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IN THE SUPREME COURT OF THE UNITED STATES

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PPL CORPORATION AND SUBSIDIARIES, :

Petitioner : No. 12-43

v. :

COMMISSIONER OF INTERNAL REVENUE :

- - - - - x

Washington, D.C.

Wednesday, February 20, 2013

The above-entitled matter came on for oral argument before the Supreme Court of the United States at 11:17 a.m.

APPEARANCES:

PAUL D. CLEMENT, ESQ., Washington, D.C.; on behalf of Petitioner.

ANN O'CONNELL, ESQ., Assistant to the Solicitor General, Department of Justice, Washington, D.C.; on behalf of Respondent.

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P R O C E E D I N G S

(11:17 a.m.)

CHIEF JUSTICE ROBERTS: We'll hear argument next in Case 12-43, PPL Corporation and Subsidiaries v. the Commissioner of Internal Revenue.

Mr. Clement.

ORAL ARGUMENT OF PAUL D. CLEMENT

ON BEHALF OF THE PETITIONER

MR. CLEMENT: Mr. Chief Justice, and may it please the Court:

This case has its origins in a decision by the British government in the Major Thatcher years to privatize a number of previously State-owned utilities. The government's plan was to keep prices constant and allow the companies to make profits by increasing efficiencies and reducing costs. Only after an initial period in which prices would be fixed would the prices be re-jiggered and then savings passed on to the consumers.

Now, this in practice worked very well for the companies. They were able to increase their efficiencies and cut costs to a greater extent than people expected. This was not, however, greeted as a uniform success. Instead, the opposition party criticized this, and said that the fat cats at the

1 utility companies had earned too much, and the
2 conservative government had made a mistake by valuing
3 the shares at IPO too cheaply.

4 And so they promised as an express election
5 promise to impose a tax on the excess profits of
6 privatized utilities. And when elected, they made good
7 on that promise and passed the Windfall Act --

8 JUSTICE SOTOMAYOR: See, I have a problem
9 with this argument because it assumes a way of looking
10 at this, but it's an assumption. You can look at it in
11 either way. You can look at it as they made too much
12 money, we want a part of that profit or they paid too
13 little for what they got.

14 And that was the debate going on in
15 Congress. Did they pay too little on the floatation
16 value, or did they make too much money? And what the
17 government says -- rightly -- is, whether you paid too
18 much or too little money depends on the value of the
19 company. And one of the factors that goes into that is
20 how much money has the company made?

21 And so you always have to look at profits to
22 some extent. So what's wrong with looking at it their
23 way? Why does it have to be your way?

24 MR. CLEMENT: Well, it has to be my way
25 because of the way the specific tax was designed. But

1 the first --

2 JUSTICE SOTOMAYOR: No, you can only do it
3 your way if you do what the amici says, which is to take
4 out from your simplified equation the fact that the
5 time -- the D element of your equation -- is constant.
6 You artificially freeze it at the time at which they
7 operated. Only by freezing that number can you come out
8 with your equation.

9 MR. CLEMENT: Well, Your Honor, we're not
10 artificially freezing the number. The number, the D --
11 1461 for almost every company -- is itself part of the
12 statute. Because they picked a period by which they
13 were going to measure the profit in value-making terms.

14 JUSTICE SOTOMAYOR: But there was at least
15 two or three companies that had a very different period
16 and they paid a huge amount, much further than their
17 gross profits. Because of that, D changed for them.

18 MR. CLEMENT: I can talk about the outlying
19 companies. They paid a different effective rate because
20 the D was different. But there's two important things
21 to remember. One, I believe it's common ground between
22 the parties that the way you apply this regulation is to
23 look at the tax in -- to use the regulatory phrase -- in
24 the normal circumstances in which it applies.

25 So I believe it's common ground that you

1 ignore the outliers anyway.

2 JUSTICE SOTOMAYOR: But you change the other
3 part of the equation, or the tax regulation, which says
4 it has to be true for all taxpayers.

5 MR. CLEMENT: No. That particular
6 provision -- think of it as like a Clark v. Martinez
7 principle for taxes. They either are creditable or
8 they're not. That's what that principle has been
9 interpreted to. The case you should look at if you're
10 really interested in it is the Exxon case, the tax court
11 where we cite it in both our briefs.

12 And there, it was a situation where again, a
13 British excess profits tax, in the main, it was an
14 excess profits tax on the companies that were developing
15 the North Sea oil field. But as the tax applied to a
16 couple of companies that really hadn't gotten any oil
17 out, it applied very differently.

18 And the tax court and the government in that
19 case both conceded no, you look at the tax in its main
20 applications. And in those main applications, everyone
21 concedes that this tax operates exactly like a
22 51.75 percent tax on profits above a threshold, a
23 threshold of four nights at the floatation value. And
24 that is not an accident. That's not some kind of tricky
25 math thing that somebody pulled up, it's right there in

1 the statute itself.

2 JUSTICE KENNEDY: Suppose everyone in the
3 case conceded that the purpose of this statute was to
4 compensate the government for having valued the shares
5 at too low a price, and this was stated right in the
6 enactment. Would that change your argument?

7 MR. CLEMENT: It wouldn't, Justice Kennedy,
8 because at the end of the day, it's the substance of the
9 tax, not its purpose behind it that matters. Now, I do
10 think in this case, as Justice Sotomayor alluded to,
11 everybody in this process really understood that those
12 were just the flip side of the same coin. You can talk
13 about the profits being too high vis-à-vis floatation,
14 you can talk about floatation being too low vis-à-vis
15 the subsequently reported profits. But what makes --

16 JUSTICE KENNEDY: Well, suppose we think
17 this is both a tax on profits and a tax on low value,
18 then what do we do?

19 MR. CLEMENT: Well, in this particular case,
20 you would say it's creditable, because the only measure
21 of value here is by looking at retrospective earnings
22 over a 4-year period. And the best hypothetical I can
23 give you is think about a foreign government that says
24 we want to tax the value of corporations, but the way we
25 are idiosyncratically going to measure value is to look

1 at their earnings over the past year.

2 Now, I would hope that tax would be for U.S.
3 substantive economic tax purposes fully creditable. Of
4 course it's a tax on income by our eyes. Now, in saying
5 that, you're not suggesting that the other country did
6 something wrong or that's not value in their conception.

7 But the whole point that this Court made
8 clear in the Biddle case going back 75 years ago is when
9 you're looking at foreign taxes for purposes of applying
10 the foreign tax credit, you don't take the foreign
11 characterizations, the foreign classifications, as a
12 given. You look at the substance of the tax for our
13 purposes.

14 And if you look -- if you apply that
15 mechanism to this tax, this tax looks exactly like a
16 U.S. excess profits tax. It is really --

17 JUSTICE KAGAN: Mr. Clement --

18 JUSTICE KENNEDY: Suppose it's a one -- if I
19 could just -- suppose -- we say, well this is a one-time
20 tax in order to recalculate, reassess the value. If
21 it's on income, it's still an excess profits tax in your
22 view.

23 MR. CLEMENT: Yes. And of course, you could
24 have had a one time, one-off tax, to use the British
25 phrase, and you could have taxed the difference between

1 the value at floatation and, let's say the London Stock
2 Exchange price at some later point. And that would have
3 been the normal estimate of value, and it would not have
4 been creditable for a number of reasons. But when you
5 do what this tax uniquely did, which is you don't look
6 at a normal rubric of value, but you look at a
7 construct -- I mean, the very fact that they had to use
8 the phrase "value in profit-making terms" tells you
9 something weird's going on here.

