No. 12-43

In the Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON 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, 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 (Pet. App. 16-17) was entered on January 13, 2012. 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 petition for a writ of certiorari was granted on October 29, 2012. The jurisdiction of this Court rests on 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 "income, war profits, or excess profits tax" under Section 901. See 26 C.F.R. 1.901-2. The regulation refers to all three types of taxes as "income tax" and states that a foreign tax "is an income tax 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 [their] fair market value." 26 C.F.R. 1.901-2(b)(3)(i)(A)-(B). The regulation further provides that "[a] foreign tax that, judged on the basis of its predominant character, is imposed on the basis of amounts described in this paragraph * * * satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph." 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). The regulation provides that "[a] foreign tax * * * that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses." 26 C.F.R. 1.901-2(b)(4). The regulation further provides that "[a] foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where the tax is almost certain to reach some net gain in the normal circumstances in which it applies because 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." *Ibid.*

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. J.A. 23. The flotation process involved the U.K. government's transfer of the companies' assets to newly created "public limited companies" in exchange for the stock of the new companies. The U.K. government then sold shares in the new companies to the public at a fixed price. J.A. 24, 63-69. In December 1990, the U.K. government privatized twelve regional electric companies, including South Western Electricity plc (SWEB). J.A. 16-17, 24.

The U.K. government regulated the prices that the privatized utilities could charge the public. Pet. App. 2; J.A. 217-222. 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; J.A. 225-229. 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. J.A. 126, 140-141, 531-532, 567; C.A. J.A. 779, 800.

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. J.A. 26. 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. *Ibid.*

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. Pet. App. 32-33; J.A. 505-510. The team rejected all three simple solutions and the first two com-

plex solutions. In particular, the team rejected an excess-profits tax because of the difficulty in computing the "excess" amounts and the need for a retrospective tax to be assured of raising a target amount. J.A. 508; C.A. J.A. 321-323, 740. Robinson further testified that an excess-profits tax was rejected because "it could have impacted quite variously on the different companies involved and could have impacted very severely on perhaps even the very survivability of some of them." J.A. 508.

Robinson and the Andersen 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 average annual 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. J.A. 509-510; C.A. J.A. 323-324, 742-743. In its final presentation to Chancellor Gordon Brown, the Andersen team identified the following "windfall principles":

- Impute value of businesses on privatisation
- Recognise the windfall as value forgone by the taxpayer
- Tax the companies on the value forgone using established principles from capital gains tax legislation
- Value could be estimated as profit before tax (PBT) x a multiple

- Windfall at privatisation could be defined as estimated value *less* sales proceeds
- Positive windfall would imply that companies were sold at less than their imputed value.

C.A. J.A. 744-746.

c. In 1997, the Labour Party regained control of the U.K. government. 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. 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. J.A. 130.

The U.K. 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." § 1(1) (Pet. App. 129). The amount of the tax was 23% of the "windfall." § 1(2) (Pet. App. 130).

The "windfall"—the base of the tax—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." U.K. Act Sch. 1, para. 1 (Pet. App. 138-139). As the Board of Inland Revenue explained, "[t]he taxable amount is calculated by taking the value of the company in profit-making term[s] and deducting the value placed on the company at the time of flotation." J.A. 134.

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." U.K. Act Sch. 1, para. 2 (Pet. App. 139). A company's "initial period" is generally the first four years after flotation. U.K. Act Sch. 1, para. 6(1) (Pet. App. 145-146). 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. U.K. Act Sch. 1, para. 2(2) (Pet. App. 139).

That number is multiplied by "the applicable price-to-earnings ratio," which is 9. U.K. Act Sch. 1, para. 2(3) (Pet. App. 139). 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. J.A. 129, 135.

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

The windfall tax can thus be expressed by the following formula, where P is the total profits for the company's initial period, 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):

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

See Pet. App. 4. Because for most companies the initial period was four years (*i.e.*, four times 365 days plus one leap day), that formula is approximately equal to the following:

$$\text{Windfall Tax} = 23\% \text{ x } ((9/4 \text{ x } P) - FV)$$

See Pet. Br. 9.

3. SWEB paid a total windfall tax of £90,419,265. J.A. 45. Petitioner, a Pennsylvania corporation with its

principal place of business in Allentown, Pennsylvania, owned a 25% interest in SWEB through petitioner's subsidiaries when the windfall tax was imposed. Pet. App. 87; J.A. 12, 16. Under 26 U.S.C. 902(a), 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. In May 2000, petitioner filed a refund claim with the Internal Revenue Service (IRS), treating petitioner's share of the windfall tax paid by SWEB as a creditable foreign income tax. Pet. App. 4; J.A. 47-48. The IRS disallowed the claim and issued a deficiency notice. Pet. App. 4; J.A. 48. Petitioner contested the deficiency notice in the United States Tax Court. Pet. App. 4; J.A. 12.

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 amount by which SWEB was undervalued 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 the windfall tax could be reformulated as a 51.75% 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 (quoting 26 C.F.R. 1.901-2(a)(1) and (3).[1]

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.* (quoting 26 C.F.R. 1.901-2(b)(1)-(4)).

The court of appeals further explained that petitioner's position suffered from a "fundamental problem": the court could not arrive at SWEB's initial-period profit as the tax base unless it both ignored the flotation value variable and applied a tax rate different from the 23% rate specified by the statute. Pet. App. 9-10. At petitioner's request, and "[f]or the sake of argument," 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 (based on petitioner's contention that subtracting the flotation value was simply Parliament's way of taxing "excess"

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[1] On the same day as the Tax Court issued its decision in this case, it issued another decision in favor of a second U.S. taxpayer claiming a foreign tax credit for the windfall tax, relying on its opinion in petitioner's case. See *Entergy Corp.* v. *Commissioner*, 100 T.C.M. (CCH) 202 (2010). The Fifth Circuit affirmed that decision, *Entergy Corp.* v. *Commissioner*, 683 F.3d 233 (2012), and the Commissioner has filed a petition for a writ of certiorari seeking review of the Fifth Circuit's ruling. No. 12-277 (filed Sept. 4, 2012).

profits rather than total profits). *Id.* at 10-11. That reformulation yielded the formula:

$$\text{Tax} = 23\% \; ((365 \text{ x } P/1461) \text{ x } 9)$$

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

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

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* [their] fair market value." *Ibid.* (brackets in original) (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.*

SUMMARY OF ARGUMENT

A. In the context of U.S. federal and state taxes imposed on the value of property, it is common for value to be determined based on the property's ability to generate income. For example, taxable values of property for purposes of the federal estate and gift taxes are determined pursuant to well-recognized valuation formulas in which income plays an essential role. State property taxes are often calculated pursuant to those same valuation methods.

The "profit-making value" imputed to a company under the U.K. Act is calculated using the "market approach" to valuation, under which the value of property is determined by identifying comparable property and deriving a price-to-earnings multiple that is applied to the subject property's income data. The company's flotation value, calculated by reference to its stock price at the time of issuance, is then subtracted to yield a taxable "windfall" amount. Those are well-recognized methods of establishing a value for property under U.S. tax law.

The fact that actual initial-period profits are used in the windfall-tax calculation does not detract from its character as a valuation formula. Nor does Parliament's decision to forgo the use of other accepted valuation methods show that the windfall tax is anything other than a tax on value. The windfall tax is calculated ac-

cording to established valuation methods that are familiar to U.S. tax law. It is tax on value both in form and in substance.

