No. 12-43

In the
Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF FOR PETITIONERS

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QUESTION PRESENTED

To avoid double taxation, section 901 of the Internal Revenue Code allows U.S. corporations a tax credit for income, war profits, or excess profits taxes paid to another country. Since at least 1938, when this Court first addressed the issue, courts have looked beyond a foreign tax's form and labels and considered its practical operation and intended effect when determining whether it is creditable for U.S. tax purposes. This case involves the application of section 901 to a "windfall tax" imposed by the United Kingdom. Although it is undisputed that the tax's practical effect is to impose a 51.75% tax on the "excess profits" certain companies earned in the four years after they were privatized, the Third Circuit—at the Commissioner's urging—reversed the Tax Court's considered judgment and, departing from decades of precedent, deemed the tax non-creditable merely because the U.K. statute nominally taxes the difference between two numbers, one of which is driven exclusively by profitability during the four-year period, rather than nominally taxing the profits themselves.

The question presented is:

Whether, in determining the creditability of a foreign tax, courts should employ a formalistic approach that looks solely at the form of the foreign tax statute and ignores how the tax actually operates, or should employ a substance-based approach that considers factors such as the practical operation and intended effect of the foreign tax.

RULE 29.6 STATEMENT

PPL Corporation is a publicly traded Pennsylvania corporation. No publicly held company owns 10% or more of PPL Corporation's stock.

The following subsidiaries of PPL Corporation have an interest in this litigation: (1) PPL Energy Funding Corporation, which is wholly owned by PPL Corporation; (2) PPL Global, LLC, which is wholly owned by PPL Energy Funding Corporation; (3) PMDC International Holdings, Inc., which is wholly owned by PPL Global, LLC; and (4) PPL UK Holdings, LLC, which is wholly owned by PMDC International Holdings, Inc.

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The Court of Appeals' opinion is reported at 665 F.3d 60 and reproduced at Pet.App.1. The Tax Court's opinion is reported at 135 T.C. 304 and reproduced at Pet.App.22.

JURISDICTION

The Court of Appeals rendered its decision on December 22, 2011, and denied a petition for rehearing on March 9, 2012. On May 10, 2012, Justice Alito extended the time for filing a petition to and including July 9, 2012. The petition was timely filed and granted on October 29, 2012. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The relevant portions of section 901 of the Internal Revenue Code, 26 U.S.C. § 901, and Treasury Regulation § 1.901-2 are reproduced in the appendix to this brief. App. 1a–49a.

STATEMENT OF THE CASE

This case involves the creditability for U.S. tax purposes of a "windfall tax" imposed by the United Kingdom on a group of companies that were privatized during the 1980s and 1990s. It is undisputed that the U.K. statute's practical effect was to impose a 51.75% tax on the "excess profits" the companies earned in the four years after they were privatized. For reasons involving the British political dynamic at the time and having nothing to do with the substance of the tax, however, the U.K. government structured it as a tax on the difference between two numbers or "values"—one of which was driven

exclusively by actual income earned during the four-year tax period—rather than as an express tax on income. The question before this Court is whether the creditability of the windfall tax under section 901 should turn, as the Commissioner has argued, on the labels and form the U.K. government chose to employ or, as the regulation, the case law, and common sense instruct, on the practical operation of the windfall tax.

A. Statutory and Regulatory Background

When Congress enacted the federal income tax in 1913, it chose to tax all income earned by U.S. citizens and corporations, including income earned and taxed abroad. *See* Revenue Act of 1913, Pub. L. No. 63-16, 38 Stat. 114. Although Congress allowed U.S. taxpayers to deduct taxes imposed by foreign countries from their income, it initially did not give taxpayers a credit for those taxes—even income taxes—against their U.S. tax liability. As a result, the U.S. tax scheme created a significant potential for double taxation of income earned abroad. When combined with "taxes levied in the United States," "the corresponding high rates imposed by certain foreign countries … place[d] a very severe burden upon" U.S. citizens and corporations earning income abroad. H.R. Rep. No. 65-767, at 11 (1918). To alleviate that burden, Congress enacted the foreign tax credit, which provides U.S. citizens and corporations a credit for "the amount of any income, war-profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein." Revenue Act of 1918, Pub. L. No. 65-254, §§ 222, 238, 40 Stat. 1057, 1073, 1080.

The "primary design" of the foreign tax credit "was to mitigate the evil of double taxation." *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932). The provision focused on income and profits taxes because those taxes raised the prospect of double taxation, in that the same income or profits would be taxed twice—once by the foreign government and once by the United States. Other foreign taxes, such as real estate taxes, continued to be subject only to a deduction, which roughly paralleled the treatment of those taxes domestically. The credit also was intended "to produce uniformity of tax burdens among U.S. Taxpayers, irrespective of whether they engaged in business abroad or in the United States," *Phillips Petroleum Co. v. Comm'r*, 104 T.C. 256, 283–84 (1995), and served the important purpose of "facilitat[ing] the[] foreign enterprises" of domestic corporations. *Chicago Portrait*, 285 U.S. at 9. In addition, as Congress recognized, double taxation of income earned abroad "places American business concerns at a serious disadvantage in the competitive struggle for foreign trade." H.R. Rep. No. 67-350, at 8 (1921). By eliminating that disadvantage, the foreign tax credit helped grow the U.S. tax base and economy as a whole. In the century since its enactment, the credit has become a critical feature of the U.S. income tax system: Domestic corporations claim tens of billions of dollars in foreign tax credits each year. *See* Scott Luttrell, IRS SOI Bulletin, *Corporate Foreign Tax Credit 2007*, Summer 2011, 140 fig.B, (foreign tax credits claimed from 2003 to 2007 ranged between $50 billion and $86 billion a year).

Although Congress has amended the foreign tax credit statute from time to time, the provision setting

forth which taxes are creditable—"income, war profits, and excess profits taxes"—has remained unchanged since its enactment in 1918 and is now found at section 901(b)(1) of the Internal Revenue Code, 26 U.S.C. § 901(b)(1). The guiding principle underlying interpretation of the statute also has remained unchanged: Since this Court first considered the issue nearly 75 years ago, it has been settled law that the meaning of terms employed in the foreign tax credit statute is to be derived from "our own revenue laws," not from the revenue laws of foreign countries. *Biddle v. Comm'r*, 302 U.S. 573, 579 (1938). Whether a foreign tax is an "income," "war profits," or "excess profits" tax thus depends on the substance of U.S. tax law, not on the labels or form chosen by the country that imposes the tax.

Consistent with this Court's direction, federal courts have looked beyond the form of foreign taxes to their substance, even treating, for example, a foreign tax nominally on gross receipts—not net income or profits—as creditable when its practical operation was as a tax on net income. *See Bank of America Nat'l Trust & Sav. Ass'n v. United States* ("*Bank of America I*"), 459 F.2d 513, 520–21 (Ct. Cl. 1972) (discussing cases). In 1983, the Treasury Department promulgated a regulation addressing whether a foreign tax is an income, war profits, or excess profits tax. *See* Treas. Reg. § 1.901-2. The preamble to the regulation explains that the "predominant character" standard the regulation sets forth is meant to adopt the same substance-based approach to creditability employed in *Bank of America I* and other pre-regulation cases. 48 Fed. Reg. 46,272, 46,273 (Oct. 12, 1983).

Under the regulation, which uses the term "income tax" to refer to all three types of taxes, a tax is creditable if "[t]he predominant character of that tax is that of an income tax in the U.S. sense." § 1.901-2(a)(1)(ii). To meet that "predominant character" standard, a tax must be "likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(3)(i). That is the case "if and only if the tax, judged on the basis of its predominant character, satisfies" three tests: It must be imposed (1) on realized income (*i.e.*, income that has already been earned), (2) on the basis of gross receipts (*i.e.*, revenue), and (3) on net income (*i.e.*, gross receipts minus significant costs and expenditures). § 1.901-2(b)(1)–(4). Those three tests track the traditional definition of a U.S. income tax. *See, e.g.*, *Eisner v. Macomber*, 252 U.S. 189, 207–08 (1920). In short, to be creditable, the "predominant character" of a foreign tax must be such that it typically reaches realized gross receipts less deductible expenses—that is, net gain.

B. The U.K. Windfall Tax

The story of the U.K. windfall tax begins in 1979 when the Conservative Party won control of Parliament. During the nearly two decades of Conservative Party rule that followed, the government brought substantial new foreign investment into the United Kingdom by privatizing dozens of nationalized companies, including many regulated utilities. JA256. To accomplish its objectives, the government typically would transfer a nationalized company to a new public limited company and offer shares of the new company to the public at a fixed price per share. In U.K.

parlance, that initial share offering is known as "flotation." After flotation, the company's shares would become publicly traded on the London Stock Exchange at whatever value the market set.

