

No. 12-43

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IN THE  
*Supreme Court of the United States*

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PPL CORPORATION AND SUBSIDIARIES,  
*Petitioners,*

—v.—

COMMISSIONER OF INTERNAL REVENUE,  
*Respondent.*

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

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**BRIEF OF ENTERGY CORPORATION AND  
AFFILIATED SUBSIDIARIES AS *AMICUS CURIAE*  
IN SUPPORT OF PETITIONERS**

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## Table of Contents

	Page
INTEREST OF <i>AMICUS CURIAE</i> ENTERGY CORPORATION AND AFFILIATED SUBSIDIARIES.....	1
STATEMENT OF THE CASE .....	2
I. Historic Excess Profits Taxes.....	3
II. The Design of the Windfall Tax Shows that the Labour Party Intended to Tax the Excess Profits of the Windfall Companies .....	6
III. The Windfall Tax Had the Effect of an Excess Profits Tax .....	11
IV. Judicial Treatment of the <i>Entergy</i> Case .....	14
INTRODUCTION AND SUMMARY OF ARGUMENT.....	17
ARGUMENT .....	19
I. The Windfall Tax Has the Predominant Character of an Excess Profits Tax. ....	19
II. The Third Circuit’s Rigid Textual Analysis Betrays the Case Law and Misconstrues the Regulation .....	26
CONCLUSION.....	30

**Table of Contents**  
(continued)

	<b>Page</b>
<b>APPENDIX</b>	
Appendix A	
Excerpt from the Expert Report of Geoffrey Robinson, <i>Entergy Corp. v. Comm'r</i> , Tax Court No. 25132-06, Exhibit 67-P.....	1a
Appendix B	
Excerpt from the Cross Examination of Philip Baker, <i>Entergy Corp. v. Comm'r</i> , Tax Court No. 25132-06, Tr. at 219-222 (April 8, 2008) .....	9a
Appendix C	
Kenneth James Curran, EXCESS PROFITS TAXATION, Ch. 1 (American Council on Public Affairs 1943).....	13a

## Table of Authorities

	Page(s)
<b>CASES</b>	
<i>Bank of America Nat'l Trust &amp; Savings v. Commissioner,</i> 61 T.C. 752 (1974), <i>aff'd</i> , 538 F.2d 334 (9th Cir. 1976) .....	2
<i>Bank of America Nat'l Trust &amp; Savings v. United States,</i> 459 F.2d 513 (Ct. Cl. 1972) .....	2
<i>Biddle v. Commissioner</i> , 302 U.S. 573 (1938) ...	17, 19
<i>Boulware v. United States,</i> 552 U.S. 421 (2008) .....	17
<i>Columbian Carbon Co. v. Commissioner,</i> 25 BTA 456 (1932), <i>acq.</i> , 1932-1 C.B. 2.....	25
<i>Ethyl Corp. v. United States,</i> 75 F. Supp. 461 (Ct. Cl. 1948) .....	25
<i>Exxon Corp. v. Commissioner,</i> 113 T.C. 338 (1999), <i>acq. in result</i> , I.R.B. 2001-31 .....	22, 23
<i>H.H. Robertson Co. v. Commissioner,</i> 176 F.2d 704 (3d Cir. 1949) .....	25

**Table of Authorities**  
(continued)

	<b>Page(s)</b>
<i>Inland Steel Co. v. United States</i> , 677 F.2d 72 (Ct. Cl. 1982) .....	2
<i>Phillips Petroleum Co. v. Commissioner</i> , 104 T.C. 256 (1995) .....	21
<i>Texasgulf Inc. v. Commissioner</i> , 172 F.3d 209 (2d Cir. 1999) .....	21, 22
 <b>STATUTES</b>	
26 U.S.C. 901 .....	<i>passim</i>
Act of March 3, 1917, ch. 159, §§ 200-207 .....	5
Act of October 3, 1917, ch. 63, §§ 200-214 .....	5
Excess Profits Tax Act of 1950, Pub. L. No. 909-81, ch. 1199, §§ 430-472 .....	6
Revenue Act of 1918, ch. 18, §§ 300-337, 40 Stat. 1057 (1919) .....	5
Second Revenue Act of 1940, Pub. L. No. 801-76, ch. 757, §§ 710-752 .....	6
 <b>REGULATIONS</b>	
26 C.F.R. 1.901-2 .....	<i>passim</i>

**Table of Authorities**  
(continued)

	<b>Page(s)</b>
26 C.F.R. 1.901-2(a)(1)(ii).....	12
26 C.F.R. 1.901-2(a)(3) .....	19, 20
26 C.F.R. 1.901-2(b) .....	20
<b>OTHER AUTHORITIES</b>	
AOD CC-2001-04 (Jul. 30, 2001) .....	22, 23
KENNETH J. CURRAN, EXCESS PROFITS TAXATION (American Council on Public Affairs 1943).....	
	4, 5
GEORGE E. HOLMES, FEDERAL INCOME TAX, WAR-PROFITS AND EXCESS-PROFITS TAXES (Bobbs-Merrill Co. 1920).....	
	4
INCOME, EXCESS PROFITS, AND ESTATE TAXES: HEARINGS BEFORE THE HOUSE COMM. ON WAYS AND MEANS (1918).....	
	4
Rev. Rul. 56-51, 1956-1 C.B. 320 .....	25
Rev. Rul. 68-318, 1968-1 C.B. 342 .....	25
Rev. Rul. 74-435, 1974-2 C.B. 204 .....	25

T.D. 7918, 1983-2 C.B. 113 .....	2
U.K. Finance (No.2) Act of 1997 .....	10

**INTEREST OF *AMICUS CURIAE*  
ENTERGY CORPORATION AND  
AFFILIATED SUBSIDIARIES<sup>1</sup>**

Entergy Corporation (“Entergy”) is a Delaware corporation headquartered in New Orleans. It is the parent company of an affiliated group of corporations that produce and provide electricity.

In 1997, one of Entergy’s subsidiaries was London Electricity plc, a U.K. electric company subject to the U.K. Windfall Tax (“Windfall Tax” or “Tax”). Entergy prevailed in the U.S. Court of Appeals for the Fifth Circuit<sup>2</sup> on the issue presently before this Court: whether the Windfall Tax is a creditable foreign tax under 26 U.S.C. 901. The Solicitor General petitioned for certiorari to review the Fifth Circuit’s decision in *Entergy Corp. v. Commissioner*.<sup>3</sup> That petition is being held pending the outcome of this case.

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<sup>1</sup> Pursuant to Supreme Court Rule 37.6, *amicus curiae* Entergy Corporation and affiliated subsidiaries state that no counsel for any party authored this brief in whole or in part and that no entity or person, aside from *amicus curiae* and its counsel, made any monetary contribution toward the preparation or submission of this brief. Petitioner and respondent have consented to the filing of this brief, and letters reflecting their consent have been filed with the Clerk of Court.

<sup>2</sup> 683 F.3d 233 (2012).

<sup>3</sup> Supreme Court No. 12-277.

## STATEMENT OF THE CASE

This case involves the creditability of the Windfall Tax. Section 901 of 26 U.S.C. provides a credit against federal income tax for the payment of any income, war profits, or excess profits tax to a foreign country. The Treasury Department regulation implementing the statute confirms that a foreign tax is creditable under Section 901 if its “predominant character” is that of an income, war profits, or excess profits tax “in the U.S. sense.” 26 C.F.R. 1.901-2(a)(3). The preamble to the regulations states that the “predominant character” standard explicitly adopts the judicial criteria established in *Bank of America Nat’l Trust & Savings v. United States*, 459 F.2d 513 (Ct. Cl. 1972); *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982); and *Bank of America Nat’l Trust & Savings v. Commissioner*, 61 T.C. 752 (1974), *aff’d*, 538 F.2d 334 (9th Cir. 1976). T.D. 7918, 1983-2 C.B. 113, 114. Under this standard, a foreign tax is creditable if it “reach[es] some net gain in the normal circumstances in which the tax applies. ... The label and form of the foreign tax is not determinative.” *Inland Steel*, 677 F.2d at 80.

