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No. 12-43

IN THE

Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

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

BRIEF OF PATRICK J. SMITH, ROBERT B. STACK, AND JOHN D. BATES AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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INTEREST OF *AMICI CURIAE*

Our interest in this case is an interest in the proper interpretation and application of the Internal Revenue Code.[1] Each of us has practiced exclusively in federal income tax law throughout our legal careers. One of us, Patrick J. Smith, has published a number of articles on issues of statutory interpretation and administrative law in the context of federal income taxation. Two of us, Robert B. Stack and John D. Bates, practice primarily in the federal income taxation of international activities. We believe this brief will bring to the Court's attention relevant matter not likely to be brought to the Court's attention by the parties and thus serves the purpose identified for *amicus curiae* briefs in Rule 37.

SUMMARY OF ARGUMENT

Respondent's regulations provide that in order to be creditable against United States income tax, a foreign tax must satisfy three requirements: a realization requirement, a gross receipts requirement, and a net income requirement. 26 C.F.R. § 1.901-2(b)(1). Throughout this case, respondent has contended the creditability of the United Kingdom windfall tax must be determined by applying these requirements to the formula for the

[1] No party or counsel for a party authored this brief in whole or in part. No party, counsel for a party, or person other than *amici curiae* made a monetary contribution intended to fund the preparation or submission of the brief. Both parties have consented to the filing of this brief.

windfall tax in the U.K. statute, rather than by applying them to petitioner's algebraically equivalent reformulation. We agree with petitioner that it is appropriate to apply these requirements to petitioner's algebraically equivalent reformulation in determining whether the windfall tax is creditable. We also agree with petitioner that, when these requirements are so applied, they are satisfied, and the tax is a creditable excess profits tax.

However, we submit that even if, as respondent contends, the creditability of the windfall tax is determined by applying these requirements to the U.K. statutory formula for the tax, the requirements are satisfied, and consequently the windfall tax is a creditable income tax. The conclusion the requirements are satisfied when applied to the U.K. statutory formula for the tax follows directly from positions respondent has taken in this case.

In the Tax Court, respondent contended the windfall tax is not an excess profits tax, as petitioner contends, but that the tax instead recaptures a tax on unrealized appreciation that would have applied to the companies subject to the windfall tax at the time of each company's flotation if the companies had not been statutorily exempted from this unrealized appreciation tax. Respondent repeatedly described the effect of the windfall tax as being "to recapture the tax on the unrealized appreciation in the Windfall Tax Company's assets that was foregone on privatization." Opening Brief for Respondent at 21, 105, *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010) (No. 25393-07). Respondent contended the windfall tax failed the realization requirement because the regulations provide that a tax on unrealized

appreciation can satisfy this requirement only if the foreign tax jurisdiction does not impose a second tax on the same appreciation when the appreciation is realized, and the windfall tax fails this no-second-tax test. *See* 26 C.F.R. § 1.901-2(b)(2)(i)(C). Respondent repeated these arguments in the Third Circuit.

In making these arguments, respondent apparently overlooked another rule regarding the realization requirement. This rule provides that the realization requirement is satisfied if a tax imposed prior to realization represents "the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer." 26 C.F.R. § 1.901-2(b)(2)(i)(B). In contrast to the unrealized appreciation rule, this rule regarding the recapture of a prior tax allowance does not require that the foreign tax jurisdiction must not later impose a second tax on the same amount. Under respondent's characterization of the windfall tax as the recapture of a tax from which the companies were previously exempted, the windfall tax satisfies the realization requirement because the tax comes within the rule that the recapture of a prior tax allowance satisfies the realization requirement regardless of whether the same amount is later taxed a second time.

In addition to satisfying the realization requirement, the windfall tax also satisfies the gross receipts requirement when this requirement is applied to the U.K. statutory formula for the tax, because a tax based on the fair market value of assets satisfies the gross receipts requirement. *See* 26 C.F.R. § 1.901-2(b)(3)(i)(B). Respondent has argued throughout this case that the U.K. statutory

formula for the windfall tax was based on the value of the companies subject to the tax because the tax base was calculated by multiplying each company's actual profits by a price-earnings ratio. Respondent has consistently contended this formula is a generally accepted method of determining a company's value. Based on respondent's position that the windfall tax was based on fair market value, and the rule that a tax based on fair market value satisfies the gross receipts requirement, the windfall tax satisfies this requirement.

The windfall tax also satisfies the net income requirement when this requirement is applied to the U.K. statutory formula for the tax, because the value of each company subject to the tax was determined under the U.K. statutory formula by multiplying the company's actual profits by a price-earnings ratio. The costs incurred in earning those profits were necessarily recognized in calculating the profits used in this formula. In addition, a tax on the unrealized appreciation in the value of a business necessarily reflects the costs that were incurred by that business, and that affected that appreciation, during the period in which the appreciation occurred. Moreover, any tax on unrealized appreciation satisfies the net income requirement by subtracting an initial value from appreciated value in calculating the tax base.

Thus, when the three requirements for creditability in respondent's regulations are applied to the U.K. statutory formula for the windfall tax, the tax satisfies each requirement, based on positions respondent has taken in this case. Consequently, the windfall tax is creditable.

Finally, while petitioner has not challenged the validity of any aspect of the regulations, nevertheless, both the realization requirement and the gross receipts requirement, in the attenuated form these requirements take in respondent's regulations, are vulnerable to challenge under the arbitrary and capricious standard of the Administrative Procedure Act, 5 U.S.C. § 706(2)(A), because of respondent's failure to explain, at the time these regulations were issued, the reasons for imposing these requirements in such an attenuated form.

