No. 12-43

In the Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT

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QUESTION PRESENTED

Whether the "windfall tax" set forth in the United Kingdom's Finance (No. 2) Act, 1997, c. 58 (U.K.), which imposed on privatized utilities a one-time 23% tax on the difference between a company's profit-making value and its privatization value, is an income tax for which a foreign tax credit is allowed under 26 U.S.C. 901.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1-15) is reported at 665 F.3d 60. The opinion of the United States Tax Court (Pet. App. 22-87) is reported at 135 T.C. 304.

JURISDICTION

The amended judgment of the court of appeals was entered on January 13, 2012 (Pet. App. 16-17). A petition for rehearing was denied on March 9, 2012 (Pet. App. 20-21). On May 10, 2012, Justice Alito extended the time within which to file a petition for a writ of certiorari to and including July 9, 2012, and the petition was filed on that date. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Section 901 of the Internal Revenue Code allows a United States citizen or domestic corporation to claim a credit against its United States income tax liability for "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." 26 U.S.C. 901(a) and (b)(1). The goal of the foreign tax credit is to reduce double taxation of foreign-source income paid to U.S. taxpayers. *Burnet* v. *Chicago Portrait Co.*, 285 U.S. 1, 7 (1932).

In 1983, the Secretary of the Treasury issued a regulation that defines a creditable foreign tax under Section 901. See 26 C.F.R. 1.901-2. The regulation states that a foreign tax is creditable "if and only if * * * [t]he predominant character of that tax is that of an income tax in the U.S. sense." 26 C.F.R. 1.901-2(a)(1)(ii). That standard is met if "the foreign tax is likely to reach net gain in the normal circumstances in which it applies." 26 C.F.R. 1.901-2(a)(3)(i).

The regulation explains that a foreign tax is likely to reach net gain "if and only if the tax, judged on the basis of its predominant character," satisfies each of three tests: the realization test, the gross-receipts test, and the net-income test. 26 C.F.R. 1.901-2(b)(1). The realization test is satisfied if the foreign tax "is imposed [u]pon or subsequent to the occurrence of events * * * that would result in the realization of income under the income tax provisions of the Internal Revenue Code." 26 C.F.R. 1.901-2(b)(2)(i)(A). The gross-receipts test is satisfied if the foreign tax is imposed on the basis of gross receipts or an equivalent thereof "computed under a method that is likely to produce an amount that is not greater than [the] fair market value." 26 C.F.R. 1.901-2(b)(3)(i). The net-income test is satisfied if "the base of

the tax is computed by reducing gross receipts * * * to permit * * * [r]ecovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts." 26 C.F.R. 1.901-2(b)(4)(i)(A).

2. a. Between 1984 and 1996, the government of the United Kingdom, under the control of the Conservative Party, privatized ownership of more than 50 state-owned companies by "flotation" (*i.e.*, public offering) of their stock. C.A. J.A. 100-101, 108. The flotation process involved the transfer of the companies' assets to newly created "public limited companies," followed by the offering of the new companies' shares to the public at a fixed price. *Id.* at 100-101. In December 1990, the U.K. government privatized twelve regional electric companies, including South Western Electricity plc (SWEB), which later became a subsidiary of petitioner. *Id.* at 88-93, 101.

The U.K. Government regulated the prices that the privatized utilities could charge the public. Pet. App. 2; C.A. J.A. 846-848. Nevertheless, because the privatized utilities increased efficiency to a greater degree than had been expected when the initial price controls were established, the companies realized substantially higher profits than had been anticipated. Pet. App. 2-3; C.A. J.A. 854-858. It was thus widely believed in the U.K. that the utilities had been sold too cheaply and that their profits were excessive in relation to their flotation value. *Id.* at 268, 1194-1195, 1339.

b. In 1996, the Labour Party began to explore the possibility of imposing a "windfall tax" on the privatized utilities, which it promised to enact if restored to power. C.A. J.A. 103-104. Geoffrey Robinson, a member of Parliament and the Labour Party's Paymaster General,

hired Arthur Andersen to assist the Labour Party's shadow treasury team in developing a proposal for the tax. *Id.* at 104.