Before this Court, however, the Commissioner maintains that creditability should be judged *only* by the label and form of the Windfall Tax. That contention is insupportable: the outcome here must be governed by the operation and practical effect of the Tax—which demonstrate that the Tax falls on a

specified portion of taxpayer income. In its brief, petitioner PPL establishes that point persuasively and shows that the Windfall Tax accordingly is creditable as an excess profits tax within the meaning of Section 901.

*Amicus* Entergy fully endorses the arguments offered by PPL. Rather than repeat those arguments in this brief, Entergy focuses on additional materials that support PPL's conclusion: evidence offered by Entergy at the trial of its companion case; the analysis of the Fifth Circuit in Entergy's appeal, which points up the flaws in the Third Circuit decision now under review; and the history and past judicial treatment of excess profits taxes. These materials leave no doubt that Congress (when it enacted Section 901) and the Treasury Department (when it promulgated the Section 901 regulations) regarded levies like the Windfall Tax to be creditable—and that the Third Circuit's contrary conclusion rests on the misguided approach that the labels and form of a foreign statute govern creditability.

## **I. Historic Excess Profits Taxes**

As generally understood in 1918 (the year the foreign tax credit was enacted), excess profits taxes, war profits taxes, and income taxes were forms of income taxes authorized by the 16th Amendment. Excess profits taxes and war profits taxes were imposed on only a portion of total income, whereas

income taxes were imposed on all income. George E. Holmes, FEDERAL INCOME TAX, WAR-PROFITS AND EXCESS-PROFITS TAXES 136 (Bobbs-Merrill Co. 1920).

At the time, excess profits and war profits taxes were thought of as distinct, although both were imposed on a specified portion of taxpayer profits.<sup>4</sup> Eventually the distinction blurred, and war profits taxes were subsumed within excess profits taxes.<sup>5</sup> The authoritative commentator Kenneth James Curran wrote in 1943, “The customary practice today ... is to use the term ‘excess profits tax’ to describe any levy that is confined to a segment of a taxpayer’s income that is considered excessive, no matter by what standard of measurement it is determined.” EXCESS PROFITS TAXATION (American Council on Public Affairs 1943) (App., *infra*, 13a-23a) at 15a-16a.<sup>6</sup>

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<sup>4</sup> See Statement of W.G. McAdoo, Treasury Secretary, INCOME, EXCESS PROFITS, AND ESTATE TAXES: HEARINGS BEFORE THE HOUSE COMM. ON WAYS AND MEANS 15 (1918) (“By a war-profits tax we mean a tax upon profits in excess of those realized before the war. By an excess-profits tax we mean a tax upon profits in excess of a given return on capital.”).

<sup>5</sup> See Holmes, *supra*, at 644 (“The law, however, does not adhere to a clear distinction between war-profits and excess-profits. ...”).

<sup>6</sup> This brief cites to four appendices. “App.” refers to the appendix attached hereto. “*Entergy* Pet. App.” refers to the appendix attached to the Solicitor General’s Petition for Certiorari in case No. 12-277. “JA” refers to the Joint Appendix

As the term itself suggests, excess profits taxes measure “normal” profits by a “standard,” or floor amount above which profits are considered excessive. The most common standards are the “invested capital” and the “profits” standards. App. 13a. The invested capital standard operates on the assumption that normal profits are measured by a return on the capital invested in the business, expressed as a percentage of invested capital. The excess profits tax is then levied on profits in excess of that percentage. The profits standard measures normal profits by the average profits earned during an earlier “base period.” App. 14a.

The first U.S. excess profits taxes, enacted in 1917, shed light on the meaning of “excess profits” as used the next year in Section 901’s predecessor. Those taxes used an invested capital standard to measure normal profits. Act of March 3, 1917, ch. 159, §§ 200-207; Act of October 3, 1917, ch. 63, §§ 200-214. The following year, Congress enacted an excess profits tax (using an invested capital standard) and a war profits tax (using an average profits standard with adjustments for changes in invested capital). Revenue Act of 1918, ch. 18, §§ 300-337, 40 Stat. 1057 (1919). Taxpayers were liable for the greater of the excess profits tax or the war profits tax. *Id.*

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accompanying PPL’s brief in this case. “Pet. App.” refers to the appendix attached to PPL’s Petition for Certiorari in this case.

Excess profits taxes enacted for World War II and the Korean War allowed taxpayers to choose between an invested capital or average profits standard to measure normal profits. Second Revenue Act of 1940, Pub. L. No. 801-76, ch. 757, §§ 710-752; Excess Profits Tax Act of 1950, Pub. L. No. 909-81, ch. 1199, §§ 430-472.

## **II. The Design of the Windfall Tax Shows that the Labour Party Intended to Tax the Excess Profits of the Windfall Companies**

Between 1984 and 1996, the United Kingdom privatized more than 50 government-owned companies, many of which were monopolies subject to economic regulation. The government privatized the companies by selling shares to investors at a fixed offering price in a “flotation” (public offering). Pet. App. 24-25.

After flotation, the privatized companies that would eventually be subject to the Windfall Tax (the “Windfall Companies”) were considerably more efficient and profitable than expected. Substantial profits led to unexpectedly high dividends, executive compensation, and share price increases, which fueled public outcry that shareholders and executives of the privatized companies had profited unduly to the detriment of the U.K. fisc and consumers. Pet. App. 29-30. According to Geoffrey Robinson, a senior Treasury Minister who drafted the Windfall Tax, “People felt that too many bureaucrats, some of

whom had never taken a risk in their lives and had not shown much managerial talent, had become overnight millionaires thanks to a botched government privatization process.” *Entergy Corp. v. Comm’r*, T.C. Memo 2010-197 (2010) Ex. (“Ex.”) 27-R at 68.

Beginning in the early 1990’s, the Labour Party stated publicly that, in order to finance social programs, it would impose a windfall tax on the excess profits of the privatized companies. “[B]y 1993, ... the shadow Chancellor [ ] put forward a program whereby we would tax those excess profits and use the funds to finance public works in the name of a youth employment program.” JA 499-500. By 1994, the idea of an excess profits tax had become a principal feature of the Labour Party’s speeches and programs leading up to the 1997 Parliamentary election. Pet. App. 31.

Drafting the Windfall Tax posed a complex task. Ex. 27-R at 66-67. There were over 150 privatized companies which could have been judged to have earned excess profits. Ex. 27-R at 70. Moreover, the companies were in different industries, had been privatized at different times, and had different accounting methods. Ex. 27-R at 67.

To get the Windfall Tax enacted by Parliament, it was imperative that it define a specific class of companies and tax each on the same basis.

Otherwise, it would be classified as a “hybrid bill.” Ex. 27-R at 79; Ex. 67-P (App., *infra*, 1a-8a) at 1a. Because hybrid bills disproportionately burden similarly situated interests, they are subject to a longer parliamentary process and are more vulnerable to parliamentary challenge. App. 1a-2a.

Additionally, a number of Windfall Companies threatened to challenge the legality of the Windfall Tax. Ex. 27-R at 75. While the outcome of the lawsuits was uncertain, a tax that discriminated among the Windfall Companies was certain to be stuck in protracted litigation. The Labour Party was also concerned that if the tax were hastily drafted, it would be subject to an endless stream of opposition amendments, and the Labour Party would have to make significant concessions to get the bill passed. Ex. 27-R at 67. Before the tax was even drafted, newspapers were predicting that the Windfall Tax would be subject to “a legal quagmire and huge parliamentary delays.” Ex. 27-R at 80.

To expedite enactment of the Windfall Tax, the Labour Party retained Arthur Andersen in 1996. Pet. App. 31-32. Gordon Brown, then the Labour Party’s Shadow Chancellor of the Exchequer, instructed Arthur Andersen to draft proposals for the imposition of a tax on the privatized companies’ excess profits that would meet Parliamentary requirements, would be sustainable by the companies, and would not conflict with U.K. or European Union law. JA 502.