STATEMENT

Because the regulations are central to the resolution of this case, an understanding of their content and history is essential to that resolution. The Internal Revenue Code allows a credit against U.S. income tax for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." 26 U.S.C. § 901(b)(1). However, the Internal Revenue Code provides no guidance for determining which foreign taxes qualify as "income, war profits, and excess profits taxes" for purposes of this credit.

In 1983, respondent issued regulations for determining which foreign taxes are creditable. T.D. 7918, *Creditability of Foreign Taxes*, 48 Fed. Reg. 46272 (October 12, 1983). The regulations provide that, to be creditable, a tax must satisfy this test: "The predominant character of that tax is that of an income tax in the U.S. sense." 26 C.F.R. § 1.901-2(a)(1)(ii). To determine a tax's predominant

character, the regulations provide: "The predominant character of a foreign tax is that of an income tax in the U.S. sense … [i]f, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies." 26 C.F.R. § 1.901-2(a)(3)(i) (alteration added).

Regarding this "net gain" requirement, the regulations provide:

> A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

26 C.F.R. § 1.901-2(b)(1). Thus, to be creditable under the regulations, a tax must satisfy three requirements: a realization requirement, a gross receipts requirement, and a net income requirement.

The realization requirement provisions are lengthy and complex, but central to resolving this case. These provisions begin as follows:

> A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed—
>
> (A) Upon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the Internal Revenue Code.

26 C.F.R. § 1.901-2(b)(2)(i). However, the realization requirement is also satisfied in two additional

situations where a tax is not imposed "[u]pon or subsequent to … 'realization events.'"

First, a tax satisfies the realization requirement if the tax is imposed "[u]pon the occurrence of an event prior to a realization event (a "prerealization event") provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer." 26 C.F.R. § 1.901-2(b)(2)(i)(B). Second, a tax satisfies the realization requirement if the tax is imposed on certain additional prerealization events other than the recapture of a prior tax allowance. 26 C.F.R. § 1.901-2(b)(2)(i)(C) ("Upon the occurrence of a prerealization event, other than one described in paragraph (b)(2)(i)(B) of this section").

Two types of tax come within this second category of taxes on prerealization events other than the recapture of a prior tax allowance: (1) a tax "based on the difference in the values of property at the beginning and end of a period," 26 C.F.R. § 1.901-2(b)(2)(i)(C)*(1)*, and (2) a tax imposed on "the physical transfer, processing, or export of readily marketable property," 26 C.F.R. § 1.901-2(b)(2)(i)(C)*(2)*. However, a tax imposed on this second category of prerealization events other than the recapture of a prior tax allowance satisfies the realization requirement "only if the foreign country does not, upon the occurrence of a later event …, impose tax ("second tax") with respect to the income on which tax is imposed by reason of such prerealization event." 26 C.F.R. § 1.901-2(b)(2)(i)(C).

The regulations also provide that a tax satisfies the realization requirement even though the tax is

imposed in situations that do not meet the requirements described above, provided those situations are not the predominant situations to which the tax applies:

> For example, a foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even though the base of that tax also includes imputed rental income from a personal residence used by the owner and receipt of stock dividends of a type described in section 305(a) of the Internal Revenue Code.

26 C.F.R. § 1.901-2(b)(2)(i).

The gross receipts requirement provisions begin as follows:

> A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of—
>
> (A) Gross receipts; or
>
> (B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.

26 C.F.R. § 1.901-2(b)(3)(i). The gross receipts requirement provisions are considerably less detailed than the realization requirement provisions.

The net income requirement provisions begin as follows:

> A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts

> (including gross receipts as computed under paragraph (b)(3)(i)(B) of this section) to permit—
>
> (A) Recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or
>
> (B) Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.

26 C.F.R. § 1.901-2(b)(4)(i). While the net income requirement provisions contain considerable additional detail, this detail is not relevant in this case.

The preamble to the regulations explained that the test for creditability adopted in the regulations was the test applied in three judicial decisions:

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

> net gain: the realization test, the gross receipts test, and the net income test. All of these tests must be met in order for the predominant character of the foreign tax to be that of an income tax in the U.S. sense.

48 Fed. Reg. at 46273. This was the only explanation the preamble provided for adopting the three-part test based on realization, gross receipts, and net income. However, none of the three judicial decisions cited in the preamble applied a three-part test to determine the creditability of a foreign tax.

The 1983 regulations followed a series of proposed and temporary regulations, which provide relevant context for understanding and evaluating the final regulations. Respondent published proposed regulations in 1979. LR-100-78, *Creditability of Foreign Taxes*, 44 Fed. Reg. 36071 (June 20, 1979). These 1979 proposed regulations listed three requirements for creditability. However, these requirements were not identical to the three requirements in the final regulations. Like the final regulations, these proposed regulations included a realization requirement and a net income requirement. In contrast to the final regulations, instead of a gross receipts requirement, these proposed regulations required that the tax must be based on income: "Paragraph (b)(1) requires that the base on which the tax is computed must be income. The tax must not be based on wealth, accumulated profits, or other non-income amounts." 44 Fed. Reg. at 36073. The preamble to these proposed regulations provided no explanation for imposing these three requirements.

