subject to the APA as are other federal agency regulations.

Whether this means that more regulations will be invalidated or whether Treasury will revisit deficient regulations and provide a reasoned explanation remains to be seen. While it may be tempting to argue that a broad spectrum of guidance is invalid, it is difficult to believe that these cases alone provide a basis to negate decades of such guidance. A more thoughtful approach is likely required to select which regulations may be susceptible to a successful challenge. ■

Entergy v. Commissioner: The "Untenable" Circuit Split

By Matthew R. Sontag*

In a prime example of the incongruous outcomes that can flow from the U.S. circuit court system, on June 5, 2012, the Fifth Circuit split from recent Third Circuit precedent and allowed a U.S. foreign tax credit for the U.K. Windfall Profits Tax (Windfall Tax). As a result, two taxpayers with "materially identical facts" have sustained incremental U.S. federal income tax liabilities on dividend income from a foreign affiliate that differ by tens of millions of dollars based solely on the parent's appellate venue.

The importance, and potentially lasting influence, of this circuit split flows directly from the courts' divergent analysis of the specific implementation of the foreign tax at issue. Any discussion must therefore begin with the precise and calculated manner in which the Windfall Tax was forged.

The U.K. Windfall Profits Tax

From the late eighties to the mid-nineties, the British government sold 32 then-public utilities into private hands. Freed of state control, the performance of these businesses rapidly surpassed even the most optimistic projections. As a result, corporate insiders and the privatizing investors realized enormous—and politically untenable—profits.

In an attempt to minimize the fallout, the U.K. government formulated the Windfall Tax, a charge to be levied only once, and only upon the 32 specific privatized taxpayers. Imposed at a nominal rate of 23%, the Windfall Tax applied to the difference between each of the formerly-public companies' "flotation price" and its "profit-making value."

As a mechanism to simplify valuation, the enacting statute defined profit-making value as nine times the annual earnings of the company averaged, in almost every case, over the four years following privatization. (The actual formula was 23% x [{(365 x (Profits / 1,461)) x 9} – Flotation Value]. *PPL Corp. v. Commissioner,* 135 T.C. 304, 328 (2010).) This calculation could be mathematically reformulated as an incremental 52% surtax on after-tax annual profits in excess of that which produced a flotation-price-to-earnings ratio of 9, being "the lowest average price/earnings ratio of the taxpaying companies during the relevant periods, grouped by sector." *Id.* at 314–15, quoting the U.K. Inland Revenue announcement dated July 2, 1997.

It is important to remember that, despite the complex calculation required, at its core the Windfall Tax was explicitly designed to impose a specific charge at a specific rate on a specific set of entities, based entirely on events which had already transpired at the time of enactment. The Windfall Tax ultimately achieved precisely that goal—31 of the 32 privatized companies paid the Windfall Tax, 29 of them at or near the 52% reformulated rate. *Id.* at 329. Ultimately the forecasted revenues from the Windfall Tax matched the actual money raised with "extreme accuracy." *Entergy Corp. v. Commissioner*, 683 F.3d 233, 238 (5th Cir. 2012) (*Entergy II*). Finally, consistent with its purpose, the Windfall Tax was a one-time charge—having provided for a single levy against profit-making value for a specified known group of companies, the Windfall Tax never again applied under any circumstances to any taxpayer.

The Credit and the Tax Court Opinion

At the time the Windfall Tax was assessed, U.S. companies had come to own significant stakes in several of the privatized enterprises. Typically, these U.S. investors responded to the Windfall Tax by claiming a deemed-paid credit under section 902 against the U.S. tax imposed on dividends received from the U.K. companies. The Service challenged these credits, and litigation ultimately ensued. The two cases giving rise to the circuit split, *PPL* and *Entergy*, were decided by the Tax Court in favor of the respective taxpayers on September 9, 2010, under the same written opinion. The opinion issued in *Entergy* states simply that that case, having "materially identical facts," was decided—without further discussion—in reliance upon the decision and opinion rendered in *PPL*. *Entergy v. Commissioner*, T.C. Memo 2010-197, 100 T.C.M. (CCH) 202 (2010).

In the *PPL* opinion, the Tax Court sought to determine whether the Windfall Tax was an "income, war profits, or excess profits tax" as those

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terms are used in the statute. *See* I.R.C. § 901(b)(1). To meet this standard, a levy must have "the predominant character" of an "income tax in the U.S. sense," meaning that such levy satisfies the realization, gross receipts, and net income tests defined under the regulations. *See* Treas. Reg. § 1.901-2(a)(3)(ii), -2(b)(1).

