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Reconsidering Substance Over Form in *PPL*

By Jacob Goldin

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The controversy surrounding *PPL Corp.* is one of substance versus form, accepting that the tax in question is economically equivalent to a tax on income. However, the fact that the tax is levied on the basis of average profits rather than total profits differentiates it from conventional income taxes in important ways.

Introduction

What defines an income tax? That sounds like the sort of purely academic question that a law student could expect in her first tax course, but the issue is headed to the Supreme Court with hundreds of millions of dollars riding on the answer.

In *PPL Corp. v. Commissioner*,[1] the Court will hear arguments concerning whether American companies that had paid a British windfall tax could claim the foreign tax credit for that payment, thereby reducing their U.S. tax liability. The dispute hinges on whether the windfall tax constitutes a tax on ''income, war profits, [or] excess profits,'' as required for the tax to be creditable under the FTC regime.[2] The Fifth Circuit in *Entergy Corp. v. Commissioner*[3] held that the tax was creditable, whereas the Third Circuit in *PPL* held that it was not. The Supreme Court has granted certiorari to resolve the conflict.

The companies seeking FTC eligibility have cast the issue as one of substance versus form, a perennial source of controversy in tax disputes. They argue that the windfall tax, despite nominally being levied on the basis of quantities other than income, is mathematically equivalent to a tax on profit. The government has largely appeared content with this framing of the debate; its chief argument is that sources of evidence external to a tax's statutory text (that is, mathematical re-expressions and statements of foreign legislative intent) are irrelevant for determining whether the tax is an income tax. Other commentators, including some of the country's most respected tax scholars, have added their voices to the chorus as well, asking the Supreme Court to side with the Fifth Circuit to reaffirm the important principle of substance over form.[4]

Yet amid the clamor to fall into the familiar battle lines of the form-versus-substance debate, the parties, courts, and commentators have been too quick to accept the underlying premise that the windfall tax is substantively equivalent to a tax on income. It's not. That is, the substantive effect of the windfall tax is not to tax a company's profits, but rather to tax its *average* profits. And although they have been largely overlooked in this context, the differences between a tax on average profits and a tax on actual profits are significant. Indeed, as I argue below, the windfall tax's focus on average rather than actual profits causes it to depart from familiar income taxes in important ways.

Background

In 1984, under the leadership of Margaret Thatcher's Conservative Party, the British government embarked on a policy of widespread privatization. Over the next 12 years, the United Kingdom privatized more than 50 state-owned companies, selling the companies' shares to private investors at fixed, predetermined prices. These newly privatized companies proved to be more profitable than expected, however, prompting government critics

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[1]Sup. Ct. Dkt. No. 12-43, 665 F.3d 60 (3d Cir. 2011), *Doc 2011-26933*, *2011 TNT 247-6*.

[2]Section 901.

[3]683 F.3d 233 (5th Cir. 2012), *Doc 2012-12171*, *2012 TNT 110-17*.

[4]*See* Brief for Amici Curiae Rosanne Altshuler, Richard M. Bird, Malcom Gillis, Arnold C. Harberger, Gary C. Hufbauer, Charles E. McLure Jr., Jack Mintz, and George R. Zodrow in Support of Petitioners, *PPL*, No. 12-43 (Aug. 2012), *Doc 2012-17707*, *2012 TNT 163-11*. *See also* Brief for Southeastern Legal Foundation, Cato Institute, and Goldwater Institute as Amici Curiae in Support of the Petition for Writ of Certiorari, *PPL*, No. 12-43 (Aug. 10, 2012), *Doc 2012-17705*, *2012 TNT 163-10*.

to allege that valuable state resources had been given away for too little in return. When the Labour Party came to power in 1997, one of its first acts was to levy the windfall tax on the newly privatized companies to redress what they perceived as the unjust transfer of state resources to investors through privatization.

Tax liability under the Windfall Tax Act was computed as 23 percent of the difference between a company's profit-making value and the price at which the company was sold to private investors (the flotation value). Profit-making value was defined as the product of (1) an imputed price-to-earnings ratio and (2) the company's annualized average daily profits during an initial period. Importantly, the initial period was not the same for each company. It was defined as the days following the company's privatization in the four years before April 1, 1997.[5] Twenty-seven of the 32 companies subject to the windfall tax had an initial period of 1,461 days, or four years. After paying the windfall tax, American-owned subsidiaries Entergy and PPL claimed FTCs in the amount of $234 million and $27 million, respectively.

