No. _____

In the

Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT.

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

PETITION FOR WRIT OF CERTIORARI

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July 9, 2012

QUESTION PRESENTED

To avoid double taxation, section 901 of the Internal Revenue Code allows U.S. corporations a tax credit for income, war profits, or excess profits taxes paid to another country. This case involves application of section 901 to a "windfall tax" imposed by the United Kingdom. Although it is undisputed that the tax's practical effect is to impose a 51.75% tax on the "excess profits" certain companies earned in the four years after they were privatized, the Third Circuit—at the Commissioner's urging—deemed the tax non-creditable because the U.K. statute nominally taxes the difference between two numbers, one of which is driven exclusively by profitability during the four-year period, rather than nominally taxing the profits themselves. In a case arising out of the same U.K. tax, same tax court proceedings, and same evidentiary record, the Fifth Circuit reached the opposite conclusion and affirmed the Tax Court's considered view. Recognizing that it was creating a clear circuit split, the Fifth Circuit affirmed that courts must look beyond the form and labels of a foreign tax statute and consider the tax's practical operation and intended effect when determining whether it is creditable for U.S. tax purposes.

The question presented is:

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

RULE 29.6 STATEMENT

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

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

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PETITION FOR CERTIORARI

To avoid the prospect of burdensome double taxation, section 901 of the Internal Revenue Code allows U.S. citizens and corporations a tax credit for any income, war profits, or excess profits tax paid to another country. For nearly 75 years, it has been settled law that whether a tax is creditable under section 901 depends on whether the tax is, *in substance*, the equivalent of a U.S. tax on net gain. It could hardly be otherwise. When assessing the U.S. tax equivalence of foreign taxes imposed under a myriad of different foreign tax regimes, there would seem to be little choice but to look beyond form to substance.

Applying that traditional approach, this should have been an easy case. It is undisputed that the tax at issue here—a windfall tax imposed by the United Kingdom—operates as a tax on the "excess profits" of certain companies that were privatized in the 1980s and 1990s. While the tax is nominally a tax on the excess "value" of those companies above their privatization price, the taxed "value" was measured entirely by the companies' profits during the four years immediately after privatization. The higher the profits, the higher the tax. And that is true not just in some vague sense of positive correlation between taxes and values and profitability. The tax indisputably operates as a 51.75% tax on excess profits during the four-year tax period.

The Commissioner nonetheless refused to treat the windfall tax as a creditable foreign tax, merely because the U.K. statute is nominally one on "value,"

not profits. The Tax Court rejected that approach as inconsistent with settled law, but the Third Circuit reversed. Shortly thereafter, recognizing that it was creating a clear circuit split, the Fifth Circuit disagreed and held the exact same windfall tax creditable, rejecting the Third Circuit's form-over-substance approach as irreconcilable with the governing regulation and case law. The Fifth Circuit and the Tax Court had it right: The hyper-formalistic approach of the Commissioner and the Third Circuit conflicts with long-standing decisions of this Court, other Courts of Appeals, and the Tax Court—not to mention with the Commissioner's own regulation and common sense. The Court should grant certiorari to resolve this square circuit conflict and reverse the Third Circuit's marked departure from the substance-based approach to creditability that the context and case law demand and that the regulation was expressly intended to incorporate.

OPINIONS BELOW

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

JURISDICTION

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

STATUTORY PROVISIONS INVOLVED

The relevant portions of section 901 of the Internal Revenue Code, 26 U.S.C. § 901, and Treasury Regulation § 1.901-2 are reproduced at App. 88.

STATEMENT OF THE CASE

A. Statutory and Regulatory Background

When Congress enacted the federal income tax in 1913, it chose to tax all income earned by U.S. citizens and corporations, including income earned and taxed in foreign countries. *See* Revenue Act of 1913, Pub. L. No. 63-16, 38 Stat. 114. Although Congress allowed a deduction for taxes imposed by foreign countries, it did not allow a credit. As a result, the U.S. tax scheme created a significant potential for double taxation of income earned abroad. To alleviate that burden, Congress adopted the foreign tax credit, providing U.S. citizens and corporations a credit for "the amount of any income, war profits and excess-profits taxes paid during the taxable year to any foreign country, upon income derived from sources therein, or to any possession of the United States." Revenue Act of 1918, Pub. L. No. 65-254, § 238, 40 Stat. 1057, 1080. The "primary design of the provision was to mitigate the evil of double taxation." *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932). Congress also intended "to facilitate the[] foreign enterprises" of domestic corporations, thereby growing the U.S. economy as a whole. *Id.* at 9.

In the century since its enactment, the foreign tax credit has become a permanent and critical

fixture of the U.S. tax system: Domestic corporations claim tens of billions of dollars in foreign tax credits each year. *See* Scott Luttrell, IRS SOI Bull., Corporate Foreign Tax Credit, 2007, p. 140 fig. B (total foreign tax credits claimed from 2003 to 2007 ranged between $50 billion and $86 billion a year).

Although Congress has amended the statute throughout the years, the provision setting forth which taxes are creditable—"income, war profits, and excess profits taxes"—has remained unchanged and is now found at section 901(b)(1) of the Internal Revenue Code, 26 U.S.C. § 901(b)(1). Significantly, it has long been understood that the meaning of those three terms is to be derived from "our own revenue laws," not from the revenue laws of foreign countries. *Biddle v. Comm'r*, 302 U.S. 573, 579 (1938). Whether a foreign tax is an income, war profits, or excess profits tax thus depends on whether the United States considers it such, not on the labels or form chosen by the foreign country that imposes the tax. *Id.*

By Treasury regulation, a tax is an income, war profits, or excess profits tax if "[t]he predominant character of that tax is that of an income tax in the U.S. sense." Treas. Reg. § 1.901-2(a)(1)(ii). To meet that standard, a tax must be "likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(3)(i). That is the case "if and only if the tax, judged on the basis of its predominant character, satisfies" three tests: It must be imposed (1) on realized income (*i.e.*, income that has already been earned), (2) on the basis of gross receipts (*i.e.*, revenue), and (3) on net income (*i.e.*, gross receipts

minus significant costs and expenditures). § 1.901-2(b)(1)–(4). In short, to be creditable, the foreign tax's "predominant character" must be such that it typically reaches realized gross receipts less deductible expenses—that is, net gain. Other foreign taxes, such as property taxes, are not eligible for the credit but are treated as deductible expenses.

