

To: Our Clients and Friends

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UK Utilities Windfall Tax is Eligible for U.S. Foreign Tax Credit

The United States Supreme Court, on May 20, 2013, held, in *PPL Corp. v. Commissioner*, that the United Kingdom's one-time "windfall tax" imposed on U.K. utilities that were privatized between 1984 and 1996 is eligible for a foreign tax credit because the tax was, in substance, a tax on income.

The U.S. permits a foreign tax credit on any income, war profits and excess profits taxes paid overseas. A foreign tax is creditable if the tax's *predominant character* is that of an income tax in the U.S. sense. The substance of the foreign tax, and not the characterization of the tax by the foreign government, is determinative.

The windfall tax was a one-time tax intended to recover a portion of the difference between the price at which a regulated company was privatized and the price at which the regulated company should have been privatized (given the profits actually earned after privatization). The price at which a company should have been privatized was determined by a formula that took into account a company's profits and the period in which it was subject to rate regulation. In form, the tax was imposed on a company's valuation. However, the major independent variable used to calculate value was a company's profits. The Court therefore held the windfall tax was, in substance, imposed on the excess profits earned by the privatized companies. The economic substance of a tax, not its form, matters when determining whether a foreign tax is to be considered an income tax in the U.S. sense, with Justice Clarence Thomas, writing for the Court stating, "we apply the predominant character test using a commonsense approach that considers the substantive effect of the tax."

This case reaffirms the principle that "the way a foreign government characterizes its tax is not dispositive with respect to the U.S. creditability analysis."

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