The Andersen team considered three "simple" and three "complex" solutions for structuring the tax. The three simple solutions were to tax gross receipts, assets, or profits. The three complex solutions were to tax excess profits, excess shareholder returns, or a "windfall" amount. C.A. J.A. 36-43, 1107-1108. The team rejected all three simple solutions and the first two complex solutions. Robinson and the Anderson team settled on a one-time tax that would be charged on the "windfall" that the utilities were thought to have received at privatization. The windfall would be the amount by which an imputed value for each company at privatization (to be determined by applying a selected price-to-earnings ratio to each company's annual average profits over a multi-year period) exceeded the actual flotation price of the company. In other words, the proposal was to tax the difference between the price at which each company was actually sold and an estimated value at which it should have been sold. *Id.* at 323-324, 742-743, 1114-1117.

c. In 1997, the Labour Party regained control of the U.K. Government. As promised, in July 1997, Parliament enacted a "windfall tax" on the privatized utilities as part of the Finance (No. 2) Act, 1997, c. 58 (U.K.) (the Act). See Pet. App. 129-151. The windfall tax was a one-time tax that was required to be paid in two installments: one-half by December 1, 1997, and the other half by December 1, 1998. C.A. J.A. 304.

The Act provides that "[e]very company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatization involved

the imposition of economic regulation shall be charged with a tax (to be known as the 'windfall tax') on the amount of that windfall." Pet. App. 129 (Pt. I, para. 1(1)). The amount of the tax was 23% of the "windfall." *Id.* at 130 (Pt. I, para. 1(2)).

The "windfall" is defined as the difference between two values: (a) "the value in profit-making terms of the disposal made on the occasion of the company's flotation" minus (b) "the value which for privatisation purposes was put on that disposal." Pet. App. 138-139 (Sch. 1, para. 1). As the Board of Inland Revenue (the U.K. taxing authority) explained, "[t]he taxable amount is calculated by taking the value of the company in profit-making terms and deducting the value placed on the company at the time of flotation." C.A. J.A. 263-264.

i. The first of those two values (the profit-making value) is determined "by multiplying the average annual profit for the company's initial period by the applicable price-to-earnings ratio." Pet. App. 139 (Sch. 1, para. 2). A company's "initial period" is generally the first four years after flotation. *Id.* at 145-146 (Sch. 1, para. 6(1)). The "average annual profit" during that initial period is equal to the company's total profits for the initial period divided by the number of days in the initial period, multiplied by 365. *Id.* at 139 (Sch. 1, para. 2(2)).

That number is multiplied by the applicable price-to-earnings ratio, which is 9. Pet. App. 139 (Sch. 1, para. 2(3)). That figure represents the lowest average price-to-earnings ratio, during the relevant period, of the 32 companies that would be subject to the tax. *Id.* at 4; C.A. J.A. 111, 258 para. 4; 264 para. 11.

ii. The second of the two values (the flotation value) is determined by multiplying the highest price per share at which shares in the company were offered during flo-

tation by the number of shares that were offered. Pet. App. 139-140 (Sch. 1, para. 3).

The windfall tax can thus be expressed by the following formula, where P is the total profits for the company's initial period,[1] D is the number of days in the initial period, and FV is the company's flotation value (the price for which the U.K. government sold the company):

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

See Pet. App. 4.

3. SWEB paid a total windfall tax of £90,419,265. C.A. J.A. 123. Petitioner, a Pennsylvania corporation with its principal place of business in Allentown, Pennsylvania, is SWEB's parent company. Pet. App. 2; C.A. J.A. 66, 72-74, 86-88, 92-94. Under 26 U.S.C. 902, if a U.S. corporation owns at least ten percent of the voting stock of a foreign corporation and receives a dividend from the foreign corporation, the U.S. corporation is deemed to have paid (for purposes of Section 901) a portion of any foreign income tax that the foreign corporation paid on the earnings and profits from which the dividend was paid. Accordingly, in May 2000, petitioner filed a refund claim with the Internal Revenue Service (IRS), seeking a foreign tax credit for petitioner's share of the windfall tax paid by SWEB. Pet. App. 4; C.A. J.A. 127-128, 142. The IRS disallowed the claim and issued a deficiency notice. Pet. App. 4; C.A. J.A. 87, 142. Petitioner contested the deficiency notice in the United States Tax Court. Pet. App. 4; C.A. J.A. 72, 88.