10 I mean, if they were really --

11 JUSTICE GINSBURG: Mr. Clement, is there
12 another example -- Justice Kennedy mentioned that this
13 was what they call one-off. It's one time only and it's
14 retrospective. Is there any instance in which a foreign
15 tax credit has been given to something that looks like
16 this, a one-time only adjustment that is -- that
17 operates retrospectively on past earnings?

18 MR. CLEMENT: Justice Ginsburg, I can't put
19 all the pieces of that together and say there's one case
20 that had all of these various features, and then it was
21 still creditable. But I don't think that matters. It's
22 very clear I think for starters that the fact that this
23 is a retroactive tax is not dispositive. You look at
24 one of the regulatory requirements, and that's
25 realization. And that treats an estimate of future

1 income generation very differently, because that doesn't
2 involve a realization event. But what the regulation
3 says is that the tax has to be imposed upon or
4 subsequent to.

5 JUSTICE SOTOMAYOR: My fear is, as warned by
6 the government and the tax professors, that the rule you
7 want us to announce to help you win is to say anytime a
8 tax uses estimates of profits, no matter how it does it,
9 it is credible -- creditable. That's the rule you want.

10 MR. CLEMENT: No, it is not. It is
11 emphatically not. And let me tell you why there is no
12 slippery slope here. First, the big thing they want to
13 tell you is, this is a normal way of valuation. And if
14 you allow this, then any valuation is going to be
15 creditable. That is flat wrong, and the reason that's
16 flat wrong is because almost every effort in valuation
17 is prospective.

18 If you want to try to value a piece of
19 property, you could value it by saying, well, what kind
20 of rents can I get on this property and I'll discount
21 them back to net present value. And I suppose you can
22 conceive of a property tax as a tax on a percentage of
23 those projected future earnings. But you know what?
24 Easily obviously not creditable, because the first
25 requirement on the regulation is that there be a

1 realization event. And when you're talking about
2 projected future income streams, there's no realization
3 events.

4 So all of those are off the table.

5 JUSTICE SOTOMAYOR: So why isn't that to say
6 I want to find the original floatation value, and
7 instead of estimating what the profits are, I'm simply
8 going to use the ones that happen?

9 MR. CLEMENT: Exactly.

10 JUSTICE SOTOMAYOR: So why is that
11 different?

12 MR. CLEMENT: Because you never would do
13 that in any normal valuation. What you would do --
14 occasionally in valuation, you have to go back in time.
15 This isn't the only place in the world that anybody
16 said, I wonder what Google's stock was worth, like, back
17 in the day. But when you do that for valuation
18 purposes, the first rule of thumb is to avoid hindsight
19 bias. And so this tax uniquely taxes nothing but
20 hindsight bias. It's going back to 1990 --

21 JUSTICE SOTOMAYOR: Well, there is an
22 argument about that because it has two components that
23 you keep ignoring: The floatation value and the time
24 that the company --

25 MR. CLEMENT: I would love to talk about

1 those other variables. The floatation value -- I mean,
2 it's a tax between the difference between -- between two
3 variables.

4 The reason I am focusing on the value and
5 profit making terms is because it's the larger of the
6 two numbers and the tax falls in the difference between
7 the two and the floatation value is basically taken as a
8 given.

9 JUSTICE KAGAN: Well, Mr. -- I'm sorry,
10 please.

11 MR. CLEMENT: Go ahead. I mean, I could
12 talk floatation value all day.

13 CHIEF JUSTICE ROBERTS: I'd really like to
14 hear what you have to say.

15 JUSTICE KAGAN: Okay. Then let me ask you
16 my question.

17 CHIEF JUSTICE ROBERTS: Wait, Justice Kagan.
18 No, Justice Kagan.

19 JUSTICE KAGAN: Do you agree -- I mean, you
20 said we should look to the way this is designed, so
21 let's look to the way that the actual formula is
22 designed. Do you agree that this tax would impose
23 identical tax liability for companies with -- at the
24 same average profits but could impose very different tax
25 liability for companies with the same total profits?

1 That's the way the thing is designed, is it not?

2 MR. CLEMENT: Yes, and that's true of every
3 excess profits tax, Your Honor. What matters for those
4 tax --

5 JUSTICE KAGAN: Well, that's the question.
6 Is that true of every excess profits tax? Take a -- a
7 hypothetical like this: You have two companies, Company
8 A and Company B, and one company operates over four
9 years and makes a lot of money and one company operates
10 over one year and makes only a quarter of that amount of
11 money. Now, a typical excess profits tax is going to
12 take Company A, which has made a lot of money, and --
13 and it's going to end up paying four times as much tax
14 as Company B, which has made only a quarter of the
15 amount of money. But under this tax, Company A and
16 Company B pay the exact same thing; isn't that right?

17 MR. CLEMENT: No. They -- they would pay
18 different taxes. I mean, they pay the same rate --

19 JUSTICE KAGAN: One year or four years?

20 MR. CLEMENT: They have the same -- they'd
21 have the same rate. They'd have -- I mean, they have
22 the same calculation, but it would affect them very
23 differently. But in --

24 JUSTICE KAGAN: In other words, a company
25 that has made four times as much profits under this

1 formula could pay the same tax; isn't that right?

2 MR. CLEMENT: I -- I don't think --

3 JUSTICE KAGAN: Because it was operating
4 four times as long.

5 MR. CLEMENT: Right.

6 JUSTICE KAGAN: And because there is that D
7 variable.

8 MR. CLEMENT: Right; that's right. But of
9 course the floatation value is going to play a bigger
10 role in the other company --

11 JUSTICE KAGAN: Assuming the floatation
12 value is the same for both companies.

13 MR. CLEMENT: Then -- then maybe it could,
14 Justice Kagan, but let me say two things about that.

15 JUSTICE KAGAN: It definitely could. It
16 would have to. And that's because what this is trying
17 to tax is not total profits; this is trying to tax
18 average profits or what may be the better way to say it,
19 if it's taxing profitability and not profits.

20 MR. CLEMENT: No. With all due respect,
21 it's taxing profits above a threshold, and the threshold
22 is determined by floatation value. For most companies
23 that the tax applies, and that is the way you look at
24 the creditability of these taxes, you ignore the
25 outlier. For most of those companies, it's going to be

1 four nights of the floatation value.

2 JUSTICE KAGAN: But -- but the reason why
3 this formula was devised in the way that this formula
4 was devised was specifically to get at the outlier. In
5 other words, it was to get at the company that only
6 operated for a short amount of time, but they wanted
7 that company to pay just as big a tax bill as the
8 company that had operated for a much longer amount of
9 time and had made many more profits. So the end result
10 is that this company that operates for a very short
11 amount of time and makes almost no excess profits pays
12 the exact same tax bill as a company with four times as
13 much excess profits.

14 MR. CLEMENT: No, that's not right, Your
15 Honor. I -- it really is not. And what they were
16 trying to do -- first of all, the outliers, the reason
17 they included them in is they figured they had to
18 because it fit within their definition of the regulated
19 companies they were trying to catch. Now, they knew
20 they had -- and this is only two companies we are
21 talking about -- they knew they had a shorter period, so
22 they knew this would fall differently on them as a
23 substantive matter no matter -- no matter how they did
24 it.