In opposing creditability, the Service argued that the intention behind the Windfall Tax, and the history of its enactment, were irrelevant to the analysis, and that any purported tax must be examined based exclusively on its statutory text. Conducting such an examination, the Service concluded that the Windfall Tax met none of the three tests of realization, gross receipts, or net income, and was therefore not an income tax in the U.S. sense, rendering the amounts paid not creditable. *See PPL*, 135 T.C. 330–32.

The Tax Court, agreeing instead with the taxpayers, took a different view of both the permissible sources of information and the conclusions to be drawn from the three-prong test. In the court's view, the history and intent of the statute are central to determining its "predominant character," and the Windfall Tax, against such background, ultimately met each of the three tests. The Tax Court therefore held the tax creditable to all taxpayers. *Id.* at 342. The Commissioner promptly appealed the decision to the circuit courts, the Third Circuit for PPL (a Pennsylvania corporation) and the Fifth Circuit for Entergy (a Texas corporation).

The Third Circuit

The Third Circuit took the first bite at the Tax Court's apple, rejecting Judge Halpern's reasoning and concluding that the Service had the better argument. *PPL Corp. v. Commissioner*, 665 F.3d 60 (3d Cir. 2011), *petition for cert. filed*, 2012 WL 2834244 (July 9, 2012) (No. 12-43) (*PPL II*). Holding that proper deference to the Regulations forbade a mathematical reformulation of a foreign statute's literal language into a form more conducive to creditability, the court found that the Windfall Tax, with its use of the "flotation" and "profit-making" values of the companies against which it was imposed, was, and *could only be*, a tax imposed—at least in part—on *value. Id.* at 65.

Even were it to consider a reformulated expression of the Windfall Tax that removed the "value" terms—which it explicitly refused to do—the Third Circuit felt that the Windfall Tax remained non-creditable. *Id.* As a levy imposed at a given rate on 9/4ths, or 2.25 times, the profits earned in the base period, the Third Circuit concluded that the Windfall Tax failed the gross receipts test. *Id.* at 67–68.

Perhaps anticipating this roadblock, the taxpayer and the Tax Court had further reformulated the levy as one imposed at a rate of approximately 52% on 1x the base period profits to the extent they exceeded 11% of each company's flotation value annually. *PPL*, 135 T.C. at 328–29. The Third Circuit concluded that to do so would "read the gross receipts requirement out of the Regulations." *PPL II*, 665 F.3d at 67. In keeping with a regulatory example that denies a credit for tax imposed based upon a mere 105% of gross receipts, the Third Circuit concluded that a levy—at whatever rate imposed—that by its literal terms reaches more than actual gross receipts does not meet the gross receipts test and thus cannot be a creditable tax. In dicta, the court further suggested that imposing the tax on net profits in excess of those actually earned also failed, for similar reasons, the net income requirements. *Id.* at 67–68.

As a result, PPL was barred from claiming a credit for the amount of Windfall Tax it was deemed to have paid. More significantly, with *PPL II* as precedent, Third Circuit taxpayers arguably cannot look beyond the literal language of a foreign statute to its intention or practical operation to determine whether it represents a creditable income tax in the United States.

The Fifth Circuit

Unpersuaded by either the Service or the Third Circuit's six-month-old opinion, the Fifth Circuit instead embraced both the history and the higher mathematics presented by the taxpayer. *Entergy II*, 683 F.3d at 236. Though "chary to create a circuit split," the Court nonetheless resoundingly rejected the rationale of the Third Circuit as "exemplif[ying] the form-over-substance methodology that the governing regulation and case law eschew." *Id.* at 237.

In explaining its decision, the Fifth Circuit described the ultimate purpose of the gross receipts requirement as a guard against foreign governments using inflated notional receipts calculations to implement a disguised "soak-up" tax, thereby shifting revenue from the U.S. Treasury to their own. Consistent with this purpose, the examples under the Regulation explicitly provide opposing fact patterns that "differentiate between permissible *imputed* actual gross receipts and impermissible notional amounts." *Id.* at 237–38 (emphasis in the original). In the first pattern, being the first two examples, the actual amount of gross receipts is difficult to calculate and the use of a formulaic amount, designed to approximate as best able the actual amount, does not render the levy non-creditable. *See* Treas. Reg. § 1.901-2(b)(3)(ii) Ex. 1 & 2. In the second pattern, being the third example (cited by the Third Circuit for its conclusions), the notional amount is "fictionally exaggerated," producing an amount clearly in excess of actual gross receipts, thus rendering the tax imposed thereby non-creditable. *Entergy II*, 683 F.3d at 238. *See* Treas. Reg. § 1.901-2(b)(3)(ii) Ex. 3.

