No. 12-43

IN THE
Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

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

BRIEF OF AMERICAN ELECTRIC POWER COMPANY, INC. AS *AMICUS CURIAE* IN SUPPORT OF PETITIONERS

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INTEREST OF THE *AMICUS CURIAE*[1]

American Electric Power Company, Inc. (AEP) is a public utility holding company. Through its affiliates, AEP ranks among the nation's largest generators of electricity, and it owns the nation's largest electricity transmission system. It services approximately 5.3 million U.S. customers in eleven states.

During 1997, AEP owned, indirectly through its subsidiaries, a 50% interest in Yorkshire Electricity Group, PLC, one of the twelve privatized British regional electricity companies that were liable for the U.K. Windfall Tax. AEP has claimed foreign tax credits for its share of that liability in computing its consolidated U.S. corporate income tax liability. In 2000, AEP completed its merger with Central and South West Corporation (CSW), another public utility holding company. During 1997, CSW owned SEEBOARD Group PLC, another British regional electricity company that was liable for the U.K. Windfall Tax. In computing its U.S. corporation income tax liability, CSW claimed foreign tax credits for the Windfall Tax paid by SEEBOARD. The IRS disallowed the credits by AEP and CSW on the ground that the U.K. Windfall Tax is not a creditable tax under Internal Revenue Code (26 U.S.C.) § 901. AEP is currently disputing that disallowance in administrative proceedings before the IRS.

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[1] Pursuant to Rule 37.6, *amicus* states that no counsel for a party authored this brief in whole or in part, and no person or entity, other than *amicus* and its counsel, made a monetary contribution to the preparation or submission of the brief. As reflected in letters filed with the Clerk, all parties have consented to the filing of this brief.

The issue presented in this case concerning the creditability of the U.K. Windfall Tax under section 901 is the same issue that AEP is contesting with the IRS in its dispute. AEP therefore has a strong interest in the outcome of this case, and it filed a brief as *amicus curiae* in the court of appeals.

SUMMARY OF ARGUMENT

A. When Congress enacted the foreign tax credit in 1918, it had recently enacted excess profits taxes designed to help fund the First World War. In making "excess-profits taxes" creditable in section 901, Congress thus surely contemplated that foreign taxes whose operation and effect is like those U.S. excess profits taxes would be entitled to the foreign tax credit. For the last century, section 901 has been consistently understood in that way. In particular, the IRS has ruled eligible for the credit taxes imposed on a portion of profits that exceed a specified return on capital. The 1983 regulations did not change that approach. They describe a three-part test for identifying taxes on net income that, in the context of an excess profits tax, should be applied to the portion of net income that is taxed. When making this determination, a court looks to the operation and effect of the tax, not to the labels attached by the foreign statute.

B. The Tax Court's analysis correctly showed that the operation and effect of the U.K. Windfall Tax is akin to that of a U.S. excess profits tax. Flotation value operated as a baseline below which "normal" profits were insulated from the tax, and above which "excess" profits were taxed. There was a direct correlation between a change in the taxpayer's profits and its tax liability, and companies paid no tax if they had no income.

Despite the label attached by the U.K. statute, the tax lacks the characteristics of a genuine tax on value.

C. The court of appeals erred in holding that the U.K. Windfall Tax is not creditable because of the way the statute describes the tax base. First, there is no basis for contending that the three-part test is not satisfied because of the role of flotation value in the calculation. A percentage of flotation value simply serves as the proxy for "normal" profits that are not subjected to the tax and thus is not part of the tax base to which the three-part test ought to apply. Indeed, because the quantity that defines the baseline for normal profits is typically a specified return on capital, rather than a net income figure, bringing that quantity into the net gain test would threaten the creditability of all excess profits taxes – contrary to long established administrative practice and the statutory text.

Second, there is no basis for the court of appeals' holding that the tax cannot be creditable because, under the calculation set forth in the statute, the 23% tax rate is applied to the taxpayers' excess profits only after those profits have been multiplied by two constants – a "price-to-earnings ratio" of nine and a fraction representing the length of the initial period. This argument leads to an absurd result because, as the Tax Court explained, this calculation is mathematically equivalent to a 51.7% tax on the excess profits. There is no rational reason why the two equivalent calculations should lead to a different result with respect to creditability. In either case, the tax reaches net gain, and the quantity being taxed is determined in compliance with the three-part test

of the regulations. Once the baseline for determining untaxed "normal" profits has been established, the only variable in the tax calculation is net profits.

The court of appeals misunderstood the example in the regulations that is the only authority cited for its decision. The example addresses a tax that uses "deemed" gross receipts and has no relevance to a tax like this one that is based on actual gross receipts. And the example does not address tax rates or calculation mechanics, but rather is concerned with the use of a fictitious proxy for gross receipts that would inevitably inflate net income, resulting in a tax that does not reach net gain. The U.K. Windfall Tax, by contrast, does reach net gain and does not involve a proxy for gross receipts.

