.g., Zvi Bodie, Alex Kane and Alan Marcus, *Investments* at 551-557 (2d Ed. 1993); Aswath Daomdaran, *Investment Valuation* at 291 (1996); Stephen A. Ross, Randolph W. Westerfield and Jeffrey Jaffe, *Corporate Finance* at 121 (4th Ed. 1996); Jay E. Fishman, Shannon P. Pratt, J. Clifford Griffith and D. Keith Wilson, *Guide to Business Valuations* at 604.7 (2002).

in excess of an allowed return on their initial capital. In support of this view, Taxpayer cites cases and rulings[7] acknowledging that a tax imposed on average profits realized in prior years may qualify as a creditable income tax. Taxpayer also cites rulings acknowledging that levies that tax income in excess of a floor amount that is based on a percentage of capital may be creditable.[8]

We agree that creditable income or excess profits taxes may be based on an average of net gain realized in more than one year, or on only the portion of the net gain that exceeds a floor amount that is itself determined with reference to a base other than income. However, none of the authorities relied on by Taxpayer suggests that a tax base computed as a *multiple* of earnings is a tax base that reaches net gain. To the contrary, such a tax base by its terms exceeds net gain. Taxpayer's only argument directed at the problem of the price-to-earnings multiplier of nine in the U.K. Windfall Tax statutory formula is that none of the Windfall Tax Companies had *U.K. Windfall Tax liabilities* in excess of their *total profits* for the relevant measurement period. This observation, to the effect that U.K. Windfall Tax liabilities were as an empirical matter less than confiscatory, does not change the fact that the tax base by its terms was not computed on the basis of realized net gain.

Instead of applying the regulatory requirements to the statutory language of the U.K. Windfall Tax, Taxpayer offers other empirical evidence concerning the operation of the tax. Taxpayer notes that of the 32 Windfall Tax Companies, only profitable companies paid the U.K. Windfall Tax. Taxpayer points to the effect the restatement of Utility's book profits had on its U.K. Windfall Tax liability, observing that Utility's reduction in book profits in its restatement for Year 4 resulted in a corresponding reduction in Utility's U.K. Windfall Tax liability (although it had no effect on Utility's U.K. taxable income or mainstream U.K. corporate income tax liability). In addition, Taxpayer cites a 1992 U.K. National Audit Office (NAO) report intended to assess the extent to which the government achieved its various objectives for privatization. Taxpayer contends that the NAO report indicates that the privatized companies were not undervalued at the time of their flotation, and concludes from this finding that the U.K. Windfall Tax could not be a tax on value.

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[7] Rev. Rul. 69-446, 1969-2 C.B. 150 (Swiss National Defense Tax, imposed on average profits for the two years preceding the assessment year, is an income tax); *Columbian Carbon Co. v. Commissioner*, 25 B.T.A. 456, 463 (1932), acq., 1932-1 C.B. 2 (Service contested timing of accrual, but not creditability, of U.K. tax based on average profits of three-year period preceding assessment year).

[8] Rev. Rul. 56-51, 1956-1 C.B. 320 (Cuban tax on profits in excess of 1/10 of estimated real worth of capital); Rev. Rul. 68-318, 1968-1 C.B. 342 (Italian tax on income exceeding six percent of capital); see also Rev. Rul. 74-435, 1974-2 C.B. 204 (Swiss Cantonal tax on income, taxed at variable rates).

Extrinsic evidence to the effect that only profitable companies were liable for the U.K. Windfall Tax and findings contained in the NAO report[9] do not establish that the U.K. Windfall Tax on its face reaches net gain. To constitute an income tax, the U.K. Windfall Tax must meet the net gain tests of Treas. Reg. §1.901-2(b). Because the U.K. Windfall Tax base is the excess of the company's value in profit-making terms over flotation value, and value is determined by reference to a multiple of annualized average daily book earnings rather than on the basis of realized net gain, we conclude that the U.K. Windfall Tax statute, on its face, does not satisfy the net gain requirement.

Issue (2) If the answer to Issue # 1 is no, is it necessary to examine the nature and substance of the U.K. Windfall Tax by reference to evidence extrinsic to the text of the statutory language in determining its creditability under section 901 of the Code?