Critically, unlike the Third Circuit, the Fifth Circuit declined to read the 9/4ths multiplier in the Windfall Tax as increasing actual gross receipts to a

notional amount. To the contrary, for the Windfall Tax, "there was no need to calculate imputed gross receipts; gross receipts were actually known," rendering the third example "facially irrelevant." Instead, the Fifth Circuit implicitly concluded that the 9/4ths multiplier served merely to adjust the tax rate. The Court articulated this view through a hypothetical extension of the Windfall Tax to encompass nine actual years. In such case, the Fifth Circuit stated, the multiplier would become 1, and even under the logic of the Third Circuit, the Windfall Tax would be creditable. The Fifth Circuit saw no reason to treat the Windfall Tax as actually enacted differently from this hypothetical version, and therefore held it creditable. *Entergy II*, 683 F.3d at 238.

Looking Ahead

As a result of their respective technical interpretations of the relevant regulation, the divergent decisions of the Third and Fifth Circuits have placed two taxpayers with "materially identical facts" into fundamentally different tax positions. The differences in these tax positions is ultimately based solely on the taxpayers' respective locations of tax litigation, thus throwing into sharp relief a fundamental risk of our system of circuit court precedent. Of wider impact is the fundamental basis on which each decision was reached: taxpayers in Texas, Louisiana, and Mississippi may for the moment confidently argue creditability based on history and mathematical reformulations, while their counterparts in Pennsylvania, New Jersey, and Delaware had best not count on such arguments, at least for now.

A circuit split of this nature cries out for resolution by the Supreme Court. As stated in the Petition for Writ of Certiorari in *PPL v. Commissioner*, filed July 9, 2012, the Third Circuit—or perhaps the Fifth—"creates a direct, acknowledged, and untenable circuit split, adopts a deeply flawed approach to creditability that is irreconcilable with the governing regulation and case law, and casts a long and lingering shadow over the creditability of foreign taxes paid by U.S. taxpayers." 2012 WL 2834244, at *35. Whether the Supreme Court will heed this cry remains to be seen. ■

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taxes when the rebates are for pre-tax premium contributions. *See* Frequently Asked Questions, www.irs.gov/newsroom/article/0,,id=256167,00.html. Plan sponsors must determine whether rebates are plan assets and ensure that they are used consistently with applicable fiduciary responsibilities. *See* Department of Labor Technical Release 2011-04.

Longer Term Issues

The following provisions are effective in 2014 or later. Although employers should consider how to address them, a final decision is not yet needed.

Employers with more than 200 full-time employees were to provide automatic health plan enrollment for employees. Fair Labor Standards Act § 18A, added by Affordable Care Act § 1511. This requirement has been delayed until the Department of Labor issues guidance. DOL Technical Release 2012-01. The Department has indicated that the regulations may not be issued until 2014. As comments have noted, automatic health plan enrollment is far more challenging than automatic 401(k) plan enrollment because of the variety of plans and types of coverage *(e.g.*, single versus family) offered by larger employers.

A 40% excise tax (the "Cadillac tax") takes effect in 2018 for health coverage costs exceeding $10,200 for single coverage and $27,500 for family coverage.

Nondiscrimination rules apply to insured health plans. Public Health Service Act (PHSA) § 2716; I.R.C. §§ 9815(a), 105(h). Notice 2010-63, 2010-41 I.R.B. 420, requested public comments on guidance needed regarding section 2716. Treasury, the Service, and the Departments of Labor and Health and Human Services determined that compliance with section 2716 should not be required until regulations or other administrative guidance of general applicability has been issued. "In order to provide insured group health plan sponsors time to implement any changes required as a result of the regulations or other guidance, the Departments anticipate that the guidance will not apply until plan years beginning a specified period after issuance. Before the beginning of those plan years, an insured group health plan sponsor will not be required to file IRS Form 8928 with respect to excise taxes resulting from the incorporation of PHS Act § 2716 into § 9815 of the Code." Notice 2010-63, *supra*; *see also* Notice 2011-1, 2011-1 C.B. 259, containing a further request for comments.

Information is required about the availability of coverage through exchanges. The Affordable Care Act requires employers to provide employees with a written notice about the exchanges by March 1, 2013. New employees must be given notice at the time of hire. Act § 1512.

Penalties will be imposed on large employers that do not provide health benefits to full-time employees or provide health benefits that are not affordable or do not provide minimum value. I.R.C. §§ 4980H, 5000A. ■