ARGUMENT

The court of appeals' decision in this case turns established law governing the foreign tax credit upside down. For almost a century, it has been settled that a U.S. taxpayer is entitled to a credit for foreign tax payments if the operation and effect of the foreign tax was akin to that of a U.S. excess profits tax or income tax. In particular, if the predominant character of the foreign levy is to tax all or some of a taxpayer's realized net income, it is creditable. That rule flows from the statutory text and is consistently reflected in the case law and the regulations. The court of appeals, however, lost its way by focusing myopically on irrelevant nuances in the regulations and misinterpreting them in a way that contradicts the basic thrust of the statute. As the Fifth Circuit correctly concluded in *Entergy Corp. v. Commissioner*, 683 F.3d 233 (5th Cir.

2012), *pet. for cert. filed*, No. 12-277 (Sept. 4, 2012), there is no sound basis for not finding the U.K. Windfall Tax to be a creditable tax.

A. Section 901 Affords a Credit for a Foreign Tax Whose Operation and Effect Is Like That of a U.S. Excess Profits Tax

Section 901 of the Internal Revenue Code (26 U.S.C.) permits a foreign tax credit for "income, war profits, and excess-profits taxes" imposed by a foreign country. The predecessor to this provision was enacted in substantially the same form in 1918. Revenue Act of 1918, Pub. L. No. 65-254, § 238(a), 40 Stat. 1057, 1080 (1919). The purpose of the credit is to mitigate double taxation of earnings from foreign sources. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932) ("primary design of the provision was to mitigate the evil of double taxation"); H.R. Rep. No. 65-767, at 11 (1918) (credit designed to alleviate "severe burden" on U.S. citizens subject to "income and war or excess profits taxes in a foreign country").

Over the century that this statute has been in effect, two principles germane to the issue in this case have been consistently applied: (1) foreign taxes that operate like traditional U.S. excess profits are creditable; and (2) creditability is determined based on the operation and effect of the foreign tax.

1. Section 901 Has Been Consistently Understood to Afford a Credit for Foreign Taxes That Are Akin to a Traditional U.S. Excess Profits Tax

a. Consistent With the Statutory Text, Section 901 Has Been Administered to Afford a Credit for Traditional Excess Profits Taxes

The foreign taxes singled out for the credit in 1918 were types of income taxes that Congress itself had recently enacted during the First World War. Typically, excess profits taxes are imposed on profits that exceed some threshold amount of "normal" profits, which is often determined by reference to a company's return on capital. *See* Statement of Treasury Secretary W.G. McAdoo, *Income, Excess Profits and Estate Taxes: Hearings Before the House Comm. on Ways and Means*, 65th Cong., Part I, 15 (1918) ("By an excess-profits tax we mean a tax upon profits in excess of a given return on capital."). For example, the Revenue Act of March 3, 1917, imposed a tax on net income exceeding the sum of: (a) $5,000; and (b) eight percent of actual capital invested and employed in the business. Pub. L. No. 64-377, § 201, 39 Stat. 1000, 1000. The Revenue Act of 1918, the same legislation that enacted the foreign tax credit, imposed taxes on income in excess of a specified return on invested capital and on income exceeding a specified pre-war base. Pub. L. No. 65-254, Title III ("War-Profits and Excess-Profits Tax").[2] Thus,

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[2] Although they may employ different mechanisms to isolate profits deemed to be excessive, "war profits" taxes imposed on

in granting credits for "income, war profits, and excess-profits taxes," Congress clearly contemplated that taxes imposed on a measure of excess profits would be creditable.

Over the last century, there has been little controversy over affording the credit to taxes that operate like a traditional excess profits tax, such as the one contained in the Revenue Act of March 3, 1917. In particular, the IRS has consistently agreed that such a tax is creditable when it is imposed on a portion of a company's net profits, even if the determination of what portion of those profits are "excess" looks to quantities other than net income. If a tax on all of a taxpayer's realized net profits in a given period is creditable as an income tax, it logically follows that a tax on a portion of those net profits is creditable as an excess profits tax.

For example, in the 1950s Cuba levied a 0.4% tax on a company's real worth of capital and a 15% tax on any profits in excess of 10% of that capital. The IRS ruled that these were two distinct taxes for foreign tax credit purposes. Rev. Rul. 56-51, 1956-1 C.B. 320. The former was not creditable because it "is levied against capital valuation and is due whether or not the taxpayer has net income for the period." *Id.* The latter tax, however, was creditable as a "tax on excess profits" because it "is imposed as an additional tax on the profits subject to taxation and is due only if there is income in the

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income realized in excess of a prior base period have long been recognized simply to be a different form of excess profits taxation. *See* Robert Murray Haig, *The Taxation of Excess Profits in Great Britain*, 10 The Am. Econ. Rev. 1, 11 (Supp. 1920) ("Both standards result in excess profits taxes").

form of profits." *Id*. at 321, 320. The ruling specifically observed that it was affording the credit even though "reference must be made to the valuation of capital declared under article 14, as a basis for computing the excess profits subject to taxation under article 15." *Id*. at 320. *See also* Rev. Rul. 68-318, 1968-1 C.B. 342, 343 (Italian tax on "portion of aggregate income exceeding six percent of taxable capital"); I.T. 3381, 1940-1 C.B. 57 (Mexican tax on profits exceeding 15% of company's net worth). Thus, the IRS consistently took the position that an excess profits tax is creditable even where an integral part of the tax calculation is a valuation that determines which profits are excess.