25 The reason they didn't care much is because

1 those companies got something that the other companies
2 didn't, which is they got to operate for the next three
3 years in a favorable regulatory environment in which no
4 excess profits tax would be imposed on them. So it may
5 look like they have a higher rate, effective rate, under
6 our calculation. They do have a higher effective rate
7 over a -- over a relatively small amount over the
8 threshold, but they make that up, essentially, in the
9 out-years because they make money under the favorable
10 regulatory regime.

11 And again, the theory of this is for four
12 years after floatation there is a favorable regulatory
13 regime in which they make excess profits. Those two
14 companies get to make money in the out-years, two,
15 three, four, without any excess profits because it was
16 really important for them to make this a one-off tax.

17 But if I can get back to your question,
18 because there is this phenomenon --

19 JUSTICE SCALIA: Excuse me. Why -- why
20 didn't -- why weren't they subject to a favorable
21 regulatory regime in two, three, and four?

22 MR. CLEMENT: They were. They weren't --
23 but they weren't subject to any tax for it. Because
24 remember, they -- this is very important for labor.
25 They are coming in after 20 years of conservative rule.

1 They don't want to be the old labor party. They don't
2 want to put in a new permanent tax, so they want to do
3 this once.

4 And so that works great for my clients
5 because they -- they were privatized in 1990. But when
6 they're doing this in 1997, they get a couple of
7 outlying companies that were only privatized in '96. So
8 what they do is they hit them with a reasonably tough
9 tax in year one but year two, three, and four they were
10 in a favorable regulatory environment and they get no
11 tax at all. So, you know, don't -- don't cry any tears
12 for them.

13 Now, the point that I thought you were going
14 to ask me, though, is even with the companies with the
15 same denominator, it is true that companies with the
16 same profits can be subjected to different taxes, but
17 that's because it's an excess profits tax. And that is
18 what is true of --

19 JUSTICE KAGAN: No, but even companies with
20 the exact same profits and the exact same floatation
21 value can be subject to different taxes, and that's a
22 result of the amount of time. That's a result of the D
23 variable. If you were right --

24 MR. CLEMENT: With respect, that's only true
25 of --

1 JUSTICE KAGAN: Excuse me. If you were
2 right, the D variable wouldn't exist. If this were an
3 excess profits tax, it would have been written without a
4 D variable because they would not have cared whether it
5 was four years or one year or any place in between.

6 MR. CLEMENT: With respect, I disagree.
7 Because, first of all, it's only those two companies,
8 from what you said, is -- it could possibly be true. As
9 to the rest of the companies, the reason that they were
10 trying to use D is because they were trying to capture
11 the excess profits during a period in which there is a
12 particular regulatory environment with -- where they --
13 where they thought they earned excess profits. For all
14 of the companies they reached, that period was the D
15 with the exception of the outliers, and the reason they
16 had a different outlier is because they were recently
17 privatized.

18 But if you think about the substance of this
19 tax, it is taxing -- their term -- value and
20 profit-making terms but not any abstract profit-making
21 terms, profits over a reported period.

22 JUSTICE KAGAN: If you were right, it would
23 just be a 52 percent tax on annual profits above 1/9th
24 of the floatation value. And it's not that. It's not
25 that. Specifically in order to get at railroad track,

1 which would have paid very little tax under your
2 formula, but instead pays a great amount of tax because
3 they think that railroad track got the same good deal at
4 the beginning as all these other companies did, but so
5 even though they didn't make much very much in the way
6 of excess profits, they were going to tax them just as
7 much.

8 MR. CLEMENT: Because they had three free
9 years in the out-years. And if you are looking at how
10 this applies, in the normal circumstances of its
11 application, then you don't have the full analysis of a
12 railroad track.

13 JUSTICE SOTOMAYOR: The problem with their
14 argument, Mr. Clement, is that you are undermining your
15 own argument. If they are getting three full years at a
16 lesser tax, it's because their floatation value was made
17 more equal by this formula.

18 MR. CLEMENT: No, that's not right.

19 JUSTICE SOTOMAYOR: So they don't need to be
20 taxed any more moving forward because they got it right.

21 MR. CLEMENT: No, that's -- with all due
22 respect, that's not right. The floatation value is
23 calculated the same way for each of these companies, and
24 the theory of why the floatation value is too low is the
25 same for all of them, which is, under the regulatory

1 policies, they are going to hold the prices firm for a
2 four-year period and they are going to increase
3 efficiencies and reduce costs, and they are going to
4 make money. That is supposed to incentivize them and
5 then that's the basis for all the regulatory policies
6 going forward.

7 JUSTICE BREYER: I wanted -- I just wanted
8 to hear what you were going to say in answer to the
9 second part of Justice Sotomayor's earlier question.
10 And to remind you of that, you were going to explain to
11 us, which I felt I needed, the second term, that second
12 term. And that just says FV for value.

13 MR. CLEMENT: Right.

14 JUSTICE BREYER: But I did notice, that if
15 you take .23 times fair value, not quite by coincidence,
16 it happens to be what the companies would have made over
17 a period of 2 years in profit, had it been the truth
18 that the value of such companies was, as valued by the
19 market, 9 times their earnings. Because a company
20 that's valued 9 times its earnings earns about 11 point
21 something percent per year, taking aside all other
22 facts; and 2 years' worth is that.

23 And I don't know if I've got that part
24 right, but if I do have that part right, then what this
25 tax does is it takes the profits the firms actually --

1 actually made over 2 years; not quite actually. It
2 assumes twice the -- the value of the first year. You
3 see, so whatever they made the first year -- and if it's
4 only 6 months, it's twice 6 months, you know -- that
5 first part figures out what they really made over the
6 first year and then multiplies it by two. And you take
7 that and you subtract from that the amount that they
8 would have made over 2 years.

9 Now -- so it looked to me pretty -- this
10 helps you, of course, but -- but it also, it's
11 calculated on an average, the average of the first
12 year's profit, they consider that the average; and
13 therefore they are right in saying, you know, a firm
14 that is only in business for 6 months will be taxed --
15 the whole 2-year extra will be taken away, even when
16 there was no 2-year extra. You see, so that firm would
17 have paid more than their gross income.

18 Of course, there is no such firm and that's
19 their problem. But we come to that later. But I want
20 your view, if you can -- if I've explained it clearly
21 enough so you get where I'm coming from. And -- and --
22 if -- if I have explained that clearly enough, I really
23 appreciate what you think about it.

24 MR. CLEMENT: Well, I -- I think so, but I
25 think I get there in a slightly different way, because I

1 guess I don't see the natural relationship between the
2 23 percent and the floatation value; but I think I get
3 to a similar place. Which is, if you think about it the
4 way that we formulate it, it's 51.75 percent of 4/9ths
5 of floatation value.

6 Now, the -- the floatation value is
7 calculated based on the initial share price plus the
8 number of shares. And the initial share price for all
9 the electrical utilities was 2 pounds 40 pence. So it's
10 just 2 pounds 40 pence by however many shares there
11 were. Okay, so that's floatation value.