B. 1. The formula used to compute a company's tax liability under the U.K. Act includes as one variable the company's profits during its initial period after flotation. Contrary to petitioner's argument, however, consideration of company profits for that purpose does not make the windfall tax a tax on income. Whenever the value of taxed property is calculated by reference to the income that the property has produced or is expected to produce, the amount of the tax can always be expressed as a percentage of actual or expected income. That mathematical relationship cannot be enough to transform a tax on value into a tax on income.

The fact that a company's flotation value is taken into account reinforces the conclusion that the windfall tax was not an income tax. If a company's flotation value is high enough, a company that made significant profits would not pay any windfall tax at all. What is important is the value the U.K government received for the company when it was sold, and whether that price accurately reflected the property's value as demonstrated by its ability to produce initial-period income. The flotation value variable also distinguishes the windfall tax from previous U.S. excess-profits taxes, which were historically imposed on a company's net income over a floor. Calculating a company's tax liability by reference to its flotation value is not a reflection of how profitable a company is over a "normal" level. It is a reflection of how valuable a company is in relation to the value the U.K. government received for the company when it was sold.

2. There is likewise no support for petitioner's argument that a foreign tax is "in substance" an income tax so long as it is not confiscatory of net gain. The decisions setting forth a "net gain" standard involve foreign tax statutes that imposed a tax on gross income rather than net income. In that context, courts sometimes found that a gross-income tax could be taxation of income in the U.S. sense. Those decisions do not support the contention that a foreign tax levied on a base other than gross or net income can be considered an income tax simply because the taxpayer is almost certain to be left with some net gain after paying the tax.

C. Under 26 C.F.R. 1.901-2(b)(2)-(4), a foreign tax is likely to reach net gain "if and only if" it satisfies three regulatory tests: the realization test, the gross-receipts test, and the net-income test. The U.K. windfall tax fails all three tests.

1. The windfall tax was not imposed upon or subsequent to a realization event. The flotation of SWEB in 1990 (the relevant event upon which the windfall tax was imposed) was not a realization event for the company, nor did any perceived appreciation in value of the company result in realization of income under U.S. tax law. For 23 of 31 companies that paid the windfall tax, the taxable windfall amount was greater than the company's total profits during the initial period. That fact further demonstrates that the windfall tax was not imposed on realized income.

2. The windfall tax was not imposed on the basis of gross receipts. Although gross receipts were used to compute a company's average annual profits, which was one variable in the windfall-tax formula, the windfall tax was not imposed on the basis of those receipts. The receipts figured into a larger formula that produced a

company value divorced from the concept of gross receipts.

3. The windfall tax fails the net-income test because the base of the tax was not a company's net income. The tax was imposed on a base "windfall" amount that reflected a company's undervaluation at the time of flotation. That number was in most cases greater than a company's total net income during its four-year initial period. Under the regulation, a tax that uses gross income or gross receipts as its base may occasionally satisfy the net-income test. The regulation does not, however, allow a free-wheeling inquiry into whether a tax based on something other than gross income or gross receipts can satisfy the net-income requirement.

D. The legislative history of the U.K. Act does not support petitioner's characterization of the windfall tax as a tax on "excess profits." The legislative history reflects Parliament's views that the companies were sold too cheaply *and* that their initial-period profits were excessive. Although that mix of concerns *might* have led Parliament to enact an excess-profits tax, Parliament instead chose as the tax base an increment of company value. Nothing in the U.K. Act's legislative history justifies disregarding that choice for purposes of Section 901.

E. Disallowing a foreign tax credit for petitioner's portion of the windfall tax paid by SWEB will not result in double taxation. Petitioner received a foreign tax credit for its portion of SWEB's income taxes paid during the years SWEB paid the windfall tax, and petitioner gets the benefit of a deduction for its share of SWEB's windfall tax paid to the U.K. government.

ARGUMENT

THE U.K. WINDFALL TAX IS NOT AN INCOME TAX FOR WHICH A FOREIGN TAX CREDIT IS ALLOWED UNDER 26 U.S.C. 901

The windfall tax is not an income tax; it is a tax on value. That is so both because the U.K. government wrote it as a tax on value and because a company's windfall tax liability is determined pursuant to a method of valuing property that is familiar to U.S. tax law. Under U.S. tax law, it is common to calculate the value of property by taking into account the property's ability to generate income. That method of calculation does not make a tax imposed on the value of property an income tax.

The fatal flaw in petitioner's position is the premise that every tax calculated using net profits as a variable is "in substance" an income tax. A mathematical relationship between a company's profitability and the amount of the tax imposed does not transform a tax on value into an income tax for purposes of 26 U.S.C. 901. Nor is a foreign tax "in substance" an income tax simply because it can be expected to leave the taxpayer with some net gain. That broad view of the concept of an income tax would greatly expand the universe of foreign taxes that would be eligible for a dollar-for-dollar tax credit under Section 901.

A foreign tax is an income tax if and only if it satisfies the requirements set forth in 26 C.F.R. 1.901-2(b)(2)-(4), and the U.K. windfall tax fails all three of those requirements. Nothing in either the legislative history of the windfall tax or the policies behind the U.S. foreign tax credit can transform the windfall tax into taxation of income. The windfall tax therefore is not creditable under Section 901.

A. The Windfall Tax Is A Tax On Value

1. Under U.S. tax principles, it is common for the value of property to be determined based on the property's ability to generate income

a. In the context of federal and state taxes imposed on the value of property, it is common for value to be determined based on the property's ability to generate income. For example, in the federal estate and gift tax contexts, the taxable value of property normally is its fair market value. See 26 U.S.C. 2031(a), 2512; 26 C.F.R. 20.2031-1(b), 25.2512-1. That value generally is determined according to one (or a combination) of three widely recognized valuation methods: the income approach, the market approach, and the asset-based approach. David Laro & Shannon P. Pratt, *Business Valuation and Federal Taxes: Procedure, Law, and Perspective* 12 (2d ed. 2011); see John A. Bogdanski, *Federal Tax Valuation* ¶ 3.01, at 3-2 (2003). The income generated by the property plays an essential role in determining value under both the income approach and the market approach.

Under the income approach, the value of an asset is calculated by determining the present value of the stream of future income that the property is projected to produce. "Capitalization of the stream of economic benefits generated by an asset is in a sense the purest form of valuation that exists." Bogdanski ¶ 3.05[1][b], at 3-51. "As Learned Hand once remarked in a nontax valuation case, 'every one knows that the value of shares in a commercial or manufacturing company depends chiefly on what they will earn.'" *Id.* ¶ 3.05[2], at 3-54 (quoting *Borg* v. *International Silver Co.*, 11 F.2d 147, 152 (2d Cir. 1925)). There are two basic methods for applying the income approach: (1) all expected future

economic benefits are projected and then discounted to present value (discounting), or (2) a single economic benefit is divided by a capitalization rate to yield a present value (capitalizing). Laro & Pratt 164.

Under the market approach, the value of property is determined by identifying comparable property and deriving a valuation multiple from the relevant data. That multiple is then applied to the subject property's data to yield a value for the property. "The most familiar market value multiple," and one of the most commonly used, is "the price/earnings (P/E) multiple." Shannon P. Pratt, *The Market Approach to Valuing Businesses* 4, 10 (2d ed. 2005) (emphasis omitted). As one valuation treatise explains,

> one frequently encounters valuations that look to the ratio of the stock price of the comparable company to its annual earnings, known as the price-earnings ratio for short. This ratio is then applied to the earnings of the company at issue to arrive at a fair market value for all of its stock.