B. The U.K. Windfall Tax

This case involves the application of section 901 to a "windfall tax" imposed by the United Kingdom in 1997. The story begins with the 1979 U.K. elections, in which the Conservative Party won control of Parliament. During the nearly two decades of Conservative Party rule that followed, the government privatized dozens of nationalized companies, including many utilities. To accomplish its privatization objectives, the government would transfer a nationalized company to a new public limited company and offer shares of the new company to the public at a fixed price per share. In U.K. parlance, that initial share offering is known as "flotation." After flotation, the company's shares would become publicly traded on the London Stock Exchange at whatever value the market set.

Although the government initially privatized primarily non-monopoly companies, it soon expanded the privatization program to include monopoly companies, which raised distinct regulatory concerns. Rather than regulate the maximum profits or rates of return of those new companies, the U.K. government decided to regulate their prices. By fixing prices for an initial period, typically four years, the government hoped to incentivize the

newly privatized companies to reduce costs and increase efficiencies, thereby maximizing profits that initially would pass exclusively to the companies and their new shareholders. Although this regulatory scheme created the potential for the companies to enjoy substantial profits during the initial term, once that term ended, the government would pass the benefits on to consumers through a downward price adjustment.

The newly privatized companies embraced this regulatory scheme whole-heartedly, and their shareholders quickly began reaping the rewards of significantly reduced costs and increased efficiencies. The public was not nearly as satisfied with its side of the bargain, however, and began demanding the very price adjustments that the government had promised to forgo until the end of each initial term. The government resisted the public pressure but ultimately paid a price: In 1997, the Labour Party defeated the Conservative Party at the polls.

The Labour Party contended that privatization had unduly benefitted many of the new companies at the expense of the public and campaigned on a promise to impose "a windfall levy on the excess profits of the privatised utilities." App. 31. The Labour Party further promised to use the revenue from that tax to fund a welfare-to-work youth employment training program. *Id.* As a Labour Party victory became increasingly likely, members of the party's shadow treasury, including the future Paymaster General and Chancellor of the Exchequer, enlisted the services of Arthur Andersen to determine how best to structure the promised tax

to raise the necessary revenue for the welfare-to-work program.

The Andersen team proposed and the incoming government agreed to a one-time "windfall tax." To calculate the "windfall" amount subject to the tax, the formula used the difference between two numbers/values: the price at which each company was sold when privatized (*i.e.*, its actual flotation value) and the notional price at which each company *should* have been sold if only the government had realized how profitable the companies would become once privatized. *See* Finance (No. 2) Act, 1997, c. 58, part I, cl. 1 & Schedule 1 (U.K.). To determine the latter retrospective number—dubbed the "value in profit-making terms"—the formula relied on a company's actual realized profits during the four-year fixed-price period immediately following privatization. In other words, the "value in profit-making terms" was (as its name suggests) based entirely on how profitable each company was during the four-year period.

As embodied in the act that Parliament passed, the windfall tax employs a simple concept and a considerably more complicated formula. The simple concept is that the new government used the companies' actual realized profits during the first four years after privatization to impose a tax reflecting the Labour Government's view that the companies had reaped windfall profits. The more profitable the company was during those four years, the higher the tax. The more complicated formula operates as follows: Total realized profits ("P") during the tax period are used to determine average annual profits, which are multiplied by a statutorily

fixed "applicable price-to-earnings ratio" of 9. Flotation value ("FV") is then subtracted, and the remainder is taxed at 23%.

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

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

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

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

Stated in those terms, the windfall tax nominally taxes the difference between two numbers or "values"—the actual flotation price and a number based on profitability during the four years after privatization. While flotation value is an actual historical number, "value in profit-making terms" does not represent any real-world value of the company based on its actual share price (such as the market value based on the publicly traded share price on a date certain). It is instead a *sui generis* number generated entirely from a company's actual profitability during the four years after privatization. Because that number is based on actual realized profits, the same formula can be restated as a tax on excess profits during the four-year period; specifically, a 51.75% tax on total period

profits in excess of 4/9 of flotation value. *See* App. 63–64.*

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

$$\text{Tax} = \{(9/4) \times 23\%\} \times [P - \{(4/9) \times FV\}]$$

Doing the math, that produces:

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

Thus, by restating the tax rate, the same tax can be formulated as either a 51.75% tax on profits in excess of a statutorily prescribed rate of return, or a 23% tax on the difference between two numbers ("flotation value" and "value in profit-making terms"). Under either formulation, a company's tax liability increases or decreases in direct proportion to its total profits in excess of 4/9 of flotation value for the total period. That exact mathematical correspondence demonstrates unequivocally that the windfall tax operates as a tax on profits.

C. Proceedings Below

South Western Electricity plc ("SWEB") was one of 12 regional electric companies privatized in 1990 and one of 32 companies that were more profitable than anticipated and thus became subject to the

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* The Tax Court described the tax as a 51.71% tax on profits in excess of 44.47% of flotation value. *See* App. 63. That slight variation reflects the inclusion of the extra leap year day, which makes the ratio used to determine average annual profits slightly more than 4/9. For simplicity, the Petition refers to the tax as a 51.75% tax on profits throughout.

windfall tax. SWEB's total windfall tax liability as assessed by U.K. Inland Revenue was £90,419,265 (*i.e.*, SWEB had earned about £175 million more than the Labour Government thought appropriate and was taxed for 51.75% of that amount). SWEB paid the tax in two installments, the first in 1997 and the second in 1998. At the time, SWEB was a partially owned indirect subsidiary of PPL Corporation ("PPL"). Accordingly, for its 1997 federal income taxes, PPL claimed a credit under section 901 for its share of SWEB's first payment. The Internal Revenue Service disallowed the claim, and PPL petitioned the Tax Court for review.