12 The -- the floor for the excess profits is
13 4/9ths of floatation value. Now, if you want to get it
14 on an annualized average basis, and if you want to --
15 you know, this is at 64a of the petition appendix when
16 the Tax Court did it. But what that means in practice
17 is this tax is taxing 51.75 percent of the profits above
18 1/9th of the floatation --

19 JUSTICE BREYER: It will do that for firms
20 that are in business for 4 years.

21 MR. CLEMENT: Yes.

22 JUSTICE BREYER: Absolutely. It won't do
23 that for a firm that was in business 6 months. And --
24 and --

25 MR. CLEMENT: It -- it will give you a

1 different number.

2 JUSTICE BREYER: A very different number.

3 MR. CLEMENT: Yes.

4 JUSTICE BREYER: Indeed, a number that could
5 exceed the money -- all the money they really make in
6 the next 2 years.

7 MR. CLEMENT: That's not true. If any
8 company here -- of any company here, that's not true.

9 JUSTICE BREYER: Yes, that's correct.
10 That's not true. There is only one company like that;
11 absolutely right. And -- but -- but some, particularly
12 on the other side, want to make quite a lot out of that
13 fact.

14 And they want to make quite a lot out of the
15 fact that for that single -- whatever it's called
16 railroad something --

17 MR. CLEMENT: Railtrack. But again,
18 Railtrack did not pay more in taxes than --

19 JUSTICE BREYER: I know -- I know they
20 didn't. It didn't happen in this instance.

21 MR. CLEMENT: And -- and -- and that is a
22 very important fact because when you are trying to
23 figure out -- what -- and again, their regulation says,
24 you look to the application of the statute in the normal
25 circumstances in which it applies.

1 In the normal circumstances in which this
2 applies, and this is -- the parties stipulated to, every
3 company paid less in this excess profits tax or windfall
4 tax than they made in initial period profits. And that
5 is all that really matters.

6 They want to focus on the fact that well,
7 for a lot of these companies, the base amount was larger
8 than the -- than their initial period profits. Who
9 cares? I mean, that's just an artificial number. This
10 act --

11 JUSTICE SOTOMAYOR: Let's go back to my
12 initial question. What's the rule -- if someone uses
13 your actual profits in any way, it's a credit that they
14 are entitled to?

15 MR. CLEMENT: No. I don't think so, because
16 again --

17 JUSTICE SOTOMAYOR: I don't know how you get
18 around it, because you seem to be saying to us that no
19 matter how -- what formula you create, so long as we can
20 simplify it in math to affect which -- take any
21 variables in it and fix them in any way, that's a
22 creditable tax. That seems to be what your argument is.

23 MR. CLEMENT: No, it's not,
24 Justice Sotomayor. Now, there's two things your
25 question I think got to; one I thought I already dealt

1 with, which is future valuation is not a problem. There
2 is no realization of it.

3 JUSTICE SOTOMAYOR: No, I'm saying to you
4 that any tax that relies upon actual profits in any way,
5 you say is wrong.

6 MR. CLEMENT: It's not right or wrong. We
7 would say it's creditable if that's its predominant
8 character. So if you want to put that as part of a
9 ten-factor test where past realized profits is one of
10 the ten factors, but you also look at real market
11 valuation and some other factor, then I'm probably going
12 to lose.

13 But in this instance, the only moving
14 factor, the only thing that changes from company to
15 company other than the floatation value, which is fixed,
16 is their profits. And nobody -- you know, nobody
17 doubts --

18 JUSTICE SOTOMAYOR: No, the floatation value
19 is not fixed; it was different for each company.

20 MR. CLEMENT: Right. But --

21 JUSTICE SOTOMAYOR: They only fixed the
22 percentage that they're going to use, but the actual
23 amount paid was different for every company.

24 MR. CLEMENT: But again, that is classic
25 excess profits tax. So let me try to come at it this

1 way, which is to say, suppose you had a country that had
2 a tax that said, we are going to tax your value and we
3 are going to measure your -- your -- your value based on
4 the income you made in the last year or the last 2
5 years.

6 Now, I would say that that is clearly a
7 creditable income tax. If they said the same thing --
8 we are going to tax your value and we are going to
9 calculate your value based on your income over the last
10 2 years, but we are going to subtract 10 percent of your
11 market cap -- that would be an excess profits tax.

12 The market cap would be different for every
13 company, so there would be another thing that was
14 different for each company, and the effective rate might
15 be different but that's okay because that's how an
16 excessive profits tax works.

17 The last thing I'd say before I go sit down
18 is that's how the 1917 United States Excess Profits Tax
19 worked. In 1918, when Congress said that foreign excess
20 profits taxes are creditable, surely that's what they
21 had in mind, and this is very similar to that classic,
22 prototypical excess profits that.

23 If I could reserve the remainder of my time.

24 CHIEF JUSTICE ROBERTS: Thank you, Counsel.

25 Ms. O'Connell?

1 ORAL ARGUMENT OF ANN O'CONNELL
2 ON BEHALF OF THE RESPONDENT

3 MS. O'CONNELL: Mr. Chief Justice, and may
4 it please the Court:

5 The windfall tax is not an income tax. It
6 tax -- is a tax on an increment of company value. A
7 company's profits multiplied by a price to earnings
8 ratio is a typical way of imputing a value on a company.
9 Using profits as one variable in that valuation formula
10 does not transform a tax on company value into an income
11 tax.

12 JUSTICE SCALIA: That -- that's a way of
13 estimating future value. I -- I don't know that anybody
14 values a company that -- that is sold on the market by
15 saying how much money did they make in the last 2 years
16 and we are going to multiply that by 9. You look at
17 what people were paying you in the market.

18 MS. O'CONNELL: Well, Justice Scalia, the --
19 what parliament was trying to do here was to impute a
20 value on the company for which should have been sold in
21 1990. And so using a stock price at some later date
22 would not have been an adequate proxy to determine what
23 that value should have been.

24 JUSTICE BREYER: If they know what it really
25 was, I guess they're all billionaires. You've got

1 triple billionaires. I mean, if you could go and figure
2 out what companies could really be sold at as opposed to
3 what the market says, I think I have the solution for
4 you. I don't know why either of us is working here.

5 (Laughter.)

6 MS. O'CONNELL: Well, the point is that
7 parliament was trying to come up with a value that it
8 should have charged for these companies in 1990, and,
9 you know --

10 JUSTICE BREYER: So, since there is no real
11 value, I -- I mean, maybe there is, because they did it
12 in the form of an IPO, and the share then went the next
13 day into the market, and when the it went the next day
14 into the market, did the market pay a lot more?

15 MS. O'CONNELL: Yes, it did.

16 JUSTICE BREYER: Really?

17 MS. O'CONNELL: There -- there is --

18 JUSTICE BREYER: All right, then you could
19 use that. You could use that.

20 MS. O'CONNELL: Well, but if you use --

21 JUSTICE BREYER: How does that relate to the
22 number 9?

23 MS. O'CONNELL: If you use just the profits
24 on the next day, that wouldn't capture all of the
25 efficiencies that were realized over the --

1 JUSTICE BREYER: Yes, yes. But of course,
2 in the -- in the past, we are making a prediction of
3 about what efficiencies will be realized, and in the
4 future we know. So the one thing that we don't know,
5 since life is risky, or we do know for sure, is whatever
6 it shows up to be in the future couldn't have been the
7 value that shareholders would have put on it in the
8 past, because they know life a risky.

9 MS. O'CONNELL: Well, that is true. And
10 that is one thing that is -- is the --

11 JUSTICE BREYER: The reason that that is
12 relevant here of course is this number 9 is a made-up
13 number. It may be made up by great experts, but since
14 they are all not geniuses who are -- own the whole
15 world, they must not be perfect experts.