Although not dealing specifically with excess profits taxes, the leading early precedents construing the foreign tax credit understood the reach of the credit in the same way, expounding the basic principle that "the term 'income tax' in §901(b)(1) covers all foreign income taxes designed to fall on *some net gain* or profit." *Bank of Am. Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d 513, 523 (Ct. Cl. 1972) (emphasis added). *See also Inland Steel Co. v. United States*, 677 F.2d 72, 80 (Ct. Cl. 1982) ("To qualify as an income tax in the United States sense, the foreign country must have made an attempt always to reach *some net gain* in the normal circumstances in which the tax applies.") (emphasis added). In repeatedly referring to "some" net gain, these formulations recognized that traditional excess profits taxes imposed on a portion of a taxpayer's profits would be creditable.

As Professor Owens observed in her seminal treatise, "the issues as to the character of the tax base . . . which are inherent in identifying an excess

profits tax are the same as those involved in identifying an income tax." Elisabeth A. Owens, *The Foreign Tax Credit* 69 (1961). Focusing on the portion of the taxpayer's income that is taxed as excess profits, the IRS approach has been that "exactly the same basic doctrine and tests will be applicable in identifying an excess profits tax as are applicable in identifying an income tax." *Id*. at 69-70; *see also* 3 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Income, Estates & Gifts* ¶ 72.4.1, at 72-11 (3d ed. 2011) (the three taxes listed in the statute "can be reduced to 'income taxes' because excess profits taxes are a type of tax on income").

b. The 1983 Regulations Did Not Alter the Treatment of Excess Profits Taxes

Nothing about this approach changed when Treasury issued the current regulations in the early 1980s. Those regulations were designed to provide additional guidance on how to classify certain kinds of foreign taxes that bore some resemblance to U.S. income taxes but also had differences. In particular, they sought to deal with issues that were arising in the context of companies extracting minerals owned by foreign states, with respect to distinguishing among subsidies, royalties, and foreign income tax payments. *See, e.g.*, 2 Joseph Isenbergh, *U.S. Taxation of Foreign Persons and Foreign Income* ¶ 55.4 (4th ed. 2012) ("Isenbergh"). The regulations did not separately address any special issues surrounding excess profits taxes. *See, e.g.*, Am. Law Inst., *Federal Income Tax Project*, Tentative Draft No. 15, at 5 (Mar. 31, 1986) ("The regulations do not purport to

define 'war profits' or 'excess profits' taxes."). Rather, the regulations simply use the term "income tax" throughout, after stating that "income, war profits, or excess profits tax" will all be "referred to as 'income tax' for purposes of this section." Treas. Reg. § 1.901-2(a)(1). The regulations thus embody the teaching of prior IRS rulings as summarized by Professor Owens – whether a foreign tax is creditable as an excess profits tax will be measured by applying to the portion of the profits taxed the same tests used when an income tax is imposed on all of a taxpayer's income.

The regulatory test applicable to all taxes creditable under section 901 asks whether the "predominant character of [the foreign] tax is that of an income tax in the U.S. sense," meaning whether it "is likely to reach net gain in the normal circumstances in which it applies." Treas. Reg. § 1.901-2(a)(1)(ii), (3)(i). The regulation then fleshes out this net gain inquiry by requiring that the foreign tax, "judged on the basis of its predominant character," satisfy all three hallmarks of a U.S. income tax: (1) imposed subsequent to "realization events"; (2) imposed on the basis of gross receipts; and (3) allows recovery of significant costs and expenses such that the tax is imposed on "net income," not gross income. *Id.* § 1.901-2(b).

The new regulations plainly were not designed to radically transform settled administrative and case law that had developed over the previous 65 years under section 901. Rather, the primary focus of the regulations was to provide clarification through more detailed rules in order to "dispel the confusion" that had developed in analyzing certain kinds of tax regimes. *Texasgulf, Inc. v. Commis-*

sioner, 172 F.3d 209, 214 (2d Cir. 1999). Indeed, the preamble to the final regulations emphasized continuity, specifically noting the drafters' intent to "adopt[ ] the criterion for creditability set forth in" the three leading precedents under section 901. T.D. 7918, 48 Fed. Reg. 46272, 46273 (Oct. 12, 1983).