1. The Parties' Arguments

The essential dispute between the Commissioner and PPL boiled down to a single dispositive legal question: whether, in determining creditability, courts should use a formalistic approach that looks solely at the text of the foreign tax statute, or a substance-based approach that takes into consideration the practical and intended effect of the tax. Relying on decades of settled precedent interpreting section 901, as well as the "predominant character" standard set forth in Treasury Regulation § 1.901-2, PPL argued that creditability "depends on the substance, and not the form or label, of the tax." App. 57–58. Under that approach, the predominant character of the windfall tax is plainly "that of an income tax in the U.S. sense" because the tax by both design and effect "is likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(1)(ii), (3)(i).

In support of that conclusion, PPL provided extensive trial testimony from multiple expert witnesses, including specialists in both U.S. and U.K. tax and accounting, the sole regulator of 17 of the affected companies (including SWEB), an internationally acclaimed finance professor, and members of the Arthur Andersen team who created the windfall tax. Those experts all agreed that, in substance, the tax operates as a tax on income, and in fact operates just like past U.S. and U.K. excess profits taxes. App. 57–60. PPL's experts illustrated how the tax formula can be restated as a 51.75% tax on profits in excess of 4/9 of flotation value, a fact to which the Commissioner stipulated. App. 62. PPL's evidence also went beyond the general application of the tax to the 32 companies. To demonstrate beyond peradventure the exclusively profit-driven operation of the tax, SWEB's former treasurer explained how, once he realized the direct link between tax liability and profits, he obtained permission from Inland Revenue to restate SWEB's profits for one of the tax years and, as a result, was able to reduce SWEB's windfall tax liability in direct proportion (51.75%) to that reduction in profits. App. 61.

The Andersen witnesses also testified that the windfall tax's drafters understood that it operated as an excess profits tax, but designed it as a "value-based" tax for "presentational" reasons peculiar to the U.K. political and economic environment at the time. App. 55–56. A finance expert further explained that the term "value in profit-making terms" represents no true economic value, has no recognized meaning in any other financial context, and appears to have been coined solely to give the

tax its form. App. 60 n.17. Contemporaneous explanations also reveal the U.K. government's understanding and intent that the tax would operate as a tax on excess profits. For instance, when the Chancellor of the Exchequer announced the proposed tax, he described it as "a new and one-off windfall tax *on the excess profits* of the privatised utilities." App. 38 (emphasis added); *see also id.* (noting Inland Revenue announcement describing tax as a "windfall tax on the *excess profits* of the privatised utilities") (emphasis added). Similarly, an official U.K. Treasury publication explained the legislation as imposing a "windfall tax … in accordance with the commitment in the Government's Election Manifesto to raise a tax on the *excess profits* of the privatised utilities." App. 39 (emphasis added).

Rather than dispute PPL's overwhelming evidence of how the windfall tax operates, the Commissioner maintained that the Tax Court could not consider the practical operation of the tax and instead was bound by its statutory formulation as a tax on the difference between two values or numbers, even though the higher of the two numbers was simply a device to determine tax liability exclusively based on profitability over a four-year period. App. 65–68. As the Commissioner put it, in an argument that would seem to deny the form-substance dichotomy altogether: "The words of the U.K. statute *are* the 'substance' of this tax." *PPL Corp. v. Comm'r*, No. 25393-07, Reply Br. for Resp. at 114. In the Commissioner's formalistic view, because the statute says it taxes "value," not realized gross receipts reduced by deductible expenses, the tax is not creditable. The Commissioner

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

2. The Tax Court's Opinion

After reviewing hundreds of pages of expert reports and trial testimony in both this case and a parallel case involving the same question about the same U.K. windfall tax, *see Entergy Corp. v. Comm'r*, No. 25132-06 (T.C.), the Tax Court (Judge James S. Halpern) issued a 62-page opinion holding PPL's windfall tax creditable.

Like the parties, the Tax Court viewed as dispositive the legal question concerning what a court "may consider in determining whether the windfall tax is a creditable tax for purposes of section 901." App. 71. The court resolved that dispute in PPL's favor, rejecting the Commissioner's "text-bound approach … [a]s inconsistent with the 1983 regulations' description of the predominant character standard for creditability." App. 21. Examining the regulation's instruction to consider whether "the foreign tax is likely to reach net gain *in the normal circumstances in which it applies*," § 1.901-2(a)(3)(i) (emphasis added), the court concluded that, by "implicating the circumstances of application in the determination of the predominant character of a foreign tax, the drafters of the 1983 regulations clearly signaled their intent that factors extrinsic to the text of the foreign tax play a role in

the determination of the tax's character." App. 72–73.

The Tax Court found that conclusion "consistent with caselaw preceding the issuance of the 1983 regulations and, in particular, two of the cases cited in the preamble to those regulations as providing the 'criterion for creditability' embodied in that standard." App. 73 (citing *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982), and *Bank of America Nat'l Trust & Sav. Ass'n v. United States* ("*Bank of America I*"), 459 F.2d 513 (Ct. Cl. 1972)). It further noted that Tax Court "cases that have applied the … regulations' predominant character standard are consistent" with that approach, and rejected the Commissioner's attempts to portray those decisions and a Second Circuit case, *Texasgulf, Inc. & Subsidiaries v. Comm'r*, 172 F.3d 209 (2d Cir. 1999), as limiting courts' review to only the form of a foreign tax statute. App. 75–76.