In addition to this difference between the 1979 proposed regulations and the final regulations regarding the identity of one of the requirements for creditability, these proposed regulations also differed substantially from the final regulations in the content of the realization requirement. The realization requirement provisions in these proposed regulations were significantly less detailed than the provisions in the final regulations. These proposed regulations included a rule like the rule in the final regulations that the realization requirement was satisfied by a tax imposed upon or subsequent to an event that would be considered a realization event for U.S. income tax purposes. However, in contrast to the final regulations, these proposed regulations did not contain detailed rules regarding prerealization events.

Instead, the only other situation identified in the 1979 proposed regulations in which a tax that was not imposed on, or subsequent to, a realization event satisfied the realization requirement was where the tax was imposed in the following situation:

> [T]he export from the foreign country of stock in trade or other property of a kind which properly would be included in the inventory of the taxpayer if on hand at the close of the taxable year, or of property held by the taxpayer primarily for sale to customers in the ordinary course of the taxpayer's trade or business, provided that the tax is computed on the basis of the fair market value of such property of the taxpayer at the time of the export.

44 Fed. Reg. at 36073. This provision was applicable only if the foreign jurisdiction imposed no charge on the disposition of the same property outside the foreign jurisdiction in a realization event. *Id.* The preamble to the 1979 proposed regulations provided no explanation of the reasons this type of tax satisfied the realization requirement. Because these proposed regulations identified fewer situations in which the realization requirement was satisfied than the final regulations, the realization requirement in these proposed regulations was considerably more restrictive than in the final regulations.

The 1979 proposed regulations were followed by temporary regulations in 1980. T.D. 7739, *Temporary Income Tax Regulations Relating to Creditability of Foreign Taxes*, 45 Fed. Reg. 75647 (March 17, 1980). These 1980 temporary regulations brought the three-part test from the 1979 proposed regulations closer to the three-part test in the final regulations by substituting a gross receipts requirement for the income requirement in the 1979 proposed regulations. The preamble to the temporary regulations provided no explanation for substituting a gross receipts requirement for the income requirement.

The realization requirement provisions in the 1980 temporary regulations were substantially the same as those in the 1979 proposed regulations except that the provision in the 1979 proposed regulations regarding the export from the foreign country of stock in trade or similar property was modified in the 1980 temporary regulations to apply to "the transfer or processing of readily marketable property." 45 Fed. Reg. at 75649. This rule was

subject to the requirement that the foreign jurisdiction not impose a charge on the same amount on the later occurrence of another event. *Id.* The preamble to these temporary regulations provided no explanation for this change.

The gross receipts requirement provisions in the 1980 temporary regulations were more complex than the corresponding provisions in the final regulations:

> (3) *Gross receipts.* A foreign charge meets the gross receipts requirement if it is imposed, without substantial deviation, on the basis of—
>
> (i) Gross receipts; or
>
> (ii) Gross receipts computed under a method that is designed to produce an amount that is not greater than fair market value and that, in fact, produces an amount that approximates, or is less than, fair market value, but only in the case of—
>
> (A) Transactions with respect to which it is reasonable to believe that gross receipts may not otherwise be clearly reflected; or
>
> (B) Situations to which paragraph (c)(2)(i)(C) of this section (relating to a transfer or processing of readily marketable property) applies.

45 Fed. Reg. at 75649. Thus, under these temporary regulations, the gross receipts requirement was satisfied by a tax based on fair market value, provided the realization requirement was satisfied because the tax was imposed on the transfer or processing of readily marketable property. The preamble to these temporary regulations provided no explanation for adopting this rule that a tax based on

fair market value satisfied the gross receipts requirement.

The last step before the final regulations was proposed regulations that were issued in April of 1983. LR-100-78, *Foreign Tax Credit*, 48 Fed. Reg. 14641 (April 5, 1983). The 1983 proposed regulations brought the realization requirement considerably closer to the requirement in the final regulations. These proposed regulations expanded the categories of events other than realization events that satisfied the realization requirement by adding a category for unrealized appreciation in the value of certain types of property. Under these proposed regulations, the categories of prerealization events satisfying the realization requirement were as follows:

> (1) The imposition of the tax upon such prerealization event is based on the difference in the values of stock, securities or readily marketable property … at the beginning and end of a taxable period; or
>
> (2) The prerealization event is the physical transfer, processing, or export of readily marketable property.

48 Fed. Reg. at 14644. The category for unrealized appreciation was narrower than in the final regulations because the rule in these proposed regulations was limited to stock, securities, and readily marketable property, while the provision in the final regulations applies to unrealized appreciation in any type of property. This prerealization event rule was subject to the requirement that the foreign jurisdiction not impose another tax on the same amount on the occurrence of a later event. The preamble to these proposed

regulations provided no explanation for expanding the categories of prerealization events satisfying the gross receipts requirement. These proposed regulations did not include any provision like the rule in the final regulations regarding the recapture of a prior tax allowance.

The 1983 proposed regulations also included provisions regarding imputed rental income on a personal residence and stock dividends like the provisions in the final regulations. The preamble to these proposed regulations provided no explanation for the adoption of this rule relating to imputed rental income and stock dividends.

The gross receipts requirement provisions in the 1983 proposed regulations were similar to those in the 1980 temporary regulations. As in the 1980 proposed regulations, the provision regarding gross receipts determined by reference to fair market value applied to two situations, which paralleled the two situations in the 1980 proposed regulations, except that the second situation was expanded to cover all prerealization events that satisfied the realization requirement, corresponding to the expansion of the situations in which the realization requirement was satisfied to include certain taxes on unrealized appreciation.