Taxpayer contends that the regulations under section 901 of the Code and case law mandate consideration of extrinsic evidence beyond the text of the foreign law when determining whether the U.K. Windfall Tax is a creditable income tax under section 901. In particular, Taxpayer asserts that the "predominant character" standard adopted by the regulations demands looking beyond the form of a foreign tax to examine the "substance and character" of the tax whenever the form of the tax presents some ambiguity on the creditability issue. In support of these statements, Taxpayer cites various cases, decided prior to the promulgation of the 1983 final regulations under section 901, in which courts reviewed the factual context in which a foreign country crafted a tax or economic analysis to determine whether a foreign tax was a creditable income tax under section 901.[10] Taxpayer also cites one case decided after the

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[9] Since both parties to this request for technical advice agreed the NAO report would not be relied upon other than for financial data, we have not relied on the findings of the NAO report for purposes of our analysis of the creditability of the U.K. Windfall Tax under section 901. However, even if we assume as fact the findings of the NAO report, we disagree with Taxpayer's assertion that empirical evidence concerning the operation of the U.K. Windfall Tax is either determinative or relevant in analyzing whether the U.K. Windfall Tax reaches net gain. The determination of whether or not the U.K. Windfall Tax satisfies the net gain requirement under the regulations is based solely on the analysis of the U.K. Windfall Tax statute.

[10] *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894, 897 (3d Cir. 1943) (disallowed expenses resulted in excise tax characterization of Canadian tax on "annual profits," computed as gross value of mine's output less specified direct costs; court noted that "The Supreme Court, without advancing any precise definition of the term 'income tax,' has unmistakably determined that taxes imposed on subjects other than income, e.g., franchises, privileges, etc., are not income taxes, although measured on the basis of income"); *New York & Honduras Rosario Mining Co. v. Commissioner*, 168 F.2d 745 (2d Cir. 1948), *reversing* 8 T.C. 1232 (1947) (tax on net profits held an income tax, reversing Tax Court conclusion that the nature and purpose of the tax was that of an excise tax); *Seatrain Lines, Inc. v. Commissioner*, 46 B.T.A. 1076 (1942) (net income tax replaced by gross receipts tax subject to reduced rate qualifies as income tax); *Santa Eulalia Mining Co. v. Commissioner*, 2 T.C. 241 (1943) (tax on gross revenues intended to reach net gain is creditable); *Bank of America National Trust and Savings Association v. United States*, 459 F.2d 513 (Ct. Cl. 1972) (gross income tax may qualify for credit if almost sure to reach net gain); *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995) (Norwegian

issuance of the final regulations, *Texasgulf Inc. v. Commissioner*, 107 T.C. 51, 69 (1996), *aff'd* 172 F.3d 209 (2d Cir. 1999). As discussed below, in *Texasgulf* the court permitted the use of empirical evidence to determine whether a processing allowance "effectively compensate[d]" for the denial of interest expense deductions within the meaning of Treas. Reg. §1.901-2(b)(4)(i) in analyzing whether the regulatory net income requirement was met.

The preamble to Treas. Reg. §1.901-2 stated that the "predominant character" standard set forth in the regulations "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. Although the preamble notes that the regulations generally incorporate the section 901 creditability criteria set forth in prior case law (i.e., whether the foreign tax is likely to reach net gain in the normal circumstances in which it applies), the regulations provide three specific tests for conducting the net gain inquiry (the realization test, the gross receipts test, and the net income test) that were not articulated in pre-regulation case law. Pre-regulation case law is of limited relevance in deciding the creditability of a foreign tax under the section 901 regulations.[11] As the Tax Court noted in *Texasgulf*, "[r]egulations can supersede prior case law to the extent that they provide requirements and definitions not found in prior case law." 107 T.C. 51, 69 (1996). In any case, analysis of pre-regulation case law does not assist in the resolution of this case, since Taxpayer does not dispute that the U.K. Windfall Tax must satisfy the net gain test of the regulations to qualify as a creditable tax.

Texasgulf involved an Ontario Mining Tax (OMT) which imposed a tax on gross receipts less deductions for certain expenses and a processing allowance. At issue was whether the OMT met the "net income" requirement of Treas. Reg. §1.901-2(b)(4) . That regulation provides that recovery of significant costs and expenses may be "computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses." Treas. Reg. §1.901-2(b)(4)(i)(B). To prove that the processing allowance was likely to approximate or

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petroleum taxes satisfied the gross receipts and net gain requirements of the 1980 temporary regulations).