Reviewing the practical effect of the windfall tax on the companies that paid it, the circumstances of its adoption, and the intent and understanding of the Parliament members who adopted it, the Tax Court concluded that, "however we describe the form of the windfall tax base, 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." App. 78–79. The court explained, "[j]ust as 'a levy can in reality be directed at net gain even though it is imposed squarely on gross income,' … so too can a foreign levy be directed at net gain or income even though it is, by its terms, imposed squarely on the difference between two values." App. 81 (quoting *Bank of America I*, 459 F.2d at

519). As for PPL's restatement of the tax as a 51.75% tax on excess profits, the Tax Court concluded that the reformulation was not, as the Commissioner argued, a "hypothetical rewrite of the Windfall Tax statute," but rather "a legitimate means of demonstrating that Parliament did, in fact, enact a tax that operated as an excess profits tax." App. 83.

On the same day, the Tax Court issued a three-page memorandum opinion in the materially identical *Entergy* case relying on its *PPL* opinion to hold Entergy's windfall tax payment creditable as well. *See Entergy Corp. v. Comm'r*, 100 T.C.M. (CCH) 202 (2010).

3. The Third Circuit's Decision

The Commissioner appealed the *PPL* decision to the Third Circuit, which reversed. App. 16–19. In an opinion that lost sight of the dispositive question whether substance or form controls and became bogged down in mathematical formulas and regulatory issues not in dispute, the court concluded that the tax does not satisfy the gross receipts or realization tests set forth in § 1.901-2(b).

Although the court purported to examine the "substance" of the windfall tax, it in fact applied a wholly formalistic approach under which it refused to consider PPL's arguments about the practical or intended operation of the tax and instead resolved creditability solely based on the text of the U.K. statute. As for PPL's argument that the tax indisputably operates as a 51.75% tax on excess profits, the court inexplicably deemed that "formulation of the substance of the U.K. windfall

tax … a bridge too far" because "[t]he regulation forbids" consideration of any formulation that "rewrite[s] the tax rate." App. 9, 14. Accordingly, the court examined whether the windfall tax satisfies the gross receipts and realization tests based on the assumption that the tax must be formulated as follows:

$$\text{Tax} = 23\% \times [2.25 \times P]$$

Of course, .23 multiplied by 2.25 is .5175, and so this formulation of the tax should have made crystal clear to the Third Circuit that the tax equaled .5175 or 51.75% of the relevant profit. Nonetheless, because it deemed such multiplication "a bridge too far," the Court concluded that "2.25 times profit" is greater than profit alone, and so concluded that the tax must not be imposed on the basis of gross receipts or realized income. App. 14–15 & n.3.

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

PPL petitioned for panel rehearing, explaining that the court's analysis was mathematically and legally flawed. Among other things, PPL argued that the court erred by ignoring the regulation's repeated instruction to judge a foreign tax on the basis of its "predominant character" and by placing undue emphasis on a wholly irrelevant illustrative example. The panel denied the petition.

4. The Fifth Circuit's Decision

In addition to appealing the *PPL* decision to the Third Circuit, where PPL is based, the Commissioner also appealed the companion *Entergy* case to the Fifth Circuit, where Entergy is based. *See* 26 U.S.C. § 7482(b)(1)(B). After reviewing the Tax Court's analysis in *PPL* and the Third Circuit's decision rejecting it, the Fifth Circuit agreed with the Tax Court and held the windfall tax creditable. *See Entergy Corp. & Affiliated Subsidiaries v. Comm'r*, --- F.3d ---, 2012 WL 1994786 (5th Cir. 2012). Finding the Commissioner's "primacy of the … text" argument "easy to dispatch," the court viewed the windfall tax "in practical terms" and concluded that it readily satisfies the gross receipts, realization, and net profits requirements. *Id.* at *3–*4. In doing so, the court emphasized that Parliament's decision to label an "entirely profit-driven figure a 'profit-making value' must not obscure the history and actual effect of the tax." *Id.* at *4. Although the court openly acknowledged the circuit split its decision created, it rejected the Third Circuit's reasoning as impermissibly "exemplif[ying] the form-over-substance methodology that the governing regulation and case law eschew." *Id.*

REASONS FOR GRANTING THE PETITION

The decision below squarely conflicts with the Fifth Circuit's decision rejecting the Commissioner's formalistic approach to creditability and holding the windfall tax creditable based on its practical and intended effect. Indeed, it is hard to imagine a more direct conflict: The Third and Fifth Circuits examined the very same foreign tax, the very same Tax Court opinion, and the very same arguments and evidence, with one court accepting the Commissioner's extreme form-over-substance argument and the other rejecting it. As a result, not only are two payers of the same foreign tax being subjected to different treatment under the same U.S. tax statute, but a single Tax Court opinion is now invalid for taxpayers in the Third Circuit and binding law in both the Fifth Circuit and the Tax Court, which has nationwide jurisdiction—a bizarre result that should not be allowed to stand.

Moreover, the decision below is badly flawed and allows the Commissioner to exalt form over substance in the one context where substance obviously must control—the treatment for U.S. tax purposes of a tax levied by a foreign government. As the Fifth Circuit aptly explained, the sort of hyper-formalism the Third Circuit employed is wholly at odds with past decisions of this and other courts uniformly rejecting the argument that creditability turns on the label or form of a foreign tax. In fact, because one can hardly expect foreign nations to employ the language of the Internal Revenue Code, this is a context where looking to substance is all but compelled.