Bogdanski ¶ 3.04[2][b], at 3-29.

b. Consistent with these valuation principles, the Treasury regulations governing estate and gift tax valuation emphasize the importance of income in determining taxable value. They require business interests to be valued based on, *inter alia*, "demonstrated earning capacity of the business." 26 C.F.R. 20.2031-3(b), 25.2512-3(a)(2). Stock that cannot be valued based on selling price must be valued based on "the company's net worth, prospective earning power and dividend-paying capacity." 26 C.F.R. 20.2031-2(f)(2), 25.2512-2(f)(2). Revenue Ruling 59-60, which sets forth guidelines for valuing stock in closely held corporations for estate and gift tax purposes, further states that

"[p]otential future income is a major factor in many valuations of closely-held stocks," and that an appraiser should "accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public." Rev. Rul. 59-60 §§ 4.02(f) and 5(a), 1959-1 C.B. 237, 241, 242.

Under the federal estate tax, 26 U.S.C. 2032A, an executor may elect to value real property used in farming or in a closely held trade or business based on its current operating use, rather than on its generally higher fair market value. This is known as the "special use valuation." Under that valuation method, the value of a farm is computed by taking the "average annual gross cash rental for comparable land," subtracting the "average annual State and local real estate taxes for such comparable land," and dividing that total by "the average annual effective interest rate for all new Federal Land Bank loans." 26 U.S.C. 2032A(e)(7)(A). Because dividing by the interest rate has the same effect as applying a multiplier (*e.g.*, $100 \div .05 = 100 \times 20$), the special use valuation formula computes taxable value as a multiple of average annual rent. Each average annual computation required under the formula is made on the basis of historical data, specifically, "the [five] most recent calendar years ending before the date of the decedent's death." *Ibid.*

c. In the context of state property taxes, it is likewise common for taxable property value to be determined based on the property's ability to generate income. 2 *Bender's State Taxation: Principles and Practice* § 20.05, at 20-29 (Charles W. Swenson ed. 2012). Although assessors generally have discretion to select the most appropriate valuation method under the circumstances, some States have enacted laws directing

use of the income approach in certain circumstances. See, *e.g.*, Colo. Rev. Stat. § 39-1-103(5)(a) (2012) ("The actual value of agricultural lands, exclusive of building improvements thereon, shall be determined by consideration of the earning or productive capacity of such lands during a reasonable period of time, capitalized at a rate of thirteen percent."); Kan. Stat. Ann. § 79-503a(g) (Supp. 2010) (factors to be used in determining property value include "earning capacity as indicated by lease price, by capitalization of net income or by absorption or sell-out period"); Wis. Stat. Ann. § 70.32(2r) (West Supp. 2012) (for property-tax purposes, "[a]gricultural land shall be assessed according to the income that could be generated from its rental for agricultural use"); Mont. Admin. R. 42.20.107(1) (2012) ("income approach valuation" used to determine "market value of commercial properties" for property-tax purposes); Ohio Admin. Code 5703-25-07(D)(2) (2010) (for public utility property tax, "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"); see also New York City Dep't of Fin., *Property: Estimating Market Value*, http://www.nyc.gov/html/dof/property/property_val_estimate.shtml (last visited Jan. 10, 2013) (in the case of commercial property and residential properties that contain 11 or more units, New York City Department of Finance "estimates [] property value based on its income producing potential," by "either divid[ing] the net income by a capitalization rate (an estimated rate of return) or [] multiply[ing] the gross income by a multiplier").

It is thus a well-understood U.S. tax principle that income may be an essential variable in calculating the value of property. Under the income approach and the

market approach, actual or projected profits for a particular property are divided by a capitalization rate or multiplied by a price-to-earnings ratio to determine a property value. Consideration of income in this sense does not change the fact that the tax is on the value of the property, not the income.

2. The windfall tax is computed using a formula that is well-understood as a method of valuing property

a. Under the U.K. Act, a company's windfall is calculated using the market approach described above. To calculate a company's windfall-tax liability, a "value in profit-making terms" is imputed to the company by multiplying its "average annual profit" during its initial period by a price-to-earnings ratio of 9. U.K. Act Sch. 1, para. 2(1), (3) (Pet. App. 139); J.A. 129. 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. J.A. 135. As the Commissioner's expert in valuation methodology testified, that formula for determining profit-making value, which is calculated as a multiple of "average annual profit" during the company's initial period, is identical to the market approach for valuing property for tax purposes. J.A. 520-522.

After a company's imputed profit-making value is calculated using the market approach, the company's flotation value (which is calculated by reference to its stock price—another accepted method of valuing property) is subtracted from the imputed value. The resulting "windfall" amount reflects the difference between the price at which a company should have been sold at flotation and the price at which it was actually sold, *i.e.*, the undervaluation of the company at the time of flotation. Finally, a 23% tax is imposed on that "windfall"

amount. See U.K. Act Sch. 1, para. 3 (Pet. App. 139-140). The windfall tax thus is calculated using accepted valuation methods that are familiar in U.S. tax law. It is a tax on value both in form and in substance, not a tax on income.

b. Petitioner contends that the windfall tax is not directed at "'value' in any normal or U.S. sense of the word" (Br. 41-42) because the formula uses a company's past profits, rather than a projection of its future earnings, to determine its profit-making value. As explained above (see pp. 17-18, *supra*), however, the use of past profits to calculate the present value of property is a familiar practice under U.S. tax law. See, *e.g.*, 26 U.S.C. 2032A(e)(7)(A) (calculating average annual rent for special use valuation of farms using data from "the [five] most recent calendar years ending before the date of the decedent's death").

When it enacted the windfall tax in 1997, moreover, Parliament was not attempting to determine the value of the privatized companies as of that date. It sought instead to devise a formula that would properly value the companies as of the date their stock was sold to the public, which for SWEB was December 1990. In 1997, Parliament did not need to project SWEB's future earnings for the four-year initial period following its 1990 flotation; those profits were known. Parliament's reliance on historical profits therefore does not alter the fact that, in the windfall tax statute, Parliament used an established valuation method to determine the value of each privatized company as of the time of flotation.

c. Petitioner further contends (Br. 42) that the windfall tax formula is not an earnest attempt to value a company because it "ignores a readily available measure of value in the form of the publicly traded price of the

companies' stock." *Ibid.* But because Parliament was attempting to value the companies as of the date of flotation, the price of the companies' stock as of some later date would have been an inadequate proxy. Particularly where, as here, the statutory formula comports with well-established valuation principles, the fact that a different—and in this case less accurate—valuation method might have been used does not cast doubt on the basic character of the U.K. windfall tax as a tax on company value.

The Parliamentary debate on the windfall tax identifies several reasons why Parliament chose the valuation formula it did. In defending the formula, which some members of Parliament criticized as simplistic and unfair, Geoffrey Robinson stated that "simplicity has great merits," including reducing the opportunities for tax avoidance and valuation disputes. J.A. 172, C.A. J.A. 460; see J.A. 158 (statement of Parliament member Ross Cranston that the "Government have rightly taken the approach of a simple formula, as set out in the schedule" because "[a]ny other approach would open opportunities for [tax] avoidance"). Robinson also repeatedly defended the price-to-earnings ratio of 9, stating that "setting the price-to-earnings ratio at nine, slightly below the lowest sectoral average[,] shows a Government who are trying to be reasonable and fair in all respects." J.A. 164; see J.A. 153. The windfall tax is thus a tax on value both in substance and in form. It is calculated according to established valuation methods that are familiar to U.S. tax law.

In any event, for purposes of the Section 901 inquiry, it is irrelevant whether Parliament employed the soundest available method of valuing the privatized companies. If the windfall tax was in fact a tax on an incre-

ment of company value, it is not creditable. The text of the U.K. Act states unambiguously that the privatized companies' profits were used, not as the base of the windfall tax, but as one determinant of company value. See U.K. Act Sch. 1, paras. 1-2 (Pet. App. 138-139).