[11] Taxpayer cites *Biddle v. Commissioner*, 302 U.S. 573 (1938) for the proposition that the "substance" of a foreign tax must be examined to determine whether it is a creditable tax under the Code. However, the issue in *Biddle* concerned which person was considered to pay a foreign tax, not whether the tax qualified as a creditable income tax. In deciding that U.K. law did not control the determination of who "paid" a tax for U.S. foreign tax credit purposes, the *Biddle* court confirmed that when a statutory term is not defined in any relevant U.S. law, its legal meaning is derived from its plain meaning in the English language as used in the U.S., and not from its meaning under foreign law. See Philip R. West, *Foreign Law In U.S. International Taxation: The Search for Standards*, 3 Fla. Tax Rev. 147, 155 (1996). In our view, the principle of statutory construction applied in *Biddle* supports the Field's position that the plain meaning of the U.K. Windfall Tax statute confirms it is a tax on value, not income.

exceed nonrecoverable expenses, the taxpayer introduced evidence that consisted of a broad representative study of OMT tax returns filed from 1968 to 1980. The study indicated that the processing allowance far exceeded the nonrecoverable expenses both in the aggregate for all taxpayer returns studied and for a large majority of OMT returns. The Service argued that the regulatory test could only be met by analysis indicating that the alternative cost recovery method was designed to approximate disallowed expenses, and not by extrinsic empirical evidence comparing the amounts of allowed and disallowed expenses.

As Taxpayer notes, the Court of Appeals, in affirming the Tax Court's decision, indicated that the "effectively compensate" and "approximates, or is greater than" language contained in the regulation provision suggests that the use of extrinsic empirical evidence may be just as appropriate as qualitative analytic evidence in establishing whether a tax base using an alternative cost recovery method meets the net income requirement. However, the Court's opinion was limited solely to an analysis of the alternative cost recovery portion of the "net income" criterion set forth in paragraph (b)(4)(i)(B) of Treas. Reg. §1.901-2, which the Court viewed as contemplating an empirical inquiry.[12] See also *Exxon v. Commissioner*, 113 T.C. 338, 359 (1999), *acq. in result*, AOD 2001-4 (similarly concluding that industry data and other empirical evidence established that allowances effectively compensated for denial of interest expense deductions under the U.K. Petroleum Revenue Tax, so the tax met the net gain requirement of the regulations).

In construing a statute, the "preeminent canon of statutory interpretation requires us to 'presume that [the] legislature says in a statute what it means and means in a statute what it says there.'" *BedRoc Ltd. LLC v. United States*, 541 U.S. 176, 183 (2004) (internal quotation and citation omitted). This inquiry "begins with the statutory text and ends there as well if the text is unambiguous." *Id.* It is well established 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." *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*, 530 U.S. 1, 6 (2000) (internal quotation marks omitted) (quoting *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 241 (1989) (in turn quoting *Caminetti v. United States*, 242 U.S. 470, 485 (1917))).

In the instant case, we find no ambiguity in applying the regulatory tests to the text of the U.K. Windfall Tax statute. The terms of the U.K. Windfall Tax Schedule 1 statutory formula are clearly defined as comparing the value of the company at two different points in time. The U.K. Windfall Tax statute does not contain any provision for the calculation of taxable profits, let alone alternative cost recovery rules with respect to

[12] While the Court held that empirical evidence of the type presented in the case could be used to establish whether the OMT met the alternative cost recovery condition of the regulation's net income requirement, the Court cautioned that its opinion should not be read to suggest that empirical evidence would be appropriate in other situations. 172 F.3d 209, 216, n. 11 (2d Cir. 1999).

which empirical evidence might be relevant under *Texasgulf* to determine whether the allowed amounts were comparable to the amount of disallowed expenses. Taxpayer suggests that empirical evidence that the base of the U.K. Windfall Tax did not exceed the aggregate net income of Utility over a period of years may be substituted for the regulatory net gain tests. This position finds no support in *Texasgulf*, in which the Court applied the regulatory realization, gross receipts, and net income tests to determine whether the OMT was a tax on net gain. In this case, reference to evidence extrinsic to the text of the U.K. Windfall Tax statutory language is neither necessary nor permissible in determining the creditability of the U.K. Windfall Tax under section 901 of the Code and the regulations thereunder.

Issue (3) If the answer to Issue # 1 is no, can the requirements of Treas. Reg. §1.901-2(b) be satisfied by reference to an algebraic reformulation of the U.K. Windfall Tax Schedule 1 statutory formula?