Employing the well-established approach embodied in the regulation and case law, this case should have been an easy one. There is no dispute that the U.K. "windfall" statute taxes the difference between two numbers, one of which is exclusively based on "profits" as that term is used for U.S. tax purposes. The only question is whether a tax that is nominally on "value," but where "value" is calculated based solely on companies' profitability during a four-year period, operates as a tax on "profits." Unless form is all that matters, the answer is obviously yes. The varying efforts of the Third Circuit and the Commissioner to resist that conclusion are in conflict with the Fifth Circuit, the considered view of the Tax Court, and common sense. In short, the decision below is in square conflict with the decision of another circuit court, cannot be reconciled with 75 years of contrary precedent, and threatens to leave taxpayers in the Third Circuit at substantial risk of the very double taxation that Congress has sought to prevent for the past century. This Court should grant review.

I. The Decision Below Squarely Conflicts With A Fifth Circuit Decision Holding The Windfall Tax Creditable.

In a case "materially identical" to this one, the Fifth Circuit considered and rejected the Third Circuit's "form-over-substance methodology" and held the same U.K. windfall tax creditable under section 901 and § 1.901-2. *Entergy*, 2012 WL 1994786, at *1, *4. Indeed, in light of an unusual procedural posture, the conflict could hardly be more acute: The Fifth Circuit reviewed the same Tax Court opinion, the same record, and the same

arguments and expressly "disagree[d] with the Third Circuit[]," refusing to "engage in th[e] sort of formalism" that its sister circuit employed. *Id.* at *6. This Court should grant certiorari to resolve that conflict and to ensure that two federal taxpayers are not treated differently solely because they are headquartered in different states. Taxpayers in the Third Circuit should not be at greater risk of double taxation than taxpayers in the rest of the Nation.

Like PPL, Entergy claimed a substantial credit (£139,962,622) under section 901 for a U.K. windfall tax payment made by its indirect subsidiary London Electricity. The cases were assigned to the same Tax Court judge, who held bench trials in both. The court issued a detailed opinion resolving the creditability issue in PPL's case, which had a much more extensive factual record, and on the same day issued a brief memorandum opinion in *Entergy* relying on *PPL* to reach the same holding. *See supra* p. 15. Because Entergy is based in Louisiana and PPL is based in Pennsylvania, the Commissioner appealed Entergy's case to the Fifth Circuit and PPL's case to the Third Circuit, resulting in simultaneous review of the same Tax Court opinion in two different courts, one of which affirmed and one of which reversed.

According to the Third Circuit, the windfall tax is not creditable because "PPL's formulation of the substance of the U.K. windfall tax is a bridge too far." App. 9. In its view, because the text of the windfall tax statute says it imposes a 23% tax on the difference between two values, a court must turn a blind eye to the undisputed facts that one of the two "values" is driven entirely by profitability during a

four-year period and that the tax operates as a 51.75% tax on excess profits. The Third Circuit did not even mention, let alone analyze, all of the evidence confirming that the drafters of the windfall tax intended to impose an excess profits tax. Thus, while the Third Circuit paid lip service to the well-established principle that the "classification of a foreign tax hinges on its economic substance, not its form," App. 9, it nonetheless treated the form of the windfall tax as dispositive of its substance. The court did so because it interpreted § 1.901-2(b)(3)(ii) as "forbid[ding]" consideration of *any* argument that changes the statutory tax rate to demonstrate a tax's practical operation. App. 13–14. In other words, although the court recognized that the tax operates as an excess profits tax, it read the regulation to render the practical operation of the tax legally irrelevant.

The Fifth Circuit considered and correctly rejected that approach as "exemplif[ying] the form-over-substance methodology that the governing regulation and case law eschew." *Entergy*, 2012 WL 1994786, at *4. Citing *Inland Steel* and *Bank of America I*, the Fifth Circuit concluded that "[t]he case law from which 26 C.F.R. § 1.901-2 is derived refutes the Commissioner's assertion that we should rely exclusively, or even chiefly, on the text of the Windfall Tax in determining the tax's 'predominant character.'" *Id.* at *3. "Viewed in practical terms," the Fifth Circuit held, the windfall tax "clearly satisfies the realization and net income requirements," as it "is based on revenues from the ordinary operation of the utilities that accrued long before the design and implementation of the tax,"

and "*only* reached—and only *could* reach—utilities that realized a profit in the relevant period, calculating profit in the ordinary sense." *Id.*

As to the gross receipts requirement, although the Fifth Circuit recognized that "[a] tax actually directed at corporate value would not, in the ordinary sense, be imposed on the basis of gross receipts," unlike the Third Circuit, it found itself "persuaded by the Tax Court's astute observations as to the Windfall Tax's predominant character." *Id.* at *4. Specifically, it noted that "the tax's history and practical operation was to 'claw back' a substantial portion of privatized utilities' 'excess profits'"; those "profits were the difference between the utilities' income from all sources less their business expenses—in other words, … net income"; and "[t]he tax rose in direct proportion to additional profits above a fixed (and carefully calculated) floor." *Id.* The court thus concluded: "That Parliament termed this aggregated but entirely profit-driven figure a 'profit-making value' must not obscure the history and actual effect of the tax, that is, its predominant character." *Id.* Although the Fifth Circuit acknowledged that it was parting ways with the Third Circuit, and that it is "always chary to create a circuit split," it found itself unable to "engage in this sort of formalism in light of the predominant character standard." *Id.* at *6.

The practical result of the Third and Fifth Circuits' divergent interpretations is that Entergy's windfall tax payment is creditable but PPL's is not, simply because the companies are located in two different states. Moreover, because of the manner in which the Tax Court exercises its nationwide

jurisdiction, the same Tax Court decision is now bad law for taxpayers based in the Third Circuit, but binding law for taxpayers based in the Fifth Circuit, and for taxpayers in other jurisdictions as well (including at least one with a U.K. windfall tax issue outstanding). *See Golsen v. Comm'r*, 54 T.C. 742, 757 (1970), *aff'd* 445 F.2d 985 (10th Cir. 1971) (Tax Court must "follow a Court of Appeals decision which is squarely on point where appeal from our decision lies to that Court of Appeals and to that court alone" but "shall … giv[e] effect to our own views in cases appealable to courts whose views have not yet been expressed"). Even beyond that, the Third Circuit's hyper-formalistic approach to creditability leaves taxpayers within its jurisdiction at a much more significant risk of double taxation than taxpayers in other parts of the Nation. This Court should grant certiorari to resolve this square conflict.