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[1] The company's "total profits" refers to the company's profit on ordinary activities after tax, as determined under U.K. financial accounting principles and as reflected in the company's profit and loss accounts prepared in accordance with the U.K. Companies Act 1985. Pet. App. 141-142 (Sch. 1, para. 5).

4. The Tax Court concluded that the U.K. windfall tax was creditable under Section 901. Pet. App. 22-87. The court rejected the Commissioner's argument that the windfall tax was a tax based on value, *i.e.*, a tax on the undervaluation of SWEB at the time of flotation. *Id.* at 79. The court explained that "a foreign levy [can] be directed at net gain or income even though it is, by its terms, imposed squarely on the difference between two values." *Id.* at 81.

The Tax Court further explained that, as petitioner had argued, the windfall tax could be reformulated as a 51.71% tax on a company's profits during the initial period, to the extent those profits exceeded an average annual return of approximately 11.1% of the company's flotation value. Pet. App. 64, 83; see Pet. 8-9. Without evaluating the windfall tax under the realization, gross-receipts, or net-income tests as required by 26 C.F.R. 1.901-2(b)(1)-(4), the court concluded that the tax "did, in fact, 'reach net gain,'" and was therefore creditable under Section 901. Pet. App. 84.

5. The court of appeals reversed. Pet. App. 1-15. As an initial matter, the court explained that the Tax Court had incorrectly applied a "predominant character" standard that was detached from the three regulatory tests mandated by 26 C.F.R. 1.901-2(b)(1)-(4). Pet. App. 6 n.1. The court clarified that, in order to be a creditable income tax under Section 901, a foreign tax must satisfy each of those three tests "bas[ed] on its predominant character." *Ibid.*

The court of appeals further explained that petitioner's position suffered from a "fundamental problem": the court could not arrive at petitioner's initial-period profit as the tax base unless it applied a tax rate different from the 23% rate provided by the statute. Pet. App.

9. At petitioner's request, the court reformulated the windfall tax formula by plugging in 1461 (the number of days in four years) for D, and by disregarding the flotation value (because, according to petitioner, subtracting the flotation value was simply Parliament's way of taxing "excess" profits rather than total profits). *Id.* at 10-11. That reformulation yielded the formula:

$$\text{Tax} = 23\% \left((365 \times P/1461) \times 9\right)$$

Id. at 11. Multiplying 365 by 9 and dividing by 1461 reduces that equation to approximately:

$$\text{Tax} = 23\% \times (2.25 \times P)$$

Ibid.

The court of appeals noted that petitioner's reformulation produced a tax base of 2.25 times profit, or 2.25 times gross receipts minus 2.25 times expenses. Pet. App. 12. The court concluded that this reformulation failed the gross-receipts test because that test requires the tax base to be based on gross receipts or an approximation thereof "likely to produce an amount that is *not greater than* [the] fair market value." *Ibid.* (quoting 26 C.F.R. 1.901-2(b)(3)(i)(B)).

The court of appeals rejected petitioner's further argument that a 23% tax on 2.25 times profits is equivalent to a 51.75% tax on profits, which makes the tax base profits alone. Pet. App. 12. The court declined to view the tax in that way, noting that under petitioner's reformulation, "*[a]ny* tax on a multiple of receipts or profits could satisfy the gross receipts requirement, because we could reduce the starting point of its tax base to 100% of gross receipts by imagining a higher tax rate." *Id.* at 13-14. The court concluded that "[t]he regulation forbids that outcome." *Id.* at 14.