Taxpayer contends that the U.K. Windfall Tax is fundamentally a classic excess profits tax. It asserts that profits are the base of the U.K. Windfall Tax, and that flotation value and the other factors in the statute (the fixed numerical constants of the 23 percent tax rate and the price-to-earnings ratio multiplier of “nine”) merely serve to determine what portion of a company’s profits are “excess” and therefore taxable. To support its position, Taxpayer submitted an algebraic reformulation of the U.K. Windfall Tax Schedule 1 statutory formula. As described in more detail below, in Taxpayer’s reformulation the various factors of the formula, including the statutory tax rate, are effectively multiplied by reciprocal fractions that, when multiplied together, equal one. Taxpayer then argues that the U.K. Windfall Tax, thus restated, as applied to Utility should be viewed as determined on the basis of the amount of book profits for each year in the four-year period that exceeded one-ninth of the flotation value (the statutory base x 4/9) at a rate of 51.7% (the statutory rate of 23% x 9/4), rather than on the basis of taxing the excess of nine times annualized average daily book profits for the four-year period over the full flotation value at a rate of 23%. Citing case law and IRS administrative rulings where algebraic equivalent equations have been used to gain a better understanding of complicated mathematical formulas, Taxpayer argues that the Service must consider its mathematical restatement in analyzing whether the U.K. Windfall Tax is a creditable tax under section 901 of the Code.

The cases cited by Taxpayer[13] do not support its argument that we must substitute its mathematical restatement for the U.K. Windfall Tax statutory formula in applying the net gain test of the section 901 regulations. In some of these cases, the court considered alternative formulas to calculate a statutory floor or limitation that was not itself expressed as a mathematical formula. See, e.g., *Anderson v. Commissioner*, 67 T.C. 522 (1976), in which the court considered various formulas to determine the part of a distribution which was "properly chargeable to capital account" and so not treated as a dividend-equivalent redemption under section 312(e) of the Code. Situations that require devising a formula to implement an ambiguous statutory term are readily distinguishable from the instant case, which involves a clear and unambiguous statutory formula. In other cases relied on by Taxpayer, courts relied on algebraic formulas to assist in establishing facts that were relevant to classifying transactions. See, e.g., *Breece v. Tom Bell Leasing*, 58 B.R. 379 (Bankr. N.D. Okla. 1986), in which the court used algebraic principles to analyze contractual payment terms, in order to determine which party was the beneficial owner of property at issue in a bankruptcy proceeding. Situations that require resort to mathematical analysis to establish facts that are relevant to applying a legal analysis are readily distinguishable from the instant case, where the relevant legal analysis must be applied to the statutory formula itself.

Taxpayer has not demonstrated, nor does it argue, that the U.K. Windfall Tax Schedule I formula is complicated or ambiguous. We see no uncertainty regarding the application of the Schedule 1 statutory formula, which uses precisely defined terms to calculate the tax base, that necessitates consideration of an algebraic restatement of the Schedule 1 formula to determine whether the U.K. Windfall Tax is a creditable tax. Consideration of facts beyond the expressed statutory language of the U.K. Windfall Tax, such as Taxpayer's mathematical restatement, in our opinion is neither required nor warranted in this case. Therefore, the requirements of Treas. Reg. §1.901-2(b) cannot be satisfied by reference to Taxpayer's algebraic reformulation of the Schedule 1 statutory formula.

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[13] *Anderson v. Commissioner*, 67 T.C. 522 (1976), aff'd 583 F.2d 953 (7th Circ. 1978) (calculation of amount "properly chargeable to capital account"); *Commissioner v. Keller's Estate*, 113 F.2d 833 (3rd Cir. 1940), aff'd 312 U.S. 543 (1941) (characterizing financial product as savings or insurance product); *Travelers Insurance Co. v. U.S.*, 28 Fed. Cl. 602 (Ct. Fed. Cl. 1993), *rev'd* 303 F.3d 1373 (Fed. Cir. 2002) (determining ordering rule for limitations); *In re Independent Automobile Forwarding Corp.*, 38 F.Supp. 976 (W.D.N.Y. 1940) (determining tax liabilities); Rev. Rul. 79-347, 1979-2 C.B. 122 (calculating limitation on dividends received deduction); *Breece v. Tom Bell Leasing*, 58 B.R. 379 (Bankr. N.D. Okla. 1986) (classifying transaction as sale or lease based on economic analysis; *Buckley v. Airshield Corporation*, 116 F. Supp.2d 658 (S.D. Md. 2000) (patent infringement); *Exxon Research and Engineering Co. v. United States*, 46 Fed. Cl. 278 (Ct. Fed. Cl. 2000), rev'd 265 F.3d 1371 (Fed. Cir. 2001) (determining validity of patent); *Martin Motor Sales, Inc. v. Saab-Scania of America, Inc.*, 452 F. Supp. 1047 (S.D.N.Y. 1978) (use of equations to calculate damages); *In re Butts Farming Association*, 1986 WL 713552 (Bankr. D. N.D. 1986) (calculating interest due); *Brooks v. Weinberger*, 730 F. Supp. 1132 (D.C. 1989) (calculating overtime pay); *Baxa Corporation v. McGaw, Inc.*, 981 F. Supp. 1348 (D. Colo. 1997) (patent infringement).