II. The Third Circuit Fundamentally Erred In Adopting The Extreme Formalism Urged By The Commissioner.

The decision below is deeply flawed. There is no dispute that the practical effect of the U.K. windfall tax is to tax or recapture "excess" profits earned by privatized utilities during a four-year period. Nor is there any dispute that the tax formula took profits into account and used a profits figure that satisfies every requirement of the regulatory regime. The only dispute is whether the fact that the tax was nominally one on "value" rather than "profit" is dispositive. But once it is understood that the "value" being taxed was determined exclusively based on a company's profitability during a four-year period, the extremeness of the Commissioner's formalism

becomes evident. The more profits a company made during the relevant four-year period, the more it paid in taxes. This was true not just in some vague sense that the two were positively correlated. The tax formula taxed 51.75% of excess profits during the four-year period. The one company that made no excess profits during the period paid no tax. App. 44. And when SWEB made an adjustment to its reported profits, it achieved a corresponding reduction in its "windfall tax." App. 61. That the tax was nominally on value as measured by profitability rather than on the profits themselves could only matter in a world where substance played no role in the analysis.

Indeed, if the windfall tax were really intended to capture differences in value, it would have been a simple matter to consult the public exchanges to determine a company's market-based value the next week, month, year, or four years after flotation. Instead, the U.K. government invented the concept of "value in profit-making terms," a concept that has been used in no other context, either before or after this tax. Because one of the critical numbers used to calculate the tax amount is not a real-world number that corresponds to any normal conception of valuation, the need to look at how the tax actually operates is manifest. That the Commissioner would nonetheless insist on considering only the form of the foreign tax—and not its real-world operation—is astounding.

The Tax Court, with its expertise in tax matters, saw through the Commissioner's hyper-formalistic position. As it pointed out, "[p]resumably, [the Commissioner] would agree that, had the [windfall] tax been enacted as a 'profit-based tax' instead of as

a tax on the difference between two values, it would have been creditable." App. 83 n.34. Under the Commissioner's "approach, the same tax is either creditable or noncreditable, depending on the form in which it is enacted, a result at odds with the predominant character standard set forth in the regulations and applied in the caselaw." App. 83 n.34. As the Tax Court explained at length, the whole point of § 1.901-2 and its predominant character standard was to adopt the approach of a string of decisions—decisions that begin with this Court's early examination of the foreign tax credit statute—rejecting the very form-over-substance approach the Commissioner now advocates. *See* App. 47–57.

As far back as 1938, this Court had no trouble rejecting the illogical argument that the creditability of a foreign tax should "depend upon its characterization by the foreign statutes and by decisions under them." *Biddle*, 302 U.S. at 578. As the Court explained, tax terminology "has for most practical purposes a well-understood meaning to be derived from an examination of the [U.S.] statutes which provide for the laying and collection of income taxes," and "[i]t is *that* meaning which must be attributed" to the terms used in the foreign tax credit statute. *Id.* at 579 (emphasis added). As a matter of common sense, any other approach would produce "a shifting standard" for creditability based on the vagaries of "foreign characterizations and classifications of tax legislation" by countries that may not use the same language, let alone the same tax system, as the United States. *Id.* Nothing in the foreign tax credit statute suggests Congress

intended such a counterintuitive result. *See id.* at 578–79.

Following *Biddle*'s instruction to "examin[e] … the *manner* in which the [foreign] tax is laid and collected," *id.* at 579 (emphasis added), lower courts have repeatedly determined creditability by focusing on the substance, not the form, of foreign taxes. For instance, in the early 1970s, the Court of Claims confirmed in *Bank of America I* that the "important thing" is the substance, not the form, of a foreign tax. 459 F.2d at 519. That case involved three foreign taxes that were designated "income taxes" in their respective countries but did not appear to satisfy "the United States notion of income taxes" because they were imposed on gross receipts, with no deduction for costs or expenses. *Id.* at 517. In keeping with *Biddle*, the Court of Claims refused to "consider it alldecisive [*sic*] whether the foreign income tax is labeled a gross income or a net income tax, or whether it specifically allows the deduction or exclusion of the costs or expenses of realizing profit." *Id.* at 519. The court instead considered "whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives." *Id.*

Two years later, the Tax Court employed the same substance-over-form approach, citing *Bank of America I* for the proposition that "the 'basic' test for determining whether a foreign tax is creditable is whether it is the substantial equivalent of an 'income tax' as revealed by an examination of our statutes." *Bank of America Nat'l Trust & Sav. Ass'n v. Comm'r* ("*Bank of America II*"), 61 T.C. 752, 760 (1974). Examining the text, statutory history, and

purpose of the foreign tax credit statute, the Tax Court concluded that the Court of Claims' substance-based approach "provides a rational and manageable basis for interpretation of section 901(b)(1), consistent with the statutory language and purpose and with the previously decided cases." *Id.* at 763. Since then, in *Inland Steel*, the Court of Claims reiterated that "[t]he label and form of the foreign tax is not determinative," and reviewed the legislative history and practical effect of a tax to determine creditability. 677 F.2d at 80.