ARGUMENT

I. Realization requirement

A. When the realization requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement because respondent has conceded the windfall tax recaptures a prior U.K. tax allowance.

When the realization requirement is applied to the U.K. statutory formula for the windfall tax, this requirement is satisfied because respondent has conceded the tax recaptured a prior U.K. tax allowance. Respondent's opening brief in the Tax Court argued at considerable length that the windfall tax was not a tax on excess profits, as petitioner contends, but that the tax instead recaptured a tax on the unrealized appreciation of the company's assets that would have applied to the company's flotation if the companies subject to the windfall tax had not been statutorily exempted from this tax on unrealized appreciation. Respondent repeated this argument in the Third Circuit. Respondent's characterization of the windfall tax is a binding concession by respondent. Based on respondent's position that the windfall tax recaptured a prior tax exemption, the windfall tax satisfies the realization requirement because the tax comes within the rule in the regulations that a recapture of a prior tax allowance satisfies the realization requirement.

Respondent's opening brief in the Tax Court included the following discussion of the "basis of the proposal" that was subsequently enacted as the windfall tax:

> …. [T]he Andersen team's November 1996 PowerPoint presentation and the testimony of Dr. Wales reveal that the underlying design of the Windfall Tax was not to tax excess profits. Rather, *the basis of the proposal was to reinstate the Taxation of Chargeable Gains Act (TCGA) taxing mechanism that would have taxed the U.K. Windfall Tax Companies' unrealized appreciation at the time of flotation had the companies not been specifically exempted from the legislation*.
>
> The Andersen team's Windfall Tax proposal, as presented in its November 1996 PowerPoint presentation, references the TCGA. During his testimony, Dr. Wales described the portion of the Andersen team's presentation relating to the TCGA as "the guts of the presentation." The TCGA imposed a tax on capital gains earned by individuals and corporations. As it relates to the Andersen team's Windfall Tax proposal, the operative sections of the TCGA are sections 171 and 179. TCGA section 171 allows a corporation to transfer appreciated assets to a subsidiary in which it owns 75% or more of the shares without triggering a tax on the gain inherent in the asset. If a corporation disposes of its stock in a subsidiary to which TCGA section 171

applied within six years of that transfer of appreciated assets, then TCGA section 179 taxes the subsidiary on the gain that avoided capital gains taxation on the initial transfer.

When the Windfall Tax Companies were privatized, appreciated assets were transferred from public corporations to new companies, in which the public corporations held shares, triggering TCGA section 171. Shortly thereafter, the stock of the new companies was floated, triggering TCGA section 179. When the Windfall Tax Companies were privatized, TCGA section 179 would have applied to trigger U.K. corporation tax on the Windfall Tax Companies on the unrealized appreciation in the assets transferred from the public corporations, had Parliament not exempted them from the application of this provision. Through specific legislation enacted by Parliament in connection with the privatization process, certain Windfall Tax Companies were exempted from TCGA section 179. *The Andersen team's proposal to tax the difference between the value of the Windfall Tax Company at the time of privatization and the price at which the Windfall Tax Company was actually offered at privatization effectively reinstated TCGA section 179 to recapture the tax on the unrealized appreciation in the Windfall Tax Company's assets that was foregone on privatization.* To the extent the underlying design of the Windfall Tax and its purported

"substance" are deemed relevant in applying the regulatory net gain tests, the record confirms that the "substance" of the tax base was not excess profits, but rather was the unrealized appreciation in the Windfall Tax Companies' assets. The exemption from corporate-level tax on this unrealized gain that would otherwise have been triggered on flotation, a benefit conferred by the implementing legislation, constituted the "windfall" from which the privatized companies were benefiting at the time of flotation.

In essence, the Andersen team proposed to reinstate a tax on appreciated but unrealized gain that would have applied to the Windfall Tax Companies upon the flotation of their shares at the time of their privatization. This tax base, revealed by the team's PowerPoint proposal and Dr. Wales' testimony to be the underlying design of the proposal ultimately enacted as the U.K. Windfall Tax, would fail the realization test, because the gain inherent in the Windfall Tax Companies' appreciated assets was unrealized. Although not relied on by petitioner, if structured as a tax on unrealized appreciation the U.K. Windfall Tax would also fail the alternative realization test set forth in Treas. Reg. § 1.901-2(b)(2)(i)(C), which allows mark-to-market regimes to meet the realization requirement, because there was no provision under U.K. law to exempt the unrealized

> gain in the Windfall Tax Companies' assets from a second tax upon a subsequent sale of the assets.

Opening Brief for Respondent at 103-106, *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010) (No. 25393-07) (emphasis added; citations omitted).

Elsewhere in this same brief, respondent summarized these points as follows:

> Ultimately, the Andersen team proposed to tax the difference between the value of the Windfall Tax Company at the time of privatization and the price at which the Windfall Tax Company was actually offered at privatization, in essence, *reinstating TCGA section 179 to recapture the tax on the unrealized appreciation in the Windfall Tax Company's assets that was foregone on privatization.*
>
> The Windfall Tax that was enacted by Parliament had the same fundamental structure as the Andersen team's Windfall Tax proposal.

Id. at 21 (emphasis added; citations and paragraph numbers omitted).

Respondent reiterated these points in his opening brief in the Third Circuit:

> …. [U]nder U.K. law, the privatization was a tax-free event for the windfall companies. Although the companies ordinarily would have been subject to a U.K. tax on their unrealized built-in gains upon privatization (and would have received a stepped-up basis for purposes of determining future taxable gain or loss), Parliament

exempted the companies from that particular tax when it privatized them.

