After *PPL*: How to Bring Congressional Intent Back to The Foreign Tax Credit Applicability Decision

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In the late 1970s and 1980s the U.K. government privatized certain public companies, including utility companies, because of inefficiencies and poor customer service. Privatization proved successful in many of the industries; instead of wasting tax dollars these industries began paying taxes. As a result of privatization the utility companies became much more efficient and they reaped large, unexpected profits, despite significant government regulation of prices. Consequently, public outrage grew in response to the perceived exploitation of British citizens by the privatized utility monopolies.

To address public concern about the utility companies’ monopoly power, some argued for a tax to address:

- that “the companies were sold off ‘too cheaply’” when privatized;
- that “the regulatory regime has been ‘too lax’”; and
- that the companies have “been able to exploit a degree of monopoly power.”

A tax that has come to be commonly known as the “windfall tax” was passed by Parliament in 1997. London Electricity, owned by an American parent, owed and paid almost £140 million and three other British utility companies also owned by American parents were affected by the tax. Subsequently, two of these American parent companies sought a foreign tax

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2 "Disgusted,” *The Economist*, Mar. 11, 1995, at 55 (“According to the Treasury, the nationalised industries then cost each taxpayer the equivalent of £300 ($480) a year in today’s money”).

3 Id.


5 "Disgusted,” supra note 2, at 55.

6 Id.


8 Finance (No. 2) Act, 1997, c. 58, section 1 (“Every company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation shall be charged with a tax (to be known as the ‘windfall tax’) on the amount of that windfall”).

9 *Entergy Corp. v. Comm’n*, 683 F.3d 233, 234 (5th Cir. 2012) (*Entergy II*).

credit from the IRS in the United States under Internal Revenue Code section 901.\textsuperscript{11}

When the American parent corporations sought an FTC for the windfall taxes paid, the request was denied by the commissioner of the IRS. Both taxpayers appealed and the Tax Court found that the windfall tax was a creditable tax.\textsuperscript{12} The commissioner appealed, and the Third Circuit found that the tax was not creditable\textsuperscript{13} while the Fifth Circuit held that it was.\textsuperscript{14} The Supreme Court heard arguments February 20, 2013, to resolve the discrepancy in tax treatment between circuits.\textsuperscript{15} The Supreme Court’s May opinion applied the law while the Fifth Circuit held that it was.\textsuperscript{16} The FTC for the windfall taxes paid, the request was denied,\textsuperscript{17} up to the total amount of the windfall taxes paid.\textsuperscript{18} In order to receive an FTC, the taxpayer must show that a tax was paid,\textsuperscript{19} and that the tax was creditable.\textsuperscript{20}

This article will argue that the development of the FTC has causeda separation between the intent of section 901 and how it has come to be applied. The code, regulations, and courts have moved away from inquiring whether granting an FTC achieves the goals of section 901 and instead courts apply a rigid, technical interpretation of the code and regulations. This article argues that the code and regulations, as well as court decisions, should re-integrate consideration of the purpose of section 901 when deciding whether a foreign tax is creditable. These changes would help guide the courts in deciding cases like PPL v. Commissioner and would lead to correct outcomes more frequently.

This article will proceed by first introducing the code sections and Treasury regulations that establish and explain the FTC in Section I. Section II will explain PPL v. Commissioner’s arguments, the circuit court decisions, and the Supreme Court decision. Section III will explain the intent of section 901 and how section 901 came to be applied by the courts. Section IV will explain the role intent should play in cases like PPL v. Commissioner, and Section V will suggest amendments to the code and the regulations to ensure that the intent of section 901 plays a prominent role in IRS and judicial interpretation in the future.

I. The Foreign Tax Credit

A. The Code

Generally, the FTC applies when a U.S. corporation or individual pays income taxes\textsuperscript{21} to a foreign jurisdiction. Instead of taxing the income twice, allowing for a deduction of the foreign tax paid, or exempting the income from the U.S. tax return, the United States allows a credit on the taxpayer’s U.S. return of the amount of the foreign taxes paid,\textsuperscript{17} up to the total amount of U.S. tax owed.\textsuperscript{18} In order to receive an FTC, the taxpayer must show that a tax was paid,\textsuperscript{19} the claimant was the payer of the tax,\textsuperscript{20} and that the tax was creditable.\textsuperscript{21}

B. Treasury Regulations

The Treasury regulations, promulgated in 1983, purport to guide the determination of whether a tax is a creditable foreign tax. To be creditable, the regulations require that the “predominant character” of the foreign tax be “that of an income tax in the U.S. sense.”\textsuperscript{22} Reg. section 1.901-2(b)(a) requires that the tax be “likely to reach net gain in the normal circumstances in which it applies”\textsuperscript{23} to meet the predominant character requirement. It goes on to state that a tax is likely to reach net gain if it satisfies the “realization, gross receipts, and net income requirements.”\textsuperscript{24} Courts have applied these requirements as a three-pronged test.

First, realization requires that the foreign tax be imposed upon the occurrence of some event that would


\textsuperscript{12}Entergy I, 100 T.C. Memo. at 1; PPL I, 135 T.C. at 305.

\textsuperscript{13}See PPL Corp. v. Comm'r, 665 F.3d 60 (3d Cir. 2011) (PPL II).

\textsuperscript{14}See Entergy II, 683 F.3d at 233.


\textsuperscript{16}The statute allows for a credit for “any income, war profits, and excess profits taxes paid.” IRC section 901(b)(1). For simplicity, this article will simply refer to the taxes as income taxes and will specify if it means excess profits taxes. War profits taxes will not be discussed.

\textsuperscript{17}IRC section 901(a).

\textsuperscript{18}IRC section 904(a).