16 MS. O'CONNELL: It is -- it is --

17 JUSTICE BREYER: Isn't that true?

18 MS. O'CONNELL: The number 9 was not an
19 arbitrary number.

20 JUSTICE BREYER: No, it was a number picked
21 by whatever company had, what is it, the -- the lowest
22 price earnings ratio or something like that.

23 MS. O'CONNELL: Right. The lowest average
24 price ratio.

25 JUSTICE BREYER: Okay. But that doesn't --

1 that means whatever company that the shareholders
2 thought would deviate the least from whatever the return
3 was and that doesn't apply -- but you don't want a
4 lecture from me on this subject.

5 What I want is an answer from you, and the
6 answer I want from you is this. As I read it and once
7 understand that this number is a semi made-up number, I
8 did look at that second term and I thought that .23
9 times 9 is about 2 years' worth -- about 2 years' worth
10 of profits that would be expected, all things left out
11 of it except profit.

12 So then once I saw that, I looked at the
13 first term. And the first term seemed to me to be their
14 actual profit. Their actual profit on an annual basis
15 multiplied by about the same number, you see.

16 And so what we do is we take -- about
17 multiplying, see -- so we take about two years' worth of
18 profit that they actually made and we subtract from that
19 two years' worth that our experts tell us they should
20 have made on the basis of the original market price.
21 The rest is excess profit and we seize all of it. For
22 two years only.

23 And by the way, if a company had only six
24 months' worth, well, then, you know, they might really
25 be hurt, because after all, they only earned six months

1 at the annual rate that showed something, and maybe they
2 didn't really earn it over the next 18 months. But the
3 reply was there was no such company. And, of course,
4 because time periods vary, rates will vary.

5 But I don't know that that matters for an
6 income tax. It's not a question of the rate; it's a
7 question on what you impose it. And you impose it on
8 income, because as he says, there are two choices here.
9 Number is really calculated on the basis of income and
10 there is another number going on, the actual floatation
11 value and this third thing, which is called the number
12 9. But primarily it is the income that makes the
13 difference.

14 Now, that's his argument. What's your
15 response? That's his argument as I understand it. I
16 don't want to put words in his mouth. But you -- you
17 explain it to me.

18 MS. O'CONNELL: Justice Breyer, I think the
19 problem with, when we start to reformulate what this tax
20 is or is not taxing or what the amount of the actual tax
21 is, just shows the danger of trying to reformulate what
22 parliament actually did in trying to determine if it's
23 an income tax. As the professor's amicus brief points
24 out, if you reformulated this into an average annual
25 profit or left the P over 4 as it was, and then divided

1 everything else by 9, this would become a 207 percent
2 tax.

3 JUSTICE BREYER: But I said, so what? Now,
4 you can answer that by saying, no, it's not so what. I
5 mean, isn't an income tax dependant upon whether it's a
6 tax on income, not the rate? And -- and whether some
7 companies pay a high rate and others pay a low rate,
8 even if that's totally arbitrary, wouldn't make a
9 definition to the characterization.

10 MS. O'CONNELL: In that characterization --

11 JUSTICE BREYER: As long as you're not --
12 they actually have the gross income from which this
13 comes.

14 MS. O'CONNELL: In that characterization,
15 Justice Breyer, the 207 percent of average annual
16 profits over one-ninth of floatation value, then, no,
17 it's not an income tax and the rate does matter because
18 it's completely confiscatory --

19 JUSTICE BREYER: No, it will. Wait, wait,
20 wait, wait. It is greater than the profit they earned
21 during the year, but it is not greater than the profit
22 that they earned during the two years, or whatever the
23 period is that everybody's paying this on.

24 MS. O'CONNELL: Right.

25 JUSTICE BREYER: Is that right?

1 MS. O'CONNELL: It's true. It's true.

2 JUSTICE BREYER: So here, by good luck for
3 them or bad luck for you or whatever it is, they have
4 not taxed more than the gross income of the companies.
5 Is that --

6 MS. O'CONNELL: They have not taxed more
7 than the total profits over a four-year period, which
8 is --

9 JUSTICE BREYER: Four-year period. Well,
10 that's -- well -- well, is it not going to be an income
11 tax if what the U.S. Government says, though it hasn't
12 said it, it could say, we want -- we want 35 percent of
13 what you earn over six years. Okay. That's what we
14 want. Now, that's still an income tax, isn't it?

15 MS. O'CONNELL: Well, the U.S. income tax --
16 what the regulation looks for is taxes that have the
17 essential features of the U.S. income tax. And, no, the
18 U.S. income tax has never been imposed on a multiple of
19 profit. It's -- it's imposed as a percentage --

20 JUSTICE BREYER: So you say whatever -- if
21 they impose it on more than a year, any country that
22 calculates the income tax over a period for more than a
23 year is outside the tax treaty because it's essential to
24 the nature of the American income tax system that it be
25 calculated year by year. You're hesitating to say that,

1 but I think --

2 MS. O'CONNELL: Yes, I am. I am. I think
3 if there was a country that imposed an income tax every
4 six years and said every sixth year, you'll pay an
5 income tax rate over the last six years and that would
6 probably still be an income tax.

7 But the point is that here, that's not
8 anything close to what they're doing or what parliament
9 has done. Parliament has taken a valuation formula
10 where it takes an actual earnings figure from the
11 company, an average annual earnings figure, and
12 multiplies it by a price-to-earnings ratio to impute a
13 value on the company. It then subtracts out what it
14 actually received for the company, which we think shows
15 that the substance of this tax is that it's a tax on an
16 increment of company value. Parliament is calculating
17 what it should have sold the company for, subtracting
18 out what it actually received.

19 JUSTICE SOTOMAYOR: Could you -- I'm sorry.

20 CHIEF JUSTICE ROBERTS: We had a lot of --
21 your friend had a lot of questions on the different
22 periods, the initial periods and changing the D value
23 and what that did to the -- that is not an argument that
24 you've made, is it?

25 MS. O'CONNELL: That's right. I think we

1 generally agree with the Petitioner that a tax is -- is
2 either an income tax or not an income tax for everybody
3 that subject to the tax and that you look at it in the
4 normal circumstances in which it applies. But I do
5 completely agree that the fact that the D figure changes
6 makes this -- just reinforces the idea that the
7 substance of this tax --

8 CHIEF JUSTICE ROBERTS: Well, but that is --
9 again, that's not an argument you've made.

10 MS. O'CONNELL: No, but our the amicus did
11 make it. I mean, that --

12 CHIEF JUSTICE ROBERTS: Well, the amicus
13 did, but I don't think we should do a better job of
14 getting money from people than the IRS does.

15 MS. O'CONNELL: Well, the point is that --
16 the fact that there is a D variable there shows that
17 what parliament was trying to do was to place an annual
18 earnings figure on each company to create a value for
19 it. A company -- it's not similar to an excess profits
20 tax in that way, that where a company that operated for
21 only six months is paying the tax at the same level that
22 a company would be that was making profits at the same
23 rate for the entire four-year period.

24 CHIEF JUSTICE ROBERTS: No, that's a good
25 articulation of the argument you haven't made.

1 JUSTICE SOTOMAYOR: So you are accepting the
2 position the government made in PPL v. Exxon. You're
3 not disavowing the position you took there.