For a company's foreign tax payment to be creditable under the FTC regime the liability must have arisen under an income, war profits, or excess profits tax (collectively referred to as an income tax).[6] A Treasury regulation further specifies that a "foreign levy is an income tax if and only if . . . [t]he predominant character of that tax is an income tax in the U.S. sense."[7] The IRS disallowed Entergy's and PPL's crediting of their windfall tax payments under the FTC provisions, arguing that tax liability under the Windfall Tax Act depends on the difference between a company's profit-making value and its flotation value, rather than its income.

Entergy and PPL challenged the IRS's determination in Tax Court. Although they conceded that the windfall tax was nominally levied on quantities other than profit, the companies argued that the tax's effect and intent were substantively identical to an income tax. In response, the IRS asserted that mathematical re-expressions and foreign legislative intent were outside the domain of permissible considerations for determining FTC eligibility and that the court should assess the tax on the basis of its statutory description alone. In its holding, the Tax Court adopted the substance-over-form reasoning urged by the companies and held that their windfall tax payments qualified for the FTC.[8]

The United States appealed the *PPL* and *Entergy* Tax Court decisions to the Third and Fifth circuits, respectively. The Third Circuit reversed the Tax Court, holding that Entergy's mathematical re-expression was impermissible.[9] In contrast, the Fifth Circuit agreed with the Tax Court and rejected the Third Circuit's reasoning as exemplifying "the form-over-substance methodology that the governing regulation and case law eschew."[10] In response to its loss in the Third Circuit, PPL filed a petition for certiorari, which the Supreme Court granted.

The Substantive Effect on the Windfall Tax

For the taxpayers' substance-over-form argument to be persuasive, the windfall tax must actually have the same substantive effect as a tax on income. The companies argue this point by algebraically re-expressing the windfall tax's liability formula so that the tax's base appears to be the total profits earned by a company during its initial period.

To understand the companies' characterization of the windfall tax, first note that a company's windfall tax liability under the statute is given by the following formula:

$$WT = 0.23 \times [\{3.65 \times \tfrac{P}{D} \times 9\} - FV] \text{ (Equation 1)},$$

in which WT denotes the amount of windfall tax owed; D denotes the number of days in a taxed company's initial period (that is, the number of days it operated following privatization and before April 1, 1997, up to a maximum of four years or 1,461 days); P denotes the total amount of profits earned during the taxed company's initial period; 9 is the imputed price-to-earnings ratio; and FV denotes the taxed company's flotation value (that is, its price at privatization).

Simple algebra allows one to simplify the windfall tax liability formula to:

$$WT = 755.55 \times \tfrac{P}{D} - 0.23 \times FV \text{ (Equation 2)}.$$

Twenty-seven of the 32 companies subject to the windfall tax, including the British subsidiaries of Entergy and PPL, had initial periods of 1,461 days. Five companies had initial periods of less than 1,461

[5]To illustrate, a firm privatized on January 1, 1995, would have an initial period from January 1, 1995, to April 1, 1997, and a firm privatized on January 1, 1987, would have an initial period from April 1, 1993, to April 1, 1997.

[6]Section 901(b)(1).

[7]Reg. section 901.1-2(a).

[8]*PPL*, 135 T.C. 304 (2010), *Doc 2010-19825*, *2010 TNT 175-3*; *Entergy*, T.C. Memo. 2010-197, *Doc 2010-19826*, *2010 TNT 175-4*.

[9]The opinion noted that the gross receipts test for a foreign income tax to be creditable under the FTC regime requires that a tax be imposed on either gross receipts or an imputed value likely to produce an amount not greater than gross receipts. Reg. section 1.901-2(b)(1). The Third Circuit argued that the windfall tax could not meet this test unless one were to impermissibly re-express the tax's base by manipulating its rate.

[10]*Entergy*, 683 F.3d at 237.

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days: National Power (1,456 days), PowerGen (1,463 days), Northern Ireland (1,380 days), Railtrack (316 days), and British Energy (260 days).

For a company with an initial period equal to 1,461 days, substituting the value D = 1,461 into Equation 2 yields:

WT = 0.5171 x P - 0.23 x FV (Equation 3).

Equation 3 can be rewritten to obtain the expression that Entergy relies on:

WT = 0.5171 x [P - 0.4448 x FV] (Equation 4).

On the basis of Equation 4, the companies argue that the windfall tax is, in effect, a 51.71 percent tax on net income above a floor of 44.48 percent of the taxed company's flotation value.