Between 1984 and 1996, the U.K. government privatized more than 50 companies. JA23–24, 30. The government initially privatized primarily non-monopoly companies, but later expanded the privatization program to include state-run monopolies such as utilities. JA206, 258–59. With that expansion came the need to establish a regulatory scheme to oversee the newly privatized companies. Rather than dictate their maximum profits or rates of return, the government decided to regulate their prices. By fixing prices for an initial period, typically four years, the government hoped to incentivize the companies to reduce costs and increase efficiencies, thereby maximizing profits that initially would pass exclusively to the companies and their new shareholders. JA223, 263–64. The regulatory scheme created the potential for the companies to enjoy substantial profits during the initial period. (JA854) Once that period ended, however, the government would pass the benefits of lower prices and increased efficiencies on to consumers through a downward price adjustment.

The newly privatized companies embraced this regulatory scheme, and their shareholders quickly began reaping the rewards of significantly reduced costs and increased efficiencies. But the public grew concerned that the companies were making too much in profits, and the Labour Party, seizing on this political opportunity, began demanding the very price

adjustments the government had promised to forgo until the end of each initial price control period. The government resisted the pressure but ultimately paid a price: In 1997, the Labour Party defeated the Conservative Party at the polls.

Although the Labour Party had opposed privatization from the start, by the time it returned to power, re-nationalization was no longer a realistic option. JA274. Nonetheless, the party continued to contend that privatization had unduly benefitted many of the new companies, and it campaigned on a vow to impose "a windfall levy on the excess profits of the privatised utilities." Pet.App.31. The party promised to use the revenue from that tax to fund a £5 billion welfare-to-work youth employment training program. Pet.App.31.

In 1996, as a Labour Party victory became increasingly likely, members of the party's shadow treasury, including future Paymaster General Geoffrey Robinson and future Chancellor of the Exchequer Gordon Brown, retained Arthur Andersen to determine how best to structure the promised tax. Although a number of companies had been privatized, the goal was to tax only those companies (primarily utilities) subject to the price control regulatory scheme that produced high profits in the years immediately after privatization. The Labour Party made clear from the outset that the Andersen team was to "design a windfall tax on the excess profits of the privatised utilities." JA326. In response, the team devised a one-time "windfall tax" to be imposed on what the Labour Party viewed as excess profits achieved during the immediate post-privatization

period. JA334–35. The tax applied only to companies "whose privatisation involved the imposition of economic regulation." Finance (No. 2) Act, 1997, c. 58, part I, cl. 1 & 2(5) (U.K.); App.50a–72a.

As embodied in the act Parliament passed, the windfall tax employs a simple concept but a considerably more complicated formula. The simple concept is that the new government used the companies' actual realized profits (*i.e.*, gross receipts less expenses) during the first four years after privatization to impose a tax reflecting the new government's view that the companies had reaped windfall profits during that initial period. The more profitable the company was during those four years, the higher the tax. That was true not just in some vague sense that the tax and those profits were positively correlated—windfall tax liability increased in direct proportion to the profits realized by the company.

The more complicated formula was based on the difference between two numbers: a company's value based on the highest fixed price at which its shares were offered when it was privatized (*i.e.*, its actual flotation value) and the company's "value in profit-making terms," which the statute defined by reference to a company's actual, realized past profits and an arbitrary fixed "price-to-earnings ratio." As set forth in the statute, the formula operates as follows:

Total realized profits ("P") during the tax period are used to determine average annual profits, which are multiplied by a statutorily fixed "applicable price-to-earnings ratio" of 9. Flotation value ("FV") is then subtracted, and the remainder is taxed at 23%. Using

"D" to represent how many days a company operated during the tax period, the statutory formula can be stated as:

$$Tax = 23\% \times \left(\left[\frac{365}{D} \times 9 \times P \right] - FV \right)$$

Because most companies subject to the windfall tax operated for 1,461 days, or four years (with one leap day), during the relevant period, tax liability typically amounted to approximately:

$$Tax = 23\% \times \left(\left[\frac{1}{4} \times 9 \times P \right] - FV \right)$$

or

$$Tax = 23\% \times \left(\left[\frac{9}{4} \times P \right] - FV \right)$$

Stated in those terms, the windfall tax nominally taxes the difference between two numbers or "values"—the actual flotation price, and a figure based on profits earned during the first four years after privatization. But while flotation value is an actual historical number, "value in profit-making terms" is an artificial construct that does not represent any real-world value of the company (such as its market value based on the price of its publicly traded shares on a date certain). JA251, 291–92, 346–47. It instead is a *sui generis* term used to describe a company's actual profits during the four years after privatization that was coined solely to give the tax its form. Pet.App.60–61 n.17; *see also* JA346–47. Because that number is based on actual realized profits, and profits are the only variable in the equation, the tax in

substance was a tax on excess profits during the four-year period, specifically, a 51.75% tax on total period profits in excess of 4/9 of flotation value. *See* Pet.App.63–64.[1]

To illustrate, if the figures inside the parentheses are multiplied by 4/9 and the figure outside the parentheses is multiplied by 9/4, the formula becomes:

$$Tax = \left(\frac{9}{4} \times 23\%\right) \times \left(P - \left[\frac{4}{9} \times FV\right]\right)$$

Doing the math, that produces:

$$Tax = 51.75\% \times \left(P - \left[\frac{4}{9} \times FV\right]\right)$$

By these simple mathematical calculations, the same tax thus can be formulated as either a 51.75% tax on profits in excess of a statutorily prescribed rate of return, or a 23% tax on the difference between two numbers (“flotation value” and “value in profit-making terms”). Under either formulation, a company’s tax liability increases or decreases in direct proportion to its total profits in excess of 4/9 of flotation value during its initial period. That exact mathematical equivalency demonstrates unequivocally that the practical operation of the windfall tax is as a tax on excess profits. In one form, the tax looks like a tax on

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[1] The Tax Court described the tax as a 51.71% tax on profits in excess of 44.47% of flotation value. Pet.App.63. That slight variation reflects the inclusion of the extra leap year day, which makes the ratio used to determine average annual profits slightly more than 4/9 (*i.e.*, 44.4%). For simplicity, this brief uses the figure 51.75% throughout.

the difference between two numbers. In the other form, the tax looks just like past U.S. excess profits taxes and past U.K. excess profits taxes that have been held creditable. And both forms yield precisely the same amount of tax liability.

C. The Proceedings Below

South Western Electricity plc ("SWEB") was one of 12 regional electric companies privatized in 1990. JA241. It was also one of 32 regulated companies that were more profitable than anticipated and thus became subject to the windfall tax. Pet.App.43–44. SWEB's total windfall tax liability as assessed by U.K. Inland Revenue was £90,419,265 (*i.e.*, SWEB had earned about £175 million more than the Labour government thought appropriate and was taxed 51.75% of that amount). JA43. SWEB paid the tax in two installments, the first in 1997 and the second in 1998. JA45. At the time, SWEB was a partially owned indirect subsidiary of PPL Corporation ("PPL"). Accordingly, for its 1997 federal income taxes, PPL claimed a credit under section 901 for its share of SWEB's first windfall tax payment. The Commissioner disallowed the claim, and PPL petitioned the Tax Court for review.

1. The Arguments and Evidence

The essential dispute between the Commissioner and PPL in the Tax Court boiled down to a single dispositive legal question: whether, in determining creditability, courts should use a substance-based approach that takes into account the practical and intended operation of the foreign tax, or must instead

use a formalistic approach that confines the analysis solely to the labels used by the foreign tax statute.

Consistent with the Treasury Regulation and the decades of case law it adopts, PPL argued that creditability "depends on the substance, and not the form or label, of the tax." Pet.App.57–58. Under that approach, this is an easy case. The predominant character of the windfall tax is "that of an income tax in the U.S. sense" because the tax by both effect and intent "is likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(1)(ii), (3)(i). Indeed, the windfall tax is not just "likely to reach net gain"—it is guaranteed to reach a specific percentage of net gain that exceeds a threshold deemed by the Labour government to represent the cut-off between acceptable and excess profits. In other words, it is guaranteed to reach 51.75% of profits in excess of 4/9 of flotation value.