4 MS. O'CONNELL: Right. But it -- it depends
5 on the normal circumstances in which it applies. But --

6 JUSTICE KAGAN: You're not saying that the
7 amicus brief is wrong. The Chief Justice is, of course,
8 right, the amicus brief is the amicus brief and the
9 amicus brief develops this argument, which I think is
10 the right argument. But you're not saying that's wrong.

11 MS. O'CONNELL: It's not wrong. We think
12 that both the D variable and the flotation value
13 variable add extra support for the idea that this is a
14 tax on an increment of company value. The D shows that
15 it's trying to impute an annual earnings figure on each
16 company. The floatation value shows that it's not
17 concerned just with how profitable any particular
18 company is, but with how profitable it is in relation to
19 what the UK government received for it as value when it
20 floated the company.

21 CHIEF JUSTICE ROBERTS: I thought you were
22 saying that that argument was wrong, because you looked
23 to the predominant character of the tax and that it's
24 either a tax -- it's either an income tax or it's not.
25 It wouldn't be an income tax on the vast majority of the

1 companies where it was the same and not on the companies
2 where it was a large value or the other way around. You
3 look at the predominant characteristic and you decide
4 whether it's a tax or not on that basis.

5 MS. O'CONNELL: That's right. But I'm not
6 saying that the -- that the argument the amicus are
7 making is wrong. We're saying --

8 JUSTICE KAGAN: Because they're saying this
9 is not an income for anybody because, in fact, this
10 doesn't tax anybody's income. It taxes annual -- excuse
11 me -- it taxes average profits, not total profits. It
12 taxes profitability as a mechanism to tax value.

13 MS. O'CONNELL: That particular aspect of
14 the amicus brief that says if it's bad for one, it's bad
15 for all, yes, that is not our position. It is not our
16 position; that you look at the tax based on the normal
17 circumstances in which it applies. So I think we are in
18 general agreement with PPL that if there are outliers
19 where net gain would be totally confiscated, you'd look
20 at it in the -- in the normal circumstances in which it
21 applies. That's what the regulation says.

22 JUSTICE KAGAN: Well, now I'm totally
23 confused, because this outlier is an outlier not because
24 the tax hasn't worked. It's an out -- it's an outlier
25 that the tax is designed to get at, that this formula

1 was developed with this D variable in order to make sure
2 that outliers, meaning people, companies that operated
3 for only a short amount of time would still pay a
4 significant tax bill.

5 So the whole design of this tax was to get
6 at the outlier. That seems to me to suggest that the
7 predominant character of the tax is not an income tax
8 but is instead a value tax.

9 MS. O'CONNELL: Well, I mean, you could also
10 get to that by saying that the predominant character of
11 this tax is -- is not an income tax because of the way
12 that it applies to everybody else. I think that's our
13 principal argument. If there were some outlying
14 companies for which this didn't look like an income tax,
15 I think the regulation allows some flexibility there
16 where it says, we look at it in the normal circumstances
17 in which it applies. And if that makes it an income
18 tax, then it's an income tax for everybody.

19 I think an important point here is that the
20 Petitioners have conceded that if parliament had chosen
21 a different valuation method, like the stock price, for
22 any particular company and then subtracted out the
23 floatation value, that that would not be a tax on
24 income, that that would be a value tax.

25 The fact that parliament chose a different

1 way to place a value on each company shouldn't become a
2 tax on income just because profits is one variable in
3 that tax equation. That would open up many foreign
4 taxes that just use this typical earnings times the
5 price-to-earnings ratio for an income tax credit, a
6 dollar-for-dollar credit in the United States, just
7 because the tax was written that way.

8 We think what parliament was doing here was
9 clearly trying to impute a value on each company, and
10 then subtracting out what it actually received. In
11 substance, it's a tax on value as well as in form.

12 If the Court thinks that both of the
13 formulas are equivalent, the tax that parliament
14 actually wrote and the rewritten tax of 51.75 percent of
15 your four years of profits over 4/9ths of the floatation
16 value, then there is a couple of reasons that you should
17 go with the tax that parliament actually wrote.

18 The first is that exemptions from taxation
19 are construed narrowly, and a business -- a foreign
20 income tax that is paid through a foreign -- or I'm
21 sorry -- a foreign tax that is paid to a foreign
22 government that is not an income tax is usually just
23 treated as a deduction. And the IRS has said throughout
24 this case that it is perfectly happy to treat this
25 windfall tax as a deduction; it just would not get a

1 dollar-for-dollar credit --

2 JUSTICE BREYER: On that -- on the question
3 of how to treat, I -- there isn't authority but, I mean,
4 if I'm quite honest about how I think about it, I think
5 the people in the tax court actually usually know more
6 about it than the judges who are not on the tax court.
7 And so when I get an opinion and the tax court all
8 thinks one thing and then the Court of Appeals is
9 thinking something else and it's highly technical, I --
10 I tend to be tempted to say, Well, the tax courts
11 deserve something.

12 Now, is there anything, really, or am I just
13 doing that wrong if I did that?

14 MS. O'CONNELL: Well, Justice Breyer, with
15 due respect to the tax court, the tax court didn't even
16 analyze any of the three regulatory tests that are set
17 forth in the regulation. I --

18 JUSTICE GINSBURG: I thought you would --
19 when you would answer that that the Commissioner gets
20 some credit, too. This is the Commissioner -- this is a
21 Treasury regulation. So one question is: Do we owe
22 that regulation any kind of -- any kind of deference?

23 MS. O'CONNELL: Yes. I think, to the extent
24 that there is any ambiguity about what the regulation
25 means, then the Commissioner's interpretation of his own

1 regulation is entitled to some order of deference along
2 the lines of "our" and our --

3 CHIEF JUSTICE ROBERTS: But there is no
4 difference between what the Commissioner says the
5 regulation means and what it says.

6 MS. O'CONNELL: That's true. Well --

7 CHIEF JUSTICE ROBERTS: It doesn't seem to
8 move the ball much one way or the other.

9 MS. O'CONNELL: That's true unless you
10 accept Petitioner's argument that what the regulation
11 means when it says you evaluate the tax based on its
12 predominant character is that that means you can rewrite
13 the tax before you start testing it against the three
14 regulatory requirements, and in which case, this would
15 be a 51.75 percent tax on four years of profits that you
16 are testing against the three regulatory requirements.

17 In which case, yes, it would probably be an
18 income tax, but that's not how the Commissioner views
19 the regulation. The Commissioner views that predominant
20 character test as: So long as the tax is predominantly
21 one where you -- it is on realized income and is
22 calculated by starting with gross receipts and
23 subtracting out costs and expenses, there can be minor,
24 nonconforming elements in the tax base -- like the
25 inclusion of imputed rental income that is not actually

1 earned by a taxpayer, which some countries include in an
2 income tax, and the tax could still be creditable.

3 The predominant character does not mean --
4 the predominant character test does not mean that you
5 completely rewrite the statutory tax base before you
6 test it against those three regulatory requirements.

7 CHIEF JUSTICE ROBERTS: What if you -- go
8 ahead.

9 What if they impose this what you would call
10 valuation tax every year and it was based the same way,
11 it's based on profits that year. Saying, We're going to
12 say, We think the value of this company is now this much
13 because they made -- whatever -- \$20 million last year.
14 And so we impose this -- this set tax. The next year,
15 we think its value is this because they made, you know,
16 10 million. So we are going to impose this tax.