Arthur Andersen proposed six options. Three of the proposals were a tax on turnover (gross revenue), on assets, and on profits. All three were rejected. JA 505-506.

The fourth proposal was a traditional excess profits tax, which used pre-privatization profits as the standard above which the excess would be calculated. JA 512. However, it was not workable because British Gas, the utility that ultimately paid the single largest amount under the Windfall Tax, had a decrease in profits after privatization. *Entergy*, 683 F.3d 233, C.A. R.E. (“R.E.”) Tab H, Scheds. 4A-4B; JA 512. Thus, an excess profits tax that used a traditional “historic profits” standard would have discriminated among the Windfall Companies. The Labour Party was forced to reject this option because it would have been vulnerable to legal challenge and would have been classified as a hybrid bill, subject to lengthy Parliamentary review and delays. JA 509-510; App. 1a-2a.

A fifth proposal was a tax on excess shareholder returns. JA 507. However, it faced the same problems as an excess profits tax using an “historic profits” standard. In this case, British Telecommunications showed decreased post-privatization shareholder returns and would have been excluded. JA 509. Also, a tax on shareholder returns would have violated the Labour Party’s promise not to raise personal tax rates, would not have taxed shareholders who profited from the

flotation but had already sold their stock, and would not have reached overseas shareholders. Therefore, this proposal was also rejected. JA 507.

As a solution to these problems, Arthur Andersen devised an excess profits tax (the Windfall Tax) using a percentage of flotation value<sup>7</sup> as the standard rather than prior period profits. It was adopted because it could be applied to all of the Windfall Companies in the same way and at the same rate. Thus, the Windfall Tax avoided the vulnerabilities to legal challenge and Parliamentary delay posed by the other options. The Tax could also be borne without economically damaging the companies and would reliably yield the amount of revenue necessary to fund Labour's social programs. JA 509-510.

The Windfall Tax was enacted by the U.K. Finance (No.2) Act of 1997 (the "Windfall Tax Act" or "Act"). Ex. 18-J. Gordon Brown, by then Chancellor of the Exchequer, described the Tax as a "one-off windfall tax on the excess profits of the privatized utilities." Ex. 15-P, ¶ 188. The United Kingdom's Board of Inland Revenue described it as a tax on excess profits. Ex. 17-P, ¶ 41. There is no mystery why this language was used to describe the Windfall Tax: as PPL shows in its brief and as we

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<sup>7</sup> Flotation value equaled the product of the per-share flotation price and the number of ordinary shares issued in the flotation. Pet. App. 139-140.

demonstrate below, the amount of tax paid is measured by the size of a specified portion of taxpayer profits.

### **III. The Windfall Tax Had the Effect of an Excess Profits Tax**

In the Tax Court, Entergy and PPL submitted extensive evidence demonstrating that the Windfall Tax had the effect of an excess profits tax. Both taxpayers offered algebraic formulations of the Windfall Tax calculation to show that the Tax was the equivalent of a 51.71 percent tax imposed on profits in excess of 4/9ths of flotation value.<sup>8</sup>

Entergy's U.K. accounting expert, Michael Taub, testified that the aggregate tax imposed on the 31 Windfall Companies equaled 20.27 percent of the aggregate Initial Period Profits.<sup>9</sup> R.E. Tab H, Scheds. 4A-4B. No Windfall Company had a Windfall Tax liability in excess of Initial Period Profits. Pet. App. 43.

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<sup>8</sup> The Tax Court described the Tax as a 51.71% tax on profits in excess of 44.47% of flotation value. Pet. App. 63. That equation reflects the inclusion of the extra leap year day, which makes the ratio used to determine average annual profits slightly more than 4/9. Omitting the extra day for the leap year results in the 51.75 percent tax rate.

<sup>9</sup> The Windfall Tax Act defined "Initial Period Profits" as a company's after-tax profits earned during its four financial years immediately following flotation. Pet. App. 36-37.

Entergy's U.S. accounting expert, Raymond Ball, testified that "[t]he effect of this tax is that, for a utility paying the tax, every £1 increase or decrease in profit, in any one of the four years [of the windfall period], would increase or decrease the tax payable ... by £0.5175." Report of Raymond Ball, Ex. 69-P ¶15. The use of flotation value in the Windfall Tax equation merely set the threshold amount above which profits were taxed. "The choice of this particular threshold presumably reflects the political circumstances that triggered the enactment of this tax, but does not alter the conclusion that it is a tax imposed on the company's net income." Ex. 69-P ¶ 26.

Additionally, profit as calculated in the United Kingdom is of the same nature as net income as calculated in the United States. Ex. 69-P ¶ 28. "Under the U.K. Windfall Tax, the profit on which the tax is based is realized gross receipts net of associated expenses. ..." Ex. 69-P ¶ 32. Thus, Ball testified that "[i]t is net income alone that is necessary for [the Windfall Tax] to be payable." Ex. 69-P ¶ 50.

PPL's accounting experts echoed the testimony of Entergy's accounting experts. Mark Ballamy, PPL's U.K. accounting expert, testified that "the windfall tax fell on the excess profits of the Windfall Tax Companies during their initial periods and that all of these profits represented realized profits." Edward Maydew, PPL's U.S. accounting expert,

testified that in substance, the Windfall Tax was a tax on profits similar to prior U.S. and U.K. excess profits taxes. Pet. App. 59.

At trial, Entergy's counsel elicited statements from the government's U.K. tax expert, Philip Baker, demonstrating that the Windfall Tax operated as an excess profits tax as opposed to a tax on excess value. According to the government's expert, the Windfall Tax taxed profits in excess of a floor amount; it did not tax corporate value. Specifically, the government's expert testified to the operation of the Windfall Tax in four hypotheticals:

1. Windfall Tax liability could arise only if a company earned sufficient profits during the initial period to cause the value in profit-making terms<sup>10</sup> to exceed flotation value;
2. Once a company earned profits sufficient to exceed the flotation value threshold, Windfall Tax liability increased in the same proportion as profits increased;
3. A company with no Initial Period Profits incurred no Windfall Tax liability regardless of how much its stock value increased; and

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<sup>10</sup> "Value in profit-making terms" was defined as nine times average annual profit earned during a company's four financial years immediately following flotation. Pet. App. 139.

4. A company with sufficient profits would incur Windfall Tax liability regardless of how much its stock value deteriorated. R.E. Tab D, Tr. at 219-222 (App., *infra*, 9a-12a).

#### IV. Judicial Treatment of the *Entergy* Case

As PPL explains in its brief (at 15-16), the Tax Court ruled for both PPL and Entergy, holding that the Windfall Tax is a creditable tax on excess profits. On the government's appeal, the Third Circuit reversed as to PPL in the decision under review. *See* Pet. Br. at 16-19. But the Fifth Circuit affirmed as to Entergy, expressly rejecting the Third Circuit's analysis in this case. *See* No.12-277, *Commissioner v. Entergy Corp.*, Pet. App. ("*Entergy* Pet App.") 1a-13a.

Writing for the Fifth Circuit panel, Chief Judge Jones began by finding that "[t]he case law from which 26 C.F.R. 1.901-2 is derived refutes the Commissioner's assertion that we should rely exclusively, or even chiefly, on the text of the Windfall Tax in determining the tax's 'predominant character.'" *Entergy* Pet. App. 6a. Viewing the Tax "in practical terms," the Fifth Circuit went on to hold that it "clearly satisfies the realization and net income requirements" of 26 C.F.R. 1.901-2. *Entergy* Pet. App. 7a. Regarding the first of these requirements, the court found that the Tax "is based on revenues from the ordinary operation of the utilities that accrued long before the design and

implementation of the tax”; “indeed, the Labour Party accurately estimated the amount the Windfall Tax would raise, as the earnings of each of the utilities were publicly available when the Labour Party drafted the tax.” *Entergy* Pet. App. 7a. As to the net income requirement, “the tax *only* reached—and only *could* reach—utilities that realized a profit in the relevant period.” *Entergy* Pet. App. 7a.