Evidence in the record suggests that the windfall tax may have been intended to recapture the tax revenue lost as a result of this exemption.... [B]ecause the companies received no basis step-up as a result of paying the windfall tax—and so would be subject to a second corporation tax on the disposition of the appreciated assets—a tax on unrealized built-in gain would fail the realization test. See Treas. Reg. § 1.901-2(b)(2)(i)(C) (providing that a tax on a prerealization event satisfies the realization test only if the foreign country does not impose a second tax on the same income upon the occurrence of a later event).

Opening Brief for the Appellant at 29 n.4, *PPL Corp. v. Commissioner*, 665 F.3d 60 (3d Cir. 2011) (No. 11-1069) (emphasis added; citations omitted).

Thus, respondent contended repeatedly and at considerable length in the Tax Court and the Third Circuit that the effect of the windfall tax was "to recapture the tax on the unrealized appreciation in the Windfall Tax Company's assets that was foregone on privatization." However, as noted in the passages quoted above from respondent's briefs, the regulations provide that a tax on the category of prerealization events that includes unrealized appreciation satisfies the realization requirement only if the following condition is satisfied:

[O]nly if the foreign country does not, upon the occurrence of a later event (other than a distribution or a deemed distribution of the

> income), impose tax ("second tax") with respect to the income on which tax is imposed by reason of such prerealization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the prerealization event).

26 C.F.R. § 1.901-2(b)(2)(i)(C). As respondent noted in the passages quoted above, this condition is not satisfied by the windfall tax because there is no mechanism in the U.K. statute exempting this unrealized appreciation from being taxed a second time when the appreciation is realized.

However, respondent's briefs neglected to mention the rule concerning the recapture of prior tax allowances. The regulations provide that a tax imposed in the following circumstances satisfies the realization requirement: "Upon the occurrence of an event prior to a realization event (a 'prerealization event') provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer." 26 C.F.R. § 1.901-2(b)(2)(i)(B). Respondent argued in the Tax Court and the Third Circuit that the windfall tax represents a recapture of the tax on unrealized appreciation that would have applied at the time of each company's flotation if these companies had not been statutorily exempted from this tax. Exemption from an otherwise applicable tax is clearly a "tax allowance." Thus, respondent contended the windfall tax represented the recapture of a tax allowance previously accorded to the taxpayer.

The position respondent expressed in its briefs in the Tax Court and the Third Circuit regarding the nature of the windfall tax is a binding concession by respondent. "A court can appropriately treat statements in briefs as binding judicial admissions of fact." *Purgess v. Sharrock*, 33 F.3d 134, 144 (2d Cir. 1994). Issues of foreign law traditionally have been treated as issues of fact rather than issues of law. *See*, *e.g.*, Roger M. Michalski, *Pleading and Proving Foreign Law in the Age of Plausibility Pleading*, 59 Buffalo Law Review 1207, 1208 n.7 (2011). While Federal Rule of Civil Procedure 44.1 changes that approach in limited respects ("The court's determination [of foreign law] must be treated as a ruling on a question of law"), this limited alteration does not mean the traditional approach is altered in other respects. The Advisory Committee Notes explain this change: "[T]he court's determination of an issue of foreign law is to be treated as a ruling on a question of 'law,' not 'fact,' so that appellate review will not be narrowly confined by the 'clearly erroneous' standard of Rule 52(a)." On any point not directly addressed in Rule 44.1, the prior rule that issues of foreign law are issues of fact should remain the controlling principle. An admission by a party is not a determination by the court and is therefore not covered by Rule 44.1. Tax Court Rule 146 is identical to Rule 44.1.

Consequently, based on respondent's position that the windfall tax recaptured a prior tax allowance, the recapture rule in section 1.901-2(b)(2)(i)(B) is applicable to the windfall tax. The recapture rule in section 1.901-2(b)(2)(i)(B) contains no provision like the one applicable to the unrealized

appreciation rule in section 1.901-2(b)(2)(i)(C) that conditions applicability of the rule on the foreign jurisdiction not taxing the unrealized appreciation a second time when the appreciation is realized. Moreover, it cannot be contended the unrealized appreciation rule in section 1.901-2(b)(2)(i)(C) overrides the recapture rule in section 1.901-2(b)(2)(i)(B), because the unrealized appreciation rule is explicitly made applicable only to a prerealization event "other than one described in paragraph (b)(2)(i)(B) of this section." Thus, the regulations are explicit that the recapture rule takes priority over the unrealized appreciation rule in cases where both rules might otherwise potentially apply.

As a result, when the realization requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement because, under the regulations, a tax on the recapture of a prior tax allowance satisfies the realization requirement regardless of whether the same item is subject to a second tax at a later time, and because respondent contended in both the Tax Court and the Third Circuit that the windfall tax recaptured a tax on unrealized appreciation that would have applied to the companies subject to the windfall tax if the companies had not been exempted from that tax.[2]

[2] In the Tax Court, petitioner disputed that the tax from which the companies were exempted at the time of flotation was a tax on unrealized appreciation. Petitioner contended that the transfer of assets to a subsidiary is a realization event even if no tax is imposed on that transfer. *See* Reply Brief for Petitioner at 101-03, *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010) (No. 25393-07). In the Third Circuit, respondent argued that the prior tax was triggered by the sale of the subsidiary's stock rather than the asset transfer and that this was not a realization event for the subsidiary. Opening Brief for the Appellant at 29 n.4, *PPL Corp. v. Commissioner*, 665 F.3d 60 (3d Cir. 2011) (No. 11-1069). However,

B. The realization requirement, in the attenuated form this requirement takes in the regulations, is vulnerable to challenge under the APA's arbitrary and capricious standard.