Certainly, nothing in the preamble or the text of the regulations suggests any change in the treatment of excess profits taxes. The judicial decisions under the new regulations are fully consistent in this respect with prior law. For example, the Tax Court found creditable under the new regulations a British tax on petroleum revenue that was identified by government officials as "an excess profits tax" and that the court found "constitutes an income or excess profits tax in the U.S. sense." *Exxon v. Commissioner*, 113 T.C. 338, 357, 356 (1999). *See also Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256, 312 (1995) (applying temporary regulations and stating that credit "encompasses foreign income taxes designed to effectively reach *some net gain* or profit") (emphasis added).

2. The Creditability of a Foreign Tax Is Measured by Its Actual Operation and Effect, Not by the Labels Used by the Foreign State

This Court laid down the basic principle for construing the foreign tax credit statute in *Biddle v. Commissioner*, 302 U.S. 573 (1938). The meaning of "income, war profits, and excess-profits taxes" is not determined "by reference to foreign characterizations and classifications of tax legislation." *Id.* at 579. Rather, a court looks to

how these terms are "used in our own revenue laws," and must "ascertain[ ] from an examination of the manner in which the [foreign] tax is laid and collected" whether the foreign tax falls within the language of section 901 "as those terms are used in our own statute." *Id*.

Later court decisions made clear that the labels attached by the foreign state would not govern creditability. In *Bank of America National Trust & Savings Ass'n v. United States*, 459 F.2d 513, 519 (Ct. Cl. 1972), for example, the court explained that "[t]he important thing is whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives." *See also Inland Steel Co. v. United States*, 677 F.2d 72, 80 (Ct. Cl. 1982) (the "label and form of the foreign tax is not determinative"). Rather, the courts considered extrinsic evidence of the operation and effect of a tax to determine its similarity to U.S. income taxes. *See, e.g.*, *id*. at 81-87.

As previously noted, the preamble to the 1983 regulations explicitly stated an intent to "adopt[ ] the criterion for creditability set forth in" these cases. T.D. 7918, 48 Fed. Reg. at 46273. And the regulations plainly contemplate an inquiry that looks deeper than the labels attached by the foreign state to its tax – both in repeatedly emphasizing the "predominant character" of the tax and in asking whether it is "likely to reach net gain in the normal circumstances in which it applies." *See, e.g.*, Treas. Reg. § 1.901-2(a)(3)(i). Accordingly, as the Tax Court found, post-regulations cases have consistently "considered evidence of the purpose, design, and operation of the foreign tax in question

in considering creditability," rather than relying on statutory labels. Pet. App. 58; *id*. at 75-77.

B. The Operation and Effect of the U.K. Windfall Tax Is Akin to That of a U.S. Excess Profits Tax

The Tax Court's analysis conformed to both of these basic principles, as the court examined whether the U.K. Windfall Tax was akin to a U.S. excess profits tax by looking to its operation and effect. The Tax Court found that "both the design and effect of the windfall tax was to tax an amount that, under U.S. tax principles, may be considered excess profits realized by the vast majority of the windfall tax companies." *Id*. at 84. Explaining that "our inquiry as to the design and incidence of the tax convinces us that its predominant character is that of a tax on excess profits," the court concluded that the tax "did, in fact, 'reach net gain in the normal circumstances in which it applied'" within the meaning of the regulations. *Id*. at 79, 84. The court's conclusion was supported by a voluminous evidentiary record concerning the operation and effect of the U.K. Windfall Tax, as well as the history of its development into the particular form in which it was enacted.

But the court's analysis did not just rely upon extrinsic evidence. The court also analyzed the tax as set forth on the face of the statute and determined that in substance the tax constituted an excess profits tax. *Id*. at 83. The tax rate was applied to a quantity that contained two basic variables – the taxpayer's "initial period profits"

and its "flotation value."[3] Because the flotation value was used to determine what portion of the profits were "normal" and hence not subject to the tax, the tax fell only on a portion of the profits component, just like a traditional excess profits tax. Thus, the Tax Court specifically found that "[t]he design of the windfall tax formula made certain that the tax would, in fact, operate as an excess profits tax for the vast majority of the companies subject to it." *Id.*

The government argued below that the court had inquired too deeply into the operation and effect of the tax. Instead, the government contended, the court should have restricted its analysis to the face of the U.K. statute and accepted the description there that the two basic variables were "flotation *value*" and "profit-making *value*." Pet. App. 8 (emphasis added); *see also id.* at 71. Since the tax base was defined as "the difference between two imputed values," the government argued, the tax must be treated as a tax on value, not an income tax. *Id.*

The court of appeals did not rest its decision on the use of the word "value" in the U.K. statute. But, even though it paid lip service to the proposition that "classification of a foreign tax

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[3] There was slight variation among the taxpayers with respect to the length of the initial period for which profits were measured. Of the 32 taxpayers subject to the tax, 29 had an initial period of four full financial years (generally 1,461 days), but three others (including one who paid no tax) had shorter periods. *See* Pet. App. 43-44. These minor deviations do not affect the predominant character of the tax and, for purposes of simplicity, we treat the tax in this brief as covering an initial period of four years.

hinges on its economic substance, not its form" (*id.* at 9), the court of appeals ultimately approached the inquiry in a very formalistic way. It erroneously ruled that the outcome was controlled by the precise way in which the foreign legislators described the tax calculation. *See infra* pp. 22-29.