The Fifth Circuit then turned to the regulatory gross receipts requirement. As to this, the court explained:

[T]he tax’s history and practical operation were to ‘claw back’ a substantial portion of privatized utilities’ ‘excess profits’ in light of their sale value. These initial profits were the difference between the utilities’ income from all sources less their business expenses—in other words, gross receipts less expenses from those receipts, or net income. The tax rose in direct proportion to additional profits above a fixed (and carefully calculated) floor.

*Entergy* Pet. App. 7a-8a. That “Parliament termed this aggregated but entirely profit-driven figure a ‘profit-making value,’” the court continued, “must not obscure the history and actual effect of the tax, that is, its predominant character.” *Entergy* Pet. App. 8a.

Having reached this conclusion, the Fifth Circuit specifically rejected the Third Circuit's contrary analysis in this case as "exemplif[ying] the form-over-substance methodology that the governing regulation and case law eschew." *Entergy* Pet. App. 9a. In particular, the Fifth Circuit noted that the Third Circuit's analysis was premised on a misunderstanding of the regulatory gross receipts requirement and accompanying illustrations. As the Fifth Circuit explained, "[t]he gross receipts requirement ... serves as one mechanism to prevent foreign nations from 'soaking up' American tax revenue by levying an income tax on an imputed amount deliberately calculated to reach some amount greater than the business's actual gross receipts." *Entergy* Pet. App. 9a. But the Windfall Tax does not rest on an "imputed amount" of gross receipts, "nor indeed on any imputation." *Entergy* Pet. App. 11a. "Instead, the Windfall Tax begins by taking 23% of the daily average of profit based on *actual gross receipts*, multiplied by a statutory constant of nine (deemed a 'price-to-earnings ratio'), less each company's flotation value. ... There was no need to calculate imputed gross receipts; gross receipts were actually known." *Entergy* Pet. App. 11a.

Moreover, the Fifth Circuit added, "the Third Circuit opinion seems to overlook that a tax based on actual financial profits in the U.K. sense necessarily begins with gross receipts." *Entergy* Pet. App. 11a. Thus, "London Electricity's profit for [the] purpose of

the Windfall Tax was calculated by computing gross receipts less operating expenses. The Windfall Tax was designed to reach a *subset* of this left-over amount by beginning with an amount predicated on *actual gross receipts* minus flotation value.” *Entergy* Pet. App 11a-12a. The Third Circuit’s refusal to take account of this reality, the Fifth Circuit concluded, is the “sort of formalism” that cannot be squared with the regulation’s “predominant character standard.” *Entergy* Pet. App 12a.

#### INTRODUCTION AND SUMMARY OF ARGUMENT

It is a fundamental principle of U.S. tax law that “tax classifications ... turn on the objective economic realities.” *Boulware v. United States*, 552 U.S. 421, 429 (2008). The Commissioner cannot deny that this doctrine of “substance over form” governs the application of Section 901, as this Court expressly held in *Biddle v. Commissioner*, 302 U.S. 573, 579 (1938), when it ruled that creditability turns on “the manner in which [the] tax is laid and collected.” That should be the end of this case. Basic algebra establishes that the Windfall Tax falls on a specified portion of realized taxpayer income—that portion expressly described by the Chancellor of the Exchequer, the U.K. Board of Inland Revenue, and the Tax’s drafters as “excess profits.” Such a levy would seem to be the very model of an “excess profits tax.”

In rejecting this common-sense conclusion, the Commissioner argues and the Third Circuit held that the labels used by a foreign tax statute must trump the statute's real-world operation. The Windfall Tax therefore is not creditable, they say, because the formula used to set the tax rate does not, in so many words, use the terminology of "excess profits." But this myopic focus on labels, which would work a radical departure from the settled understanding of Section 901, is wrong. As the Fifth Circuit demonstrated in *Entergy's* case, the reality is that the amount produced as the tax base by the Windfall tax formula is, *in every case*, a "*subset*" of "gross receipts less operating expenses." *Entergy* Pet. App. 11a-12a. A tax imposed on that subset must be an "excess profits tax." Indeed, in this respect the Windfall Tax is functionally indistinguishable from historic excess profits taxes, imposed both by the United States and by foreign nations, which predated and shaped the understanding of the term "excess profits tax" as it is used in Section 901 and the implementing regulation.

No other court has ever adopted the Third Circuit's approach to Section 901, which disregards the real operation of the tax at issue. It departs from the intent of Congress and the manifest meaning of the governing regulation. The Third Circuit's decision accordingly should be set aside.

## ARGUMENT

Under 26 U.S.C. 901, U.S. taxpayers are entitled to credit the payment of any foreign income, war profits, or excess profits against their federal income tax liability. The principles of law governing creditability of a foreign tax were forged by an unbroken line of cases beginning with *Biddle v. Commissioner* and embodied in 26 C.F.R. 1.901-2 since 1983. Central among these principles is that creditability depends on the substance of the foreign tax law, i.e., its operation and effect, as opposed to the labels used in the foreign law.

Despite this wealth of authority, the Commissioner argues that creditability of a foreign tax is determined exclusively by the literal text of the foreign tax statute, and that consideration of other evidence is legal error. Not a single case supports the Commissioner's position, and while the Third Circuit in *PPL* correctly stated the applicable principle, it failed to apply it.

### **I. The Windfall Tax Has the Predominant Character of an Excess Profits Tax**

The Windfall Tax is a creditable excess profits tax. Under C.F.R. 1.901-2, the "predominant character" of a foreign tax is that of an income, war profits, or excess profits tax in the U.S. sense if "the foreign tax is likely to reach net gain in the normal circumstances in which it applies." 26 C.F.R. 1.901-

2(a)(1)(ii); 1.901-2(a)(3). To be creditable, a foreign tax, judged on the basis of its predominant character, must satisfy each of the three tests in 26 C.F.R. 1.901-2(b).<sup>11</sup>

Since the relevant Section 901 regulation was promulgated in 1983, every decision testing creditability has examined the operation and effect of the foreign tax to determine its predominant character. As the Fifth Circuit acknowledged, no decision has determined creditability exclusively, or even chiefly, by the text of the foreign statute.<sup>12</sup> That reality demonstrates a judicial consensus on the proper application of Section 901—a consensus wholly inconsistent with the Commissioner’s approach. Adopting the Commissioner’s proposed rule would work a disruptive and dramatic departure

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<sup>11</sup> A foreign tax, judged on the basis of its predominant character, is creditable if (i) it is imposed subsequent to the occurrence of events that would result in the realization of income under the Internal Revenue Code (the “realization test”), (ii) it is imposed on the basis of gross receipts or gross receipts computed under a method that does not exceed fair market value (the “gross receipts test”), and (iii) the base of the tax is computed to permit recovery of significant costs and expenses attributable to such gross receipts (the “net income test”). 26 C.F.R. 1.901-2(b)(2) – (4).

<sup>12</sup> See *Entergy* Pet. App. 6a (“The case law from which 26 C.F.R. § 1.901-2 is derived refutes the Commissioner’s assertion that we should rely exclusively, or even chiefly, on the text of the Windfall Tax in determining the tax’s ‘predominant character.’”).

from the uniform current understanding of the statute.

In *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995), the Tax Court evaluated a Norwegian petroleum tax under the temporary Section 901 regulation preceding the current regulation. The court received evidence of Norway's purpose in designing the tax and how it actually operated. *Id.* at 291-292, 301-302. Indeed, the Commissioner offered evidence about the design of the tax<sup>13</sup> and expert testimony that the tax base did not approximate gross receipts.<sup>14</sup> Although the text of the petroleum tax statute did not satisfy the gross receipts test, the court analyzed quantitative data and found that the base of the tax, in effect, approximated gross receipts. *Id.* at 312. Therefore, the court found the petroleum tax creditable as an excess profits tax under Section 901. *Id.* at 316.