Issue (4) <u>If the answer to Issue # 3 is yes, is Taxpayer's proposed reformulation the mathematical equivalent of the U.K. Windfall Tax Schedule 1 statutory formula?</u>

Since, as discussed in Issue # 3 above, the requirements of Treas. Reg. §1.901-2(b) cannot be satisfied by reference to an algebraic restatement of the U.K. Windfall Tax statutory formula, whether the proposed algebraic reformulation is the mathematical equivalent of the U.K. Windfall Tax statute does not further the analysis of whether the tax is a creditable income tax. Nevertheless, for completeness we have reviewed Taxpayer's reformulation. Using basic algebraic principles, Taxpayer's economic expert restructured the one-time U.K. Windfall Tax Schedule 1 formula to construct an alternative formula that would produce an equivalent amount of tax if applied to each of the four years of a company's initial period after privatization. As noted above, the alternative formula is derived by multiplying the statutory tax rate (23%) by 9/4 and multiplying the statutory tax base [(365 x average daily profits for a four-year base period x 9) – flotation value] by the reciprocal fraction of 4/9, to produce an algebraically equivalent tax liability. The algebraic restatement is as follows:
U.K. Windfall Tax = 23% x 9/4 x [(annualized average daily profits x 9) – FV] x 4/9

= 51.7% [(total four-year profits ÷ 4) x 9 – FV] x 4/9 or 44.4%

= 51.7% [total four-year profits – 44.4% FV]

= 51.7 % (P_1 - 11.1% FV) +
51.7 % (P_2 - 11.1% FV) +
51.7 % (P_3 - 11.1% FV) +
51.7 % (P_4 - 11.1% FV)

Where:
"51.7%" is the annual tax rate that would be applied to the reformulated base to produce an amount of tax equivalent to that produced by applying the statutory 23 percent tax rate to the actual statutory base.

The FV multiplier of "11.1%" is the algebraic equivalent of dividing the total flotation value by the statutory price-to-earnings ratio of nine, to correspond to eliminating the multiplier of nine from the statutory profits element, multiplying FV by four to complete the reciprocal fraction, and then dividing by four to correspond to restating the four-year average statutory profits element into four separate annual profit terms.

"P" represents the annual profits of the company for each of years 1 through 4 in the initial period following privatization.

"FV" represents the flotation value of the company at privatization.

In critiquing Taxpayer's reformulation, the Field's economic expert did not dispute that Taxpayer's expert followed the basic rules of algebra in attempting to recast the statutory formula into that of an annually-applied excess profits tax. However, he questioned the utility of the algebraic analysis "because it is incomplete (in that it does not address the role played by variables other than net profits) and based on inappropriate assumptions (in that it assumes that all companies subject to the tax have an "initial period" of four full fiscal years and that a relatively low level of profits in one year would necessarily give rise to a credit that could be used to offset excess-profits taxes in future years)."

Among the variables mentioned by the Field's economic expert were the Windfall Tax Companies' dates of privatization and their "disposal percentage," or percentage of shares offered to the public. The 32 Windfall Tax Companies were privatized over a period of almost twelve years. The dates of privatization, even for those companies that did have a full four-year period, were not identical. The Field's expert noted that the Taxpayer's theory presupposes that the various companies were subject to tax on profits arising in entirely different years, depending on the dates on which they were privatized, which is not characteristic of an annually-applied excess profits tax. The Field's expert also noted that the limitation of the tax base to the proportionate value attributable to the privatized shares supports the characterization of the tax as falling on windfall gains arising from privatization rather than excess profits, since the companies' profits benefited all shares.