\textsuperscript{19}Cont’l Ill. Corp. v. Comm’r, 998 F.2d 513, 516 (1993) (holding that the taxpayer must show that a tax was paid to a foreign jurisdiction because “American businessmen would have strong incentives to collude with foreign businessmen” to get the benefit of the credit without having paid the tax).

\textsuperscript{20}Biddle v. Comm’r, 302 U.S. 573, 581 (1938) (finding that a U.S. shareholder who received a dividend from a British company “less” income tax did not pay a tax to a foreign jurisdiction).

\textsuperscript{21}Inland Steel Co. v. United States, 677 F.2d 72, 82 (1982) (holding that the payment of the Ontario Mining Tax was not a creditable tax because it “was not intended to reach a concept of net gain in the United States tax sense”).

\textsuperscript{22}Reg. section 1.901-2(a) (as amended in 2012).

\textsuperscript{23}Reg. section 1.901-2(b)(1).

\textsuperscript{24}Id.
also be considered a realization event under the code. Second, the foreign tax must be imposed upon “gross receipts” or “gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.” And finally, the net income requirement seeks to ensure that the foreign tax allows recovery of “significant costs and expenses.”

II. **PPL v. Commissioner**

A. **The Tax**

The U.K. windfall tax is a one-time, 23 percent tax on the difference between the utility company’s “profit-making value” and its “flotation value.” The profit-making value is determined by the average annual profit per day of the company, usually over four years, multiplied by its price-to-earnings ratio (nine). The flotation value is the price at which the U.K. government originally sold the company. The Third Circuit expressed the formula mathematically this way:

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

In determining if the tax is a creditable tax, both circuits applied the three-prong “predominant character” test from the regulations. The question at issue in both cases is whether the three prongs of reg. section 1.901-2 are satisfied.

B. **Arguments**

1. **PPL and Entergy**

PPL argues that the windfall tax has the predominant character of a U.S. income tax and that therefore the FTC should apply. When the formula is simplified, PPL says, it is essentially a 51.75 percent tax on excess profits; therefore, it qualifies as a creditable tax. The commissioner stipulated “that none of the 31 companies that paid windfall tax had a windfall tax liability in excess of its total profits over its initial period,” therefore, according to PPL, the tax did effectively reach net gain in every instance of its application. In fact, PPL claims that the Labour Party “intentionally” designed the tax to reach net profits.

Also, PPL says a tax on value would address the ability of an asset “to generate income in the future,” but it would not tax the profits the asset has made in the past as the windfall tax does. Finally, had the U.K. government wanted to tax the value of the corporations, it could have easily done so by measuring the value of the publicly traded stock.

2. **IRS Commissioner**

The commissioner argues that the windfall tax is a tax on the value of these corporations and therefore is not a creditable tax. In essence, the argument is that the formula calculates the value of the companies and then a 23 percent tax is imposed on that value. Profits are used as a factor in determining value, but that does not make this an excess profits tax. He applies the three prongs of the Treasury regulations and concludes that based on the characterization of the windfall tax as a tax on value, none of the three requirements are met.

The commissioner also argues that the legislative history of the U.K. act does not indicate that this is a creditable tax. An adviser from the Arthur Andersen firm, hired to help draft the tax proposal, stated that the purpose of the tax was to tax foregone value due to too low an initial selling price, too lenient regulatory rules, and the use of monopoly power. Chancellor Gordon Brown said he understood that the windfall tax was an excess profits tax. The commissioner also

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30PPL Corp. v. Comm’r, 665 F.3d 60, 22-63 (3d Cir. 2011).
31Id. at 63. Nine is an approximation for “the lowest average sectoral price-to-earnings ratio of the companies liable to the tax.” Id. (citing the Joint Appendix at 264). This number, although important in the calculations, is not at issue in this decision.
32Id.
33Reg. section 1.901-2(b)(1); supra notes 22-29 and accompanying text.
34Entergy Corp. v. Comm’r, 683 F.3d 233, 235 (5th Cir. 2012); PPL II, 665 F.3d at 64-65.
35In this section, I will refer to PPL and Entergy as simply PPL. The Supreme Court is reviewing the Third Circuit decision, but Entergy Corp. submitted an amici brief and argues similarly to PPL.
36Brief for Petitioner at 37, PPL v. Comm’r, No. 12-43 (argued Feb. 20, 2013) (citing Minnesota Tea Co. v. Helvering, 302 U.S. 609, 613 (1938)).
37Id. at 38.
38Id. (quoting Petitioner’s Appendix at 79).
39Id. at 39.
40Id. at 41.
41Id. at 42.
43See id.
44Id. at 43-47.
45Id. at 45.
46Id. As mentioned in supra note 16, “income tax” and “excess profits tax” are used somewhat interchangeably here, since both are creditable foreign taxes.
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highlights statements by the U.K. Treasury and a member of Parliament. Ultimately, though, the commissioner concedes that the parliamentary purpose for the tax is somewhat ambiguous, but maintains that the law itself expressly taxes valuation of the companies, not profits.

And finally, the commissioner urges the Court to find that if the FTC is disallowed, double taxation is not a concern. PPL paid the income tax in the United Kingdom in the years it made the income and received an FTC in the United States at that time. Also, PPL can request a deduction for this non-income tax, just not the FTC.

C. Third Circuit Decision

Ultimately the Third Circuit decided that the tax is not creditable because it was not levied on gross receipts. It simplified the formula and found that it was a 23 percent tax on profits multiplied by 2.25. Thus, the base of the tax was greater than profits and could not be the equivalent of gross receipts.