17 MS. O'CONNELL: I think that would not be an
18 income tax, because they are using a valuation formula
19 that is imputing a value on the company and then
20 taxing that value.

21 CHIEF JUSTICE ROBERTS: Based solely on the
22 amount of income?

23 MS. O'CONNELL: Well, if that -- if that
24 were the only characteristic, then I think a property
25 tax that is calculated that way could become an income

1 tax, and that's not what the income tax credit -- the
2 foreign tax credit is designed to do.

3 CHIEF JUSTICE ROBERTS: How could -- a
4 property tax calculated that way? In other words, based
5 on income from the property?

6 MS. O'CONNELL: Times the price-to-earnings
7 ratio.

8 If -- if what you are saying is that the --
9 the tax that the foreign government is imposing is just
10 a tax based on last year's income and they are calling
11 it a property tax or something like that, I think that
12 is what Petitioner was giving as an example. That,
13 I'm -- I think, I would think would be an income tax.
14 If the only variable in the tax base was profits, yes.
15 I they --

16 CHIEF JUSTICE ROBERTS: But if they said, We
17 are going to multiply it by a price/earnings ratio.

18 MS. O'CONNELL: Yes.

19 CHIEF JUSTICE ROBERTS: Based on how much
20 you earned.

21 MS. O'CONNELL: Yes.

22 CHIEF JUSTICE ROBERTS: Which sounds like
23 income.

24 MS. O'CONNELL: No, that sounds like value.
25 And I -- and that's another thing --

1 CHIEF JUSTICE ROBERTS: The "how much you
2 earned" part sounds like income.

3 MS. O'CONNELL: Yes, but -- but any
4 valuation formula will use some known data from the
5 company to determine a company's value. So if you
6 are -- if you are applying just to a company -- say that
7 the United States was imposing a property tax on
8 corporations and it decided to calculate the value of
9 the corporation by taking its last year's earnings times
10 the price-to-earnings ratio, that could be reformulated
11 to look like a tax on the company's --

12 JUSTICE BREYER: If the reformulation --
13 think of -- think that first term. Put it in your mind.
14 That first term does have a number -- .23 -- and let's
15 do times 9, which is that valuation business. And what
16 you get is a little over 2. Okay? And you are going to
17 get that every time. That's not going to vary from
18 company to company. That varies as long as the universe
19 is here.

20 So we know we're going to multiply .2 --
21 rather, 2 point something times that first part of the
22 first term. And that first part of the first term
23 consists of nothing other than, for the four-year
24 company, the average one-year profit. So the only --
25 what you are telling people to do in that first term is

1 simply multiply by a little over than 2, a little more
2 than 2, the average profit earned over a four-year
3 period. That's what it says.

4 So there is nothing there but income. It's
5 average income, I grant you. But there is nothing there
6 but income.

7 And then what you subtract from that, what
8 you subtract from that is a quarter -- is a quarter of
9 the value, I grant you. But it's a hypothetical value
10 used with the number 9 of what one-quarter of the value
11 of the floatation price taken in.

12 So there's an aspect to it that does have --
13 unless you do it the way I was doing it initially, there
14 is an aspect to it that does concern at least a
15 hypothetical value. But the heart of the equation in
16 determining this so-called present value is nothing
17 other than taking average income over the four-year
18 period.

19 Now, if I'm right -- am I right about that?

20 MS. O'CONNELL: No, if you're --

21 JUSTICE BREYER: Okay.

22 MS. O'CONNELL: First of all, if the first
23 part of the equation is -- is profits multiplied by 2,
24 then -- then no. That is not --

25 JUSTICE BREYER: No, no. It is -- the very

1 first part of the first part is the profits, the average
2 profit over the four-year period. It says P. And then
3 P with all this day business, that's just times 365
4 because they want to annualize it.

5 So if you have a four years, what you are
6 going to have is you will have 365 times -- and then
7 it's going to wipe out and you will have divided by 4.
8 So you will take the total profit over the four-year
9 period, and you'll divide it by 4. That gives you the
10 annual profit. So now we have finished the first half
11 of the first part.

12 And the second half -- and we are going to
13 take .23 of that. Okay?

14 No, we are not going to take any yet.

15 Taking .23 -- you're going to take .23 of the number 9,
16 and that leaves you with the 2 -- that brings you to the
17 little over 2.2.

18 MS. O'CONNELL: If you --

19 JUSTICE BREYER: So what we are doing is
20 taking the average annual profit over a four-year
21 period. We average it, and then we multiply it by two
22 point something. Okay? And what that is doing -- then
23 what that is doing is getting you just the average
24 annual? Two years' worth of average annual.

25 And from that, we subtract a quarter of what

1 they received in the initial price, which happens to be
2 what the market -- if it really was 9 -- about what it
3 was expecting it to earn during a two-year period.
4 That's why I put in the last part. But even if I am
5 wrong about that, I am right about the first half,
6 aren't I?

7 MS. O'CONNELL: Well, and I think what you
8 are -- the one point of this that is missing is: If you
9 are going to multiply the other part by 2, you also have
10 to multiply the tax rate by 2. And if this is --

11 JUSTICE BREYER: That's why I said
12 50 percent.

13 MS. O'CONNELL: No, no, it would be -- it
14 would be 100-and-some percent. It would be twice the
15 51 point --

16 JUSTICE BREYER: Yeah, yeah, yeah, that rate
17 could be a problem for somebody at some time in some
18 place.

19 MS. O'CONNELL: It would be --

20 JUSTICE BREYER: It wasn't a problem here
21 because all of these companies but one did have and did
22 fit within the four-year category. So as to all these
23 companies but one, it did not exceed gross income; it
24 did not exceed net income; it was 50 -- what the number
25 that he arrived at.

1 MS. O'CONNELL: Well, Justice Breyer, in
2 your -- in your reconstructed formula, the tax rate is
3 going to be twice the 51.75 percent. And that's --

4 JUSTICE BREYER: It is?

5 MS. O'CONNELL: Yes. Because you have -- if
6 you're dividing --

7 JUSTICE BREYER: Of the one year, you
8 haven't calculated on one year, but it's 50 percent of
9 two years, isn't it?

10 I'm sorry, I am now confused enough that
11 I --

12 MS. O'CONNELL: It's 50 percent for all four
13 years. For one year, it's 207 percent.

14 JUSTICE BREYER: All right.

15 MS. O'CONNELL: It's 51.75 percent for all
16 years.

17 JUSTICE BREYER: All right. I have said
18 enough -- my law clerks would have picked this up. They
19 would have written it down and I will be able to go back
20 with the transcript to study it, which I will do.

21 (Laughter.)

22 MS. O'CONNELL: Justice Breyer, I just -- I
23 want to address for a minute the -- the issue that it
24 wasn't confiscatory of any particular taxpayer's net
25 gain. That's not the relevant question, and I know

1 there's some discussion about this in the brief, but if
2 all you were to do were to compare the final tax bill to
3 the company's net profits over the year, there's a lot
4 of things that are not income taxes that would then
5 become income taxes, like an excise tax that is charged
6 on the number -- or the number of products that are
7 manufactured or sold in a particular company in any
8 given year, so long as there -- if it leaves the
9 taxpayer with a nickel, then it's -- then that's an
10 income tax.