Petitioner has not challenged the validity of any aspect of respondent's regulations. As a result, the Court is unlikely to decide this case on the basis that the regulations are invalid. Nevertheless, it is relevant as background and context that several aspects of these regulations are vulnerable to challenge under the arbitrary and capricious standard of the Administrative Procedure Act, 5 U.S.C. § 706(2)(A). The imposition of some form of realization requirement for creditability is supported by the role played by realization in U.S. income tax law. However, because the attenuated form taken by the realization requirement in the regulations is so far removed from the conventional understanding of realization, it is not clear what purpose is served by

the issue of whether this prior tax was a tax on realized or unrealized appreciation does not affect respondent's characterization of the windfall tax as a recapture of the prior tax exemption. Petitioner also disputed this characterization of the windfall tax. *See* Reply Brief for Petitioner at 103-06, *PPL Corp. v. Commissioner,* 135 T.C. 304 (2010) (No. 25393-07). The Tax Court agreed with petitioner that the prior tax from which the companies were exempted was a tax on a realization event but treated petitioner's argument that respondent's characterization of the windfall tax was incorrect as a concession by petitioner that made it unnecessary to decide the case on that basis. *See* 135 T.C. at 333 n.25. Because petitioner argued in the alternative that the prior tax would have satisfied the realization requirement, treating petitioner's argument against respondent's characterization as a concession seems questionable. Moreover, if this was a concession, respondent did not accept it, because respondent repeated the argument in the Third Circuit.

retaining a realization requirement in this attenuated form.

The two most commonly identified items of economic income that do not satisfy a conventional understanding of realization are the unrealized appreciation in the value of property that is held by a taxpayer, but that has not been sold, and imputed rental income on a taxpayer's personal-use property, such as a personal residence. *See*, *e.g.*, *Cottage Savings Association v. Commissioner*, 499 U.S. 554, 559 (1991) ("Rather than assessing tax liability on the basis of annual fluctuations in the value of a taxpayer's property, the Internal Revenue Code defers the tax consequences of a gain or loss in property value until the taxpayer 'realizes' the gain or loss"); *Helvering v. Independent Life Insurance Co.*, 292 U.S. 371, 379 (1934) ("The rental value of the building used by the owner does not constitute income within the meaning of the Sixteenth Amendment"); Joseph Isenbergh, *The End of Income Taxation*, 45 Tax L. Rev. 283, 288 (1989) ("The exclusion from taxable income of virtually all imputed … income … drives taxable income apart from economic income. Imputed income is the value derived from the ownership of durable assets").

However, under the regulations, taxes that reach either or both of these types of economic income satisfy the realization requirement. Under the regulations, a tax on unrealized appreciation satisfies the realization requirement, provided the same appreciation is not taxed a second time when the appreciation is realized. 26 C.F.R. § 1.901-2(b)(2)(i)(C). In addition, under the regulations, a tax that includes in its tax base imputed rental

income on a personal residence satisfies the realization requirement, provided such imputed rental income is not the predominant item in the tax base. 26 C.F.R. § 1.901-2(b)(2)(i).

In light of these significant departures from the conventional understanding of realization, there is a serious question regarding what purpose is served by retaining a realization requirement in such an attenuated form. Commentators have noted this anomaly regarding the realization requirement in the regulations. *See*, *e.g.*, D. Kevin Dolan, *General Standards of Creditability Under §§ 901 and 903 Final Regulations – New Words, Old Concepts*, 13 Tax Management International Journal 167, 169, 170 (1984) ("The [provisions of the] regulations [on realization] contain exceptions … which almost engulf the general rule"; "The liberalization of the realization requirement seems to have been made on the basis realization is not a fundamental characteristic of the U.S. tax system…. [O]ne wonders why the [realization] requirement was not simply eliminated") (alterations added); Marc M. Levey, *Creditability of a Foreign Tax: The Principles, the Regulations, and the Complexity*, 3 Journal of Law and Commerce 193, 209-10 (1983) ("[I]t is difficult to visualize a tax failing the overall issue … because of a realization taint. This result appears to be intentional…. [T]he denial of a credit due to a realization flaw tended to lead to international double taxation, thus frustrating the purpose of the foreign tax credit system") (alterations added).

None of the preambles to the various proposed, temporary, or final regulations explained the rationale for retaining a realization requirement in

the highly attenuated form that requirement takes in the regulations. Respondent's failure to provide such an explanation provides a basis for challenging the imposition of the realization requirement in the regulations under the APA's arbitrary and capricious standard. *See*, *e.g.*, *Motor Vehicle Manufacturers Association v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29, 43, 48-49 (1983); *Judulang v. Holder*, 131 S. Ct. 476, 479 (2011). Because petitioner has not challenged the validity of the regulations, the Court's opinion should make clear that the Court is not expressing a view on the validity of the realization requirement or any other aspect of the regulations.

However, even though the realization requirement in the regulations is vulnerable to challenge under the arbitrary and capricious standard, it is nevertheless clear that, when this requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement, based on respondent's concession that the tax recaptures the tax on unrealized appreciation from which the companies subject to the windfall tax were statutorily exempted at the time of their flotation.

II. Gross receipts requirement

A. When the gross receipts requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement because respondent has conceded the tax is based on fair market value.