As discussed above, in Taxpayer's reformulation, the 23% statutory tax rate was multiplied by 9/4 to arrive at the 51.7% annual tax rate applied to the reformulated base. However, three companies subject to the U.K. Windfall Tax had initial periods shorter than four years, which are not taken into account in Taxpayer's recast of the statutory formula. The Field's economic expert demonstrated that different reciprocal fractions would have to be used in applying Taxpayer's approach to restate the statutory formula as applied to those companies that had an initial period of less than four years. Under Taxpayer's reformulation, those companies would be subject to a higher tax rate than the 51.7 percent annual rate imputed by the Taxpayer (69 percent in the case of a three-year initial period (23% x 9/3) and 103.5 percent (23% x 9/2) in the case of a two-year initial period).

Taxpayer's proposed methodology thus posits that the U.K. Windfall Tax imposed different tax rates on utilities subject to the tax based not on the level of their profits, but on the length of time between the initial flotation and the imposition of the tax. Moreover, Taxpayer's methodology presupposes that the U.K. imposed confiscatory tax rates, in excess of 100% of book profits, on those utilities that were most recently privatized before the imposition of the tax. These features are not characteristic of any of the "classic" annually-applied excess profits taxes to which Taxpayer seeks to compare the U.K. Windfall Tax.

The Field's expert also demonstrated that numerical equivalence between the tax imposed under the actual U.K. Windfall Tax statute and the tax imposed under Taxpayer's algebraic reformulation is achieved only if an offset (a negative or refundable tax) would result from low profits in a particular base period year, which would somehow offset the positive tax generated in other base period years. Refundable credits are not a typical feature of annually-applied excess profits taxes.

Taxpayer's response to these observations is that these features are anomalies that apply to only a minority of the companies subject to the Windfall Tax, and so constitute minor aberrations that do not disturb the "predominant character" of the U.K. Windfall Tax as an excess profits tax. In our view, Taxpayer misconstrues the meaning of the regulatory "predominant character" test. Treas. Reg. §1.901-2(a)(3) plainly states that the predominant character of a foreign tax is that of an income tax in the U.S. sense if, within the meaning of Treas. Reg. §1.901-2(b), the foreign tax is likely to reach net gain in the normal circumstances in which it applies and is not a "soak-up" tax. The predominant character test thus looks not to the rate structure of the tax, but rather to whether the base of the tax is net gain as defined in the three-part realization, gross receipts, and net income test set out in Treas. Reg. §1.901-2(b). The predominant character test permits a tax to qualify if the base includes particular items that do not meet the net gain test, so long as the levy as a whole generally reaches net gain. See, e.g., Treas. Reg. §1.901-2(b)(2)(i) (tax in its predominant character may meet the realization test even if the tax base also includes imputed rental income and stock dividends). As discussed above, the predominant character of the U.K. Windfall Tax is not that of an income tax, because the tax is imposed on unrealized appreciation, not net gain.

Taxpayer bases its position on its argument that the U.K. Windfall Tax formula can be algebraically rewritten to produce tax in an amount that could have been assessed under a different, hypothetical levy that satisfies the net gain requirement of Treas. Reg. §1.901-2(b). However, in our view, permitting a nonqualifying levy to qualify by resort to such a hypothetical restatement strips the regulatory tests of their meaning. In particular, because standard valuation techniques employ a multiple of earnings to value stock, any value-based tax could be rewritten to qualify as a tax on earnings.

Taxpayer's reformulation significantly changes the statutory formula, as evidenced by the fact that it would not reach equivalent results for all 32 Windfall Tax companies. In attempting to recast the statutory formula into that of an annually-applied excess profits tax, Taxpayer's expert eliminated the Schedule 1 price-to-earnings ratio multiplier of nine by multiplying the statutory tax base by 4/9 and multiplying the statutory tax rate by the corresponding reciprocal fraction of 9/4. Taxpayer acknowledges that different reciprocal fractions, resulting in different tax rates, must be applied to the statutory formula in order to arrive at the Windfall Tax actually paid by those companies with initial periods of less than four years. These variable reformulations of the statute may

produce a mathematically equivalent amount of tax, but only by fundamentally revising the Schedule 1 statutory formula and rate structure.