D. Fifth Circuit Decision

The Fifth Circuit was convinced that the windfall tax reaches gross receipts and net income. Profits were the variable in the formula, so the net income requirement is met because, by definition, profits are receipts minus expenses. The Fifth Circuit was persuaded by the Tax Court’s reasoning that the predominant character of the tax was to “claw back” “excess profits,” and the initial profits were calculated based on gross receipts minus expenses, or net income. The Fifth Circuit disagreed with the Third Circuit’s analysis of the gross receipts requirement, simply finding that the tax is imposed by a formula that takes into account actual gross receipts, thus is creditable. Ultimately, the Fifth Circuit held that the predominant character of the windfall tax was to tax excess profits and the formula was able to meet the requirements of reg. section 1.901-2, and therefore Entergy ought to receive the FTC.

E. Supreme Court Decision

The Supreme Court applied the predominant character test explained above and concluded that the windfall tax is creditable. According to Justice Clarence Thomas’s opinion, “the crucial inquiry is the tax’s economic effect.” The Court was convinced by PPL that the tax was a tax on excess profits, which is a creditable income tax according to the code. The commissioner’s argument that the tax was one on the valuation of these companies was not persuasive to the Court, because, according to the opinion, the valuation used by the tax was based on profits. The Court’s ultimate decision was correctly based on the character of the tax. The confusion remains, however, because the lower courts were split and the regulations are unclear and difficult to apply uniformly.

III. Intent

A. Congressional Intent of Section 901

The FTC was originally enacted to prevent double taxation of American citizens or corporations that earn income abroad. In 1918 the highest marginal tax rate approached 77 percent. T.S. Adams, a Treasury tax adviser when the FTC was established, supported the idea of an FTC for the sake of equity. He argued that the high tax rates during World War I were unfair to taxpayers and could potentially bankrupt taxpayers when combined with foreign taxes. The FTC was passed in 1919.

Other arguments, besides fairness, have been made to support the FTC. The FTC made it less expensive to invest overseas, which was important when European countries needed money to rebuild after World War

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54 Id. at 46.
55 Id. at 46-47.
56 Id. at 47-48. For the discussion on the intent of section 901, see infra notes 63-70 and accompanying text.
57 Id. at 47.
58 Id.
59 Id.
60 The Third Circuit simplified the formula to Tax = 23% x \((365 \times 9) - FV)\) and simplifying; \((365 \times 9) / 4 = 2.25\).
61 Id.
62 PPL Corp. v. Comm’r, 665 F.3d 60, 66 (3d Cir. 2011).
64 Id. at 239.
65 Id. at 239.
66 Id. at 1047; S. Adams, “International and Interstate Aspects of Double Taxation,” 22 Proc. Nat’l Tax Ass’n 193, 197 (1929) (“There is something in the legislative mind which recognizes that if one taxpayer is being taxed twice while the majority of men similarly situated are being taxed only once, by the same tax, something wrong or inequitable is being done, which, other things being equal, the legislator should correct if he can”).
I.67 This logic persists despite the lack of a specific need for investment in Europe; the promotion of foreign trade in general is also a reasonable goal of Congress in allowing an FTC.68 Also, Adams believed that the FTC was essential for tax enforcement and legitimacy reasons.69 Finally, some argued that if the United States did not grant an FTC, companies would be incentivized to close their U.S. branches70 and the United States would be unable to collect tax revenue from these companies.

B. Development of the FTC

Although the wording of the FTC changed as the code was amended,71 the basic language that “the tax computed [herein] shall be credited with: . . . the amount of any income, war-profits and excess taxes paid during the taxable year to any foreign country” remained consistent.72 Courts’ applications of this general language, however, have diverged from the initial interpretation. The following cases are examples of how the courts applied the FTC code sections and Treasury regulations since they were passed and promulgated.

In Seatrain Lines, Inc. v. Commissioner,73 the Board of Tax Appeals was persuaded that a 3 percent Cuban tax was an income tax, not an excise tax, for several reasons: that the tax was considered an income tax by the taxing authorities of Cuba, that the forms issued were like income tax forms, and that the setting and development of the tax indicated that it was an income tax.74 The commissioner himself, although arguing that U.S. law was more important, conceded that Cuban law was important in determining the nature of the tax.75 Also, that the Cuban tax was not exactly like the U.S. income tax was not determinative to the court.76 The Board of Tax Appeals stated, “If no deductions were permitted by Cuban statute the tax would still be an income tax.”77

Similarly, in 1943 the Tax Court decided a case in which a U.S. company had paid tax on its gross revenue from mining properties in Mexico.78 The tax was calculated by deducting freight and switching charges, the cost of treatment of the ores, and a production tax from the gross income and then multiplying by 10 percent.79 Santa Eulalia claimed a section 901 credit for $13,000 in 1937 and 1938 for the tax paid to Mexico.80 In determining that the tax was an income tax for U.S. tax purposes, the court considered that from the context of the statute, the tax was intended to be an income tax.81 The court found that the multiple mentions of income in the Mexican statute meant that it was an income tax, even though “the method of determining the tax does not conform strictly to that by which income taxes are computed under our own laws.”82

In another 1943 case, the Third Circuit found that the Québec Mining Tax was not a creditable tax because it was a tax on the “mining privilege” and did not allow deductions for overhead costs of running the business.83 In essence, according to the court, the tax did not reach gain or profit.