Perhaps blinded by its focus on the tax formula in algebraic terms, the court of appeals did not directly take issue with the Tax Court's findings that the U.K. Windfall Tax operated as an excess profits tax. The court of appeals was remarkably silent on this point, apparently believing that the Tax Court's finding was irrelevant. But the statute indicates that the credit should be available for a foreign tax that operates like a U.S. excess profits tax. Accordingly, before turning to the court of appeals' discussion of the tax calculation, we briefly address why the Tax Court was correct in viewing this tax as an excess profits tax and the government was wrong in arguing that it is a tax on value.

In *New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937), this Court addressed in the state tax context the question whether a tax is properly classified as an income tax or as a property tax. The specific issue was whether a state tax on rental income from real property located in another state was barred as equivalent to a tax on the real estate. The Court asked where the tax burden fell, remarking that the "incidence of a tax on income differs from that of a tax on property." *Id.* at 314. In particular, a hallmark of a property tax is that the "property may be taxed although it produces no income." *Id.* An income tax is measured "by the amount of income received over a period of time,"

while a property tax is measured "by the value of the property at a particular date." *Id.*

Evaluated using these criteria, it is apparent that the U.K. Windfall Tax is an income tax, not a tax on value. There was a direct correlation between a change in a company's initial period profits and a change in its tax liability. *See* Pet. App. 61-62. And when a company had no income during the relevant period, its tax liability was zero – an attribute identified in *Graves* as indicative of an income tax, not a property tax. *See* Pet. App. 44, 64-65 (British Energy had no Windfall Tax liability "because of low initial profits"); 300 U.S. at 314.

Other aspects of the tax confirm that the U.K. Windfall Tax was a tax on income, not value. Although the statute termed the profits component of the tax calculation "value in profit-making terms," that component consisted of historical profits, which might not reflect the company's actual value going forward. An obviously better measure of true "value of the property at a particular date" (*id.*) would have been readily available market valuations, but the U.K. Windfall Tax calculation took no account of those. Moreover, the tax fell on the parties who earned excess profits – namely, the companies. It did not fall on the parties who benefitted from the alleged undervaluation at the time of privatization – namely, the original shareholders of the newly privatized companies. Again, this reflects the "incidence of a tax on income," which "differs from that of a tax on property." *Graves*, 300 U.S. at 314. In short, there is no serious basis for disputing the Tax Court's conclusion that the design, operation,

and effect of the U.K. Windfall Tax was that of an excess profits tax.

C. The Government Misapplies the Regulations in Arguing That the U.K. Windfall Tax Fails to Meet the Formal Requirements of the Three-Part Test

As noted, the court of appeals did not dispute the Tax Court's finding that the U.K. Windfall Tax operated like an excess profits tax, with the tax falling on a portion of a company's average annual net income over a four-year period. And there is no basis for disputing that those amounts subjected to the tax – that is, the "initial period profits," which came directly from the companies' book income – satisfied the three-part test of the regulations. The British financial reporting requirements are materially indistinguishable from those in the United States. The amounts were derived from actual gross receipts that had been realized, with deductions for expenses. *See generally Entergy v. Commissioner*, 683 F.3d 233, 236 (5th Cir. 2012).

The government has argued, however, that the U.K. Windfall Tax, as written, nevertheless fails to satisfy the three-part net gain test under the regulations. In this regard, the government argued that actual profits was but one factor in computing what the statute terms "value in profit-making terms," and that the windfall tax "was then imposed on the difference between profit-making value and flotation value." Respondent's C.A. Br. at 31-32. As such, the government contended that the resulting tax base fails the regulatory test. *Id.* In addition, the government argued that the Tax Court erred in analyzing the tax by looking at mathematically equivalent algebraic restatements

instead of the precise form in which the tax calculation is described in the U.K. statute. These contentions threaten the creditability of all excess profits taxes and must be rejected.

1. The Baseline Quantity That Identifies "Normal Profits" Need Not Be Derived from Net Gain

The government argued in the court of appeals that, in the case of an excess profits tax, the portion of net income that is taxed is just "one component of the tax base" and the three-part net gain test must be applied to the "tax base itself." Respondent's C.A. Reply Br. at 5. In so doing, the government failed to acknowledge that the other "component of the tax base" for an excess profits is the quantity used to determine how much of a company's profits are "excess" – here, the "flotation value" of each company – a quantity that typically is not correlated with net income. Accordingly, the government argued, PPL could not show that "the base of the windfall tax was computed in a manner that satisfies the three-part test" because the computation necessarily incorporates the flotation value, which did not reflect net gain. *Id*.; *see also* Respondent's C.A. Br. at 32; Pet. App. 8 (according to the government, the "tax base" is "the difference between two imputed values," and this tax base "fails to meet either the gross receipts or the net income requirement" because neither value represents gross receipts and "the tax base" does not account for recognized expenses); *id*. at 66 ("As a tax imposed on a base equal to the unrealized difference between two defined values, rather than directly on realized gross receipts reduced by

deductible expenses, respondent argues that it necessarily fails to satisfy any of the three tests.").