Creditability of the U.K. Windfall Tax must be determined on the basis of the statute actually enacted by the U.K. Parliament, not on a different form of the tax that could have been, but was not, enacted. The structural form of a tax cannot be disregarded when analyzing the creditability of a tax under Treas. Reg. §1.901-2(b), because the regulatory tests are designed to evaluate the terms, not the purpose, of the levy.

Similarly, the structural form of a tax is a crucial factor in determining the amount of tax paid under Treas. Reg. §1.901-2(e)(4), where foreign law provides for a credit toward a taxpayer's liability for one levy (the "first levy"), the amount of tax paid for another levy (the "second levy'). In a multiple levy situation, Treas. Reg. §1.901-2(e)(4) provides that the second levy is considered paid in full first and the first levy is considered paid only to the extent not offset by the second levy. An opposite result would occur, however, if the foreign law provided that a taxpayer may credit toward its liability for the second levy the amount of tax paid under the first levy. In such a situation, the first levy would be considered paid in full. The structural form of the tax determines which tax is considered fully paid. See *Helvering v. Queens Ins. Co.*, 115 F.2d 341 (2nd Cir. 1940), and Rev. Rul. 91-45, 1991-2 C.B. 336.

The fact that Taxpayer's recast of the Schedule 1 statutory formula (which eliminates the specifically stated price-to-earnings ratio multiplier of nine) reaches algebraically equivalent results and, assuming that the book profits element of the equation met the net gain requirement, could qualify as a creditable tax under section 901 had the U.K. Parliament enacted it is irrelevant, because Parliament did not enact Taxpayer's annually-applied restatement of the U.K. Windfall Tax Schedule 1 formula. Taxpayer's reliance on its algebraic restatement of the Schedule 1 statutory formula is therefore misplaced.

Issue (5) <u>In analyzing the algebraic reformulation of the U.K. Windfall Tax, is it appropriate to compare the reformulation to U.S. excess profits taxes and other creditable foreign taxes?</u>

Taxpayer's argument that the U.K. Windfall Tax satisfies the net gain requirement of the regulations is based on the premise that the U.K. Windfall Tax statutory formula can be recast algebraically to resemble an annually-applied excess profits tax. Taxpayer cites various foreign taxes where the Service has allowed foreign tax credits, under section 901 or pursuant to a treaty, as well as previously-imposed U.S. excess profits taxes, which it claims operate just like the restated U.K. Windfall Tax. In particular, Taxpayer relies on two revenue rulings that predate the 1983 section 901 regulations: Rev. Rul. 56-51, 1956-1 C.B. 320 (involving the creditability of a Cuban tax) and Rev. Rul. 68-318, 1968-1 C.B. 342 (involving the creditability of an Italian tax) in which the Service

concluded the foreign taxes were creditable.[14] Taxpayer also describes the excess profits taxes imposed in the U.S. during World War I and World War II. Taxpayer argues, based on its algebraic reformulation of the U.K. Windfall Tax statutory formula, that the "economic substance" of the U.K. Windfall Tax is just like the Cuban and Italian excess profits taxes and the previously-imposed U.S. excess profits taxes.

The fact that Taxpayer's restated formulas would produce tax amounts equivalent to those obtained under the U.K. Windfall Tax statutory formula does not justify substituting the revised formulas for the statutory formula. Algebraic similarities between Taxpayer's restated formulas and the form of other creditable foreign taxes or previously-imposed U.S. excess profits taxes is not an alternative route to creditability of the U.K. Windfall Tax under section 901 of the Code. Creditability of the U.K. Windfall Tax is solely dependent on whether or not the tax base established by the U.K. Windfall Tax statute directly satisfies all the requirements set forth in Treas. Reg. §1.901-2(b). We note that the creditability of the foreign taxes described in Rev. Ruls. 56-51 and 68-318 cited by Taxpayer were determined under pre-regulation standards and have not been measured under the current regulatory standards set forth in Treas. Reg. §1.901-2(b). However, even if we assume that the profits element in the foreign taxes described in the revenue rulings would satisfy the net gain requirement of Treas. Reg. §1.901-2(b), the taxes described therein are distinguishable in two important respects from the U.K. Windfall Tax. First, the tax base in each ruling, as with the other excess profits taxes cited by Taxpayer, was determined by reference to taxable profits, whereas under the U.K. Windfall Tax a company's value is determined with respect to its book profits. More importantly, the foreign tax base considered in each ruling consisted of net profits in excess of a floor amount measured based on capital, whereas, as noted above, the base of the U.K. Windfall Tax is computed with reference to a profits figure *multiplied by nine* in excess of a floor amount based on initial flotation value. The inclusion of the profits multiplier in the U.K. Windfall Tax base, not the way in which the floor amount is defined, is the critical factor that precludes characterization of the U.K. Windfall Tax as reaching net gain.