B. The Windfall Tax Is Not "In Substance" An Income Tax

The windfall tax takes into account a company's profits during its four-year initial period to assess the profit-making value of that company as of the date of flotation. Use of company profits as one variable in the statutory formula does not make the windfall tax an income tax. Petitioner's "substance-over-form" argument reflects the premise that, if a tax is calculated using profits as a variable, it necessarily is "in substance" a tax on income. That premise is unsound.

1. A tax that is calculated using profits as a variable is not necessarily "in substance" an income tax

a. As petitioner emphasizes (Br. 9-10, 37-50), the statutory formula used to calculate the U.K. windfall tax can be re-expressed as approximately 51.75% of the difference between (1) a company's profits during its four-year initial period and (2) 4/9 of its flotation value. Petitioner contends on that basis that the windfall tax is properly viewed as a 51.75% tax on each company's "excess profits." Those mathematical calculations do not show that the windfall tax is "in substance" an income tax.

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 in turn is a specified 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 rela-

tionship were sufficient by itself to render the tax an income tax, the distinction between a tax on income and a tax on value would be largely eviscerated. This Court has long recognized that "[t]he incidence of a tax on income differs from that of a tax on property." *New York ex rel. Cohn* v. *Graves*, 300 U.S. 308, 314 (1937). That principle holds true even when the formula used to calculate value includes actual or projected income as one variable.

b. Petitioner is also wrong in contending (Br. 9) that "profits are the only variable in the [windfall tax] equation." *Ibid.* Each company's taxable windfall amount is calculated by subtracting its actual flotation value from its assessed profit-making value. Because the flotation value is a separate variable that is different for each company, two companies with the same initial-period profits may face substantially different windfall-tax liability because one was sold to the public at a higher price. Indeed, at least one privatized utility (British Energy plc) paid no windfall tax at all, even though it realized a profit during its initial period, because its flotation value was higher than its profit-making value as determined under the statutory formula. See Appellee's R.E. at Tab H, sch. 4B, *Entergy Corp.* v. *Commissioner*, 683 F.3d 233 (5th Cir. 2012) (No. 10-60988), petition for cert. pending, No. 12-277 (filed Sept. 4, 2012).

It is therefore wrong, or at least potentially misleading, to describe the U.K. Act as providing that "[t]he more profitable the company was during [the four-year initial period], the higher the tax." Pet. Br. 8. To be sure, for any particular privatized company, flotation value is a fixed historical fact that will not change depending on the company's subsequent operation. Once a particular company's flotation value has been estab-

lished and can be treated as a constant, plugging higher initial-period profit figures into the statutory formula will indeed produce higher windfall-tax liability.[2] It does not follow, however, that tax liability under the U.K. Act depends only on profitability, or that more profitable privatized companies will necessarily pay more tax than will less profitable businesses. Rather, the sum that the U.K. government received for a company at flotation is an equally important determinant of the amount (if any) of windfall tax that the company owes.

c. The use of flotation value as a variable in the statutory formula also is not typical of excess-profits taxes. See Entergy Corp. & Affiliated Subsidiaries Amicus Br. (Entergy Amicus Br.) 3-6; Am. Elec. Power Co. Amicus Br. (AEP Amicus Br.) 6-7. In 1917, Congress enacted an excess-profits tax that was imposed at the rate of 8% of a taxpayer's net income exceeding the sum of $5000 and 8% of its "actual capital invested." See Act of Mar. 3, 1917, ch. 159, Tit. II., 39 Stat. 1000. The "invested capital" standard is based on the assumption that "normal" profits are measured by a return on capital invested in the business.

Congress also enacted excess-profits taxes around the time of World War II and the Korean War. Under the Excess Profits Tax Act of 1940, ch. 757, Tit. II, 54 Stat. 975, a tax was imposed on the taxpayer's net income over an allowance. To calculate the allowance, a taxpayer could choose between an "invested capital" method and a "base period" method. Under the "base period" method, the allowance was based on the taxpayer's average profits during a set base period of 1936-1939; profits above that average profit were taxed. The

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[2] That is why SWEB's downward adjustment to its financial statements reduced its windfall-tax liability. See Pet. Br. 38.

Korean War excess-profits tax was calculated in a similar way. See Excess Profits Tax Act of 1950, ch. 1199, Tit. I, 64 Stat. 1137. Within the United States, excess-profits taxes thus have historically been imposed on a base of net income over a floor, with the floor being determined by either historical net income during a base period, or a specified percentage of return on the company's capital investment.

Amicus Entergy contends that, in the U.K. windfall tax, "[a] percentage return on flotation value served the function of an invested capital standard." Entergy Amicus Br. 25; see AEP Amicus Br. 14 ("[T]he flotation value was used to determine what portion of the profits were considered 'normal.'"). Under the formula established by the U.K. Act, however, a company could make far higher initial-period profits than it did during any historical base period and pay no windfall tax, so long as the U.K. government was properly compensated for the value of the company at flotation. The U.K. Act requires that initial-period profits be compared, not to any measure of "normal" profits, but to the value that was placed on the company when it was sold. That difference between the windfall tax and historic excess-profits taxes reinforces the conclusion that the windfall tax is a tax on value.

d. Petitioner's theory of the case largely centers on its effort to demonstrate the mathematical equivalence of two potential formulas for computing the windfall tax. The first is the following:

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

See Pet. App. 4. The second is petitioner's proposed rewrite:

$$\text{Windfall Tax} = 51.75\% \text{ x } (P - (4/9 \times FV))$$

See Pet. Br. 10.

For purposes of computing a particular privatized company's windfall-tax liability, those formulas are indeed equivalent. Assuming that 1461 (four years including a leap day) is used as the value for D, both formulas will produce essentially the same number for tax owed when the same values for P (initial-period profits) and FV (flotation value) are used in the two equations. For purposes of identifying the applicable tax rate and the base on which the windfall tax is imposed, however, the two formulas have very different implications. The first formula uses profits as one determinant of company value and taxes an increment of value at a rate of 23%. The second treats income as the tax base, and it imposes a tax of 51.75% on an increment of initial-period profits above a floor set at four-ninths of flotation value. Although the two formulas produce the same tax liability if P and FV are held constant, that is just a matter of algebra. It is the choice between the two that determines whether the windfall tax is properly viewed as a tax *on* income. And there is no question which of the two formulas Parliament actually enacted.

It bears emphasis, in this regard, that the question before this Court has nothing to do with the *propriety* of Parliament's action. Congress obviously could not, and in enacting Section 901 did not purport to, limit the authority of any foreign government to enact any type of tax. The question here is not whether the U.K. government could impose and collect the tax, but whether certain costs incurred as a result of the U.K. Act should be borne by petitioner or instead by the U.S. Treasury. Petitioner's insinuations that Parliament used a subterfuge to obscure what was in substance an income tax are

therefore particularly misplaced in this context. Although the application of Section 901 does not turn on the label that a foreign government attaches to its tax, United States courts should accept the relevant foreign law's designation of the applicable tax rate and the base on which the tax is imposed. Under that approach, the U.K. Act did not impose an income tax.

In any event, there is no sound reason to doubt that the formula used in the U.K. Act accurately reflects Parliament's reasons for imposing the windfall tax. The companies subject to the tax had previously been owned by the U.K. government, and the government was believed to have sold the companies at too low a price. The windfall tax is an attempt to recover some of that lost value. Whether that effort was a wise exercise of Parliament's authority (cf. Pet. Br. 6, 7) is not relevant to the issue before this Court. What matters is whether the windfall tax is taxation of income as that concept is understood in the United States. It is not.