In *Texasgulf Inc. v. Commissioner*, 172 F.3d 209 (2d Cir. 1999), the Second Circuit judged the creditability of the Ontario Mining Tax ("OMT"). The OMT statute excluded deductions for investment

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<sup>13</sup> See *Phillips Petroleum*, 104 T.C. at 292 ("Respondent's allegations that Norway sought a desired or prescribed level of compensation through enactment of the PTA was drawn from comments made by a group in committee recommendations before the [Norwegian Legislature]. ...").

<sup>14</sup> See *id.* at 302 ("In the case at bar, we received testimony and expert reports from three expert witnesses: petitioners put forth two experts ... respondent one expert, Peter R. Odell.").

interest, cost depletion, and royalties paid and instead allowed a deduction for a fixed “processing allowance.” *Id.* at 212. The court reviewed empirical evidence to determine how the OMT operated with respect to the entire industry. *Id.* at 215. Because the processing allowance exceeded nonrecoverable expenses for nearly 85 percent of taxpayers, the court found that the processing allowance effectively compensated for nonrecoverable expenses and accordingly held that the OMT reached net gain and was creditable under Section 901. *Id.* at 215-217.

In *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999), *acq. in result*, I.R.B. 2001-31, the Tax Court evaluated the creditability of taxes imposed pursuant to the U.K. Petroleum Revenue Act (“PRT”). The PRT did not allow a deduction for interest expenses. *Id.* at 346. Both the Commissioner and Exxon offered testimony from U.K. government officials regarding the purpose of the PRT, expert testimony as to how the PRT operated, and data showing how the PRT affected taxpayers. *Id.* at 342, 348, 354, 357.<sup>15</sup> After evaluating the evidence, the court found

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<sup>15</sup> Additionally, in *Exxon*, the Commissioner argued that it was appropriate to use quantitative data to analyze the creditability of the PRT. 113 T.C. at 359. Although it has no precedential value, the Commissioner’s Action on Decision in the *Exxon* case is flatly inconsistent with his current argument. In the AOD, the Commissioner stated, “While we generally believe that quantitative data should not be used exclusively to establish whether the net income requirement is satisfied, we agree that

that the PRT provided several allowances that effectively compensated for the disallowed interest expenses. *Id.* at 357. Thus, the court held the PRT to be a creditable excess profits tax under Section 901. *Id.* at 359-60.

In the Tax Court, Entergy and PPL offered extensive evidence of the operation and effect of the Windfall Tax. Both taxpayers presented witnesses and documents demonstrating that the unquestioned purpose and effect of the Windfall Tax were to tax the excess profits of the privatized companies. *See, e.g.*, Pet. App. 58-59. They showed that the algebraic restatement of the Windfall Tax formula proved that the Windfall Tax was a tax on profits above a floor. *See, e.g.*, Pet. App. 62-63. They submitted quantitative data confirming that the Windfall Tax operated as an excess profits tax with respect to each taxpayer individually and all of the taxpayers combined. *See, e.g.*, Pet. App. 59, 82-83.

The Commissioner's own witness testified that the Windfall Tax operated as an excess profits tax, not as a tax on company value. He testified that:

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the exclusive use of such data may be appropriate in situations involving specialized taxes that apply to a limited number of taxpayers, such as the PRT." AOD CC-2001-04 (Jul. 30, 2001). The Windfall Tax, in the instant case, was a specialized tax that applied to a limited number of taxpayers—and here, quantitative data (that is, data demonstrating the actual relation of the tax to taxpayer profits) show that the Windfall Tax *is* a tax on excess profits.

(i) Windfall Tax liability could arise only if there were sufficient profits during the initial period to cause the value in profit-making terms to exceed flotation value; (ii) once the flotation value threshold was exceeded, Windfall Tax liability increased in the same proportion as profits increased; (iii) a company with no Initial Period Profits incurred no Windfall Tax liability regardless of how much its stock value increased; and (iv) a company with sufficient profits would incur Windfall Tax liability regardless of how much its stock value deteriorated. App. 9a-12a.

The Fifth Circuit reviewed the Tax Court's findings and was "persuaded by the Tax Court's astute observations as to the Windfall Tax's predominant character: the tax's history and practical operation were to 'claw back' a substantial portion of privatized utilities' 'excess profits' in light of their sale value." *Entergy* Pet. App. 7a-8a. The algebraic reformulation of the Windfall Tax, the Fifth Circuit continued, demonstrated conclusively that "[t]he tax rose in direct proportion to additional profits above a fixed (and carefully calculated) floor." *Entergy* Pet. App. 8a.

There can be no question that under 26 U.S.C. 901, an excess profits tax is creditable. Several decisions and revenue rulings, which predate promulgation of the Section 901 regulations and therefore shed light on their intended operation, either assumed or concluded that foreign excess

profits taxes were creditable. See *H.H. Robertson Co. v. Comm'r*, 176 F.2d 704, 707 (3d Cir. 1949) (conceding that the U.K. World War II Excess Profits Tax was creditable); *Ethyl Corp. v. United States*, 75 F. Supp. 461, 465 (Ct. Cl. 1948) (assuming that the U.K. World War II Excess Profits Tax was creditable); *Columbian Carbon Co. v. Comm'r*, 25 BTA 456, 474 (1932) (conceding that the U.K. World War I Excess Profits Tax was creditable), *acq.*, 1932-1 C.B. 2; Rev. Rul. 68-318, 1968-1 C.B. 342 (finding creditable an Italian tax on profits in excess of a percentage of capital); Rev. Rul. 56-51, 1956-1 C.B. 320 (finding creditable a Cuban tax on profits in excess of a percentage of capital); Rev. Rul. 74-435, 1974-2 C.B. 204 (finding creditable a Swiss Cantonal tax imposed at variable rates on multi-year profits).

The Windfall Tax bore the hallmarks of previous excess profits taxes enacted in both the United States and United Kingdom. A percentage return on flotation value served the function of an invested capital standard. Once that standard was exceeded, every additional £1 in profit resulted in an additional £0.5175 of tax. Ex. 69-P ¶15. Very notably, the Commissioner has not offered any principled ground on which the Windfall Tax can be distinguished from traditional, and unquestioned, excess profits taxes using an invested capital standard. Therefore, the Tax Court and the Fifth Circuit correctly held that the Windfall Tax was a creditable excess profits tax under 26 U.S.C. 901.

## II. The Third Circuit's Rigid Textual Analysis Betrays the Case Law and Misconstrues the Regulation

The fundamental error committed by the Third Circuit, as argued persuasively in PPL's brief, was its insistence that creditability of the Windfall Tax could be judged only by the wording of the statute. In this, the Third Circuit was plainly at odds with the pre-1983 case law on which 26 C.F.R. 1.901-2 is premised, the text of 26 C.F.R. 1.901-2, and the post-1983 decisions interpreting 26 C.F.R. 1.901-2, including the Tax Court's and Fifth Circuit's decisions in *Entergy*. The decisions in *Phillips*, *Texasgulf*, *Exxon*, and now *Entergy* make clear that legislative intent and empirical evidence of how a foreign tax actually affects taxpayers are part of the relevant inquiry into creditability.

Moreover, the Third Circuit erroneously and illogically believed that an entirely inapposite example in the regulation foreclosed the use of simple algebra to factor out the 9/4ths multiple in the Windfall Tax. Alone in its reasoning, the Third Circuit could not tolerate a tax base that had the appearance of taxing more than 100 percent of profits. Through simple algebra, the mirage dissolved and exposed the substance of the Windfall Tax as a traditional excess profits tax. This Court would have to ignore the entire body of foreign tax credit jurisprudence to find that a restatement of the Windfall Tax into a 51.71 percent tax on profits in

excess of a fraction of flotation value must be blocked from view. The Fifth Circuit would not go there, and neither should this Court.

Had the Third Circuit examined the reformulation, it would have seen that Initial Period Profits exceeded the restated tax base for every company. Furthermore, the Third Circuit ignored evidence demonstrating that the Windfall Tax reached net gain. It failed to even acknowledge that the aggregate tax burden of the 31 companies equaled 20.27 percent of the aggregate Initial Period Profits,<sup>16</sup> or that no Windfall Company had a Windfall Tax liability in excess of its Initial Period Profits.<sup>17</sup>

The Third Circuit also made no serious effort to explain why the Windfall Tax is not, in reality, a tax on excess profits. To the contrary, one implication of the court's reasoning is that an excess profits tax can never be creditable, a position that Congress did not adopt in Section 901 and the government has never advanced.