An excess profits tax, in general, is a tax levied on a company's profits above a specified level that is considered normal. A percentage of capital employed by the company or average earnings in the past are generally used to measure what are "normal" profits and what are "excess" profits. In the case of the U.S. excess profits taxes imposed during World Wars I and II, the taxes were imposed on a company's net income shown on its income tax return in excess of a defined floor amount, determined

[14] Taxpayer also cites several cases that assumed without deciding that various U.K. taxes on excess profits, defined as taxable profits in excess of prewar profits or a percentage of various measures of capital, were creditable. *Columbian Carbon Co. v. Commissioner*, 25 B.T.A. 456 (1932), acq., 1932-1 C.B. 2; *H.H. Robertson v. Commissioner*, 176 F.2d 704 (3d Cir. 1949); *Ethyl Corp. v. U.S.*, 75 F.Supp. 461 (Ct. Cl. 1948).

as a percentage of the company's capital.[15] In contrast, the U.K. Windfall Tax was imposed on a company's average daily book income over a variable base period following privatization *multiplied by nine* in excess of a defined floor amount, initial flotation value. By its terms, the U.K. Windfall Tax is a tax on value, and the fact that taxable values are determined with reference to a measure of profits does not transform it into a tax on income. But even if it were permissible to deconstruct the statutory terms, the presence of the price-to-earnings ratio multiplier in the U.K. Windfall Tax statutory formula provides the critical distinction between this nonqualifying levy and qualifying income or excess profits taxes.

Issue (6) <u>If the answer to Issue # 4 is yes, does the U.K. Windfall Tax satisfy the requirements of Treas. Reg. §1.901-2(b)?</u>

Taxpayer's contention that the U.K. Windfall Tax satisfies the net gain requirement of Treas. Reg. § 1.901-2(b) is premised, first, upon accepting that its algebraic restatement (language not contained in the U.K. statute) can be substituted for the U.K. Windfall Tax Schedule 1 statutory formula, and, second, accepting as fact that U.K. GAAP (generally accepted accounting practice) principles are essentially similar to U.S. tax law principles. Profits under paragraph 5 of Schedule 1 of the U.K. Finance (No. 2) Act 1997 are taken from accounts prepared in accordance with the Companies Act 1985, which sets forth the financial reporting requirements for U.K. companies. Accounts under the Companies Act are prepared under U.K. GAAP.

The Field does not accept as fact that reported profits under the Companies Act (determined under U.K. GAAP) is based on net income in the U.S. sense. It asserts that to the extent this factual issue needs to be resolved, the case should be returned to Exam for review. Since we reject Taxpayer's primary argument that the creditability of the U.K. Windfall Tax can be determined with reference to an algebraic restatement based on actual book profits rather than with reference to the statutory formula that uses a multiple of annualized average profits, we need not reach the issue of whether profits under U.K. GAAP is determined on the basis of net gain within the meaning of Treas. Reg. §1.901-2(b).

As stated above, no uncertainty or ambiguity exists regarding the terms or application of the U.K. Windfall Tax Schedule 1 statutory formula that necessitates the need to consider Taxpayer's proposed reformulation in analyzing whether the U.K. Windfall Tax is a creditable tax under section 901 of the Code. The use of average book profits multiplied by nine in the Schedule 1 formula serves as a basis for determining the unrealized appreciation in a company's value, rather than as a measure of net income that is subject to the 23 percent U.K. Windfall Tax rate. Because the tax base is based

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[15] The 1917 tax (Revenue Act of 1917, secs 201-203, 39 Stat. 1000-1001) was imposed at a rate of 8 percent on a company's net income that exceeded the sum of $5,000 and an amount of capital invested in the U.S. Similar excess profits taxes (e.g., National Industry Recovery Act of 1933, sec. 216; Revenue Act of 1942, ch. 619, 56 Stat. 798, 899) were imposed during the years leading up to World War II.

on nine times the annualized average book profits during the initial period following privatization, rather than on net gain, the U.K. Windfall Tax does not satisfy the net gain requirement of Treas. Reg. §1.901-2(b).

CAVEAT:

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.