2. A tax on value that is not confiscatory of net gain is not necessarily "in substance" an income tax

Petitioner also relies (Br. 26-31) on case law that predates the 1983 Treasury regulation. Petitioner describes those decisions as holding that a foreign tax is creditable under Section 901 so long as the tax "is likely to reach net gain." Pet. Br. 31. All of those decisions, however, involved foreign statutes that specifically identified gross income as the base on which the tax was levied.

As a general matter, a gross-income tax is not similar in concept to an "income tax" in the U.S. sense. That is because the U.S. income tax is imposed only on those taxpayers who have a net gain after deducting from gross income the costs and expenses incurred to produce

that income. See *Eisner* v. *Macomber*, 252 U.S. 189, 207-208 (1920). In the decisions on which petitioner relies, the courts concluded that a foreign gross-income tax may bear a sufficient resemblance to the U.S. income tax, thereby allowing the taxpayer to qualify for a tax credit under Section 901, if the tax would almost certainly reach net gain in the normal circumstances in which it applies.

The decisions petitioner cites do not suggest that *every* foreign tax that is likely to reach a taxpayer's net gain—even a tax on the value of property—is eligible for a dollar-for-dollar tax credit under 26 U.S.C. 901. To the contrary, those decisions describe an income tax as a tax on gain or profits and explain that "[t]axes plainly on subjects other than income, even though measured to some extent by income, are not income taxes." *Inland Steel Co.* v. *United States*, 677 F.2d 72, 80 (Ct. Cl. 1982) (per curiam).

a. *Seatrain Lines, Inc.* v. *Commissioner*, 46 B.T.A. 1076 (1942), involved a 3% tax imposed by the Cuban government on "money received by foreign shipping companies for cargoes and passengers taken aboard in Cuban ports." *Id.* at 1077. The Board of Tax Appeals explained that the tax had formerly been a 6% tax on net profits, but had been adjusted to a 3% tax on gross income because of "controversy [that] arose between the shipping companies and the tax authorities * * * on the question of what proportion of expenses should be allowed against revenues * * * in determining 'net profits.'" *Ibid.* The Board explained that the reduction in the tax rate had been "adopted as a compromise measure in order to avoid the complex and vexatious allocation and calculation of the deductible items peculiar to the [taxpayer's] business," and that the tax clearly

"took [the] place" of the former 6% tax on net profits under Cuban tax law, thus preserving its character as an income tax. *Id.* at 1080-1081.

In *Bank of America National Trust & Savings Ass'n* v. *United States*, 459 F.2d 513, cert. denied, 409 U.S. 949 (1972) (*Bank of America I*), the Court of Claims evaluated three foreign taxes that "were all in substance levies on the taxpayer's gross income from its banking business carried on by its branch in the particular country." *Id.* at 516-517. The court explained that "[f]or none of the three taxes was the taxpayer permitted to deduct from gross income the costs or expenses of its banking business or of producing its net income," which was problematic because "gain is a necessary ingredient of income." *Id.* at 517. The court concluded that "[i]n certain situations a levy can in reality be directed at net gain even though it is imposed squarely on gross income," which would be the case if it were clear that the costs, expenses, and losses incurred in making that gain were less than gross income. *Id.* at 519. The court held that "a direct income tax is creditable, even though imposed on gross income, if it is very highly likely * * * always to reach some net gain in the normal circumstances in which it applies." *Id.* at 519-520. The court concluded, however, that the foreign taxes at issue were not creditable because they were levied on gross income with no allowance for deductions of costs and expenses, and that "[a]ny taxpayer could be liable whether or not it operated at a profit during the year." *Id.* at 524.

In *Bank of America National Trust & Savings Ass'n* v. *Commissioner*, 61 T.C. 752 (1974), aff'd, 538 F.2d 334 (9th Cir. 1976) (Table) (*Bank of America II*), the Tax Court evaluated the same foreign taxes and agreed with the Court of Claims' holding that Section 901(b)(1) "in-

cludes a gross income tax if, but only if, that impost is almost sure, or very likely, to reach some net gain because costs or expenses will not be so high as to offset the net profit." *Id.* at 760 (quoting *Bank of America I*, 459 F.2d at 523).

Finally, in *Inland Steel*, the Court of Claims evaluated whether the taxpayer was entitled to a foreign tax credit for the Ontario Mining Tax, which was imposed on sale proceeds of iron. 677 F.3d at 79. The court concluded that the tax was not an income tax because it did not allow "significant costs of the mining business" to be deducted, and it was imposed on an "artificial computation of net profit" that would not "be recognized as such in this country." *Id.* at 84-85.

b. None of those pre-regulation foreign-tax-credit cases suggests that every foreign tax can be considered taxation of income so long as it can be expected to reach net gain. In all of those cases, the base of the foreign tax was gross income, and the courts described the U.S. concept of an income tax as "*a direct tax on gain or profits*." *Bank of America II*, 61 T.C. at 760 (emphasis added) (quoting *Bank of America I*, 459 F.2d at 523); see *Bank of America I*, 459 F.2d at 517, 519-520 (stating that "an income tax is a direct tax on gain or profits" and holding that "*a direct income tax* is creditable, even though imposed on gross income, if it is very likely to reach some net gain in the normal circumstances in which it applies") (emphasis added); *Keasbey & Mattison Co.* v. *Rothensies*, 133 F.2d 894, 897 (3d Cir.) ("[A]n income tax is a direct tax upon income."), cert. denied, 320 U.S. 739 (1943); see also *Allstate Ins. Co.* v. *United States*, 419 F.2d 409, 414 (Ct. Cl. 1969) (same).

In particular, none of the pre-regulation decisions suggests that a court, in applying Section 901, can adopt

an understanding of the applicable tax base different from that specified in the relevant foreign law. It is one thing to say that a foreign tax on gross income can operate "in substance" as an "income tax in the U.S. sense," even though the relevant foreign law does not allow deductions for incurred expenses. It is quite another to say that a foreign tax imposed by its terms on an increment of property value can be reconceptualized, through offsetting alterations to the statutory tax base and tax rate, as a tax on income. The decisions on which petitioner relies do not support that proposition.

c. Petitioner may be correct 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. Br. 45 (quoting Pet. App. 79). But if that were a sufficient basis for treating the tax as creditable under 26 U.S.C. 901, a variety of taxes that are indisputably computed using criteria other than income (*e.g.*, a tax on the value of property) would trigger a dollar-for-dollar credit so long as the amount of the tax was unlikely to exceed the taxpayer's net gain. The foreign tax credit is an exemption from taxation that must be narrowly construed, *Texasgulf, Inc.* v. *Commissioner*, 172 F.3d 209, 214 (2d Cir. 1999); *Keasbey & Mattison*, 133 F.2d at 898, and it applies only to "income, war profits, and excess profits taxes," 26 U.S.C. 901(b)(1). Although a comparison between the amount of a tax and the taxpayer's net gain may bear on whether a *gross*-income tax is "an income tax in the U.S. sense," 26 C.F.R. 1.901-2(a)(1)(ii), such a comparison is not a stand-alone test for creditability.

C. The Windfall Tax Does Not Satisfy Any Of The Three Regulatory Tests Set Forth In 26 C.F.R. 1.901-2(b)(2)-(4)

The 1983 Treasury regulation defines a creditable "income, war profits, or excess profits" tax for purposes of 26 U.S.C. 901. See 26 C.F.R. 1.901-2. The agency promulgated the regulation to bring structure and clarity to the inquiry used to determine whether particular foreign taxes are creditable under Section 901. The regulation adopts the "net gain" standard that had emerged in the case law, but it lays out specific criteria required to meet that standard.