This proposed approach is illogical. In the government's view, creditability turns on an analysis of the "tax base," the quantity to which the statutory rate of tax is applied. Under the statutory text, a constructed value termed "value in profit-making terms" is reduced by flotation value and the resulting tax liability is 23% of the difference. Flotation value is used to define that portion of the company's profits on which an excess profits tax is *not* imposed. So there is no reason why the "manner" in which flotation value is computed should satisfy the three-part regulatory test, even if determining that value is necessary to determining the taxpayer's ultimate foreign tax liability. Indeed, the IRS rejected precisely this argument in Rev. Rul. 56-51, 1956-1 C.B. 320, 320, stating that an excess profits tax is creditable, even though "reference must be made to the valuation of capital . . . as a basis for computing the excess profits." *See supra* pp. 7-8.

The court of appeals expressed agreement with this argument, even while acknowledging the likely death blow that it would deal to credits for excess profits taxes. *See* Pet. App. 9-10. The court stated that the regulation "expressly defines an excess profits tax as an 'income tax," apparently suggesting that the three-part test must be applied to the entire excess profits tax calculation, including determining the quantity that defines how much is "excess." Pet. App. 10-11 n.2. In response to PPL's protest that this approach would disqualify traditional excess profits taxes, the court of appeals stated that PPL's "argument merely

suggests that the regulation misinterprets the statute," and it was too late for PPL to argue that the regulation is invalid. *Id*. at 10 n.2.[4] Ultimately, however, the court of appeals chose not to rest its holding on this analysis, stating that it would "indulge for the sake of argument PPL's contention" that the calculation of flotation value should not be subjected to the three-part test analysis.

In fact, the court of appeals' determination to "indulge" PPL is compelled by the statutory text, not merely by "historical practice." *Cf*. Pet. App. 11 n.2. The statute affords the credit to foreign taxes that operate like U.S. excess profits taxes, but the

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[4] The court's suggestion that PPL should have argued that the regulations conflicted with the statute is only one example of how the court of appeals fundamentally misunderstood the regulations and mistakenly believed that they worked a major change in the law by imposing a more restrictive three-part test. The court also stated that there was "tension" between the text of the regulation and the preamble, and therefore determined to disregard the preamble, when in fact there is no such tension. Pet. App. 6-7 n.1. In support of this proposition, the court pointed to a post-1983-regulations decision that "reached the opposite result" from a pre-regulations decision concerning the operation of the Ontario Mining Tax. *Id*. (citing *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209 (2d Cir. 1999), and *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982)). But, if anything, these cases contradict the court's premise because it was the later, post-regulations case that upheld the credit. To the extent the contrast between these cases is relevant here, it shows that the 1983 regulations are more "favorable to taxpayers" than the "more restrictive" predecessor regulations. Isenbergh, ¶ 56.2.4 at 56,005-06 & n.27. *See Texasgulf*, 172 F.3d at 216-17 (explaining that the 1983 regulations' explicit recognition of "allowances that effectively compensate for nonrecovery" of expenses makes the credit more readily available in certain cases).

government's approach would threaten the credit for such taxes that were routinely regarded as creditable for decades. The U.K. Windfall Tax is not unique in determining "normal" profits by reference to a quantity that does not reflect net income. Rather, the quantity that defines what profits are "excess" typically is based on a permissible rate of return on capital, and therefore including that quantity in the "tax base" and requiring the manner of computing that base to satisfy a test aimed at "net gain" will necessarily result in denying the credit. The government's position thus would override the consistent prior administrative treatment of excess profits taxes and, indeed, would as a practical matter eliminate excess profits taxes from the foreign tax credit statute.

A regulation that effectively eliminated excess profits taxes from section 901 by applying the net gain test in the manner the government requests would surely be invalid for contradicting the statute. But there is no reason to interpret the existing regulation that way. Contrary to the court of appeals' statement, the regulation does not try to distort reality by "expressly defin[ing] an excess profits tax as an 'income tax.'" Pet. App. 10 n.2. Rather, the language in the regulation is much more reasonably read to provide simply that, when the regulation uses the term "income tax," the same rules apply to the portion of income taxed under an excess profits tax. *See supra* pp. 9-10; *Exxon v. Commissioner*, 113 T.C. 338, 356-59 (1999) (applying regulation's net income test and concluding that the foreign tax "in its predominant character, constitutes a tax in the nature of an

excess profits tax (i.e., an income tax) in the U.S. sense"). In that way, the court can determine whether the foreign tax is calculated to reach "some net gain." Accordingly, the Court should apply the regulatory test only to the portion of PPL's income that is subject to taxation, without addressing how flotation value is determined.