To prove as much, PPL provided extensive testimony from expert witnesses, including specialists in both U.S. and U.K. tax and accounting, Pet.App.59; JA353–445; an internationally acclaimed finance professor, Pet.App.59–60; JA446–91; members of the Arthur Andersen team who designed the windfall tax, Pet.App.32–33, 58–59; JA247–93; and the U.K. regulator who devised the relevant regulatory scheme and regulated 17 of the 32 companies subject to the tax (including SWEB), Pet.App.27–29, 58; JA196–247. Those witnesses all agreed that, in substance, the windfall tax operates as a tax on income, and in fact operates just like past U.S. and U.K. excess profits taxes. Pet.App.57–60. PPL's experts illustrated how the tax formula can be restated as a 51.75% tax on

profits in excess of 4/9 of flotation value, a mathematical reality to which the Commissioner stipulated. Pet.App.62 & n.20; JA427–30, 457–61. And to illustrate beyond peradventure the exclusively profits-driven practical operation of the tax, SWEB's former treasurer explained how, once he realized the direct link between tax liability and profits under the windfall statute, he obtained permission from the U.K. Financial Reporting Review Panel (over the initial objection of Inland Revenue) to restate SWEB's profits for one of the tax years and, as a result, was able to reduce SWEB's windfall tax liability in direct proportion (51.75%) to that reduction in profits. Pet.App.61; *see also* JA42–43, 190–92, 550–51, 556–58.

The Andersen witnesses testified that the drafters of the tax understood that it operated as an excess profits tax but dressed it up as a tax on the difference between two purported "values" for "presentational" reasons peculiar to the U.K. political and economic environment at the time. Pet.App.58–59. They explained that they were "instructed" by the Labour Party "to design a windfall tax on the excess profits of privatised utilities," JA333, and that "[f]rom the start, there was never any doubt that" they were tasked with designing an "excess profits" tax, JA326. The Andersen team further testified that an excess profits tax "is what we all believed the 'Windfall Tax' to be." JA329; *see also, e.g.*, JA292.

Finally, the evidence at trial confirmed the U.K. government's understanding and intent that the windfall tax would operate as a tax on excess profits. When Chancellor Brown introduced the tax as part of

the 1997 budget, he explained that "[o]ur reform of the welfare state … is funded by a new and one off windfall tax on the excess profits of the privatised utilities." JA126. Later that same day, Inland Revenue released a notice stating that "[t]he Chancellor today announced the introduction of the proposed windfall tax on the excess profits of the privatised utilities." JA128, 241, 275. Throughout the enactment process, the government repeatedly described the tax as "meeting the commitment that we made in our election manifesto to introduce a windfall levy on the excess profits of the privatised utilities." JA146; *see also, e.g.*, JA140 (U.K. Treasury publication describing statute as imposing a "windfall tax … in accordance with the commitment in the Government's Election Manifesto to raise a tax on the excess profits of the privatised utilities").

Rather than dispute PPL's evidence in any material respect, the Commissioner argued that the Tax Court should ignore it altogether. In the Commissioner's view, the court was bound by the U.K. statutory formulation of the windfall tax as a tax on the difference between two "values," even though the higher of those two figures was an artificial number derived exclusively from actual realized profits over a four-year period. Pet.App.65–68. Under the Commissioner's formalistic approach, because the statute says it taxes the difference between two "values," not excess profits, the tax is not creditable. As the Commissioner put it, in an argument that would seem to deny the form-substance dichotomy altogether: "The words of the U.K. statute *are* the 'substance' of this tax." Reply Br. for Resp. 11, *PPL Corp. v. Comm'r*, No. 25393-07 (U.S. Tax Ct. 2009).

The Commissioner alternatively argued that the tax was intended to tax the difference between two values and uses realized profits merely as "a reasonable approximation of how … [c]ompanies might have been valued at the time of flotation if subsequent earnings could have been known." Pet.App.70.

2. The Tax Court's Decision

After reviewing all the expert reports and trial testimony in both this case and a parallel case involving the same U.K. windfall tax, the Tax Court issued a 62-page opinion holding the windfall tax creditable. Pet.App.22–86; *see also Entergy Corp. v. Comm'r*, 100 T.C.M. (CCH) 202 (2010) (summarily finding same tax creditable based on its *PPL* decision).

Like the parties, the Tax Court considered dispositive the legal question of what a court "may consider in determining whether the windfall tax is a creditable tax for purposes of section 901." Pet.App.71. The court rejected the Commissioner's formalistic answer to that question as contrary to the foreign tax credit statute and "inconsistent with the 1983 regulations' description of the predominant character standard for creditability." Pet.App.72. Examining the regulation's instruction to consider whether "the foreign tax is likely to reach net gain *in the normal circumstances in which it applies*," § 1.901-2(a)(3)(i) (emphasis added), the court concluded that, by "implicating the circumstances of application in the determination of the predominant character of a foreign tax, the drafters of the 1983 regulations clearly signaled their intent that factors extrinsic to the text of the foreign tax statute play a role in the determination of the tax's character." Pet.App.72–73.

The Tax Court found that conclusion "consistent with caselaw preceding the issuance of the 1983 regulations and, in particular, two of the cases cited in the preamble to those regulations as providing the 'criterion for creditability' embodied in that standard." Pet.App.73 (citing *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982), and *Bank of America I*). It further noted that "cases that have applied the … regulations' predominant character standard are consistent" with that approach, and rejected the Commissioner's attempts to portray those cases as limiting courts to considering only the form of a foreign tax statute. Pet.App.75–76.

Reviewing the windfall tax's practical effect, the circumstances of its adoption, the understanding of the Andersen team that designed it, and the public statements of the Labour ministers who presented it, the Tax Court agreed with PPL that the windfall tax operated in substance as a tax on excess profits. Pet.App.23–45. The court explained that PPL's restatement of the tax as a 51.75% tax on excess profits was not, as the Commissioner argued, a "hypothetical rewrite of the Windfall Tax statute," but rather "a legitimate means of demonstrating that Parliament did, in fact, enact a tax that operated as an excess profits tax." Pet.App.83. Considering that and all of PPL's other evidence to the same effect, the Tax Court concluded that "the design and incidence of the tax convinces us that its predominant character is that of a tax on excess profits." Pet.App.78–79.

3. The Third Circuit's Decision

The Commissioner appealed the *PPL* decision, and the Third Circuit reversed. Pet.App.16–19. The

Commissioner once again stressed that "the court should consider only the language of the windfall-tax statute" and not "the actual effect of the tax on the windfall companies." Opening Br. for Appellant 11, *PPL Corp. v. Comm'r*, No. 11-1069 (3d Cir. 2011). In an opinion that became bogged down in mathematical formulas and a portion of the regulation that the parties stipulated was not applicable, JA193–94, the court concluded that the tax was not creditable.

Although the court purported to examine the "substance" of the windfall tax, it in fact applied a wholly formalistic approach: It refused to consider PPL's arguments about the practical or intended operation of the tax and instead resolved creditability based solely on the form of the U.K. statute. As for PPL's argument that the tax operates as a 51.75% tax on excess profits, the court deemed that "formulation of the substance of the U.K. windfall tax … a bridge too far" based on its view that "[t]he regulation forbids" consideration of any formulation that "rewrite[s] the tax rate." Pet.App.9, 14. Accordingly, the court examined whether the windfall tax satisfies the regulation's gross receipts and realization tests based on the assumption that the tax must be formulated as follows:

$$Tax = 23\% \times [2.25 \times P]$$

Of course, 23% multiplied by 2.25 is 51.75%, and so this formulation of the tax should have made clear that the tax equaled 51.75% of the excess profit. Nonetheless, because it inexplicably deemed such multiplication "a bridge too far," the Court ignored this mathematical equivalence and simplistically concluded that "2.25 times profit" is greater than

profit alone and, therefore, that the tax is not imposed on the basis of gross receipts or on realized income. Pet.App.9, 12, 14–15 & n.3.

In reaching its conclusion, the court relied heavily on a single illustrative example from a section of the regulation that addresses how to determine whether a tax that is *not* based on *actual realized* gross receipts, but instead is based on an estimation of expected gross receipts, satisfies the gross receipts test. *See* Pet.App.13–14; Treas. Reg. § 1.901-2(b)(3)(ii), ex. 3. Although both parties explained at oral argument that this Example 3 does not apply here—the profit figure used to calculate the windfall tax is derived from *actual* gross receipts (and otherwise satisfies the regulatory tests for net profits)—the court decided that Example 3 rendered irrelevant the mathematical certainty that a 23% tax on 2.25 times profit is identical to a 51.75% tax on profit.

The Third Circuit's decision directly conflicts with the Fifth Circuit's decision in the companion *Entergy* case, which the Commissioner also appealed. After reviewing the Tax Court's analysis in *PPL* and the Third Circuit's decision rejecting it, the Fifth Circuit agreed with the Tax Court and held the windfall tax creditable. *See Entergy Corp. & Affiliated Subsidiaries v. Comm'r*, 683 F.3d 233, 236 (5th Cir. 2012). Finding the Commissioner's formalistic argument "easy to dispatch" in light of the regulation and the case law it adopts, the court viewed the tax "in practical terms" and concluded that it readily satisfies the gross receipts, realization, and net profits tests. *Id.* In doing so, the Fifth Circuit emphasized that the U.K. government's decision to label an

"entirely profit-driven figure a 'profit-making value' must not obscure the history and actual effect of the tax." *Id.* at 236–37. The court rejected the Third Circuit's contrary conclusion as "exemplif[ying] the form-over-substance methodology that the governing regulation and case law eschew." *Id.* at 237.