As the preamble to the regulation explains,

> [u]nder these final regulations, the predominant character of a foreign tax is that of an income tax in the U.S. sense if the foreign tax is likely to reach net gain in the normal circumstances in which it applies. This standard, found in § 1.901-2(a)(3)(i), adopts the criterion for creditability set forth in *Inland Steel Company* v. *U.S.*, 677 F.2d 72 (Ct. Cl. 1982), *Bank of America National Trust and Savings Association* v. *U.S.*, 459 F.2d 513 (Ct. Cl. 1972), and *Bank of America National Trust and Savings Association* v. *Commissioner*, 61 T.C. 752 (1974). The regulations set forth three tests for determining if a foreign tax is likely to reach net gain: the realization test, the gross receipts test, and the net income test. All of these tests must be met in order for the predominant character of the foreign tax to be that of an income tax in the U.S. sense.

T.D. 7918, 1983-2 C.B. 113, 114. Thus, "[a]lthough § 1.901-2's preamble reaffirms *Inland Steel*'s general focus upon the extent to which a tax reaches net gain, both the preamble and § 1.901-2 introduce three detailed tests for conducting the net gain inquiry." *Texasgulf,*

Inc., 172 F.3d at 216; see Pet. App. 6-7 n.1 (court of appeals stating that the regulation does not adopt a "'predominant character standard' [that is] independent of the three requirements," and that under the regulation, a court "may not * * * simply ask whether the 'predominant character' of a foreign tax is that of a U.S. income tax without addressing the [three regulatory] requirements").

Under the regulation, a foreign tax triggers the dollar-for-dollar credit "*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) (emphasis added). That regulation has the force of law, see *Mayo Found. for Med. Educ. & Research* v. *United States*, 131 S. Ct. 704 (2011), and petitioner has conceded that "[t]here is no dispute regarding the validity of the [r]egulation," Pet. C.A. Br. 39 n.15. Because the U.K. windfall tax does not satisfy any of those three regulatory requirements, it is not an income tax for which a foreign tax credit is allowed under 26 U.S.C. 901.

1. The windfall tax does not satisfy the realization test

A foreign tax satisfies the realization test if "it is imposed * * * [u]pon or subsequent to the occurrence of events ('realization 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). By its terms, the U.K. windfall tax was imposed upon a deemed "windfall" amount that reflected the company's undervaluation at the time of flotation, *i.e.*, the difference between the price at which the company was sold at flotation and the price at which it should have been sold. The relevant event upon which the windfall tax was imposed is thus the flotation of a

company at too low a value, which for SWEB occurred in 1990.

The U.K. government's sale of SWEB's stock to the public during the flotation process was not a realization event to SWEB, because SWEB was not a party to that sale. See J.A. 63-69. Instead, the flotation process merely changed the identity of SWEB's shareholders. And even if the company had directly sold its stock to the public, it would not have realized income as a result. A corporation's raising of capital through an original issuance of stock is not an event "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); see 26 U.S.C. 1032; *General Electric Co.* v. *United States*, 299 F.2d 942, 945-947 (Ct. Cl.), cert. denied, 371 U.S. 940 (1962).

As we explain above (see pp. 23-28, *supra*), although the U.K. Act's formula for computing profit-making value used initial-period profits as one variable, Parliament's objective was to value the companies as of the date of flotation. The "windfall" that Parliament chose to tax thus was the undervaluation of the companies at flotation, not a perceived appreciation in value during the four years thereafter. But even if the relevant windfall were thought to be an increase in SWEB's value during the company's initial period, the U.K. windfall tax would not satisfy the realization test. Although economists may consider appreciation in value of property held by a taxpayer (such as stock or real property) to be income, appreciation is not generally subject to tax under U.S. tax principles. See *Cottage Sav. Ass'n* v. *Commissioner*, 499 U.S. 554, 559 (1991); *Weiss* v. *Weiner*, 279 U.S. 333, 335 (1929). Rather, the Internal Revenue Code taxes gain from property when the gain

has been realized through a sale or other disposition of the property. 26 U.S.C. 1001; *Cottage Sav. Ass'n*, 499 U.S. at 559.

The formula used to calculate the windfall tax "did not ensure that the companies had actually realized the amount being taxed." Pet. App. 14 n.3. To the contrary, for 23 of the 31 companies that had a windfall-tax liability, the base on which the windfall tax was imposed exceeded the realized initial-period profits. See Appellee's R.E. at Tab H, sch. 4B, *Entergy Corp.*, *supra* (No. 10-60988). Of the 12 electric companies that paid the tax, ten companies—including SWEB—had taxable "windfalls" that were roughly £100 million greater than their total initial-period profits. J.A. 195. SWEB's total profits for its initial period were £306.2 million, but its taxable windfall (*i.e.*, the difference between its imputed profit-making value and its flotation value) was £393.1 million. *Ibid.* That disparity highlights the fact that the windfall tax was not imposed on past realized gain.

2. The windfall tax does not satisfy the gross-receipts test

Under the Treasury regulation, "[a] foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of * * * [g]ross receipts; or * * * [g]ross receipts computed under a method that is likely to produce an amount that is not greater than fair market value." 26 C.F.R. 1.901-2(b)(3)(i). Although a company's profit-making value under the U.K. Act depends on its average annual profit during the initial period, which involves computation of gross receipts during that period, the windfall tax was not imposed on the basis of those gross receipts. In the windfall-tax formula, the average annual profit of the company is multiplied by 9 to yield a

profit-making value, and the tax is imposed on the difference between that value and the company's flotation value. That tax base therefore is a company value that is divorced from the traditional concept of gross receipts.

Petitioner criticizes (Br. 42-48) the court of appeals' reliance on Example 3 illustrating the regulation's gross-receipts test. That Example discusses the application of the gross-receipts requirement to a foreign tax on the extraction of petroleum that "deems" a company's gross receipts from extraction to be 105% of the fair market value of the petroleum extracted. See 26 C.F.R. 1.901-2(b)(3)(i)(A), Ex. 3. Example 3 explains that such a foreign tax would not meet the gross-receipts requirement because "[t]his computation is designed to produce an amount that is greater than the fair market value of actual gross receipts." *Ibid.*

Although the example is not directly applicable because it analyzes imputed gross receipts rather than actual gross receipts, it provides a useful analogy. The U.K. windfall tax computes a company's annual average profit using its actual gross receipts, but that average is multiplied by a price-to-earnings ratio of 9 to yield a company's profit-making value. A company's profit-making value thus had no apparent relation to gross receipts and may well have exceeded gross receipts during the initial period. As the court of appeals explained, a tax imposed on an amount in excess of the fair market value of gross receipts fails the gross-receipts test. Pet. App. 12-14.

Petitioner seeks to avoid that conclusion by recharacterizing the U.K. windfall tax as a tax of 51.75% on any initial-period profits in excess of 4/9 of a company's flotation value. Pet. Br. 10. But as the court of

appeals further recognized, Example 3 assumes that the tax base specified in the relevant foreign law is to be taken as given. "[A] 20% tax on 105% of receipts is mathematically equivalent to a 21% tax on 100% of receipts, the latter of which would satisfy the gross receipts requirement." Pet. App. 13. Example 3 would make no sense, however, if a U.S. taxpayer could render the hypothetical 20% tax creditable simply by recharacterizing it as a 21% tax on a lower tax base. See *id.* at 13-14.