Shortly after *Inland Steel*, the Treasury Department promulgated § 1.901-2, which defines an "income tax" in the same manner as those cases: A tax is an "income tax" if "[t]he predominant character of that tax is that of an income tax in the U.S. sense," which is the case if the tax is "likely to reach net gain in the normal circumstances in which it applies." § 1.901-2(a)(1)(ii), (3)(i); *compare Bank of America I*, 459 F.2d at 519–20 (tax is an income tax if "it is very highly likely, or was reasonably intended, always to reach some net gain in the normal circumstances in which it applies"). As the preamble to the regulation explains, "[t]his standard … adopts the criterion for creditability set forth in *Inland Steel* …, *Bank of America* [*I*] …, and *Bank of America* [*II*]." 48 Fed. Reg. 46,272, 46,273 (Oct. 12, 1983).

Notwithstanding that clear instruction to read § 1.901-2 in harmony with the substance-over-form approach of the cases that came before it, and brushing aside the Tax Court's analysis of how the U.K. windfall tax clearly operated as a tax on excess profits, the Third Circuit inexplicably concluded that

the Commissioner's hyper-formalistic approach was somehow compelled by a regulation expressly intended to reject it. As the Fifth Circuit correctly recognized, nothing in the regulation supports the Third Circuit's dubious conclusion that § 1.901-2 is "in tension with" the very cases it "purports to adopt." App. 6–7 n.1.

At the outset, there is no merit to the Third Circuit's suggestion that other courts have perceived such non-existent "tension" between § 1.901-2 and the wealth of section 901 cases. *See* App. 6–7 n.1. In fact, after considering the issue in depth, the Second Circuit concluded that, if anything, the regulation compels a *more* flexible approach to creditability. *See Texasgulf*, 172 F.3d at 216–17. *Texasgulf* involved the same tax the Court of Claims had deemed not creditable in *Inland Steel*. Relying on a provision that instructs courts to consider whether a foreign tax on an amount in excess of net profit nonetheless "provides allowances that effectively compensate for nonrecovery of … significant costs or expenses," § 1.901-2(b)(4)(B), the court found itself bound by the regulation to place even greater weight on the tax's substance than the *Inland Steel* decision had, and thus rejected the Court of Claims' pre-regulation conclusion that the same tax was not creditable. *See* 172 F.3d at 216–17. In doing so, the Second Circuit interpreted § 1.901-2 as encouraging examination of the same type of "empirical evidence" of a tax's practical effect the Third Circuit rejected here. *Id.* at 215.

The Tax Court reached the same conclusion in *Phillips Petroleum Co. v. Commissioner of Internal Revenue*, 104 T.C. 256 (1995), a case involving the

application of materially analogous provisions of an interim version of the regulation to three Norwegian taxes. To determine whether two of the taxes were royalties, the court undertook an "exhaustive examination of the [taxes themselves], other Norwegian general tax legislation, legislative history, [and] the testimony from two Norwegian tax experts." *Id.* at 288. And to determine whether the third was "most appropriately described as an 'excess profits' tax, as Congress has used that term when it has been written into the Internal Revenue Code," the court studied the "purpose, design, and effect" of the tax on the companies that paid it. *Id.* at 291, 316. As *Phillips Petroleum* and *Texasgulf* reflect, there is simply no merit to the Third Circuit's suggestion that § 1.901-2 was intended to do anything other than what its preamble says—adopt the substance-based approach to creditability that every decision before it had employed.

The Third Circuit derived its contrary conclusion primarily from Example 3 of the gross receipts subsection of the regulation, which it seemed to think superimposed extreme formalism not just on the gross receipts analysis, but on the entirety of § 1.901-2. But as the Fifth Circuit explained, Example 3 "do[es] not illustrate the meaning of '*actual* gross receipts'" at all—it instead deals with the discrete concept of "*imputed* gross receipts," a concept with no application whatsoever here. *Entergy*, 2012 WL 1994786, at *5 (emphasis added). While certain methods of imputing gross receipts may be appropriate when actual gross receipts are "difficult to calculate or impractical to know," some foreign countries have also "use[d]

imputed, rather than actual, income formulas … 'structured to tax artificial or fictitious income' in order to increase domestic tax receipts." *Id.* Example 3 is thus part of a series of examples designed to "differentiate between permissible *imputed* actual gross receipts and impermissible notional amounts," *id.*, not to superimpose rigid formalism on the entire creditability inquiry.

Unlike in those examples, the U.K. windfall tax "at no point imputes gross receipts," as "gross receipts were actually known" long before the windfall tax "was even proposed." *Id.* Indeed, the nominal "value" taxed by the windfall tax can be calculated only once historical profits in the four years after privatization are known. Accordingly, "an example detailing an impermissible method for calculating *imputed* gross receipts (based on historical practices by OPEC countries) is facially irrelevant" to the creditability of the windfall tax. *Id.* Indeed, there is no question that "a tax based on actual financial profits in the U.K. sense necessarily begins with gross receipts" as that term is understood in U.S. tax law. *Id.* at *6. Only by accepting the Commissioner's anomalous invitation to turn a blind eye to the practical operation of the windfall tax could the Third Circuit nonetheless hold the tax not creditable, albeit by focusing on an inapposite example that even the Commissioner recognizes is irrelevant. That it erroneously employed such a hyper-technical approach in the context of a foreign country whose tax laws are among the most comparable to our own leaves little doubt that the Third Circuit—and the Commissioner—would not hesitate to do the same

when dealing with taxes from the many countries whose provisions are even less likely to have the attributes of U.S. taxes on their face.

In short, the extreme formalism adopted by the Third Circuit at the Commissioner's urging cannot be reconciled with the text of section 901, decades of precedent uniformly employing a substance-over-form approach to creditability, the Commissioner's own regulation doing the same, or common sense. It is one thing to insist that players within the U.S. governmental and legal systems turn square corners, but it makes no sense to refuse to look beyond form when evaluating the U.S. tax consequences of taxes imposed by foreign governments. This Court should grant certiorari to reject the Commissioner's profoundly misguided approach and rectify the Third Circuit's erroneous departure from settled precedent "eschew[ing]" the "form-over-substance methodology" that its decision "exemplifies." *Id.* at *4.