In 1972 the U.S. Court of Claims took up a section 901 issue when Bank of America requested an FTC for the Thailand business tax, the Philippine tax on banks, and the Buenos Aires tax on profit-making activities.84 None of these taxes allowed deductions for costs or expenses of doing business.85 The court articulated that it is essential to ensure the base of the foreign tax is gain, not all revenue or income, in order to mirror the U.S. income tax.86 The court pointed out that the constitutionality of a tax on gross income has not been ascertained, so it rejected “the position that all foreign

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67 See id. at 1049.
68 Revenue Act of 1918: Hearing Before the Committee on Ways and Means, 65th Cong. 650 (1918) (statement of Phanor J. Eder, secretary, Mercantile Bank of the Americas) (pointing out that paying income taxes to two countries disadvantages American companies compared with foreign companies that pay income tax only once).
69 T.S. Adams, “Effect of Income and Inheritance Taxes on the Distribution of Wealth,” 5 Am. Econ. Rev. 234, 235 (1915) (“To enforce a progressive income tax the cooperation of the taxpayer must be secured. But to secure his cooperation the rates must be fair and reasonable.”).
70 Supra note 68, at 649.
72 Revenue Act of 1918, section 222. See also IRC section 901(b) (2006) (“The following amounts shall be allowed as the credit: . . . the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year”). See also PPL v. Comm'r, 569 U.S. ____, * n.2 (2013).
73 In Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894, 897-898 (3d Cir. 1943).
74 Santa Eulalia Mining Co. v. Comm'r, 2 T.C. 241 (1943).
75 Id. at 242.
76 Id. at 243.
77 Id. at 245.
78 Id.
79 Id.
80 Id.
81 Id. at 245.
82 See id. at 271-272.
gross income taxes, no matter whether or not they tax or seek to tax profit or net gain, are covered by [section 901].”

Also, the court disregarded the foreign country’s label of the tax, saying that the sole importance of the foreign statute is whether its application is likely to reach net gain, similar to the U.S. income tax. Ultimately, the court concluded that the taxes were not creditable because section 901 clearly indicated that profits are to be taxed, not gross income. This court explicitly highlighted its attempt to comport with the legislative intent of section 901.

The Tax Court analyzed the same taxes as those at issue in Bank of America I and a Taiwanese tax for other tax years and held that the taxes were not creditable because section 901 clearly indicated that profits are to be taxed, not gross income. This court explicitly highlighted its attempt to comport with the legislative intent of section 901.

In Inland Steel, the court analyzed the Ontario Mining Tax (OMT) Act, which “was based solely on sales of unprocessed iron ore.” Caland, a U.S. corporation, claimed an FTC for the $947,537 it paid for the OMT. The court inquired whether the OMT allowed deductions to adjust its base. Accordingly, the court concluded that the OMT did not reach net gain, similar to the U.S. income tax. Ultimately, the court concluded that the OMT did not reach net gain in the United States tax sense, and therefore was not similar to a U.S. income tax. The court then questioned if the tax nevertheless reached net gain. Because so many expenses that would be deductible in the United States were left in the tax base, the court concluded that the OMT did not reach net gain in the U.S. sense.

Inland Steel was decided in 1982, and reg. section 1.901-2 was promulgated in 1983. For purposes of determining if a foreign tax reaches net income, reg. section 1.901-2 explicitly adopts the criterion used by the courts in Inland Steel, Bank of America II, and Bank of America I. Thus, the IRS intended to codify the courts’ interpretations of the net income requirement.

Like the company in Inland Steel, Texassgulf, Inc. was subjected to Canada’s OMT and claimed an FTC for a total of $32 million in 1978, 1979, and 1980. This version of the OMT, however, was somewhat different from the OMT in Inland Steel. In Texasgulf, Inc. v. Commissioner, Texassgulf argued that the tax was creditable because first, this version permitted a processing allowance that, unlike the OMT in Inland Steel, made up for the nonrecoverable expenses that were at issue in Inland Steel; and second, the nonrecoverable expenses were de minimis. The Tax Court agreed with Texasgulf because it found that the processing allowance approximated or exceeded most taxpayers’ nonrecoverable expenses.

On appeal, the Second Circuit analyzed how the tax was applied to all taxpayers, not just Texassgulf, and found that, in the aggregate, the processing allowance approximated the nonrecoverable expenses, so the tax reached net income. The court distinguished Inland Steel because at the time it was decided reg. 1.901-2 had not yet been promulgated, therefore when Inland Steel was decided it was not clear that approximations of nonrecoverable expenses would satisfy the net income requirement.

Exxon Corporation v. Commissioner raises the same question regarding the United Kingdom’s petroleum revenue tax (PRT). In 1974 the U.K. secretary of state for energy warned the government that unless it changed its tax structure, it would forgo potential revenue from crude oil excavation in the North Sea. In response, the United Kingdom replaced the corporate income tax with the ring fence tax and the PRT. Under U.K. law the ring fence tax is an income tax; it requires oil and gas companies to segregate income and

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87 Id. at 273 (“[taxing only gain] comports better with the dominant purpose of the credit to avoid or minimize double taxation of income”).

88 Id. at 274.

89 Id. at 283.


91 Id. at 762.

92 Inland Steel Co. v. United States, 677 F.2d 72 (Ct. Cl. 1982).

93 Id.

94 Id. at 80-81.

95 Id. at 81.

96 Id. at 82.

97 Id. at 84-87. See also Rev. Rul. 85-16, 1985-1 C.B. 180 (“the Ontario Mining Tax is [not] an income tax within the meaning of section 901(b) of the Code”).


99 Id.

100 Texassgulf, Inc. v. Comm’r, 172 F.3d 209, 211 (2d Cir. 1999).

101 Id. at 214. This processing allowance in the new version of the OMT was somewhat like the standard deduction for individuals. When an individual files a tax return he can choose the standard deduction or can itemize deductions; if the itemized deductions add up to less than the standard deduction, the individual will choose the standard. It does not seem like the OMT allowed companies to have a choice, but rather it just allowed a “standard” deduction to all of them.