Petitioner also points out (Br. 46) that, under the regulation, "[a] foreign tax that, judged on the basis of its predominant character, is imposed on the basis of [gross receipts] satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph." 26 C.F.R. 1.901-2(b)(3)(i) (flush language). That language merely allows a foreign tax with minor non-conforming elements, such as inclusion of unrealized rental income (which amounts are not "gross receipts") in the tax base, to meet the gross-receipts test based on its "predominant character." See 26 C.F.R. 1.901-2(b)(2)(i) (flush language). It does not mean that a foreign tax satisfies the gross-receipts test so long as "gross receipts" is one variable in the tax formula.

3. The windfall tax does not satisfy the net-income test

a. 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). The "base" of the U.K. windfall tax is not computed in that way. Rather, as explained above, the base of the tax is computed

by assessing a company's value using average annual profit and a price-to-earnings multiple, then subtracting its flotation value. A 23% tax rate is applied to that base.

For 23 of 31 companies that paid the windfall tax, including SWEB, the company's windfall amount subject to tax was an amount *greater* than its net profits during the initial period. J.A. 195; see p. 36, *supra*. As the court of appeals correctly recognized, those data show that the base on which the tax was imposed was neither a company's net income nor a subset of net income (such as net income above a specified amount). Pet. App. 14 n.3.[3] The data thus refute the contention of amicus Entergy that "the amount produced as the tax base by the Windfall tax formula is, in every case, a subset of gross receipts less operating expenses." Entergy Amicus Br. 18 (emphasis and internal quotation marks omitted). In

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[3] Petitioner contends (Br. 48-49) that the court of appeals "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." *Id.* at 48. The court of appeals said no such thing, and petitioner's citation to footnote 2 of the court of appeals' opinion does not support its characterization. See Pet. App. 10-11 n.2. In footnote 2, the Third Circuit simply addressed and rejected petitioner's argument that 26 C.F.R. 1.901-2 provides no guidance on what constitutes a creditable excess-profits tax. See Pet. C.A. Br. 36. The court pointed out that the same three-part test applicable to income taxes (realization, gross-receipts, net-income) applies to excess-profits taxes, and it noted that petitioner had not challenged the validity of the regulation for failing to set forth a different test for excess-profits taxes. In any event, the court recognized that if the windfall tax were an excess-profits tax, then it presumably would have been imposed on a subset of the companies' total profits. It rejected that characterization because "the [windfall] amount being taxed [] was greater than initial-period profit." Pet. App. 14 n.3.

fact, the tax base was the difference between the price at which a company was sold (as computed based on the statutory formula for assessing profit-making value) and the price at which it should have been sold. For most companies subject to the tax, that difference was greater than the company's total profits during its initial period.

b. Although petitioner does not directly address the net-income test, it contends that a foreign tax may be creditable "even if the base of that tax does not consist of net gain in the U.S. sense." Pet. Br. 45. The net-income test requires, however, that "the base of the tax [must be] computed by reducing gross receipts * * * to permit * * * recovery of significant costs and expenses." 26 C.F.R. 1.901-2(b)(4)(i)(A). Petitioner's argument that "what matters is whether a tax 'is likely to *reach* net gain,' not the base on which it is imposed," Pet. Br. 45 (citation omitted), flatly ignores the Treasury regulation.

c. Petitioner contends (Br. 45) that, under the regulation, a tax "that is unambiguously imposed on something greater than net gain, such as gross receipts," may still be creditable if "'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." *Ibid.* (quoting 26 C.F.R. 1.901-2(b)(4) (flush language)). The flush language petitioner quotes is less permissive than petitioner suggests. That language provides:

> A foreign tax *whose base is gross receipts or gross income* does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross re-

> ceipts or gross income, respectively, and the tax rate is such that after the tax is paid persons subject to the tax are almost certain to have net gain.

26 C.F.R. 1.901-2(b)(4) (flush language) (emphasis added). That language establishes that, in rare circumstances, a foreign tax "whose base is gross receipts or gross income" may satisfy the net-income requirement even though the taxpayer's costs and expenses are not deducted in determining the tax base. The limited nature of that exception is consistent with pre-regulation case law. See pp. 29-32, *supra*. Where (as here) the base of a foreign tax is *neither* net nor gross income, the regulation does not allow the foreign tax to be characterized as an income tax simply because it can be expected to leave the taxpayer with some net gain.

d. That the regulation requires the base of a foreign tax to be net income does not mean that the Commissioner's position turns on "labels" and "form." As petitioner correctly observes (Br. 33-35), the regulation calls for "scratching" beneath the surface of the foreign statute in certain aspects to account for non-income-tax-like elements of the foreign tax base and otherwise to look for essential equivalence with U.S. income-tax features. See, *e.g.*, 26 C.F.R. 1.901-2(b)(4)(i) (flush language) (stating that for net-income test, "[a] foreign tax law that does not permit recovery of one or more significant costs or expenses, but provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses"); see also 26 C.F.R. 1.901-2(b)(2)(i) (flush language) (stating that realization test may be met "even though the base of [the] tax also includes imputed rental income" as long as it is not "based only or predominantly on such imputed rental income");

26 C.F.R. 1.901-2(b)(3)(ii) (gross-receipts test may be met if approximation thereof is computed under a method not likely to produce an amount exceeding fair market value).

That structured flexibility does not mean, however, that every foreign tax—including a tax on a subject other than income—can be classified as an income tax so long as it will normally reach net gain. The base of the U.S. income tax is gross income minus allowable deductions. The Treasury regulation identifies foreign taxes with a similar base to receive the dollar-for-dollar credit against a taxpayer's U.S. income tax liability that Section 901 allows.

In that respect, the "labels" and "form" that a foreign government uses to formulate a tax are relevant, even if they are not determinative of how the tax should be classified. See, *e.g.*, *Phillips Petroleum Co.* v. *Commissioner*, 104 T.C. 256, 295-296 (1995) ("While labels should not be determinative in the question of creditability, the declaration of the lawmaking power is entitled to much weight."); cf. *United States* v. *Mississippi Chem. Corp.*, 405 U.S. 298 (1972) (in determining the tax consequences of purchasing stock in federally established farm banks, the form of the stock chosen by Congress "must have considerable impact" and "has [a] bearing on the tax consequences of the purchases"). The "base" of the windfall tax could not be described as net income unless both the tax base and the tax rate are rewritten, which is what petitioner has done to characterize the tax as a 51.75% tax on excess profits. There are infinite ways to express the algebraic formula that is the windfall tax, but the classification of the tax should be based on the iteration selected by Parliament. By treating the tax as a formula whose factors can be rearranged at will,

petitioner has stripped the U.K. statute of its core concepts. See pp. 26-27, *supra*.

e. Petitioner suggests (Br. 23, 26) that foreign statutory text cannot form the basis for analysis due to language and conceptual barriers. That argument rings especially hollow in this case, as the U.K. statute is in English, and petitioner's accounting expert testified that British and U.S. accounting principles are "fundamentally the same." J.A. 434. All of the key terms used in the windfall tax are defined in detail in the U.K. statute. As we explain above, moreover, it is well-established as a matter of U.S. tax law that (i) the value of income-producing property can be calculated by reference to actual or projected income, and (ii) a tax on property so valued is not an income tax. If the text of the U.K. Act is taken at face value, the tax is in substance a tax on excess value (*i.e.*, the difference between the actual value of the privatized companies and the amounts the U.K. received for them at flotation) rather than a tax on income as such.