Such logic suggests that a tax's predominant character can be revealed only by the tax base as set forth in the foreign taxing statute.<sup>18</sup> According to the

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<sup>16</sup> R.E. Tab H, Scheds. 4A-4B.

<sup>17</sup> Pet. App. 82-83.

<sup>18</sup> *See* Pet. App. 9 (“In our view, PPL’s formulation of the substance of the U.K. windfall tax is a bridge too far. No matter how many of PPL’s proposed simplifications we may

Third Circuit, if the Windfall Tax had the predominant character of a tax on profits, profits would be the only variable in the tax base.<sup>19</sup> Such reasoning would deny creditability if the tax base includes variables besides profits. However, that approach reads the concept of “excess” profits out of the statute altogether.

The court is simply wrong. Its reasoning implies a lack of understanding of how an excess profits tax functions. Excess profits taxes require a variable in the tax base besides profits to serve as a floor over which “excess” profits are derived. The Windfall Tax used a rate of return on flotation value as that floor.

There is absolutely no doubt that 26 C.F.R. 1.901-2 did not, and could not, deny creditability of excess profits taxes simply because the base of the tax is profits above a floor, as opposed to total profits. A regulation to that effect would flatly contravene the language of 26 U.S.C. 901. With all due respect to the Third Circuit, that it could contemplate such an astonishing possibility reveals how confused it

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accept, we return to a fundamental problem: the tax base cannot be initial-period profit alone unless we rewrite the tax rate.”).

<sup>19</sup> See Pet. App. 9 (“Were this a tax on initial-period profit, as PPL contends that it is in substance, the tax base would simply be P [for profit] so that we could express the tax thus: Tax = 23% x P.”).

was by the government's insistence on rigid textualism.

The Third Circuit's refusal to consider the evidence led to a result that cannot be squared with 26 C.F.R. 1.901-2. The predominant character standard demands more. Under 26 C.F.R. 1.901-2, the Third Circuit was required to consider the design, operation, and effect of the Windfall Tax. Because the totality of the evidence demonstrates that the Windfall Tax is the equivalent of a U.S. excess profits tax satisfying each of the three tests in 26 CFR 1.901-2, this Court should find that it is creditable.

**CONCLUSION**

For the foregoing reasons, the decision of the Third Circuit should be reversed.

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## **APPENDIX**

**Table of Appendices**

**Page**

Appendix A  
Excerpt from the Expert Report of Geoffrey  
Robinson, *Entergy Corp. v. Comm'r*, Tax Court  
No. 25132-06, Exhibit 67-P..... 1a

Appendix B  
Excerpt from the Cross Examination of Philip  
Baker, *Entergy Corp. v. Comm'r*, Tax Court  
No. 25132-06, Tr. at 219-222 (April 8, 2008) ..... 9a

Appendix C  
Kenneth James Curran, EXCESS PROFITS  
TAXATION, Ch. 1 (American Council on Public  
Affairs 1943)..... 13a

*Appendix A*

**EXCERPT FROM THE EXPERT REPORT OF  
GEOFFREY ROBINSON,  
TAX COURT NO. 25132-06, EXHIBIT 67-P**

**Appendix 1**

Hybrid Bills House of Commons Information Office,  
Factsheet L5, Legislative Series. Revised February  
2005.

\* \* \* \*

**The windfall tax (Finance (No.2) Bill) is not a Hybrid  
Bill**

For the windfall tax (Finance (No.2) Bill), it was essential to ensure that a specific class of companies was defined and that all companies within it were treated on exactly the same basis. If this was not the case, the Bill would be categorised as hybrid and subject to the 'examination' procedure set out in the attached note; more importantly it would not be a Money Bill enjoying the rights to raise and collect taxes.

\* \* \* \*

**Introduction**

A hybrid bill has characteristics of both a public bill and a private bill. Although of general interest, the

content of the bill would significantly affect the interests of certain individuals or organisations. The bill's progress through parliament therefore includes elements of both the public bill and private bill procedures.

Speaker Hylton-Foster described a hybrid bill as “*a public bill which affects a particular private interest in a manner different from the private interests of other persons or bodies of the same category or class*”.

Hybrid bills may be introduced by the Government or by a backbencher. These bills are introduced only rarely, the last occasion before the current *Crossrail Bill* being the *Channel Tunnel Rail Link Bill* introduced in 1994.

### **Examination**

It is not always clear whether a bill should be introduced through the public, private or hybrid bill procedure. Every public bill is examined in the Department of the Clerk of the House before second reading for its compliance with the House's rules. In determining this they take into account the practice and precedents of many years. If the Clerks consider that private interests may be affected, the House will order the bill to be considered by the Examiners of Petitions for private bills. If they find that any standing orders for private business apply to the bill it is treated as a Hybrid, if the Standing Orders do

not apply then the bill proceeds as a public bill. Once the bill has been referred to the Examiners it appears on the Order Paper with a note 'to be reported on by the Examiners'. Second reading cannot take place until the Examiners report. However, in 1976, the House approved a motion to set aside any application to the *Aircraft & Shipbuilding Industries Bill* (a Government bill) of the Private Business Standing Orders.

Bills brought in by the Government (or a backbencher) which propose to undertake works of national importance, but in a local area, have usually been hybrid. Examples include the *Croydon Aerodrome Extension Bill* of 1924-25, the *British Museum Bill* of 1962-63, the *Maplin Development Bill* of 1972-73 and the *Channel Tunnel Bills* in the 1970s and 1980s. A list of all hybrid bills introduced since the 1985-86 session of Parliament is given in the Appendix on page 5.

Other examples of bills which have been proceeded with as hybrids are the *Port of London Bills* 1903 and 1908, the *London Passenger Transport Bill* in 1931, the *Bank of England Bill* in 1945 and the *Transport (London) Bill* of 1968-69.

Bills relating to London have sometimes been hybrid, but in recent years most major bills relating to the capital have been considered as public bills, e.g. the *Greater London Authority (Referendum) Bill* in 1998 and *Greater London Authority Bill* in 1999. Bills

relating to the City of London have usually been private but occasionally hybrid.

### **Private Members Bills**

Private Members may introduce a public bill that the Examiners decide is hybrid, because it is to all intents and purposes a private bill. Such a bill has little chance of becoming law, but a political point will have been made. Examples of such bills are the *Epsom & Walton Downs Regulation (Amendment) Bill* of 1952-53 and the *West Midlands County Council (Abolition) Bill* in 1981-82.

### **Proceedings on the bill**

#### **Preliminary proceedings**

A Minister or other Member in charge of a Public bill should be aware at an early stage that it could contain elements of a Hybrid bill. In the case of a Government bill, the Parliamentary draftsmen or Department concerned will almost certainly have pointed this out: steps will have been taken to ensure compliance with Standing Orders (with regard, for example, to advertisements, the drawing up of any necessary plans, etc). Where the Examiners find that the bill has not complied with Standing Orders, it is referred to the Standing Orders Committee (as under Private bill procedure: see Factsheet L4). If this Committee decides that the bill should not proceed,

the promoters of the bill usually abide by this decision.

### **Second reading**

The procedure for second reading of a hybrid bill is the same as for a public bill. After second reading, in order to enable anyone specially and directly affected by the bill to make their case against it, the bill is committed to a select committee, normally made up partly of members chosen by the House and of others chosen by the Committee of Selection; the *Channel Tunnel Bill* in 1985-86 however, was sent to a Committee of nine Members, wholly chosen by the Committee of Selection. The motion to refer the bill to a select committee normally also sets down the requirements for the receipt of petitions against the bill.

### **Petitions**

Any individuals or organisations that oppose the bill can submit petitions against it. The petitions have to be deposited within a stipulated time in the Private Bill Office and must conform to the rules for petitions against private bills.