103 Texassgulf, Inc. v. Comm’r, 172 F.3d at 215 (citing reg. section 1.901-2(a)(1)).

104 Id. at 215-216.

105 Id. at 216-217.


107 Id. at 342.
expenses of North Sea exploration from other income and expenses.108

The PRT is imposed on gross income from North Sea oil and gas retrieval with the purpose of taxing extraordinary profits and accelerating revenue.109 The PRT allows for the deduction of significant costs and expenses, but does not allow the deduction of interest expenses.110 However, it does allow a deduction for “uplift,” or “amounts equal to 35 percent of most capital expenditures relating to a North Sea field.”111 This deduction is provided in lieu of the interest expense deductions.112

The Tax Court held that despite the nondeductibility of interest expenses, the PRT is still a tax because the uplift allowance reduced the tax base to a base more similar to that of the U.S. income tax.113 Also, the court notes that a U.K. government official described PRT as an “excess profits tax.”114 The court found it important, if not dispositive, that PRT was meant to tax excess profits, which is an income tax for purposes of section 901 and creditable in the United States.115 Ultimately, it held that the PRT was an income tax and therefore creditable.116

The previous cases illustrate that the Treasury regulations have not necessarily led to outcomes that meet the initial goal of section 901. Had the courts applied section 901 and the Treasury regulations correctly, the cases all would have been based on whether or not the foreign tax was an income tax and whether applying the U.S. income tax would result in double taxation or undertaxation.

IV. The Importance of Intent

When analyzing if an FTC should be granted to a U.S. taxpayer, the courts sometimes explicitly consider the congressional intent of IRC section 901. In Inland Steel Company v. United States, for example, the court accepted that the prevention of double taxation was the primary goal of the FTC and encouraging foreign investment was a subordinate purpose.117 In Texagulf v. Commissioner the court again explicitly stated that avoiding double taxation was the “design” of the FTC.118 In order to ensure that U.S. taxpayers are not overtaxed or undertaxed, courts must consider if the foreign tax is equivalent to that of a U.S. income tax. Thus, the application of section 901 and its regulations is essential to ensure that the tax base is properly defined.119 The problem lies in the shortcomings of the current code and the regulations; neither allows enough room for the application of congressional intent or an inquiry into double taxation or undertaxation.

A. Congressional Intent

As explained above, the intent of section 901 is to prevent U.S. taxpayers from double taxation on their income.120 Another intent is to prevent income from escaping taxation. Because the United States has chosen to tax its citizens on worldwide income, it had two choices to achieve this intent. First, it could completely exempt foreign-source income from being included on a U.S. tax return. In that case, taxpayers would pay only their foreign-source taxes and would not be required to report that income to the United States on a return. Exemption, however, would allow taxpayers with foreign-source income to escape the principle of taxing citizens on worldwide income. In a jurisdiction with rates lower than the U.S. tax rate, the taxpayer would be in a better position than a U.S. resident paying taxes in the United States. Thus, the United States chose to include foreign-source income on its returns and provide a tax credit for foreign taxes paid.121

How courts apply congressional intent is as important as the intent itself. If courts do not understand, misapply, or otherwise misconstrue the congressional

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108Id. at 344. The court was swayed by the regulation’s language that the tax must “effectively compensate” and “approximate” a tax on net income.
109Id. at 349.
110Id. at 345.
111Id. at 347.
112“The cumulative total amount of uplift deduction allowed to Exxon was £1.8 billion, almost twice the cumulative total £900 million interest expense that under PRT was not allowed as a deduction to Exxon.” Id. Also, the total uplift allowance for all companies was £12.4 billion, £4.2 billion more than the total interest expenses that were not allowed. Id. at 348.
113Id. at 357.
114Id.
115Id. at 359.
116Id. at 359-360.
117 See, e.g., Inland Steel Co. v. United States, 677 F.2d 72, 79-80 (1982) (“the primary objective of the foreign tax credit, however, is to prevent double taxation; election of American foreign trade is a secondary objective”).
118 Texagulf v. Comm’r, 172 F.3d 209, 214 (1998) (finding that the FTC was “designed to ‘mitigate the evil of double taxation’” (quoting Burnet v. Chi. Portrait Co., 285 U.S. 1, 7 (1932))).
119 See, e.g., Entergy Corp. v. Comm’r, 683 F.3d 233, 237 (5th Cir. 2012) (“the gross receipts requirement therefore serves as one mechanism to prevent foreign nations from ‘soaking up’ American tax revenue by levying an income tax on an imputed amount deliberately calculated to reach some amount greater than the business’s actual gross receipts”).
120 See supra notes 63-70 and accompanying text.
121 Adams preferred the use of an FTC over exemption because he thought residence-based taxation was an important “backstop” to source-based taxation. Graetz and O’Hear, supra note 63, at 1038. Allowing an exemption would sacrifice this backstop feature of residence-based taxation. That feeling was echoed by a U.S. committee that discussed international taxation. Members of the committee “preferred the tax credit over an exemption for reasons of progressivity and for concerns over some income escaping taxation altogether.” Id. at 1069 n.193.
intent, the statute is virtually meaningless or may become, in effect, its own antithesis. As demonstrated in the cases above, courts began interpreting section 901 by considering whether the foreign tax is similar to a U.S. income tax. Initially in *Seatrain Lines, Keasbey & Mattison Co.*, and *Santa Eulalia Mining Co.*, the courts were less concerned with whether the tax was calculated in exactly the same way as the U.S. income tax than with whether if it was meant to tax the corporation’s income. In all three of these cases, the court identified the foreign tax as an income tax enough like the U.S. income tax to receive the FTC, despite calculating the tax differently from the way the United States calculates its income tax.122

Many years later, by the 1970s, the cases had developed and courts had come to apply a much more formulaic approach to analyzing whether a foreign tax is a tax on income. In *Bank of America I* and *Bank of America II*, the Court of Claims and Tax Court found that a foreign tax was not an income tax because it did not allow certain deductions that the U.S. income tax would allow.123 *Inland Steel* followed the same logic, holding that because certain deductions were excluded from the OMT, it was not an income tax in the U.S. sense.124 It is easy to fathom that these cases could have been decided incorrectly. Because the court was so determined to compare the U.S. income tax with the foreign income tax, it disallowed a credit based on a difference in formula. It is perfectly reasonable for a country to impose an income tax that is not calculated precisely the same way as all other income taxes (or the U.S. income tax in particular).