SUMMARY OF ARGUMENT

The Commissioner's core contention in this case is a remarkable one. In his view, the standard for determining the creditability of a foreign tax is so rigidly formalistic that a court must ignore the *undisputed* fact that the practical operation of a foreign tax is as a tax on profits, and instead confine its analysis *solely* to the labels and form used in the foreign tax statute. In other words, even though foreign taxes are imposed in numerous foreign languages, by countries with radically different tax systems, and for reasons unique to those countries, the Commissioner would have the labels and form a foreign country employs, and not the substance of the tax it imposes, determine how the tax should be treated for purposes of U.S. tax law.

That approach is so contrary to common sense—not to mention the substance-over-form principle that pervades U.S. tax law—that it could prevail only if the foreign tax credit statute unambiguously compelled it. As this Court concluded nearly 75 years ago, section 901 does no such thing. Instead, this Court and lower courts have consistently recognized that the context of evaluating the U.S. tax consequences of foreign taxes enacted in a variety of different languages and systems all but demands a consideration of substance,

not form. And the Commissioner's own regulations expressly embrace a substance-over-form approach that looks to the practical operation of a foreign tax and whether it is "likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(3)(i). In short, as the Fifth Circuit correctly concluded, the Commissioner's core contention is easy to dispatch: The creditability of a foreign tax turns on its substance, not the labels or form a foreign country employs.

Once the Commissioner's hyper-formalistic approach is rejected, this is an easy case. There is no real dispute that the U.K. windfall tax is, in substance, an excess profits tax in the U.S. sense. The tax is the mathematical equivalent of a 51.75% tax on excess profits. Indeed, SWEB conclusively proved as much when it restated its profits and reduced its windfall tax liability by 51.75 pence for each pound that it reduced its reported profit. Both the drafters of the tax and the Parliament members who adopted it acknowledged that it was designed as and operated as a tax on excess profits. And those profits were unambiguously net profits in the U.S. sense, *i.e.*, actual realized gross receipts less costs and expenses over a four-year period. The tax thus was not just "likely," but *certain*, "to reach net gain in the normal circumstances in which it applies." Because that is all the statute, the regulation, and the case law require to establish creditability, the windfall tax is creditable, and the decision below should be reversed.

ARGUMENT

The Commissioner's hyper-formalistic position in this case is born of necessity. Unless labels and form

are all that matters, this is a remarkably straightforward case. The Commissioner concedes that the windfall tax operates just like a 51.75% tax on excess profits earned during the four years immediately following privatization, *i.e.*, the portion of net profits in excess of the threshold the U.K. government decided was appropriate for the companies it taxed. And the Commissioner concedes that those excess profits are net profits in the U.S. sense, *i.e.*, they are the companies' actual realized gross receipts less costs and expenses during the four-year period. Indeed, the Commissioner could hardly contend otherwise, as the windfall tax's equivalence to a 51.75% tax on excess profits is a matter of mathematical certainty, and SWEB reduced its windfall tax by 51.75% of the reduction in its reported profits when it restated its income for one year of the relevant tax period. In short, the Commissioner essentially concedes that the windfall tax is, in substance, an excess profits tax in the U.S. sense.

Given those undisputed facts, the Commissioner has no choice but to insist that courts may not consider the substance of a foreign tax *at all* when determining creditability, and instead must confine their analysis to the labels and form that a foreign country chose to adopt. In his view, simply because the windfall tax is nominally a tax on the difference between two numbers or "values," and not formally labeled a tax on excess profits, it is not creditable. Never mind that one of those two numbers is an artificial number derived from actual, realized net profits during a four-year period, thus plainly rendering a tax on the difference between the two a tax on those reported profits. According to the

Commissioner, because the U.K. government did not *call* the windfall tax an excess profits tax, the Court must turn a blind eye to the fact that it is one.

Only under a statute that compelled the most formalistic of approaches to creditability could that argument prevail. Indeed, given that substance trumps form in every other U.S. tax law context, it would take particularly compelling evidence to conclude that Congress intended form to trump substance in this most unlikely of contexts. But as this Court and lower courts have recognized for decades, section 901 gives no indication whatsoever that Congress intended to adopt the Commissioner's illogical approach to creditability. In fact, as the case law repeatedly makes clear, the statute compels exactly the opposite—namely, that the creditability analysis *must* evaluate substance, not form.

That case law is directly applicable because it served as the foundation for the regulation, which explicitly adopts the approach of the cases that came before it. Like those cases, the regulation instructs courts to ignore labels even to the point of treating foreign taxes nominally on gross receipts as income taxes so long as their practical operation makes them likely to reach net profit. *A fortiori*, the U.K. windfall tax, which *necessarily* reaches net profit, is creditable under that substance-based approach. In short, far from supporting the Commissioner's rigid approach to creditability, the statute, the regulation, and the case law it incorporates all adopt the common-sense approach that substance, not form, must govern when considering the U.S. tax consequences of taxes imposed by foreign governments.

I. Whether A Foreign Tax Is Creditable Depends On Its Substance, Not The Labels Or Form A Foreign Country Employs.

Under any sensible approach to determining the U.S. tax consequences of a tax imposed by a foreign country, whether a tax is creditable must turn on its substance, not the labels that the enacting country employs. Indeed, it is difficult to imagine a context less suited to a rigidly formalistic approach than determining the treatment for U.S. purposes of foreign taxes, which may not be written in the same language, often reflect different tax systems, and usually arise under unique legal, political, and social regimes. Recognizing as much, every court to consider the issue—including this one—has rejected the notion that the creditability analysis should elevate form over substance, even in cases in which the taxation of profits as a substantive matter was far less obvious than here. So, too, did the Commissioner when he put in place a regulation that adopts the same substance-based approach that the case law before it established. In short, nothing in the foreign tax credit statute, the regulation, or the governing case law provides any support for the hyper-formalistic approach on which the Commissioner's position depends.

A. The Principle that Substance Trumps Form Is a Fixture of U.S. Tax Law Generally and Foreign Tax Credit Cases in Particular.

1. Because any rational tax scheme demands uniform application, "tax law deals in economic realities, not legal abstractions." *Comm'r v. Southwest Exploration Co.*, 350 U.S. 308, 315 (1956). The

familiar "principle of looking through form to substance" thus is "the cornerstone of sound taxation" and is pervasive throughout tax law. *Estate of Weinert v. Comm'r*, 294 F.2d 750, 755 (5th Cir. 1961). The courts and the Commissioner alike have routinely invoked that principle when determining the tax consequences of a transaction. *See, e.g.*, *Boulware v. United States*, 552 U.S. 421, 429 (2008) ("tax classifications … turn on the objective economic realities of a transaction rather than ... the particular form the parties employed"); *Comm'r v. Hansen*, 360 U.S. 446, 461 (1959) ("the incidence of taxation depends upon the substance, not the form, of the transaction"); Br. for the United States, *United States v. Consumer Life Ins. Co.*, Nos. 75-1221, 75-1260, 75-1285, 1976 WL 181554, at *34 (U.S. 1976) (emphasizing "the familiar axiom that economic substance rather than form is controlling for purposes of federal taxation"); Joseph Isenbergh, *Review: Musings on Form and Substance in Taxation*, 49 U. Chi. L. Rev. 859 (1982) (describing how the Commissioner has consistently and successfully relied on substance versus form distinction in litigation).

That well-settled principle is regularly applied in a host of contexts when determining the legal consequences of a tax. For instance, when examining whether a state tax is preempted by federal law, this Court has reiterated that "neither state courts nor Legislatures, by giving the tax a particular name, or by using some form of words, can take away our duty to consider its nature and effect." *Macallen Co. v. Massachusetts*, 279 U.S. 620, 625 (1929); *see also, e.g.*, *Jefferson Cnty., Ala. v. Acker*, 527 U.S. 423, 539 (1999)

("[t]he practical impact, not the State's name tag, determines" whether a tax violates federal law).