If the promoter of a bill challenges the status (*locus standi*) of a petitioner, the select committee itself determines who may and who may not be heard and on which sections of the bill. Decisions of the Court of

Referees, who decide similar cases relating to private bills, are binding on the Committee.

### **Proceedings if no Petitions are Deposited**

If no petitions are deposited against the bill within the stipulated time, the bill will be recommitted to a standing committee or committee of the whole House, who will then consider it in the same way as a public bill.

### **Select Committee**

If petitions are received, the select committee will meet and consider the bill in very much the same way as a private bill committee would (see Factsheet L4). However, there are certain differences; in particular, that the promoters do not need to establish the need for the bill since the House has already put on record its approval of the principle of the bill at second reading.

First the petitioners make their case, calling witnesses if necessary. Witnesses are normally examined on oath. When the opponents of the bill have completed their case, and the promoters have been heard in reply, the committee considers the clauses of the bill, reporting it to the House with or without amendment. If the committee wishes to communicate its view on the subject matter of the bill, or if the promoters no longer wish the bill to proceed, the committee may make a special report to the House.

### **Later Stages**

The bill, once reported, is normally re-committed to a committee of the whole House or to a standing committee. Report stage and third reading take the same form as all other public bills. The bill is then sent to the House of Lords where there is a further opportunity for objectors to petition and to appear before a select committee.

### **Carry-Over between Sessions**

As with private bills, the House has, when necessary, considered motions to suspend hybrid bills from one session to another: the *Channel Tunnel Rail Link Bill* was suspended twice. When a General Election has been called, motions have also been considered to allow hybrid bills to recommence at the point they had reached before the election. Motions of these kinds may, of course, be opposed and negatived; in which case the bill would fail, or have to start all over again.

### **Tracking the progress of hybrid bills**

Hybrid bills appear in the “Public bills before Parliament” section of the *Weekly Information Bulletin*, with HYBRID in brackets after the title. These words do not form part of the official title of the bill.

### **Royal Assent**

When both Houses have approved a Hybrid bill, it receives Royal Assent in exactly the same way as a public bill. These Acts are numbered in the Public and General Acts series.

*Appendix B*

**EXCERPT FROM THE CROSS EXAMINATION OF  
PHILIP BAKER, *ENTERGY CORP. V. COMMR*,  
TAX COURT NO. 25132-06, TR. AT 219-222  
(APRIL 8, 2008)**

Q No. It's not necessary for where I'm going, if you don't mind. Your counsel can explore the rest of the paragraph, but I'm focused on those two sentences, and I would like to explore them with you with some hypotheticals.

If a company had no net profits during the four-year initial period, and -- we're talking about a four-year, 1,461-day period -- would it have had any windfall tax liability?

A No. It couldn't --

Q No. Your answer is no. Is that correct?

A Yes.

Q Once a company's average annual profits during the initial period, multiplied by nine, the constant given in the statute, exceeded its flotation value such that it was liable for the windfall tax, is it not correct to state that the greater the profits, the greater its windfall tax liability would be?

A It is correct, once it exceeded.

Q It is correct. Thank you. If a company that was subject to the windfall tax had no net profits during the four-year initial period, but its stock price had tripled during that period because of the appreciation, for example, of land that it might have owned that, all of a sudden, was in an area that someone wanted to develop, would it have paid any windfall tax liability?

A There have been no profits for any of those four years.

Q I'll do it again because I really want the record to be perfectly clear, and I want to be sure you understand my question.

If a company that was subject to the windfall tax had no net profits during the four-year initial period -- just assume its expenses equaled its income -- but its stock price tripled because, during that period, land that it owned appreciated dramatically in value, and investors thought this would be a great play, and it caused the stock price to triple, would it have had any windfall tax liability?

A No, it wouldn't have.

Q It would not have. Let me put another hypothetical to you, a different set of facts. A company, subject to the windfall tax, had average

annual profits during its initial period, multiplied by nine, which were in excess of its flotation value --

A You mean the value for privatization purposes.

Q Yes, the value for privatization purposes, one of the two factors in the formula in the statute that the government has said is so clear. But its share price, its share price, fell during that time from flotation over a four-year period because of -- in this country, we have this problem -- maybe you're lucky enough in the U.K. not to have it, but let's assume asbestos lawsuits were brought against the company because it's an electric-generating company, and it used asbestos to insulate its piping, and, all of a sudden, every former employee got together in a class action, which maybe you don't even permit in the United Kingdom, and sued for astronomical sums.

A Actually, we do now. We do permit --

Q I feel sympathy for you, sir. You can tell where my sympathies lie on that issue, but --

A We have something called "group litigation orders," which have been used primarily in tax contexts, interestingly enough.

Q But let me be sure you're following me, sir. I'll restate it. I don't want the record to be

12a

confused by our little byplay on procedure in the U.K.

My other hypothetical is that the company had annual average profits during its initial period, multiplied by nine, which were in excess of the privatization flotation value, but its share price fell during that time because of asbestos lawsuits pending against it. Would it have had a windfall tax liability?

A Yes, because the value, in profit-making terms, would have exceeded the value for privatization purposes.

Q So that even though its share price went down during that period, if its profits were large, large enough, there would be a tax imposed.

A Yes.

MR. GARDNER: I have no further questions.

*Appendix C***EXCESS PROFITS TAXATION**by **Kenneth James Curran****CHAPTER I  
Fundamentals**

An excess profits tax is a form of business income tax. It is distinguished from the ordinary business income tax in a fundamental way. Whereas the ordinary tax is levied on all of a firm's income, the excess profits tax is levied upon only a portion of the income. Under an excess profits tax the income is divided into two parts, one of which is exempt on the ground that it represents "normal" earnings while the other part is subject to the tax on the assumption that it is "different" or "excessive."<sup>20</sup>

To divide the income of a firm into "normal" and taxable portions requires a yardstick by which normal earnings may be measured; this yardstick is usually referred to as the "standard" of the tax. A number of standards have been employed in connection with excess profits taxes at one time or another. The commonest, and probably the most significant from the economist's point of view, are the "invested capital standard" and the "profits standard."

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<sup>20</sup> The exempt or normal part of a firm's income may, of course, amount to its entire income.

The invested capital standard operates on the assumption that the normal return to a business may be measured by the capital invested in that business, and this normal return (or exemption) is expressed as a per cent of the invested capital ordinarily measured as of the time when it was first made. The profits standard, on the other hand, measures normal profits by the average profits of a former so-called base period in which conditions are assumed to have been normal. It is difficult, if not impossible, for a tax employing this standard to avoid all reference to invested capital. Some firms may not have been in existence in the base period. Furthermore, base period earnings may not be a satisfactory criterion because the size of the firm may have changed since that time. Finally, the use of base earnings as the sole measure of normal profits may subject a firm, and even an entire industry, to destructive taxation if a state of depression existed in the base period. In such cases, it is customary to adjust the exemption, or provide a supplementary exemption, by reference to invested capital.

Other standards have been employed by excess profits taxes at various times. The Federal excess profits tax of 1933 based the exemption—that is, normal profits—on the value of the capital stock as declared by the taxpayer. Another recent excess profits tax, limited to certain military contracts of the national government, took as its measure both the contract price and the cost of performing the

contract.<sup>21</sup> An excess profits tax restricted to the liquor industry in Ohio likewise used costs as a measure of the exemption.<sup>22</sup> Although such standards may be successfully employed in special industries or for special purposes, they are logically inferior to the invested capital standard and the profits standard as means of isolating unusual profits in the taxation of business in general.

Unfortunately, confusion in terminology has surrounded the excess profits tax. Until recently, Congress tended to confine the term to a levy employing invested capital as a measure of normal earnings.<sup>23</sup> A typical wartime tax measuring normal earnings by the profits of a period before the war was distinguished as a “war profits tax.” On the other hand, during World War I Cordell Hull, then a representative from Tennessee, maintained (with the British tax system in mind) that a genuine excess profits tax employed the profits standard.<sup>24</sup> The use of capital, he held, was merely a means of graduating the income tax. The customary practice today, and that followed by the author of the present study, is to use the term “excess profits tax” to describe any levy

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<sup>21</sup> The so-called Vinson-Trammell excess profits tax.