Reg. section 1.901-2 codified this formulaic application of the three-prong requirements in *Bank of America I, Bank of America II*, and *Inland Steel*.125 Unfortunately, the regulation has driven courts away from considering the intent and purpose of section 901 and instead forced them to apply a rigid test that does not necessarily ensure that taxpayers will not be double taxed or undertaxed.

The courts applied reg. section 1.901-2 in *Texsgulf* and *Exxon* and found that Canada’s OMT and the United Kingdom’s PRT are creditable taxes because they both allowed a standard deduction of sorts and reduced the tax base to something along the lines of net gain or profit.126 The courts made little to no mention of attempting to uncover whether double taxation or undertaxation would result from a decision either way. The courts were satisfied with deciding the cases based on the rigid application of the Treasury regulation.

The problem is acutely apparent when one realizes that *Texsgulf* and *Inland Steel* dealt with the same tax. The court had disallowed the credit in *Inland Steel*. The court was convinced in *Texsgulf* that the tax became an income tax because it allowed a sort of standard deduction that simulated a tax base closer to net income. The nature of the tax, however, did not change between the two cases, just the method of calculation. Thus, since it was the same tax, meant to apply to the same type of income, one of those cases was wrongly decided. If it was not designed to tax income in the U.S. sense, a slight variation in calculation should not have changed that and made the FTC available to this company.127 This result is just as apt to be abused by foreign countries as would blindly following other countries’ tax labels.

**B. Parliamentary Intent**

In addition to congressional intent becoming less important, the characterization of the foreign tax by the foreign country has also become less meaningful. Of course, there are legitimate reasons not to inflexibly follow the intent of other countries; the United States does not rely on other countries’ statutes and interpretations to determine the interpretation of its laws. Nevertheless, there is ample reason to consider the foreign country’s intent more so in this context than most others.

To be clear about the remaining analysis, it is important to define what is meant by intent. Foreign country intent is not meant to ask what the foreign country

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122 *Santa Eulalia Mining Co. v. Comm*, 2 T.C. 241, 245 (1943) (“although the method of determining the tax does not conform strictly to that by which income taxes are computed under our own laws, we do not think that that determines the nature of the tax”); *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894, 898 (1943) (finding that, although the tax allowed deductions for certain expenses and was calculated on the basis of profits, it was a tax on the mining privilege, not the mine’s income); *Seatrain Lines, Inc. v. Comm*, 46 B.T.A. 1076, 1081 (1942) (allowing the FTC even “if no deductions were permitted” because the tax was levied on income).


124 *Inland Steel Co. v. United States*, 677 F.2d 72, 82 (1982). Interestingly, the Third Circuit in *PPL Corp. v. Comm* interpreted *Inland Steel* and *Bank of America* as not applying the three requirements articulated in the regulations, and rather indicated that these cases erroneously considered the predominant character of the tax. *PPL Corp. v. Comm*, 665 F.3d 60, 64 n.1 (2011). The IRS, however, looked to *Bank of America* and *Inland Steel* when writing reg. section 1.901-2. *See supra* note 98 and accompanying text. Thus, it would seem that the Third Circuit is somewhat mistaken in its interpretation of *Inland Steel* and *Bank of America*.

125 *See supra* note 98 and accompanying text.


127 *Calculation method may matter in some situations, but the important point and what this article ultimately shows is that the nature of the tax is what is important, not the calculation. Thus, the calculation may be illustrative of the nature of the tax, but should not be determinative of whether it is an income tax or not.*
intends to call income, but rather if the foreign country intends to tax income as it is defined in the United States. To illustrate, suppose a foreign country implements a consumption tax but calls it an income tax. This proposal does not advocate that the United States grant an FTC for the consumption tax paid. On the other hand, if a foreign country implements a (perhaps very low rate) tax on gross receipts, that would not qualify for an FTC in the United States because it does not satisfy one of the prongs of the regulations. This article argues that it is still an income tax and might deserve FTC treatment. In order to avoid double taxation or undertaxation of income it is important to ascertain whether the foreign governing body was attempting to tax or succeeded at taxing net income. Considering the language, interpretation, and history of the statute will only help our courts interpret and apply section 901 as close to perfectly as possible.

Considering foreign countries’ interpretations of their own laws seems to have been at least a factor in the early decisions. In Seatrain Lines Inc., the commissioner actually admitted that the Cuban interpretation of the law was important in determining if it was an income tax in the U.S. sense. The court there also considered how the Cuban authorities understood the tax and how the paperwork functioned and found that the historical development of the tax all indicated that it was an income tax. Later in Santa Eulalia Mining Co., the Tax Court found it important that the context of the statute considered the Mexican tax an income tax. Even in Inland Steel, the court considered the history and purpose of the OMT. These cases stayed true to the intent of section 901 and most accurately reflected the anti-double-taxation and anti-undertaxation principles of the FTC because they considered the characteristics of the tax base.

As time went on, though, the courts became less inclined to even consider how the foreign country characterized the foreign tax. The Tax Court in Texasgulf did not mention Canada’s characterization of the OMT, despite the consideration of it in Inland Steel. In Exxon, the Tax Court at least mentioned that a government official called the PRT an “excess profits tax.” Despite that brief mention, though, the court based its decision on “credible expert witness testimony, industry data, and other evidence.” Leaving aside whether these corporations should have received an FTC, it is alarming that the court failed to consider the intent of the statute, considering that the United States sacrificed revenue on the basis of the wrong type of analysis. If the court continues to disregard consideration of double taxation and undertaxation, there is the potential for the technical and formulaic regulations and precedents to completely undermine the entire purpose of granting an FTC.