The same rule has been invoked when evaluating the constitutionality of taxes in multiple contexts, including the Privileges and Immunities Clause, *see, e.g.*, *Lunding v. New York Tax Appeals Tribunal*, 522 U.S. 287, 297 (1998) (analysis "must depend not upon any mere question of form, construction, or definition, but upon the practical operation and effect of the tax"); the dormant Commerce Clause, *see, e.g.*, *Oklahoma Tax Comm'n v. Jefferson Lines, Inc.*, 514 U.S. 175, 183 (1995) (considering "not the formal language of the tax statute but rather its practical effect"); the Due Process Clause, *see, e.g.*, *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435, 444 (1940); and the intergovernmental tax immunity doctrine, *see, e.g.*, *City of Detroit v. Murray Corp. of America*, 355 U.S. 489, 492 (1958). As this Court has stressed, courts must look past "the formal language of the tax statute [to] its practical effect." *Quill Corp. v. North Dakota*, 504 U.S. 298, 310 (1992).

The logic behind the principle that substance, not form, must govern is obvious: Any other approach would wreak havoc on the stability and uniform application of tax law. "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." *Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945). Accordingly, whether dealing with the tax consequences of a transaction or the legal consequences of a tax, it is well settled that a "given result at the end of a straight path is not made a

different result ... by following a devious path." *Minnesota Tea Co. v. Helvering*, 302 U.S. 609, 613 (1938).

2. If there were one context in which abandoning the rule that substance trumps form would make the least sense, it would be in determining the domestic tax consequences of a tax imposed by a foreign government. Indeed, the concept of confining the analysis to the words or form of a statute makes no sense when it comes to taxes that may be assessed in myriad languages, by countries with fundamentally different tax systems, and for political, economic, and social reasons unique to those countries. There is no reason to expect those foreign countries to adopt the sometimes obscure locutions of our Internal Revenue Code. The process of translating—literally and figuratively—foreign taxes for purposes of U.S. tax law demands an inquiry into their practical operation and effect.

A purely formalistic approach to determining the creditability of foreign taxes would also undermine the important policy purposes Congress intended the foreign tax credit statute to serve. One of the credit's central aims is to promote uniform treatment of U.S. taxpayers. Another is to "facilitate," rather than discourage, "the[] foreign enterprises" of domestic corporations by assuring them that they will not face double taxation at home on profit that has already been taxed by the country in which it was earned. *Chicago Portrait*, 285 U.S. at 9. Those purposes can only be achieved by a rule that looks beyond the form of countless foreign taxes to determine whether in practical operation they subject income to double

taxation. If the analysis were to turn on form, not substance, a tax with the exact same practical effect of imposing double taxation could be creditable when imposed by one country but not when imposed by another. Moreover, foreign governments often have just as many political and legal incentives as our own legislatures to manipulate the "form, construction, or definition" of a tax to obscure its "practical operation and effect." *Lunding*, 522 U.S. at 297. Congress could hardly have intended to elevate those foreign efforts above substance when the unifying principle throughout our own tax law is that substance trumps form.

In keeping with those common-sense principles, this Court long ago rejected the illogical notion that the creditability of a foreign tax should "depend upon its characterization by the foreign statutes and by decisions under them." *Biddle*, 302 U.S. at 578. *Biddle* involved the meaning of the phrase "income taxes paid" in the foreign tax credit statute as applied to British tax laws governing stockholders and corporations.[2] Under the relevant British law, stockholders were "required to report as income, in addition to the amount of dividends actually received, amounts which reflect their respective proportions of the tax paid by the corporation on its own profits." *Id.* at 575. In other words, British law "treat[ed] the

[2] At the time, the foreign tax credit statute was codified at 26 U.S.C. § 131. While it has since been recodified, the statute allows a credit now, as it did in 1938, for "the amount of any *income … taxes paid*" to a foreign country. 26 U.S.C. § 901(b)(1) (emphasis added).

stockholder as though he were the taxpayer" even though the tax was in fact paid by the corporation. *Id.* at 581. Because U.S. law would treat the corporation, not the stockholder, as having paid the tax in that situation, the question arose whether the stockholder could receive a credit under the foreign tax credit statute.

In answering that question in the negative, the Court explained that "[t]he phrase 'income taxes paid,' as used in our own revenue laws, has for most practical purposes a well-understood meaning to be derived from an examination of the statutes which provide for the laying and collection of income taxes." *Id.* at 579. "It is *that* meaning," the Court concluded, that "must be attributed" to the term in the foreign tax credit statute. *Id.* (emphasis added). Even though British law treated the stockholder as having "paid" the tax, the dispositive question remained whether "what the stockholder has done in conformity to British law … is the substantial equivalent of payment of the tax as those terms are used in our own statute." *Id.* Any other approach would produce "a shifting standard" for creditability based on the vagaries of "foreign characterizations and classifications of tax legislation" by countries that may not use the same language, let alone the same tax system, as the United States. *Id.* As the Court concluded, nothing in the foreign tax credit statute remotely suggests Congress intended such a counterintuitive result. *See id.* at 578–79. Substance thus trumped form in *Biddle* in a way that benefitted the U.S. Treasury to the detriment of the taxpayer. Ever since, courts have focused on the substance and practical effect of foreign taxes without regard to

whether that approach favors the government or the taxpayer.

3. Following *Biddle*'s instruction to "examin[e] … the *manner* in which [a] tax is laid and collected," *id.* at 579 (emphasis added), courts have determined creditability by focusing on the substance, not the form, of foreign taxes. For instance, the Court of Claims confirmed in *Bank of America I* that the "important thing" is the substance, not the form, of a foreign tax. 459 F.2d at 519. *Bank of America I* involved three foreign taxes that on their face did not satisfy "the United States notion of income taxes" because they were imposed on gross receipts, with no comparable deduction for costs or expenses to ensure that only net gain was taxed. *Id.* at 517. In keeping with *Biddle*, however, the Court of Claims refused to "consider it alldecisive whether the foreign income tax is labeled a gross income or a net income tax, or whether it specifically allows the deduction or exclusion of the costs or expenses of realizing the profit." *Id.* at 519. Recognizing that there are situations in which the "costs, expenses, or losses incurred in making the gain would, in all probability, always (or almost so) be the lesser part of gross income," thereby ensuring that "the assessment would fall ultimately upon" the "net gain remaining," the court concluded that "a levy can in reality be directed at net gain even though it is imposed squarely on gross income." *Id.* As the court put it, "[t]he important thing is whether the other country is attempting *to reach* some net gain, not the form in which it shapes the income tax or the name it gives." *Id.* (emphasis added).

Seatrain Lines, Inc. v. Commissioner, 46 B.T.A. 1076 (1942), one of the cases on which *Bank of America I* relied, is illustrative of the substance-based approach that courts have employed when applying section 901. *Seatrain* involved a 3% tax on gross income Cuba had imposed to replace a predecessor 6% tax on net profits. *See Bank of America I*, 459 F.2d at 520. While the Cuban government imposed the new tax on gross income, not net gain, the tax was nonetheless held creditable because the halving of the tax rate approximated the amount of the foregone deductions and thus ensured that the 3% gross income tax had the same practical effect as the 6% tax on net profits that it replaced. *Id.* Because "the key is *the effect* of the foreign tax on net gain," the Court of Claims explained, "a gross income tax which embodies within itself (via the rate or otherwise) consideration of the taxpayer's relevant costs and expenses" is every bit as creditable as a tax on net income at a higher rate. *Id.* at 520–21 (emphasis added).

The Tax Court employed the same substance-over-form approach in *Bank of America National Trust & Sav. Ass'n v. Comm'r* ("*Bank of America II*"), 61 T.C. 752 (1974), agreeing with the Court of Claims that "the 'basic' test for determining whether a foreign tax is creditable is whether it is the substantial equivalent of an 'income tax' as revealed by an examination of our statutes." *Id.* at 760. And the Court of Claims reaffirmed that approach in *Inland Steel*, where it reiterated that "[t]he label and form of the foreign tax is not determinative" of creditability, which instead turns on "whether taxation of net gain is the ultimate objective or effect of that tax." 677 F.2d at 80.

The creditability questions in those cases were substantially more difficult than in the case at hand, where the foreign tax undisputedly falls on net profits, *i.e.*, gross receipts minus expenses and deductions. Nonetheless, those lower court cases are relevant for two reasons. First, as noted, the Commissioner's effort to treat a tax on the difference between two numbers or purported "values," one of which is derived exclusively from profits, as something other than a tax on excess profits depends on a hyper-formalistic application of section 901. Thus, the substantial body of lower court precedent following *Biddle* and looking to substance over form—even to the point of treating a tax on gross receipts as a tax on net income—greatly undermines the Commissioner's position.