Average Profits and Actual Profits

The companies' arguments are flawed because they represent a tax on *average* profits as if it were a tax on *actual* profits. When companies differ in the lengths of their initial periods, a tax on average profits reaches a very different base (both conceptually and economically) than does a tax on actual profits.

To understand the distinction, compare Equation 2 with Equation 3. In Equation 2 the amount of tax owed depends on average daily profits (P/D). In contrast, in Equation 3, tax liability depends only on total profits (P). By restricting attention to companies with initial periods of 1,451 days — that is, by holding D constant — the taxpayers' algebra disguises the fact that windfall tax liability depends on the length of a company's initial period (in addition to profits earned).

That windfall tax liability depends on both D and P (rather than on P alone) undermines the notion that it is effectively a tax on income. To understand why, consider a hypothetical company (A) with an initial period of 1,000 days that earns profits of $100 million during that time. Suppose further that A's flotation value is $300 million. Using Equation 2, it is easy to calculate A's windfall tax liability:

$$WT = 755.55 \times \frac{100,000,000}{1,000} - (0.23 \times 300,000,000) = \$6,555,000$$

Now consider a second hypothetical company (B) that is identical to A in all but the following respect: B begins operating as a private company one day earlier than A, so that its initial period consists of 1,001 days. Suppose that B earns total profits of $100,100,000 during that time. From Equation 2, B's windfall tax liability is:

$$WT = 755.55 \times \frac{100,100,000}{1,001} - (0.23 \times 300,000,000) = \$6,555,000$$

Note the oddity of this result for an alleged income tax: B earned a full $100,000 more in income than A yet does not owe a penny more in tax.

To drive the point home, consider a third hypothetical company (C) that operates for 1,001 days in its initial period and earns total profits of $100,005,000 during that time. C's windfall tax liability is:

$$WT = 755.55 \times \frac{100,005,000}{1,001} - (0.23 \times 300,000,000) = \$6,483,294$$

This result is even stranger than before: Although C earned more total profit than A, C's windfall tax liability is $71,706 lower.

The explanation behind these examples is that it is average profit rather than actual profit that determines windfall tax liability. A company that operates for half a year must pay taxes as if it had continued to earn profit at the same rate during the full four-year period. An equally profitable company that operates for the full four-year period owes the same amount of tax as the company that operated for six months, despite having earned eight times as much income. These features of the tax make sense if the goal is to levy companies based on their value (measured by profitability), but they are out of place in a tax designed to reach companies' actual profits.

A potential objection to the above line of argument is that although the base of the windfall tax is technically average income, its substantive effect is identical to a tax on actual income if one only considers companies with initial periods of the full four years. However, a foreign tax either is or is not FTC-eligible for all persons subject to the tax; creditability cannot depend on the characteristics of the taxpayer in question.[11] Thus, even if the windfall tax effectively amounted to an income tax for only some taxpayers, it would not be creditable under the FTC provisions. Moreover, the application of the windfall tax to Railtrack Group plc and to British Energy plc proves that the distinction between average and actual profits is more than hypothetical. Both of those companies had initial periods of less than a single year but owed as much under the windfall tax as if they had continued to earn income at the same rate for the full four-year period.[12]

[11] Reg. section 1.903-1(a).

[12] Indeed, the algebraic manipulations relied on by the taxpayers imply that Railtrack Group and British Energy faced staggeringly high income tax rates — 239.1 and 290.6 percent, respectively — as compared with most other companies that faced a rate of only 51.71 percent. Although questions of legislative intent are outside the scope of this article, it seems likely that if the windfall tax was understood as an income tax at the time of its passage, Railtrack Group and British Energy would have raised objections to being singled out for such harsh treatment. Yet if those discussions occurred, they do not appear to have been mentioned in the evidence presented by the parties.

Conclusion

In many ways, the issues presented in *Entergy* and *PPL* are archetypal illustrations of the substance-versus-form debate in tax law: One side has argued for a narrow focus on the statutory language used to describe the tax, while the other has asked courts to consider the tax's actual economic effects. With a stark circuit split thrown into the mix, the choice between substance and form appears perfectly teed up for Supreme Court review.

Yet the core assertion underlying this debate — that the windfall tax is in effect a tax on income — is deeply flawed. A tax on income is substantively different than a tax on average profits. Average profits are related to actual profits, but the two concepts differ in fundamental ways. As illustrated above, one company may have higher profitability than another — and thus higher windfall tax liability — but less total income over the four-year period covered by the tax. Thus, while substance over form is certainly an important doctrine, its applicability to *Entergy* and *PPL* is far from clear.

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