III. The Third Circuit's And The Commissioner's Elevation Of Form Over Substance Has Broad Implications For Taxpayers.

At a very basic level, the formalistic approach to creditability urged by the Commissioner and adopted by the Third Circuit is at odds with one of the most fundamental tenets of tax law. The principle that substance trumps form is not unique to the foreign tax credit statute. It is the "cornerstone of sound taxation," and its "most persistent advocate … is … the Commissioner." *Estate of Weinert v. Comm'r*, 294 F.2d 750, 755 (5th Cir. 1961); *see also, e.g.*, *Boulware v. United States*, 552 U.S. 421 (2008); *Higgins v. Smith*, 308 U.S. 473 (1940); *Gregory v.*

Helvering, 293 U.S. 465 (1935); *see generally* Joseph Isenbergh, *Review: Musings on Form and Substance in Taxation*, 49 U. Chi. L. Rev. 859 (1982).

If anything, that foundational principle should apply with all the more force in this context, where the task is to consider the U.S. tax consequences of statutes that may be written in foreign languages and based on foreign tax codes. This Court has been wary of creating "magic word" tests even when dealing with the U.S. Congress. *See, e.g.*, *Henderson ex rel. Henderson v. Shinseki*, 131 S. Ct. 1197, 1203 (2011); *Morrison v. National Austl. Bank Ltd.*, 130 S. Ct. 2869, 2883 (2010). But it is hard to imagine a context less well suited to extreme formalism than the consideration of the U.S. tax consequences of taxes imposed by foreign nations. Those taxes can be assessed in a wide range of manners, by countries with radically different tax systems, in a myriad of different languages, and for political, economic, and social reasons unique to those countries. The process of translating—literally and figuratively—those foreign taxes for purposes of U.S. taxes demands an inquiry into substance. Yet neither the Third Circuit nor the Commissioner even attempted to provide any justification for abandoning substance in a setting where doing so seems to serve no purpose other than filling the government's coffers. In this context no less than in any other, "[r]esort to substance" should not be "a right reserved for the Commissioner's exclusive benefit, to use or not to use—depending on the amount of the tax to be realized." *Estate of Weinert*, 294 F.2d at 755; *see also Comdisco, Inc. v. United States*, 756 F.2d 569, 578 (7th Cir. 1985) (same).

The potential consequences of the Commissioner's anomalous elevation of form over substance reach well beyond the specific factual context of this case. Domestic corporations claim tens of billions of dollars in foreign tax credits each year. *See supra* p. 4. Because § 1.901-2's "predominant character" standard and the three-factor test apply to income, war profits, and excess profits taxes alike, *see* § 1.901-2(a)(1), the Third Circuit's misguided approach threatens the creditability of every foreign tax that does not precisely mirror a U.S. income tax. Perhaps even more troublingly, the Commissioner's willingness to urge such extreme formalism in the context of a tax that is so obviously creditable when viewed in practical terms leaves little doubt that the Commissioner would not hesitate to do the same in a context where the practical operation of a foreign tax is not so readily identifiable. Thus, as a prominent tax publication has noted, "the *PPL* and *Entergy* decisions represent more than just disparate views of a narrow tax question"; they "raise[] fundamental questions about the test for creditability." 136 Tax Notes 139, 141 (July 9, 2012).

In addition, the Third Circuit made the profoundly troubling suggestion that, in direct contradiction to the statute's text, an excess profits tax could *never* be creditable under the regulation's three-factor test. *See* App. 10–11 n.2. The court appeared to believe that because § 1.901-2 does not explain how to distinguish excess profits from net profits, it does not contemplate that excess profits taxes are creditable at all, simply because *excess* profits will always be less than *net* profits. *See* App.

10–11 n.2 (suggesting PPL should have "argued that the … regulation was arbitrary or capricious because it mingles 'excess profits taxes' with the other statutory terms"). That alone reveals how deeply confused and lost the court was—nothing in § 1.901-2 remotely suggests that a tax on a *subset* of net gain somehow ceases to satisfy the net gain test. Quite the contrary, as the cases from which § 1.901-2 is derived make clear, the point of the test is to ensure that "the other country is attempting to reach *some* net gain," not *all* net gain. *Bank of America I*, 459 F.2d at 519 (emphasis added). The Third Circuit's erroneous suggestion otherwise injects substantial uncertainty into the creditability analysis for all excess profits taxes.

Finally, wholly apart from the broader consequences of the Commissioner's newfound aversion to the substance-over-form principle that he is typically the first to embrace, the creditability of the windfall tax is itself an issue of significant consequence. PPL sought a combined credit of $27.3 million for SWEB's windfall tax payments; with interest, the financial impact of the creditability issue for PPL is approximately $39 million. Entergy claimed a $234 million credit for London Electricity's windfall tax payments, *see Entergy*, 2012 WL 1994786, at *1, and American Electric Power Company, Inc., is currently engaged in administrative proceedings on the same issue in relation to approximately $285 million in windfall taxes paid by two of its subsidiaries. Thus, those three companies alone have hundreds of millions of dollars riding on whether the windfall tax is creditable and, at the moment, they are being

treated differently for no reason other than where they happen to be headquartered.

In short, the decision below creates a direct, acknowledged, and untenable circuit split, adopts a deeply flawed approach to creditability that is irreconcilable with the governing regulation and case law, and casts a long and lingering shadow over the creditability of foreign taxes paid by U.S. taxpayers. The Tax Court and the Fifth Circuit correctly recognized that the Commissioner's hyper-formalistic arguments have no place in the foreign tax credit context, which by its very nature demands a practical and substance-based approach to creditability. This Court should grant review and do the same.

CONCLUSION

The Court should grant the petition.

Respectfully submitted,

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