Second, and equally important, these cases form the foundation on which the Treasury Department based its regulation in 1983. By that time, it was already settled law that the creditability of a foreign tax under section 901 does not turn on questions of form. As the cases recognize, when confronted with a foreign tax that does not nominally fall on income in the U.S. sense, the statute requires courts to examine the practical operation of a tax to determine whether, notwithstanding its label and form, the tax was likely to reach net gain in the U.S. sense. Far from attempting to abandon that settled interpretation of the statute as compelling a substance-based approach to creditability, the Commissioner's 1983 regulation expressly embraces it.

B. The Treasury Regulation Embraces the Same Substance-Based Approach to Creditability as the Cases Before It.

1. Not only does the language of Treasury Regulation § 1.901-2 mirror almost precisely the standard the case law articulates, but the preamble to the final regulation confirms that it "adopts the criterion for creditability set forth in *Inland Steel* …, *Bank of America* [*I*] …, and *Bank of America* [*II*]." 48 Fed. Reg. at 46,273; *compare* § 1.901-2(a)(3)(1) ("The predominant character of a foreign tax is that of an income tax in the U.S. sense [i]f … the foreign tax is likely to reach net gain in the normal circumstances in which it applies."), *with Bank of America I*, 459 F.2d at 519–20 (tax is an income tax if "it is very highly likely, or was reasonably intended, always to reach some net gain in the normal circumstances in which it applies"), *and Inland Steel*, 677 F.2d at 80 ("To qualify as an income tax in the United States sense, the foreign country must have made an attempt always to reach some net gain in the normal circumstances in which the tax applies."). Thus, under the regulation, as under the cases before it, creditability turns on the "ultimate objective or effect" of a tax, not "[t]he label and form" the foreign country gives it. *Inland Steel*, 677 F.2d at 80.

The regulation itself refutes any contrary contention. Section 1.901-2 reiterates more than a dozen times that creditability turns not on the labels or form of a foreign law, but on the "predominant character" of the tax it imposes. *See, e.g.*, § 1.901-2(a)(1)(ii), (a)(3), (b)(1), (b)(2)(i), (b)(3)(i), (b)(4)(i). That term comes from the Commissioner's own substance-

based determinations in pre-regulation creditability decisions. *See, e.g.*, Rev. Rul. 56-51, 1956-1 C.B. 320 (tax's "predominant character will determine whether the tax is an income tax"). The regulation further instructs that courts must assess the "predominant character" of a foreign tax by determining whether the tax is "likely to reach net gain *in the normal circumstances in which it applies*." § 1.901-2(a)(3)(i) (emphasis added). As the Tax Court explained, that language does not just invite consideration of the practical effect of a foreign tax; it demands it. *See* Pet.App.72–73 ("By implicating the circumstances of application in the determination of the predominant character of a foreign tax," § 1.901-2 confirms "that factors extrinsic to the text of the foreign tax statute play a role in the determination of the tax's character.").

Other provisions throughout the regulation also instruct that the practical operation of a foreign tax can render it "an income tax in the U.S. sense," § 1.901-2(a)(1)(ii), even if the foreign country did not label or structure it as such. For example, the regulation treats a tax as satisfying the net income test not only if it allows for "recovery of significant costs and expenses," but also if it "provides allowances that *effectively compensate* for nonrecovery of such significant costs or expenses." § 1.901-2(b)(4)(i) (emphasis added). And the regulation goes on to explain that even a gross income tax that does neither can still satisfy the net income test if, "in the normal circumstances in which it applies," a taxpayer's "costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid

persons subject to the tax are almost certain to have net gain." § 1.901-2(b)(4)(i)(B); *see also, e.g.*, §§ 1.901-2(a)(2), (d)(1), (f)(3) (requiring application of U.S. principles when considering effect of a foreign tax).

Like the case law that preceded it, the regulation thus allows some foreign taxes to be treated as creditable income taxes for U.S. purposes even if they are denominated gross receipts taxes. In that respect, it is far more permissive than anything remotely necessary to treat a tax nominally on excess "value" as a tax on excess profits when such "value" is derived exclusively from actual net profits over a four-year period. And those permissive provisions are also completely inconsistent with a hyper-formalistic insistence that the language and form of a foreign statute should dictate the outcome. It is impossible to determine whether "businesses subject to [a] tax are almost certain never to incur a loss (after payment of the tax)," *id.*, without looking beyond form to examine how a tax actually affects those who pay it. Other provisions of the regulation similarly demand consideration of the practical operation of foreign taxes. *See, e.g.*, § 1.901-2(b)(3)(i)(B) (describing circumstances in which a tax imposed on the basis of an *estimation* of gross receipts may nonetheless be treated as imposed on the basis of gross receipts).

At bottom, the very existence of the regulation thus belies the Commissioner's position, as the whole point of the regulation, like the cases before it, is to illustrate how to determine whether a foreign tax that is *not* labeled or structured like "an income tax in the U.S. sense," § 1.901-2(a)(1)(ii), should nonetheless be considered one. The *raison d'être* of the regulation is

fundamentally inconsistent with the Commissioner's position here. If the language of the foreign statute were all-decisive, the regulation would not exist in anything like its current form.

2. In keeping with the understanding that § 1.901-2 embraces the substance-based approach the cases before it applied, courts have continued to eschew a formalistic approach to creditability since the regulation took force—often at the Commissioner's express urging. Indeed, if anything, courts have suggested that § 1.901-2 places even greater emphasis than the case law that preceded it on the practical operation of a foreign tax. That is particularly evident in the Second Circuit's decision in *Texasgulf, Inc. & Subsidiaries v. Commissioner*, 172 F.3d 209 (1999), which involved the same tax the Court of Claims had concluded was not creditable in *Inland Steel*. The Court of Claims had reached that conclusion after determining that the costs and expenses not deductible from gross income under the tax were "too widespread and important to permit the conclusion that some net gain is sure to be reached." *Inland Steel*, 677 F.2d at 85. But in *Texasgulf*, the taxpayer produced quantitative evidence that one of the tax's other allowable deductions operated in such a manner that, for the majority of taxpayers, it exceeded the amount of nondeductible expenses U.S. law would have allowed. *See Texasgulf*, 172 F.3d at 213.

In deeming that evidence sufficient to affirm the Tax Court's holding that the tax was creditable, the Second Circuit explained that § 1.901-2 contemplates consideration not only of the kind of "qualitative analytic evidence" the Court of Claims had considered

insufficient in *Inland Steel*, but also of "quantitative, empirical evidence" of how a foreign tax actually affected the taxpayers who were subject to it, *id.* at 216—*i.e.*, the exact kind of evidence PPL presented to prove conclusively that the windfall tax operates as an excess profits tax. *Cf.* U.S. Tax Ct. R. 146 (permitting consideration of "any relevant material or source" when "determining foreign law"); 2 Joseph Isenbergh, *International Taxation* ¶ 56.2.4, 56,005–06 (4th ed. 2011) (explaining that regulation "enlarge[d] the range of applications of the *Bank of America* doctrine that are favorable to taxpayers").

Texasgulf presented a much more difficult creditability question than the case at hand. But the point is that any appreciation of the flexible, practical, experiential approach reflected in the regulation and employed in the cases that preceded and followed it makes clear that, as the Fifth Circuit correctly concluded, the Commissioner's "primacy of the … text" argument is "easy to dispatch." *Entergy*, 683 F.3d at 236. As every court save the Third Circuit has recognized, both the regulation and "[t]he case law from which [it] is derived refute[] the Commissioner's assertion that [courts] should rely exclusively, or even chiefly, on the text of" a foreign tax statute when determining creditability. *Id.* "The important thing is whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives." *Bank of America I*, 459 F.2d at 519. Accordingly, the creditability of the U.K. windfall tax depends on whether "the predominant character of th[e] tax is that of an income tax in the U.S. sense," § 1.901-2(a)(1)(ii), not on whether the U.K. government chose to label or present it as such.

II. The Predominant Character Of The U.K. Windfall Tax Is That Of An Income Tax In The U.S. Sense.

The Commissioner's insistence on a rigidly formalistic approach to creditability in this case is understandable. Applying the substance-based standard that the statute, regulation, and case law compel, there can be no serious dispute that the U.K. windfall tax is creditable. As the Commissioner conceded, the tax operates exactly like a 51.75% tax on excess profits in the normal circumstances in which it applies. Pet.App.62 & n.20; JA 35–41. It is not just likely, but a certainty, that the tax reaches net gain because although it is nominally a tax on the difference between two numbers or "values," one was derived exclusively from actual, realized net profits in the four-year period following privatization. Under a correct application of the long-established test for creditability, any contention that the tax is not creditable must fail.