D. The Legislative History Of The U.K. Act Does Not Support Petitioner's Attempt To Characterize The Windfall Tax As An Income Tax

Petitioner contends (Br. 13-14, 39-40) that the legislative history of the U.K. Act reveals the windfall tax to be an excess profits tax "dressed * * * up" as a tax on value for unspecified "'presentational' reasons peculiar to the U.K. political and economic environment at the time." *Id.* at 13 (quoting Pet. App. 58). According to petitioner (Br. 8-9), Parliament created a formula that determined an "artificial" profit-making value for each company by applying an "arbitrary" price-to-earnings ratio of 9, thereby imposing an excess-profits tax disguised as a tax on the difference between two values.

The legislative history of the windfall tax does not bear out that characterization.

In support of its contention that Parliament intended to tax "excess profits," petitioner relies almost entirely on testimony from Arthur Andersen employees. Those employees were not the "drafters of the tax" (Pet. Br. 13), however, but instead were paid consultants of Geoffrey Robinson. J.A. 502. Nor did they coin the phrase "value in profit-making terms." Christopher Wales of the Andersen team testified that, although the team presented its windfall tax proposal to the U.K. Treasury, the Office of Parliamentary Counsel drafted its own legislation, which differed from the Andersen proposal. In particular, Parliamentary Counsel devised the statutory phrase "value in profit-making terms," which was not in the Andersen proposal. J.A. 343-345; C.A. J.A. 1200-1201. And after making its presentation to the U.K. Treasury, the Andersen team had no further involvement in the enactment of the U.K. Act. C.A. J.A. 1209-1213.

Thus, the Andersen team's unsubstantiated testimony that the windfall tax was "dressed up" as a value tax for unspecified political reasons does not establish that Parliament shared that view. And the Andersen team's speculation as to the meaning of "value in profit-making terms" is entitled to no weight. Even if their views were shared by Geoffrey Robinson, a single Member of Parliament, there is no basis for ascribing those views to Parliament as a whole. See *Western Air Lines, Inc.* v. *Board of Equalization*, 480 U.S. 123, 131 n.* (1987) (rejecting affidavit of lawyer involved in legislative process, stating that "[a]ppellants' attempt at the creation of legislative history through the *post hoc* statements of interested onlookers is entitled to no weight"); *Bread*

Political Action Comm. v. *FEC*, 455 U.S. 577, 582 n.3 (1982) (giving no weight to affidavit by Senator's executive assistant, who drafted legislation); see also *Graham Cnty. Soil & Water Conservation Dist.* v. *United States*, 130 S. Ct. 1396, 1409 (2010) (Senator's post-enactment letter was of "scant or no value" in determining legislative intent).

In any event, the record refutes petitioner's claim that the windfall tax was structured as a value tax solely for "presentational" reasons. To the contrary, the perceived undervaluation of the privatized companies was just as much a justification for the tax as the companies' perceived excess profits. Andersen's own proposal to the U.K. Treasury stated that "[t]he structure of the tax should reflect, as closely as possible, the reason for its imposition. As we understand it, these reasons have been identified by the Labour Party as value foregone by the taxpayer as a result of privitisation at too low a price; a regulatory regime that was initially too lax; and the exploitation of an initial degree of monopoly power." C.A. J.A. 236. Britain's Institute of Fiscal Studies, which wrote extensively about the windfall tax, identified the same three reasons for the tax. *Id*. at 779.

In the same budget speech that petitioner cites for Gordon Brown's reference to taxing "excess profits" (Pet. Br. 14), Brown stated that "[i]n determining the details of the tax, I believe I have struck a fair balance between recognising the position of the utilities today and their under-valuation and under regulation at the time of privatisation." J.A. 126. Brown explained that "[a] company's tax bill will be based on the difference between the value that was placed on it at privatisation, and a more realistic market valuation based on its after-tax profits for up to the first [four] full accounting years

following privatisation." *Ibid.* In its explanatory notes accompanying the windfall-tax bill, the U.K. Treasury stated that "[t]he profits made by these companies in the years following privatisation were excessive when considered as a return on the value placed on the companies at the time of their privatisation by flotation * * * because the companies were sold too cheaply and regulation in the relevant periods was too lax." J.A. 140-141. And in the Parliamentary debate over the windfall tax, Geoffrey Robinson stated that "the rationale of the tax" was that "the companies were sold off too cheaply when their shares were offered under value on flotation, and were regulated too loosely in the initial period after privatisation." J.A. 148.[4]

Parliament's perception thus was *both* that the utilities had been sold too cheaply *and* that their initial-period profits had been excessive. As the Tax Court stated, "both [petitioner and the Commissioner] may be said to be correct in their assessment of the political motivation for the windfall tax." Pet. App. 80. Based on that assessment of the companies' privatization and its aftermath, Parliament might reasonably have chosen *either* to tax the companies' perceived excess profits *or* to impose a tax on some increment of company value. The law that Parliament actually enacted, however,

[4] The possibility that a U.S. foreign tax credit would not be available to U.S. shareholders of the privatized companies, because the windfall tax was "a tax on capital rather than income," was discussed during the Parliamentary debate. Members of Parliament expressed the view that the windfall tax would *not* be eligible for a tax credit in the United States. J.A. 162, 169-170, 176; see C.A. J.A. 830 (Chartered Institute of Taxation's July 1997 Representations on the Finance Bill) ("Windfall Tax, as structured, does not give rise to a credit of this type because it is not a tax on profits but rather a tax based on the value of the company itself.").

unambiguously identified the base of the tax as the difference between a company's "value in profit-making terms" and the price for which the company was sold. *Id.* at 138-140. And in treating initial-period profits as one determinant of company value, Parliament employed a valuation method that is frequently used for U.S. tax purposes. Thus, while Parliament might have levied a tax on excess profits as such, it instead treated profits as one variable to be used in calculating company value, an increment of which value was the base on which the tax was imposed. Nothing in the U.K. Act's legislative history justifies disregarding that choice.

E. Disallowing A Foreign Tax Credit For Petitioner's Portion Of The Windfall Tax Paid By SWEB Does Not Result In Double Taxation

Petitioner contends (Br. 26-27) that its version of "substance-over-form" is necessary to preserve Congress's policy of mitigating double taxation through 26 U.S.C. 901. But Section 901 operates only to prevent double taxation *of income*, and there was no double taxation of SWEB's income here. SWEB paid U.K. income tax in the same years that it paid the windfall tax (1997 and 1998), and a foreign tax credit was available to petitioner for that income tax. 9/22/11 C.A. Oral Arg. Tr. 33.

This does not mean that foreign taxes other than income taxes are irrelevant to a U.S. taxpayer's obligations under the Internal Revenue Code. Under 26 U.S.C. 164(a)(3), taxpayers may claim a deduction for foreign non-income taxes paid. A taxpayer (like petitioner) that did not directly pay the foreign tax receives the benefit of the deduction through other Internal Revenue Code provisions governing dividends paid by the foreign subsidiary. See, *e.g.*, 26 U.S.C. 316(a); 26

C.F.R. 1.902-1(a)(9). The dollar-for-dollar credit provided in 26 U.S.C. 901, however, is reserved for foreign taxes that have the predominant character of a U.S. income tax. That provision is an exemption from taxation that must be narrowly construed. *Texasgulf, Inc.*, 172 F.3d at 214; *Keasbey & Mattison Co.*, 133 F.2d at 898. It should not be extended to foreign taxes, such as the U.K. windfall tax, that do not have the essential features of the U.S. income tax.

CONCLUSION

The judgment of the court of appeals should be affirmed.

Respectfully submitted.

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