The court of appeals further held that the windfall tax failed to satisfy the realization test, which requires that the foreign tax be "imposed [u]pon or subsequent to the occurrence of events * * * that would result in the realization of income" under U.S. income tax provisions. 26 C.F.R. 1.901-2(b)(2)(i)(A); Pet. App. 14 n.3. The court observed that SWEB's windfall amount subject to tax (£393.1 million) was greater than its total profit during its four-year initial period (£306.2 million). Pet. App. 14 n.3. For that reason, the court stated, "[t]he U.K. windfall tax did not ensure that the companies had actually realized the amount being taxed." *Ibid.*

ARGUMENT

The court of appeals correctly held that, because the U.K. windfall tax fails to satisfy any of the regulatory criteria set forth in 26 C.F.R. 1.901-2(b)(1)-(4), it is not an income tax for which a foreign tax credit is allowed under 26 U.S.C. 901. Although the court's decision is correct, it squarely conflicts with the Fifth Circuit's decision in *Entergy Corp.* v. *Commissioner*, 683 F.3d 233 (2012), which held that a different taxpayer was entitled to a foreign tax credit under Section 901 based on its payment of a windfall tax to the U.K. government. To further the uniform administration of the federal tax laws, the Court should resolve the conflict.

1. The U.K. windfall tax fails to satisfy any of the three regulatory criteria set forth in 26 C.F.R. 1901-2(b). The court of appeals therefore correctly held that the windfall tax is not an income tax that is creditable under Section 901.

i. The windfall tax fails the realization test because it was not imposed upon or subsequent to any realization event. 26 C.F.R. 1.901-2(b)(2)(i)(A). By its terms, the tax was imposed upon a "windfall" amount that repre-

sents the undervaluation of the company at the time of flotation. Under U.S. tax law, a tax on value or appreciation is not a tax on realized income. See *Cottage Sav. Ass'n* v. *Commissioner,* 499 U.S. 554, 559 (1991); *Weiss* v. *Wiener*, 279 U.S. 333, 335 (1929).

Under the U.K. windfall tax, the mathematical formula used to determine a company's value includes as one variable the company's profits during the four years after flotation. The fact that value is calculated by reference to profits, however, does not mean that the U.K. windfall tax is an income tax. Calculating property value based on the property's ability to generate income is a widely used valuation method called the "income capitalization" method. See John A. Bogdanski, *Federal Tax Valuation* para. 3.05[1], [2] (2012); 2 *Bender's State Taxation: Principles and Practice* § 24.05[3] (Charles W. Swenson ed. 2012). In the United States, various property taxes permit or require taxable value to be determined based on the ability of property to generate income. See, *e.g.,* 26 U.S.C. 2032A(e)(8) (election to value family farm for federal estate tax purposes by capitalizing hypothetical rent); 26 C.F.R. 20.2031-3(b) and 25.2512-3(a)(2) (business interests must be valued for federal estate and gift tax purposes based on, *inter alia*, "demonstrated earning capacity of the business"); 26 C.F.R. 20.2031-2(f)(2) and 25.2512-2(f)(2) (for federal estate and gift taxes, stock that cannot be valued based on selling price is valued based on "company's net worth, prospective earning power and dividend-paying capacity").[2]

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[2] See also, *e.g.*, Ohio Admin. Code 5703:25-07(D)(2) (2008) (for property tax purposes, "income approach should be used for any type of property where rental income or income attributed to the real property is a major factor in determining value"); Mont. Admin. R.

Whenever the value of taxed property is calculated by reference to the income that the property has produced or is expected to produce, and the tax is in turn computed as a percentage of the property's value, the amount of the tax can always be expressed as a percentage of actual or expected income. If that mathematical relationship were sufficient by itself to render the tax an income tax, the distinction between a tax on income and a tax on the value of income-producing property would be largely eviscerated. Moreover, SWEB's total profits for the initial period were £306.2 million, but its taxable windfall amount was £393.1 million—almost £90 million more than its total profits during the initial period. That further demonstrates that the windfall tax was not imposed on past realized profits. Pet. App. 14 n.3.

ii. The U.K. windfall tax is not imposed on the basis of gross receipts, and it therefore fails the gross-receipts test. See 26 C.F.R. 1.901-2(b)(3)(i)(A). Although the windfall tax computes a company's profit-making value based on average annual profit during the initial period, which involves computation of gross receipts during that period, that average is multiplied by 9 to yield profit-making value. A company's profit-making value thus far exceeds its gross receipts during the initial period. As the court of appeals explained, a tax imposed on a value in excess of the fair market value of gross receipts fails the gross-receipts test. See Pet. App. 12-14 (citing 26 C.F.R. 1.901-2(b)(3)(ii), Ex. 3). The windfall tax was imposed on the difference between a