A. The Windfall Tax Is Not Only Likely But Certain to Reach Net Gain in the Normal Circumstances in Which It Applies.

1. Under the regulation, the creditability of a foreign tax turns on whether, "judged on the basis of its predominant character," the tax "is likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(b)(1). The U.K. windfall tax easily satisfies that standard. As the Commissioner stipulated in the Tax Court, *see* Pet.App.62 & n.20; JA 35–41, it is not just "likely," but a mathematical certainty that, for the vast majority of taxpayers, the

windfall tax reached 51.75% of profits in excess of 4/9 of flotation value. *See supra* p.10.[3] Indeed, SWEB conclusively proved as much when it made a downward adjustment to its reported profits and reduced its windfall tax liability by 51.75% of the amount of the reduced profits. Pet.App.61. There is also no dispute that the actual, realized profits in the years following privatization that were used in the windfall tax calculation were "net gain" in the U.S. sense—*i.e.*, they were measured by subtracting significant costs and expenses from gross receipts. *See* Tr. of Oral Argument 39–40, *PPL Corp. v. Comm'r*, No. 11-1069 (3d Cir. 2011). In fact, 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." Pet.App.79. Accordingly, for every company that paid it, the windfall tax was not just "likely to" but did *in fact* "reach net gain." § 1.901-2(b)(1).

As the Fifth Circuit correctly concluded, "[v]iewed in practical terms," the windfall tax thus is plainly creditable. *Entergy*, 683 F.3d at 236. The tax "is

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[3] That was the case for 27 of the 32 companies subject to the tax. Of the remaining five, one paid no windfall tax because it had no excess profits. Pet.App.64–65. For three more, the effective tax rate and percentage above which profits were considered excessive differed marginally because their initial periods were slightly longer or shorter than four years. Pet.App.64. The final company had a significantly shorter initial period (only 316 days), and thus was treated as an outlier by the Tax Court. Pet.App.65; *see Exxon Corp. v. Comm'r*, 113 T.C. 352 (1999) (tax need only "satisfy the predominant character test in its application to a substantial number of taxpayers").

based on revenues from the ordinary operation of the utilities that accrued long before the design and implementation of the tax," and thus "clearly satisfies the realization and net income requirements." *Id.* And because U.S. and U.K. tax principles are materially analogous, "a tax based on actual financial profits in the U.K. sense necessarily begins with gross receipts." *Id.* at 238. The windfall tax "*only* reached—and only *could* reach—utilities that realized a profit in the relevant period, calculating profit in the ordinary sense." *Id.* at 236. In short, in every sense that matters under the regulation's "predominant character" standard, the windfall tax operates exactly like a 51.75% tax on excess profits.

That the tax does so is no mere coincidence. The Labour Party intentionally designed the windfall tax to operate as a tax on a subset of the net profits realized by each company during the initial period after its privatization, when profits were deemed excessive. For years before it enacted the tax, the Labour Party campaigned on a promise to impose a "windfall levy on the *excess profits* of the privatised utilities." JA118 (emphasis added). And when the leaders of the Labour Party hired Arthur Andersen to craft the promised tax, that is exactly what they instructed the Andersen team to create. As the leaders of that team testified, "[f]rom the start, there was never any doubt that our task was to design a windfall tax on the excess profits of the privatised utilities." JA326; *see also, e.g.*, JA337 ("I was instructed by the Labour team to design a windfall tax on the excess profits of privatised utilities"). And as they further testified, "[t]hat is what we all believed the 'Windfall Tax' to be." JA326; *see also, e.g.*, JA292

("There is, in conclusion, no doubt in my mind that the character of the tax [we] designed was that it was taxing excess profits: that was in reality what we were asked to do and it is what we did."); JA514 ("The whole thing is about the profits. Had there been no excess profit, there would be no tax. Because they [had] excess profits, we had tax.").

Indeed, even after the tax was dressed up in its "value-based" form, the new Labour government continued to make clear that the tax was exactly what the party had promised—*viz.*, a tax on excess profits. When introducing the new government's budget, Chancellor Brown explained that "[o]ur reform of the welfare state … is funded by a new and one off windfall tax on the *excess profits* of the privatised utilities." JA126 (emphasis added). Inland Revenue referred to "the proposed windfall tax" as a tax "on the *excess profits* of the privatised utilities." JA128 (emphasis added). Paymaster General Robinson described it as "meeting the commitment that we made in our election manifesto to introduce a windfall levy on the *excess profits* of the privatised utilities." JA146 (emphasis added). The true character of the windfall tax was not lost on the Conservative Party either. In protesting that the tax "defined excess profits arbitrarily," Shadow Chancellor of the Exchequer Peter Lilley explained exactly how it operated: "They have taken average profits over four years after flotation. If those profits exceed one ninth of flotation value, the company will pay windfall tax on the excess." JA152.

2. Notwithstanding the indisputable and undisputed fact that the windfall tax operates as a

51.75% tax on excess profits, the Commissioner insists the tax should really be considered a tax on value—specifically, a tax on "the undervaluation of a company at the time of flotation." Cert. Br. for the United States 10–11. That is just a variation on the same flawed contention that the labels and form of a foreign tax trump its substance. While the windfall tax is nominally a tax on the difference between two numbers or "values," one of those figures—"value in profit-making terms"—is measured by the yardstick of a company's reported profits in the initial period following privatization. To treat a tax on that "value" as anything other than a tax on excess profits is to blink reality. "Value in profit-making terms" is simply a novel presentational mechanism the Andersen team designed to isolate excess profits. Pet.App.58–59 n.16; JA292, 350.

The Commissioner noted in his certiorari-stage brief (at 10) that value is often measured by, among other things, the ability of an asset to generate income. But it is an asset's assumed value to generate income in the future—not the fact that it realized a certain amount of income or profits in the past—that is relevant to value. It is for that reason that high-technology companies that have generated little income—and paid little income tax—are sometimes valued highly, while some low-technology companies that have generated substantial income in the past are nonetheless valued lower. That the U.K. tax was assessed on a "value" derived *exclusively* from past, reported profits over a defined period makes clear that the tax is not directed at "value" in any normal or U.S. tax sense of the word. As one of the Andersen team members explained, the tax thus incorporates "an

underlying concept of value (based on actual ex-post earnings) that would be alien to any valuer." JA292; *see also* Pet.App.60–61 n.17 (summarizing testimony from PPL's finance expert that "value in profit-making terms" "is not a standard economic term or concept" and "has no meaning in any other context").

That the U.K. tax operates as a retrospective tax on excess profits, rather than on current "value" in any normal or U.S. tax sense, is underscored by the fact that it ignores a readily available measure of value in the form of the publicly traded price of the companies' stock. Each company was publicly traded on the London Stock Exchange throughout the entire tax period, meaning its fair market value either at a fixed point or throughout the tax period was readily ascertainable by reference to the price at which its shares were traded, which reflected an estimate of future profitability and a host of other factors (including the likelihood of future windfall profits taxes) that determine present value. Nonetheless, the windfall tax wholly ignores a company's publicly traded stock price and employs a "valuation" formula that produces a figure with no discernible relationship to any standard measure of value. *See* JA472–75. That is because, as its framers conceded, the point of "value in profit-making terms" was to isolate excess profits for purposes of taxing them, not to assess the companies' true value at flotation in any recognized sense of the term.

B. The Third Circuit Misconstrued and Misapplied Controlling Law.

The Third Circuit did not and could not reject either the Tax Court's careful factual findings or

PPL's irrefutable evidence that the practical and intended operation of the U.K. windfall tax is as a 51.75% tax on excess profits. Instead, it simply rendered all of the findings and evidence irrelevant by accepting the Commissioner's invitation to adopt an approach to creditability that "exemplifies the form-over-substance methodology that the governing regulation and case law eschew," and simultaneously focusing on an inapposite regulatory example that not even the Commissioner considered applicable. *Entergy*, 683 F.3d at 237.