In addition to satisfying the realization requirement, the windfall tax also satisfies the gross receipts requirement when this requirement is applied to the U.K. statutory formula for the tax. Under the regulations, the gross receipts requirement is satisfied if the foreign tax is imposed on an amount that is "computed under a method that is likely to produce an amount that is not greater than fair market value." 26 C.F.R. § 1.901-2(b)(3)(i)(B). The windfall tax satisfies the gross receipts requirement because respondent has conceded the tax was based on the fair market value of each company that was subject to the tax.

In light of the rules providing that taxes on unrealized appreciation can satisfy the realization requirement, it is understandable why the regulations provide that a tax that is based on fair market value satisfies the gross receipts requirement. A tax on unrealized appreciation is necessarily based on the fair market value of the appreciated property. It would be nonsensical for the regulations to contain provisions permitting a tax on unrealized appreciation to satisfy the realization requirement if such taxes would inevitably fail the gross receipts requirement.

Respondent argued at length in both the Tax Court and the Third Circuit that the statutory formula in the windfall tax for determining the profit-making value of a company is a reasonable method for determining the company's fair market value. Respondent's opening brief in the Tax Court included the following discussion of this point:

> The U.K. Windfall Tax is a tax on the difference between two values. The first value, Profit-Making Value, is calculated by multiplying an earnings multiple of nine by a company's average annual book earnings. *The earnings multiple of nine was a reasonable multiplier to use to approximate a fair market value for SWEB at the time of flotation*. As respondent's expert witness Peter Ashton opined, *the method used to calculate the Profit-Making Value represents a generally accepted methodology for computing the equity value of a company*.

Opening Brief for Respondent at 107, *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010) (No. 25393-07) (emphasis added; citations omitted).

Respondent's opening brief in the Third Circuit included the following discussion of the same subject:

> [T]he statute provided that profit-making value was to be determined by multiplying the [*sic*] "the applicable price-to-earnings ratio" of 9 by "average annual profit." As the Commissioner's accounting expert, Peter Ashton, explained, *this formulation is widely used in determining company value*. He stated that the statutory formula for profit-making value is "identical to the market

> multiples method for computing the value of a firm, or more precisely the equity (stock) value of the firm," and that "[m]ultiples such as the P/E [price-to-earnings] ratio are frequently used in valuation analyses and are viewed as an accurate means to determine value," citing to numerous valuation treatises and articles in support. Even taxpayer's expert, Stewart Myers, acknowledged that *multiplying earnings by a price-to-earnings ratio is a recognized method for estimating the economic value of a company. And U.S. case law is replete with instances in which a company's value was determined by computing a multiple of net earnings, where the multiple was a price-to-earnings ratio.* Inland Revenue's bulletin summarizing the windfall tax confirms that the statutory formula for profit-making value was intended to yield company value: "Company value will be calculated by multiplying average annual profits after tax over the period by a price/earnings ratio of 9."

Opening Brief for the Appellant at 25-27, *PPL Corp. v. Commissioner*, 665 F.3d 60 (3d Cir. 2011) (No. 11-1069) (emphasis added; citations omitted). Respondent repeated these arguments in his response to petitioner's petition for certiorari:

> Calculating property value based on the property's ability to generate income is a widely used valuation method called the "income capitalization method. In the United States, various property taxes permit

> or require taxable value to be determined based on the ability of property to generate income.

Brief for the Respondent at 10 (citations omitted).

Thus, when the gross receipts requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement because the regulations provide that a tax based on fair market value satisfies the gross receipts requirement, and because respondent has contended throughout the litigation of this case that the U.K. statutory formula for determining profit-making value is a reasonable method of determining fair market value.

The temporary and proposed regulations that were issued prior to the final regulations contained provisions explicitly stating the gross receipts requirement was satisfied by a tax on unrealized appreciation provided the tax satisfied the realization requirement. The preamble to the final regulations explained that the elimination from the final regulations of these explicit provisions coordinating the gross receipts requirement with the realization requirement represented *a relaxation of restrictions* on the rule that a tax based on fair market value satisfies the gross receipts requirement:

> The regulations also allow a tax imposed on a base of estimated gross receipts if the method used is likely to produce an amount that is not greater than fair market value. *The proposed regulations would have allowed a tax imposed on estimated gross receipts only in the case of*: (1) Transactions with respect to which it is reasonable to believe

> that gross receipts may not otherwise be clearly reflected, or (2) *certain prerealization events*. In response to comments made by the public, *these restrictions have been deleted*.

48 Fed. Reg. at 46273 (emphasis added).

In light of this explanation that this change in the final regulations was intended to eliminate restrictions on the applicability of the rule that a tax on fair market value satisfies the gross receipts requirement, the implication of this explanation is that any tax based on fair market value should satisfy the gross receipts requirement. As an interpretation of regulations by the agency that issued them, this explanation of the fair market value rule under the gross receipts requirement in the preamble to the final regulations is entitled to deference under the principle applied in cases such as *Auer v. Robbins*, 519 U.S. 452 (1997). An agency's interpretation of its own regulations that is presented in the preamble to those regulations does not raise any of the concerns relating to according deference to an agency's interpretation of its own regulations that have been identified in the case of interpretations that are expressed by an agency at a time *later than* the issuance of the regulations to which the interpretation relates. *See*, *e.g.*, *Christopher v. SmithKline Beecham Corp.*, 132 S. Ct. 2156, 2168 (2012); *Talk America, Inc. v. Michigan Bell Telephone Co.*, 131 S. Ct. 2254, 2266 (2011) (Scalia, J., concurring). The government made this same point regarding the application of the *Auer* principle to preambles to regulations in its briefing in a tax case decided by the Court last term:

> Deference to the Department's interpretation of the applicability clause is particularly appropriate because the Department issued that explanation contemporaneously with the rule itself, in the *Federal Register* preamble. Deferring to such a contemporaneous agency clarification cannot "encourage[ ] the agency to enact vague rules which give it the power, in future adjudications, to do what it pleases." *Talk Am., Inc. v. Michigan Bell Tel. Co.*, 131 S. Ct. 2254, 2266 (2011) (Scalia, J., concurring); cf. John F. Manning*, Constitutional Structure and Judicial Deference to Agency Interpretations of Agency Rules*, 96 Colum. L. Rev. 612, 689-690 (1996).

Reply Brief for the United States at 18-19, *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012) (No. 11-139). *See also* Kevin M. Stack, *Interpreting Regulations*, 111 Michigan Law Review 355 (2012) (arguing that regulations should be interpreted by reference to their preambles).

Since respondent has conceded that the windfall tax was based on fair market value, the windfall tax satisfies the gross receipts requirement because of the rule that a tax based on fair market value satisfies the gross receipts requirement.

B. The gross receipts requirement, in the attenuated form this requirement takes in the regulations, is vulnerable to challenge under the APA's arbitrary and capricious standard.

As noted above, while petitioner has not challenged the validity of any aspect of the regulations, nevertheless, several aspects of the regulations are vulnerable to such a challenge. As discussed above, the imposition of a realization requirement in the attenuated form this requirement takes in the regulations is one aspect of the regulations that is vulnerable to challenge. Another aspect of the regulations that is vulnerable to challenge is the gross receipts requirement, particularly in light of the attenuated form taken by the realization requirement in the regulations.

It is clear that a gross receipts requirement bears a close relationship to a realization requirement, at least when "realization" and "gross receipts" have their normal meanings. In the case of a normal realization event such as a sale of property, gross receipts are what the seller realizes on the sale. If the realization requirement in the regulations were based on the conventional understanding of realization, it might make sense to impose a gross receipts requirement in addition to a realization requirement.

However, in light of the substantial attenuation of the realization requirement in the regulations that results primarily from the rule that taxes on unrealized appreciation can satisfy this requirement, together with the similar attenuation in the gross

receipts requirement that results from the fact that taxes on fair market value satisfy the requirement (so that taxes on unrealized appreciation can satisfy the requirement), it is far from clear what purpose is served by the imposition of such an attenuated gross receipts requirement in addition to such an attenuated realization requirement.

None of the preambles to the various proposed, temporary, or final regulations provided any explanation of the reasons why the gross receipts requirement was imposed as a condition for creditability in addition to the realization requirement, in light of the extremely attenuated form taken by both requirements in the regulations. Thus, like the realization requirement, the gross receipts requirement is vulnerable to challenge on the basis of respondent's failure to explain, at the time the regulations were issued, why the gross receipts requirement was imposed.

Any residual purpose that might be served by these two requirements in the attenuated form they take in the regulations would be much better served by provisions that were targeted more clearly and more directly at whatever potential taxing regimes were intended to be excluded from creditability under these requirements in their attenuated form. Thus, for example, at a minimum, in light of the rule that a tax based on fair market value satisfies the gross receipts requirement, the clarity and transparency of the regulations would have been substantially increased if the gross receipts requirement had been renamed a fair market value requirement.

However, even though the gross receipts requirement as formulated in the regulations is vulnerable to challenge under the arbitrary and capricious standard, it is nevertheless clear that the windfall tax satisfies this requirement, because respondent has conceded that the windfall tax was based on fair market value, and the regulations provide that a tax based on fair market value satisfies the gross receipts requirement.

III. Net income requirement

A. When the net income requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement.

Finally, when the net income requirement is applied to the U.K. statutory formula for the windfall tax, the tax satisfies this requirement. Under the net income requirement, the foreign tax base must permit the recovery of the reasonable costs and expenses attributable to the item that is being taxed. The U.K. statutory formula for determining the profit-making value of a company subject to the tax was based on the company's actual reported profits. That formula necessarily takes into account the costs incurred by the company in earning those profits, because those costs were taken into account in the determination of the profits used in that formula. Moreover, a tax on the unrealized appreciation in the value of a business necessarily takes into account the costs that were incurred by that business, and that

had an effect on that appreciation, over the period of time in which that unrealized appreciation occurred.

As in the case of the gross receipts requirement, it would be nonsensical for the regulations to provide that a tax on unrealized appreciation satisfies the realization requirement if such a tax would inevitably fail the net income requirement. The reason a tax on unrealized appreciation satisfies the net income requirement is that the subtraction of the initial value of the property from the property's appreciated value in calculating the tax base represents the cost recovery the net income requirement demands. Because the windfall tax base was equal to the excess of profit-making value over flotation value, this tax satisfies the net income requirement for the same reason any tax on unrealized appreciation satisfies the net income requirement. The subtraction of flotation value from profit-making value in the calculation of the windfall tax base represents the cost recovery the net income requirement demands.

CONCLUSION

When the realization requirement, the gross receipts requirement, and the net income requirement in respondent's regulations are applied to the U.K. statutory formula for the windfall tax, the tax satisfies these requirements. Accordingly, the windfall tax is creditable.

Respectfully submitted,

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