2. The Court of Appeals Erred in Holding That the Creditability of a Foreign Tax Depends on Whether the Computation Set Forth in Foreign Law Multiplies the Tax Base by Another Number Before the Statutory Tax Rate Is Applied

Setting aside flotation value, the court of appeals concluded that the U.K. Windfall Tax fails to satisfy the regulatory test because the precise manner of calculation of the portion of the tax base that specifically incorporates net income runs afoul of a particular nuance in the regulations – namely, an example that illustrates an aspect of the gross receipts rule that is inapplicable to this case. In so holding, the court completely misread the regulations and reached an absurd result that could not possibly have been intended by Congress or by the drafters of the regulations.

a. The Court of Appeals' Reasoning Leads to Absurd Results

As the Tax Court found, the operation of the U.K. Windfall Tax can be summarized in a fairly simple algebraic formula. The tax was imposed on a portion of the company's average annual profits over the initial period of its operation; the profits potentially subject to tax were reduced by the

company's "flotation value." The specific tax base consisted of the profits earned over the relevant period (four years for all but a handful of companies), divided by the length of the period and multiplied by a predetermined "price-to-earnings ratio" set at nine, less flotation value. That quantity was taxed at a 23% rate. The only variable in this tax base was the company's profits. Using "P" to represent those net profits and "FV" to represent "flotation value," the parties stipulated and the courts below agreed that the overall tax formula can be expressed as follows for all but a handful of companies:

$$23\% \times [(P/4 \times 9) - FV]$$

Pet. App. 4, 9, 62-63. Applying basic algebraic simplification, that formula reduces to:

$$51.7\% \times (P - 4/9FV)$$

The latter formula describes a 51.7% tax on a portion of net profits, which the Tax Court held was plainly creditable. The court of appeals did not disagree with that conclusion; there is no conceivable basis for doing so. But the court of appeals held that the algebraic simplification described above was an impermissible "bridge too far." Pet. App. 9. The court identified the "fundamental problem" as follows: "the tax base cannot be initial-period profit alone unless we rewrite the tax rate," which the court found to be prohibited by the regulations. *Id.* Therefore, the court of appeals held, the tax had to be analyzed by applying the regulatory test to the earlier version of the formula listed, as a 23% tax on a quantity that represented 9/4 (or 225%) of net profits. According to the court

of appeals, such a tax plainly fell afoul of the regulatory test.

On its face, the court of appeals' decision is absurd. In substance, a 23% tax on 225% of profits is exactly the same thing as a 51.7% tax on 100% of profits. It is inconceivable that Congress would have wanted the U.S. tax law to treat them differently, and nothing in the statute supports the court of appeals' view. Moreover, the approach taken by the court of appeals would give foreign governments complete leeway to determine whether a tax would be creditable, as they could easily manipulate the form of the tax in the manner that the court of appeals found to be dispositive. The court's ruling thus defeats the longstanding principle that creditability depends upon how a foreign tax conforms to U.S. tax principles.

b. Example 3 of the Gross Receipts Portion of the Regulations Lends No Support Whatsoever to the Court of Appeals' Decision

If there were some ambiguity in how to construe the regulations, the above considerations would counsel against accepting the court of appeals' interpretation. But there is in any event no such ambiguity. The court's decision rests on a complete misunderstanding of the regulations, which in no way support the meaningless distinction drawn by the court.

The court's reasoning is based on a single example in the regulations that illustrates the gross receipts aspect of the three-part test. *See* Pet. App. 12-14 (citing Treas. Reg. § 1.901-2(b)(3)(ii), Ex.

3). This example, which was not presented to or discussed by the Tax Court, is completely irrelevant to a proper analysis of the creditability of the U.K. Windfall Tax.

The gross receipts test states that the tax must be "imposed on the basis of—(A) Gross receipts; or (B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value." Treas. Reg. § 1.901-2(b)(3)(i). The U.K. Windfall Tax is based on actual gross receipts under subsection A. Example 3 illustrates the application of subsection B, which allows use in certain circumstances of imputed gross receipts. Thus, as the Fifth Circuit explained in *Entergy*, it should have been immediately apparent to the court of appeals that Example 3 has nothing to do with this case. *See* 683 F.3d at 237-38.

A closer look at Example 3 further illuminates how far astray the court of appeals went in finding it dispositive here. The basic gross receipts test is found in subsection (A); a typical income tax will be based on actual gross receipts. Subsection (B) can be described as a liberalizing provision that recognizes the possibility of foreign taxes that cannot be based on actual gross receipts but are sufficiently like traditional income taxes that they ought to be creditable.