Focusing simplistically on the statutory formula used to compute the windfall tax, and the fact that it multiplies initial period profits by 2.25 (or 9/4) before subtracting flotation value, the court concluded that the tax does not satisfy the gross receipts prong of the regulation because "the calculation of the tax base begins with an amount greater than gross receipts." Pet.App.15. Because the tax is nominally a "23% tax on 2.25 times profit," and 2.25 times profit is "an amount greater than gross receipts," the Third Circuit's analysis was at an end. Pet.App.12, 14–15. Never mind that a 23% tax on 2.25 times profit is the mathematical equivalent of a 51.75% tax on profits. Never mind that profits are less than gross receipts and are calculated in a way that begins with gross receipts. And never mind that the tax is not just "likely," but certain, to reach net gain. Never mind all that. Having accepted the Commissioner's invitation to elevate form over substance, all that mattered to the Third Circuit is that the windfall tax statute *says*

it is a "23% tax on 2.25 times profit" minus flotation value, not a 51.75% tax on excess profit. Pet.App.14.[4]

As already demonstrated, that hyper-formalistic approach and the simplistic conclusion that any tax nominally levied on an amount greater than gross receipts cannot be creditable are irreconcilable with the statute, regulation, and controlling case law. Whether the windfall tax is described as a 23% tax on 2.25 times excess profit or a 51.75% tax on excess profit alone, the fact remains that it is not just "likely," but *certain*, to actually "reach net gain in the normal circumstances in which it applies." § 1.901-2(b)(1). In other words, no matter its label or form, "taxation of net gain is the ultimate objective [and] effect of that tax." *Inland Steel*, 677 F.2d at 80. To render creditability of the tax dependent upon which of two mathematically equivalent formulations the U.K. government chose to employ would violate the long-settled principle that "[t]he label and form of the foreign tax is not determinative," *id.*, and undermine the important uniformity purpose the substance-based approach serves. As the Tax Court explained, any

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[4] As PPL explained in its petition for rehearing, among its many errors, the Third Circuit erroneously restated the windfall tax in a manner that greatly exaggerates tax liability. Based on its mistaken belief that PPL was asking it to "cast flotation value aside," Pet.App.10–11 n.2, the court restated the tax as a 23% tax on "value in profit-making terms" alone (*i.e.*, 2.25 times total period profit), without subtracting flotation value, the key component necessary to determine how much of a company's net realized profit was "excessive." That misformulation would produce a windfall tax liability nearly double the amount actually assessed.

approach under which "the same tax is either creditable or noncreditable, depending on the form in which it is enacted," is wholly "at odds with the predominant character standard set forth in the regulations and applied in the caselaw." Pet.App.83 n.34.

That is all the more true given that both the regulation and the case law explicitly contemplate that the creditability analysis may take into account whether the tax rate effectively compensates for aspects of the tax base that do not mirror U.S. taxes. As the Court of Claims explained in *Bank of America I*, a foreign tax that "embodies within itself (via the rate or otherwise)" elements that ensure that it will reach net gain is creditable, even if the base of that tax does not consist of net gain in the U.S. sense. *Bank of America I*, 459 F.2d at 520–21 (providing as an example of a creditable tax one in which rate was decreased to compensate for increasing base to an amount greater than net profit). The regulation similarly explains—repeatedly—that what matters is whether a tax "is likely to *reach* net gain," § 1.901-2(a)(3)(i) (emphasis added), not the base on which it is imposed. Thus, even a tax that is unambiguously imposed on something greater than net gain, such as gross receipts, remains creditable if, *inter alia*, "the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain" remaining. § 1.901-2(b)(4)(i). That is unquestionably the case here, as the Commissioner "stipulated that none of the 31 companies that paid the windfall tax had a windfall tax liability in excess of its total profits over its initial period." Pet.App.79.

And, of course, this case is far easier than many of the cases contemplated by the regulation. Here, the tax is not calculated based on an actual, real-world base that is greater than profits, like gross receipts. Here, the tax is imposed on a base that consists of an artificial number derived from actual, realized profits. A tax on an artificial "value" derived exclusively from actual, realized profits is no different in substance from a tax directly imposed on the actual, realized profits. It simply defies common sense, and the regulation and the case law, to treat the two differently for purposes of determining whether they result in double taxation.

Nonetheless, the Third Circuit still concluded that it must ignore that the windfall tax operates as a 51.75% tax on actual, realized profits. The court reached that conclusion primarily based on inferences it drew from Example 3 of the regulation's gross receipts test, which it appeared to understand as imposing a rigid requirement that the statutorily described base of a foreign tax can never "begin[] with an amount greater than gross receipts"—even though the regulation says explicitly that a foreign tax "imposed on the basis of amounts described [as gross receipts] satisfies the gross receipts requirement *even if it is also imposed on the basis of some amounts not described*" as gross receipts. § 1.901-2(b)(3)(i) (emphasis added).

Example 3 is neither relevant to this case nor a legitimate basis for the Third Circuit's rigid approach. As the Fifth Circuit explained, Example 3 "do[es] not illustrate the meaning of '*actual* gross receipts'" at all—it instead deals with the discrete concept of

"*imputed* gross receipts." *Entergy*, 683 F.3d at 237–38 (emphasis added); *see* § 1.901-2(b)(3)(i)(B) (tax not imposed on basis of actual gross receipts satisfies gross receipts test if imposed on basis of "[g]ross receipts computed under a method that is likely to produce an amount that is not greater than fair market value"). That concept has no application here because the U.K. windfall tax "at no point imputes gross receipts." *Entergy*, 683 F.3d at 238. It does not need to, because it is based directly on *actual* realized profits, which "were actually known" long before the tax "was even proposed." *Id.* Indeed, the critical "value" that drives the windfall tax formula can be calculated only once historical profits in the four years after privatization are known. And because U.S. and U.K. accounting principles are in all relevant respects the same, "a tax based on actual financial profits in the U.K. sense necessarily begins with gross receipts" in the U.S. sense. *Id.* Accordingly, "an example detailing an impermissible method for calculating *imputed* gross receipts (based on historical practices by OPEC countries) is facially irrelevant" to the creditability of the windfall tax. *Id.*; *cf.* Rev. Rul. 78-63, 1978-1 C.B. 228 (describing the types of taxes "intentionally structured to tax artificial or fictitious income" that Example 3 addresses).

In fact, if anything, Example 3 only underscores the problems with the Commissioner's and the Third Circuit's formalistic approach, as the whole point of the examples accompanying the gross receipts test is to explain that a foreign tax does not satisfy (or fails) the gross receipts test just because a foreign country says it is (or is not) based on gross receipts. While certain methods of imputing gross receipts may be

appropriate when actual gross receipts are "difficult to calculate or impractical to know," some foreign countries have also "use[d] imputed, rather than actual, income formulas … 'structured to tax artificial or fictitious income' in order to increase domestic tax receipts." *Id.* at 237. By "differentiat[ing] between permissible *imputed* actual gross receipts and impermissible notional amounts," *id.* at 237–38, the gross receipts examples reject a formalistic approach to creditability that would allow foreign countries to use labels and forms to manipulate the analysis. The Third Circuit's reliance on Example 3 to reintroduce that kind of unyielding formalism into the analysis thus is directly contrary to the substance-based approach to creditability that the examples exist to reinforce.

The Third Circuit veered even further off course when it suggested that the U.K. windfall tax is not creditable because it was imposed on a *subset* of initial period profits, rather than on *total* period profits. *See* Pet.App.10–11 n.2. By that logic, an excess profits tax would *never* be creditable, as a tax on "excess" profits is, by definition, a tax on less than total profits, because it assumes some rate of "normal" profit and imposes a surtax only on the excess. Indeed, the Third Circuit seemed to contemplate exactly that, and even went so far as to suggest PPL should have challenged the validity of the regulation on the ground that it effectively eliminated the credit for excess profits taxes. *Id.*

PPL did not raise any such challenge because the regulation neither compels nor supports that impermissible conclusion. The regulation is focused

on identifying situations in which a tax nominally on something like gross receipts is "likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(3)(i). So long as what a tax reaches is in fact net gain, it is irrelevant what percentage of that net gain it reaches. That much is clear from the case law, which repeatedly states that under the statute a tax need only reach "*some* net gain" to be creditable. *Bank of America II*, 61 T.C. at 760 (quoting *Bank of America I*, 459 F.2d at 523) (emphasis added); *see also Inland Steel*, 677 F.2d at 84 (examining whether tax "ha[d] the effect of falling on *some* net gain" (emphasis added)); § 1.901-2(b)(4)(i) (tax satisfies net income prong when it "is almost certain to reach *some* net gain" (emphasis added)). And it is equally clear from the fact that any other reading of the regulation would, as even the Third Circuit recognized, *see* Pet.App.10–11 n.2, render it irreconcilable with the statute, which explicitly allows a credit for "excess profits taxes." 26 U.S.C. § 901(b)(1).

At bottom, in searching for some basis to accept the Commissioner's fundamentally erroneous position, the Third Circuit arrived at a decision that is wholly at odds with the regulation and the long-standing case law interpreting section 901. While the Third Circuit paid lip service to the rule that the "classification of a foreign tax hinges on its economic substance, not its form," Pet.App.9, it nonetheless treated the form of the windfall tax as dispositive of its substance. Contrary to the statute and the regulation itself, the court read the regulation to render the practical operation of the tax as an excess profits tax legally irrelevant. To sustain that approach would be to eviscerate the fundamental rule that the creditability

of a foreign tax should not "depend upon its characterization by the foreign statutes." *Biddle*, 302 U.S. at 578.

CONCLUSION

The Court should reverse the decision below and hold the U.K. windfall tax creditable.

Respectfully submitted,

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