<sup>22</sup> *Tax Research Foundation, Tax Systems of the World* (Chicago: Commerce Clearing House, 1934), p. 55.

<sup>23</sup> For instance, the excess profits tax levied by the Revenue Act of 1918 was called the War Profits and Excess Profits Tax because it employed both the profits standard and the invested capital standard.

<sup>24</sup> *Congressional Record*, LVI, p. 10165.

that is confined to a segment of a taxpayer's income that is considered excessive, no matter by what standard of measurement it is determined.

The word "profits" as it appears in excess profits tax laws and throughout this study is synonymous with statutory net income. That is, it is the gross income of a firm less those costs that the law has permitted to be deducted. It is not used in the sense, frequently evident in economic theory, of a return to the owners of a business in their function as owners as distinct from their function as suppliers of capital.

The primary objective of an excess profits tax is to raise revenue for the government. There are, however, certain other objectives which may explain why this tax is employed. It has been recommended as a means of recapturing for the public the high profits of firms benefiting from special favors—such as tariff protection—received from the government. It has also been recommended as a supplement to price fixing in wartime because it enables the government to set prices at a sufficiently high level to assure the necessary production with the realization that a large portion of the extravagant profits that this policy yields to the low-cost firm will become part of the public coffers. It has been employed to control objectionable industries by discouraging profits obtained through aggressive exploitation of the market. It has been used, moreover, merely as a means of assisting the

collection of the capital stock tax in the United States. Although these objectives have played an important part in the formulation of excess profits taxes, they are logically and historically less significant than the two major objectives—namely, the taxation of business according to ability and the taxation of profits arising out of war.

The concept of “ability” as a guide in distributing the tax burden over the country has generally been used in a purely personal sense. Its measure has been vague but it has been related in a rough way to the personal sacrifices required by the taxpayer in the payment of taxes. It has been assumed that the wealthy individual has ample ability to bear taxation because he can turn over to the government a large portion of his income without sacrificing anything essential to comfort or health. On the other hand, it has been assumed that the poor individual has little ability to bear taxation since the payment of even the slightest portion of his income may deprive him of essentials. In this sense, of course, “ability” has no place in the taxation of business, for businesses are not living organisms and they can not make sacrifices of the sort described above. It is possible, however, to view the ability of a business in a different light. In a capitalistic economy, a man or a group of men embark upon a commercial undertaking for the sake of the profits they hope it will yield them. Were there no hope of profits the undertaking would be pointless and they would be unwilling to risk their capital, or even their

credit, in such an endeavor. It is quite probable, however, that in any particular case there is a minimum expected return sufficient to launch an undertaking or maintain it after it has been launched.<sup>25</sup> Profits exceeding this minimum return are superfluous in the sense that the hope of their gain was not necessary to attract the needed amount of capital or retain it in the business once it had been invested. Such superfluous or excessive profits have a peculiar ability to bear taxation, for even though they are confiscated by the government no repressive effect upon business is exerted in the sense that business is not deprived of the capital necessary for its existence.

The idea of an excess profits tax as a levy on business according to ability to pay leads to the employment of the invested capital standard rather than the profits standard. It is, of course, true that the profits standard has been recommended at times for this purpose. In a period of great economic disturbance, such as war, great changes in the earnings of business appear; against this chaotic state the earnings of a former period may well appear "normal." It may be assumed that the earnings of the former period emerged from the workings of competition and are therefore an indication of the return that business must have to

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<sup>25</sup> The rate necessary to attract a given amount of additional capital would be quite different from the rate necessary merely to maintain an investment once it has been made.

survive. However, it is clear that they indicate the necessary return only in a rough sense. The earnings of many firms in the so-called "normal" period may in no way have been related to those necessary to maintain the existing capital within the industry or to achieve a given growth. The earnings of a monopolistic firm, for example, are not ironed out by the forces of competition and may have been unnecessarily high. The earnings in highly competitive industries may also have been unnecessarily high if at the time the industries were in the process of adjustment. It is likewise obvious that the earnings in some monopolistic and in some competitive industries may well have been low (or even non-existent) in the "normal" period because of conditions prevailing then. As a result, the use of the profits standard will not lead to the taxation of business according to ability, for it will permit the extravagant earnings of some firms to escape and will subject the earnings of others to destructive taxation unless a special protective measure is taken. If the motive behind the excess profits tax is to tax business according to ability it will determine "normal" profits in relation to the capital invested in the business and will disregard the profits experience of any particular series of years.

The peculiar concept of ability to pay as used by the excess profits tax has both theoretical and practical limitations. From the theoretical side it must be recognized that in stressing one function of profits, another function is ignored; after all, profits

serve not only as a means of attracting capital to industry but also as an incentive to efficiency. It is the hope of increasing the income after the payment of all taxes that spurs management to greater efficiency. If all such additional income goes to the government, the effort necessary to secure greater efficiency is not likely to be made. The tendency of an excess profits tax to lead to wasteful expenditures and lax methods in industry has received a good deal of attention.

Although it is true that there is a minimum return that will be sufficient to attract a given amount of capital to a given industry, or to maintain the capital in the industry, it is impossible to draft a completely sound excess profits tax because of practical difficulties. There is not a single rate of return that is sufficient for all industries at all times. There are, rather, many rates of return. These rates will vary from time to time and from industry to industry. In an industry involving little risk the rate may be low, whereas in an industry involving great risk it may be high. Within a single industry the necessary rate of return may vary widely from time to time, depending upon the entire economic setting. It will be affected by the liberality of the tax law in defining invested capital and net income, by the probable distribution of a given income over time, by the weight and structure of the personal income tax, by the amount of new capital to be attracted to the industry, by the speed with which this capital is to be attracted, etc. Although all of these factors and many

others are pertinent in determining the necessary rate of return, it is obvious that they cannot all be considered by a legislature in the course of drafting an excess profits tax.

It is essential that the theoretical limitation and the complexity of the task of taxing business on the basis of ability to pay be understood if abuse of the excess profits tax is to be prevented. "Excess profits" can never be superfluous as an incentive to efficiency. The higher the tax rate, the greater the tendency toward slackness in industry. Furthermore, such a tax can not in practice isolate exactly that portion of the return not necessary to attract or maintain capital. If these limitations are understood and taken into consideration, an intelligently drawn excess profits tax may, under certain conditions, become an invaluable fiscal instrument.<sup>26</sup> Vast revenue may be raised by this tax with less disturbance to industry than would result from the effort to secure an equivalent amount by other means.

As has been pointed out, the second major objective of an excess profits tax is to tax profits arising out of war. When a country employing the tax is not directly involved in war this objective may be justified on the ground that war profits have a moral taint. When, on the other hand, a nation is actually

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<sup>26</sup> The fiscal characteristics of the tax are discussed in Chapter IX.

engaged in warfare, the tax reflects popular aversion to the creation of vast fortunes out of the sacrifices necessitated by war demands.

If an excess profits tax is designed primarily to reach war gains, it will employ the profits standard. Normal earnings will be measured by the taxpayer's average profits in some period before the war, and the assumption will be made that an increase of his profits is attributable to the war. A prosperous firm will, of course, escape the burden of the tax if its profits have not become larger.

It is obvious that the excess profits tax likewise has its weakness as a means of reaching war profits. All changes in the profits of a firm between two periods of time can not be attributed to a single economic disturbance—even when it is one as important as war. The increase of a firm's earnings may in no way be attributable to the war. It is possible that its earnings would have been still higher had there been no war. On the other hand, a firm may be favorably affected by a war and yet earn less than before. The effect of war on profits could only be determined if it were possible to compare the wartime profits with the profits that would have been received had there been no war—which, of course, can not be done.

Nevertheless, the excess profits tax is the most satisfactory means we have of isolating war profits

23a

for special taxation when the profits standard is employed.