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42.20.107(1) (2011) ("income approach valuation" used to determine "market value of commercial properties" for property tax purposes); Wis. Stat. Ann. § 70.32(2r) (West 2011) (for property tax purposes, "[a]gricultural land shall be assessed according to the income that could be generated from its rental for agricultural use").

company's profit-making value (of which one variable is gross receipts during a defined period) and its flotation value. That tax base is a company value that is divorced from the traditional concept of gross receipts.

iii. For the same reason, the windfall tax does not satisfy the net-income test. 26 C.F.R. 1.901-1(b)(4)(i)(A). Although the company's profit-making value takes into account the company's average annual profit during the initial period, that is not the base of the tax. Net income during the initial period is one of many variables used to determine a company's profit-making value. The windfall tax imposes a tax on that value to the extent the company was undervalued at flotation.

Parliament could have employed any number of strategies, including a tax on the company's excess profits to recoup the windfall that the privatized utilities were believed to have. Parliament chose to enact a tax on the difference between the price at which each company was sold at flotation and the price at which it should have been sold, based on its ability to generate income. That is a tax on value, not an income tax.

2. Although the court of appeals' decision is correct, it squarely conflicts with the Fifth Circuit's decision in *Entergy*, *supra*. In *Entergy*, the Fifth Circuit rejected the Commissioner's argument that the windfall tax was a tax on the undervaluation of the utilities at flotation. 683 F.3d at 236-237. The court invoked case law from before the 1983 adoption of the Treasury regulation to conclude that it was not required to rely "exclusively, or even chiefly, on the text of the Windfall Tax" to determine its predominant character. *Id.* at 236.

The court in *Entergy* concluded that the windfall tax satisfied the realization test because the tax "is based on revenues from the ordinary operation of the utilities

that accrued long before the design and implementation of the tax." 683 F.3d at 236. The court further held that the net-income test was satisfied because "the tax only reached—and only could reach—utilities that realized a profit in the relevant period." *Ibid.* (emphasis omitted). The court acknowledged that "[a] tax actually directed at corporate value would not, in the ordinary instance, be imposed on the basis of gross receipts." *Id.* at 236. But the court concluded that the "practical operation" of the tax was to "claw back" a portion of the utilities' "'excess profits' in light of their sale value," and that the gross-receipts test was satisfied because those initial-period profits were calculated as "gross receipts less expenses." *Id.* at 236-237. The court noted that, under the U.K. windfall tax statute, "each utility could only be subject to the Windfall Tax after making a profit exceeding approximately an 11% annual return on its initial flotation value, and the Windfall Tax liability increased linearly with additional profits past that point." *Id.* at 238.

The Fifth Circuit acknowledged that its ruling was directly contrary to the Third Circuit's decision in this case. *Entergy*, 683 F.3d at 237-239. The Third and Fifth Circuits are thus squarely in conflict on the question presented. This Court's intervention is necessary to resolve that conflict.

3. The U.K. windfall tax was a one-time tax paid by a limited number of companies in the United Kingdom, only some of which are owned by U.S. corporations. The specific question presented in this case is therefore unlikely to recur or to have significance for a large number of U.S. taxpayers. As petitioner correctly notes (Pet. 34), however, at least one other U.S. taxpayer has an unresolved claim for a foreign tax credit based on the U.K. windfall tax. Questions may also arise concerning the

creditability under Section 901 of taxes paid under other foreign tax statutes.

By their nature, issues regarding the regulatory tests set forth in 26 C.F.R. 1.901-2(b) will necessarily arise in cases involving specific foreign tax laws that are unlikely to affect a large number of Americans. Nevertheless, this Court's guidance on the correct analytical approach for evaluating foreign taxes under Section 901 and the Treasury regulation may have significant administrative importance beyond the specific foreign tax law at issue here. And in any event, the square circuit conflict with respect to the U.K. windfall tax itself implicates the important federal interest in uniform enforcement of the federal tax laws. *Aquilino* v. *United States*, 363 U.S. 509, 514 (1960). Accordingly, the Commissioner agrees that this Court should grant the petition for a writ of certiorari to resolve the conflict between the Third and Fifth Circuits.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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