It is clear from the early cases’ strong reliance on foreign interpretation of foreign statutes and current cases’ weak or nonexistent discussion of foreign interpretation of foreign statutes that courts are less inclined to even consider a foreign country’s statutory intent.

C. The Role of Intent in PPL

In PPL v. Commissioner and Entergy v. Commissioner, both circuit courts provided a background of the windfall tax and its intent. However, in determining that the windfall tax was not creditable, the Third Circuit states that it is considering the “predominant character” of the tax, but never considers any U.K. interpretation or evidence to ascertain that predominant character. Also, the Fifth Circuit, despite disagreeing with the Third Circuit, expressly dismisses the commissioner’s argument that it should look to the text of the windfall statute to determine its predominant character. It then goes on to resolutely apply the three-prong analysis of the net income test. Disregarding congressional and parliamentary intent is, as stated above, disconcerting when the attention to intent is replaced with a rigid formulaic test.

In its opinion, the Supreme Court did not discuss the intent of section 901 or the importance of double taxation or undertaxation. It did, however, ultimately make its decision based on the predominant character being that of an income tax in the U.S. sense, which reaches the correct conclusion. The Fifth Circuit’s application of the principle is more in line with this consideration than the Third Circuit’s, since it did discuss the “practical operation” of the windfall tax. The Third Circuit erroneously interpreted the Treasury regulations to disallow considering the holistic predominant character, despite the regulations’ explicit

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129 Id.
130 Santa Eulalia Mining Co. v. Comm’r, 2 T.C. 241, 245 (1943).
131 Inland Steel Co. v. United States, 677 F.2d 72, 82 (1982).
132 See Texasgulf, 172 F.3d at 209.
134 Id. at 359.
135 Entergy Corp. v. Comm’r, 683 F.3d 233, 234 (5th Cir. 2012); PPL Corp. v. Comm’r, 665 F.3d 60, 62-63 (3d Cir. 2011).
136 PPL II, 665 F.3d at 64.
137 As mentioned above, the Third Circuit dismissed discussion of the predominant character of the tax by stating that previous courts were wrong in their interpretations in Inland Steel and Bank of America I. See supra note 124.
138 Entergy II, 683 F.3d at 236.
139 Id. The Fifth Circuit, however, may have gotten closer to a satisfactory result by factoring in the statute’s “practical operation” to recover these energy companies’ excess profits, despite explicitly rejecting this type of interpretation from the commissioner.
adoption of Inland Steel and Bank of America II.\textsuperscript{140} Despite the Supreme Court’s ultimately correct decision, more needs to be done to ensure that taxpayers (and other governments) are forewarned of tax treatment and to ensure that the U.S. achieves equity in taxation.

V. The Code and Regs Should Be Amended

Reg. section 1.901-2 was written to guide the IRS and courts in achieving the goal of preventing double taxation or undertaxation of residents. The three prongs were meant to help the IRS and courts compare the foreign tax at issue with the U.S. income tax, and then to determine if it is similar enough to grant a credit. As previously stated, though, the regulation has become a rote checklist that requires a foreign tax to look exactly like and be calculated exactly like the U.S. income tax. This has driven the application of section 901 away from its intent and harms the very taxpayers section 901 was enacted to protect. The code and regulations should be amended to bring section 901 application back into conformity with its intent to achieve its goal of relieving taxpayers from double taxation and undertaxation.

A. Amendments

IRC section 901 should be amended to emphasize the importance of intent in its application. A subsection or sentence should be added beneath section 901(b)(1) to require that the secretary and courts consider the “predominant character” of the tax. This requirement exists in the regulation as it is currently written, but codifying it will emphasize the importance of a holistic approach to the application of section 901 and therefore the importance of prioritizing its intent, not the regulation’s three-prong test.

Also, reg. section 1.901-2 should be amended to require that the courts simply use these prongs as factors in their analysis of foreign taxes and whether to grant an FTC.\textsuperscript{141} Reg. section 1.901-2(a)(3) should be amended to state:

When determining if the predominant character of a foreign tax is that of an income tax, the IRS and courts should consider the following factors. These factors shall not be applied as an inflexible checklist, but rather should be used to determine if the foreign tax is in fact an income tax.

Moreover, the regulations should include instructions that the courts and the IRS include the foreign country’s characterization of the tax as one of the factors as well. The language in the statute, the legislators’ arguments, and the circumstances leading up to the passage of the tax are all informative of what type of tax it is. Of course, in some instances the foreign country may be aiming to take advantage of the United States’ FTC,\textsuperscript{142} but applying these regulations and considering the predominant character of the tax will expose those plots.

B. Application of Amendments

With these amendments, FTC cases would be much easier for the courts to decide correctly. As explained above, the court found that the OMT was not a tax in Inland Steel, but when applying the rigid regulations, it found in Texasgulf that the same tax was a creditable tax because of a simple change in the formula.\textsuperscript{143} The court should have considered whether the tax, as a whole, had the character of an income tax, despite how it was calculated. Had it done that, Texasgulf likely would have come out differently.

There is also a chance for a case to result in an income tax not being credited because it does not meet the three-prong test, despite its intent to tax income in the foreign country. For example, if a foreign country taxes income on a mark-to-market system, it would not satisfy the realization requirement in the United States, even though it may satisfy the gross income and net income requirements. This tax would be a different type of income tax, but an income tax nevertheless, and the U.S. taxpayer would get no relief from double taxation, as is the purpose of section 901. It is easy to see how the inflexible application of the regulations could completely avoid the purpose of section 901.