11 That's not what the income tax means. What
12 matters is what the tax base is. That's how you
13 determine if it's a tax on income. The realization test
14 requires that, because you can't impose a tax on income
15 that the taxpayer hasn't actually realized. And the
16 gross receipts and the net income tax also require it.

17 JUSTICE GINSBURG: Ms. O'Connell -- if the
18 Court should go the way the Fifth Circuit went -- or the
19 Tax Court went -- could the regulation be changed so it
20 wouldn't happen again?

21 MS. O'CONNELL: If so, then I -- I think it
22 should be changed. And I don't know exactly how that
23 would look, but maybe it could make it more clear that
24 you're supposed to just look at the tax base -- I think
25 the regulation does say that. But yes, I think there

1 would be room for -- for the IRS to -- to make the
2 regulation even more clear than it already is, if this
3 Court were to conclude that the windfall tax is an
4 income tax.

5 JUSTICE BREYER: Why -- why should it be
6 changed? I mean, why should companies, American
7 companies doing business abroad, in borderline cases
8 have to pay tax on the same income twice?

9 MS. O'CONNELL: Well, Justice Breyer,
10 they're not. SWEB, the subsidiary of Petitioner, paid
11 the British income tax in the same years that it paid
12 this windfall tax, in 1997 and 1998. And Petitioner got
13 a dollar-for-dollar foreign tax credit for its portion
14 of that British income tax that was paid in those years.

15 For any other tax that's imposed by a
16 foreign government that's not the income tax or that's
17 not an excess profits tax or a war profits tax, the
18 company can get a tax deduction. That's how classes --
19 or other taxes are normally treated. You deduct from
20 the amount of income that you are reporting to the IRS
21 via the dollars that you paid toward that foreign tax,
22 and the -- the value of that deduction depends on the
23 marginal tax rate that the taxpayer is paying.

24 So you might get 35 cents on the dollar for
25 every dollar that you can subtract from your income tax

1 base. But the dollar-for-dollar credit in section 901
2 is reserved for foreign taxes that have the equivalent
3 features of the U.S. income tax, and the windfall tax
4 simply doesn't.

5 It's written as a valuation formula, and
6 it's not just written that way, but that's the substance
7 of what it's trying to do. It's imputing a value on
8 each company for what the U.K. government should have
9 charged, and it's subtracting out the amount of money
10 that it actually received.

11 And I think that's an important point to
12 keep in mind when determining what is the -- the
13 substance of the tax, is that the U.K. government is not
14 just going out into the world and taxing companies that
15 it thinks are particularly profitable, to try to get
16 more money. The U.K. government used to own these
17 companies, and it sold them at too low a price, and the
18 windfall tax is an effort to get back some of that value
19 that it should have asked for when it sold them.

20 Whether that's a good idea or a bad idea,
21 it's not an income tax, in the U.S. sense, and it should
22 not be entitled to a credit under section 901.

23 Thank you.

24 CHIEF JUSTICE ROBERTS: Thank you, counsel.

25 Mr. Clement, you have 4 minutes remaining.

1 REBUTTAL ARGUMENT OF PAUL D. CLEMENT
2 ON BEHALF OF THE PETITIONER

3 MR. CLEMENT: Thank you. Just a few quick
4 points in rebuttal.

5 First of all, just for the record, if what
6 they really wanted to do in the British government was
7 to tax value as we normally understood it, there was a
8 ready mechanism available, the London Stock Exchange
9 price.

10 Now they want to say, well, but we wanted to
11 go back and value it in 1990, but as alluded to, they
12 could have done that because on day one, there was about
13 a 20 percent pop -- to use the IPO word -- there's about
14 a 20 percent pop in value at the end of the first day's
15 trading. They could have taxed that. If they wanted to
16 be a little less precise but capture a little more
17 value, they could have gone 30 days out or 60 days out,
18 on the theory that it took a while for the information
19 to make it in to the market. That would have been a
20 value tax. I wouldn't be up here arguing that it's
21 creditable.

22 But what they did was something very
23 different. They used a sui generis, very unique concept
24 of value. Not value unmodified, but value in
25 profit-making terms. And not profit-making terms in

1 some abstract sense that takes into account future
2 income streams, but profit-making terms as measured by 4
3 years of reported profits that satisfy every test of the
4 regulation: They're realized profits, they're based on
5 gross receipts, and they reflect exactly to the penny,
6 to the pence, the net income.

7 That's what they base this tax --

8 JUSTICE KAGAN: Mr. Clement, what do you
9 think would -- is the answer -- suppose that the Labour
10 government had come in, not after 4 years but after 2
11 years, that they looked at those 2 years of profits,
12 they said that's enough for us to know that these
13 companies were grossly undervalued, and they had done
14 this exact same formula, and the result is that they
15 would have ended up with a tax rate of over 100 percent.

16 Would that have been creditable or not?

17 MR. CLEMENT: I would be here with a more
18 difficult case, Justice Kagan. I would love to argue
19 that that is still creditable, because I think you could
20 live in a country that has an income tax, especially an
21 excess profits tax of a few disfavored industries, that
22 has a rate over 100 percent. But I would run into a
23 regulatory hurdle, and if I had had that case, I would
24 have had to challenge the regulations. I would have
25 loved to do it.

1 JUSTICE KAGAN: I guess what the
2 hypothetical suggests is that in some respects, the fact
3 that you now -- that you have a tax rate here of between
4 zero and 1 is a bit of a fluke. You know, if they had
5 come in a little bit earlier and done the exact same
6 thing, based on their understanding of how profitable
7 these companies were, which they would have seen after 2
8 years, you wouldn't have been able to make the same
9 argument.

10 MR. CLEMENT: Can I just say, though, it
11 wouldn't have been a fluke, because one of the things
12 that the people that constructed this tax wanted out of
13 this tax is they wanted it paid.

14 So it's not a fluke that they didn't impose
15 a huge tax in excess of initial period profits on any
16 company, because they wanted to make sure the incidence
17 of this tax was on companies that could actually pay it.
18 And if you do that based on 4 years' of reported
19 profits, you're pretty sure that people are going to be
20 able to pay it.

21 I would like to bring back to the concession
22 I think that ultimately was made by the government, that
23 if a foreign government has a tax on value, that the
24 only measure of value is the past years' reported
25 income, that that would be a creditable income tax.

1 Well, I don't think it changes if you multiply it by 9.

2 I don't think it changes if you divide it by 4.

3 I don't think if there is one company, that
4 you divide it by 1/4 instead of 4 -- that any of that
5 changes the analysis, nor does it change the analysis if
6 you subtract out some figure that represents a market
7 cap or initial floatation value.

8 That would make it an excess profits tax
9 rather than a simple income tax, and that is what the
10 British government did.

11 I'll just close by bringing you back
12 75 years to the Biddle case. In the Biddle case, there
13 was an argument about a British tax, and whether we
14 should follow the form of the tax or the substance of
15 this tax.

16 This Court said that we of course, in
17 looking at a foreign tax, don't bind ourselves by
18 foreign classifications or characterizations. We look
19 to the substance of the tax.

20 In the Biddle case, the rule that you look
21 to substance not form benefited the Commissioner.
22 There's no reason for a different rule when the shoe is
23 on the other foot.

24 Thank you.

25 CHIEF JUSTICE ROBERTS: Thank you, counsel.

1 Counsel.

2 The case is submitted.

3 (Whereupon, at 12:14 p.m., the case in the
4 above-entitled matter was submitted.)

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