A good example of this is a tax on income from mineral production. When the producer is an integrated mining company, income attributable to production activities alone cannot be measured directly. When the product is sold by the taxpayer after processing, the actual gross receipts from that sale would include income attributable to

processing, not just income from mineral production. Thus, the foreign taxing authority will use a proxy to estimate the gross receipts attributable to production, and the regulation allows for a tax computed in this way to be creditable – if the proxy is accurate.[5]

At the same time, the drafters of the regulations were keenly aware that opening the door to such imputed gross receipts could lead to abuse. A few years earlier, the IRS had reviewed its approach towards certain foreign taxes, including surtaxes imposed on oil companies by Libya and Saudi Arabia. *See* Rev. Rul. 78-63, 1978-1 C.B. 228. Those taxes were based on "posted prices set in excess of actual market price," which allowed the countries to extract additional revenues from the foreign oil companies. *Id*. at 229. The IRS ruled that those taxes did not qualify for the credit because the tax base was "measured from an arbitrarily determined value (the posted price)" and hence was "artificial or fictitious." *Id*. at 230, 232. The ruling explained that keying the tax to this artificially inflated price, rather than actual sales, meant that "the requirement that the tax be imposed on realized income is not satisfied." *Id*. at 230. Thus, to protect against potential abuse, the gross receipts test in the regulation emphasizes

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[5] The Ontario Mining Tax at issue in *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982), is an example of this kind of tax that may well have been within the contemplation of the drafters of the regulations. That tax purported to tax income from mineral production, and the statute provided that the gross revenue from production should be assumed to equal the market value of the output at the mining pit's mouth. *Id*. at 81.

that the imputed value for gross receipts must be "likely to produce an amount that is not greater than fair market value." Treas. Reg. § 1.901-2(b)(3)(i)(B).

Example 3 simply illustrates the application of the fair market value limitation. It posits a situation, like the "posted price" in the Libyan and Saudi Arabian surtax ruling, where the foreign law uses an artificial or fictitious quantity as the basis for the tax. Specifically, the example posits a tax on petroleum extraction income in which "gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted." Treas. Reg. § 1.901-2(b)(3)(ii), Ex. 3. It is tautological that such a tax falls outside the plain language of the gross receipts test. Because it "is *designed* to produce an amount that is greater than the fair market value of actual gross receipts" (*id.* (emphasis added)), it necessarily follows that the "deemed" value is not "likely to produce an amount that is not greater than fair market value." Treas. Reg. § 1.901-2(b)(3)(i)(B).

None of this has anything to do with "rewrit[ing] the tax rate," as the court of appeals found. *See* Pet. App. 9. The hypothetical Example 3 tax fails because the "deemed" value is not a genuine proxy for gross receipts. As government counsel stated to the court of appeals at oral argument, "the reason that creditability is denied [in Example 3] is because the foreign country in imposing the tax is actually assuming that the taxpayer has gross receipts in excess of what the fair market value is." Tr. of Oral Argument at 16,

PPL Corp. v. Commissioner, No. 11-1069 (3d Cir. 2011).

As a simple illustration shows, the tax cannot be trusted to reach net gain if the proxy for gross receipts is artificially inflated. *See id.* ("So the foreign country is starting by taxing a number that is greater than perhaps the actual profits that the taxpayer realized."). Suppose that a taxpayer has expenses equal to its actual gross receipts. Under an income tax regime that applies U.S. principles, its net income (and tax liability) ought to be zero. But in the example 3 situation where gross receipts subject to tax are inflated, that taxpayer will have taxable income and an attendant tax liability. Therefore, the tax does not reach net gain; it taxes something else even though there is no net gain. By contrast, the difference on which the court of appeals rested its decision – between a 23% tax on 225% of profits and a 51.7% tax on 100% of profits – is a difference of form with no practical significance whatsoever. In particular, under either method of doing the calculation, the foreign tax is calculated to reach net gain.

The court of appeals found Example 3 relevant because it mistakenly believed that accepting the Tax Court's analysis would render Example 3 "a nullity." Pet. App. 13. The court's explanation was that "a 20% tax on 105% of receipts is mathematically equivalent to a 21% tax on 100% of receipts." *Id.* That is true enough "mathematically," but it completely misses the point because the problem at the root of Example 3 is not cured by restating the tax rate. Example 3 addresses the determination of gross receipts for calculating a tax on net income, but the court's discussion appears to view it as a

direct tax on gross receipts (which is generally not a creditable tax). Inflating gross receipts for an income tax will lead to an inaccurate determination of net income, which is the quantity being taxed. For example, in the illustration above where net income should be zero, the inflated proxy for gross receipts will always incorrectly yield some net income no matter how the tax rate is restated. The reasoning of the Tax Court thus does not in any way undermine the rule illustrated in Example 3.

In short, the court of appeals erred in believing that the Tax Court's analysis of the substance of the tax ran afoul of the regulations in any way.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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