In PPL, the Fifth Circuit implicitly considered the character of the windfall tax, while the Third Circuit noticeably did not. Looking at the net income factors, which were not overwhelmingly helpful as evidenced by the two circuits finding different results, in conjunction with the purpose of the windfall tax, it was likely an income tax and therefore creditable.\textsuperscript{144} The tax

\textsuperscript{140}PPL II, 665 F.3d at 64 n.1. This footnote in PPL alludes to the essential argument of this article, acknowledging that the cases and regulations are “in tension with one another.” Id. The Third Circuit simply dismissed the tension by saying the text of the regulations prevails because the preamble is not part of the regulations. Id. This conclusion is dismissive and incorrect.

\textsuperscript{141}Cf. King v. Comm’t, 458 F.2d 245, 249 (6th Cir. 1972) (“these portions of the regulations are so broadly drawn that they may be used in some cases to defeat the clear legislative intent”).

\textsuperscript{142}For example, a country may implement an excise tax calculated on profits and call it an income tax, hoping that U.S. taxpayers will get a credit and therefore will not be dissuaded from investing in that country. In essence, that country is hoping to reap the tax revenues that belong to the United States.

\textsuperscript{143}Some will argue, as the court did, that it was not a simple change in the formula, but an allowance for the deduction of expenses that made the tax more like a U.S. income tax. This is not a sufficient explanation, however, because foreign countries can simply calculate a tax similar to the way the U.S. calculates income tax, then increase the tax rate to receive the same revenue. The U.S. treatment of a foreign tax should not mechanically depend on the calculation of the foreign tax in ignorance of its character and whether it is, in fact, an income tax.

\textsuperscript{144}Entergy Corp. v. Comm’t, 683 F.3d 233 (5th Cir. 2012).
could arguably be on either net income or on the difference between the valuation of the companies at the time of sale and now. What is the tipping point here is why Parliament enacted the statute: to correct the exploitative profitability of these companies and tax the excess profits.\textsuperscript{145} Thus, this was an income tax and creditable.

One could still argue that this was a tax on value and that therefore my proposal is not helpful. However, the strongest support for the tax is not that someone in Parliament spontaneously thought the companies had been undervalued; rather it was the efficiency the companies had achieved and their profitability. Ultimately it was the income that Parliament wanted to tax, not the value of the companies. Applying my approach would lead both courts to this answer and avoid the confusing split that resulted under the current regulations.

C. Criticisms

First, some critics will say that the three factors that are detailed in the Treasury regulations achieve exactly what this article is proposing: a simplified way to apply the ultimate goal of section 901. What the analysis above has shown, however, is that after the regulations were promulgated and applied by courts, the courts rigidly applied those factors to determine if an FTC was appropriate, to the detriment of the overarching goal of section 901: preventing double taxation and undertaxation.

Also, IRC section 903 includes a credit for a tax paid in lieu of income, war profits, or excess profits. Thus, some may criticize this proposal as being superfluous, given that if a tax does not meet the strict requirements of section 901, it could reach the requirements of section 903 and be creditable.\textsuperscript{146} This criticism overlooks the importance of ensuring that the intent of section 901 is met in its application. If the IRS and courts are misapplying section 901, it does not matter if a taxpayer may be granted relief under another section. The correct application of section 901 will avoid double taxation and undertaxation, instead of relying on another section to pick up the slack. Also, if section 901 is incorrectly applied and the IRS or a court grants a credit when it is not warranted, section 903 will not remedy that.

Alternatively, some may argue that this proposition is likely to overcredit and therefore undertax by making it easier for courts to find that the foreign tax is enough like an income tax. It is not apt to result in overcrediting and undertaxation; instead, it will likely result in more accurate results, results that better comply with the intent of section 901. If this means that more credits are granted than have previously been granted, so be it; section 901 should be applied accurately. The correct implementation of a statute should not be sacrificed for the benefit of the public coffers.

Finally, others will argue that these regulations would be too amorphous and therefore difficult to apply. My response, again, is that these regulations, although less linear and therefore less systematic for courts to apply, are more likely to lead to accurate results that comply with the intent of section 901. Thus, they are more desirable than the current regulations. Also, there are other statutes, regulations, and common law that are vague and difficult to implement,\textsuperscript{147} yet Congress and the courts are willing to allow them for the sake of the most correct results possible. Congress, agencies, and the courts are human institutions and the lack of flexibility “would seriously impair the effective administration of the tax policies of Congress.”\textsuperscript{148}

VI. Conclusion

This article has focused on the intent of section 901 and its regulations. It has concluded that the current interpretation of section 901 and reg. section 1.901-2 is not sufficient to correctly answer the question whether a complicated foreign tax is an income tax for U.S. purposes. This difficulty is squarely represented in the cases of Entergy v. Commissioner and PPL v. Commissioner. If the code and the regulations, however, are amended somewhat to force the IRS, taxpayers, and the courts to truly consider the predominant character of the foreign tax, it is likely that section 901 will be more accurately applied and achieve its ultimate purpose of not double taxing or undertaxing U.S. taxpayers.

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\textsuperscript{145} See Chennells, \textit{supra} note 7, at 1. Remember, this article refers to the “income tax” as a creditable foreign tax, but that includes excess profits and war profits taxes as articulated in the code. See \textit{supra} note 16.

\textsuperscript{146} Bank of Am. Nat’l Trust & Sav. Ass’n v. Comm’r, 61 T.C. 752, 761 (1973) (“in enacting [section 903], Congress was concerned that the provisions of section 901(b)(1) provided too narrow a base for determining the availability of the foreign tax credit” (citing Motland v. United States, 192 F. Supp. 358 (N.D. Iowa 1961))).

\textsuperscript{147} See, e.g., \textit{San Antonio Ind. Sch. Dist. v. Rodriguez}, 411 U.S. 1, 98-99 (1973) (Stewart, J., dissenting) (“a principled reading of what this Court has done reveals that it has applied a spectrum of standards in reviewing discrimination allegedly violative of the Equal Protection Clause”).

\textsuperscript{148} Comm’r v. Court Holding Co., 324 U.S. 331, 334 (1945).