NO. 12-43

In the
Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

PETITIONERS,

v.

COMMISSIONER OF INTERNAL REVENUE,

RESPONDENT.

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

REPLY BRIEF FOR PETITIONERS

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RULE 29.6 STATEMENT

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

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

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REPLY BRIEF

As the Tax Court correctly understood, the United Kingdom's windfall tax is a tax on value in name only. In practical operation, its predominant character is a straightforward excess profits tax on 51.75% of profits above a designated floor (4/9 of flotation value). Although it was nominally structured as a tax on the difference between two "values," one of them was based entirely on actual profits over a four-year period. The tax so clearly operated as a tax on excess profits that even its sponsors referred to it as such. Unless form entirely trumps substance—contrary to long-settled case law, the regulations, and the Commissioner's own position in other cases—this tax must be treated as a creditable excess profits tax.

PPL's opening brief argued at length that form does not trump substance, and that construing the domestic tax consequences of foreign taxes is the last place in which a form-over-substance rule would make sense. The Commissioner does not directly take issue with any of that, but nonetheless insists that United States tax authorities and courts must take the base and rate of a foreign tax as a given. But there is no coherent reason to treat the base and rate of a foreign tax as sacrosanct, while looking to substance only when it comes to other aspects of the tax. Nothing in the statute or regulation supports that counterintuitive rule. To the contrary, the regulation explicitly rejects a form-over-substance approach and affirmatively authorizes looking beyond a foreign government's designation of "gross receipts" or "wages" as the tax base to determine whether the tax reaches net income in practical operation.

Indeed, this case perfectly illustrates the logical problems with the Commissioner's insistence that form trumps substance when it comes to a foreign tax's base and rate. The windfall tax nominally imposes a 23% tax on a windfall value. But it does not measure the tax base using any ordinary metric of value. A normal value calculation avoids hindsight bias and focuses prospectively on, *inter alia*, the future income-generating potential of an asset. The base here is generated by a backward-looking calculation driven entirely by actual, realized profits over a four-year period. Moreover, a traditional value tax is imposed on the holder of the valuable asset, which here would be the companies' shareholders. But this tax is imposed on the income-generating companies themselves, which makes perfect sense if the tax is in substance an excess profits tax, but no sense at all if it is a traditional tax on value.

The Commissioner's other objections all depend on the flawed premise that form trumps substance when it comes to the base of a foreign tax. The Commissioner complains that this tax does not operate in the same manner as traditional U.S. excess profits taxes. But once the means of calculating the floor of the tax is distinguished from the tax on the profits in excess of the floor (something a substance-over-form approach surely allows), the tax operates in precisely the same manner as past U.S. excess profits taxes. The Commissioner also complains that the tax does not satisfy the regulation's three-part test. But the Commissioner reaches that conclusion only by applying the requirements to the form of the tax, rather than to its substance, an approach the regulation itself forbids. The substance or "predominant character" of the tax clearly satisfies each requirement.

In the end, this case really does turn on the fundamental and recurring question of whether form should trump substance. Tax law generally looks beyond form to substance, and there are particularly compelling reasons to do so when determining the domestic tax consequences of foreign taxes. That is enough to decide this case. The windfall tax is in practical operation a classic excess profits tax. Accordingly, it should be creditable.

ARGUMENT

I. Whether The Windfall Tax Is Creditable Turns On Its Substance, Not Labels Or Form.

It has long been settled that form cannot trump substance when it comes to tax laws. The Commissioner ostensibly accepts that venerable principle, but nonetheless insists that it does not control with respect to "the relevant foreign law's designation of the applicable tax rate and the base on which the tax is imposed." Resp.Br.28. As the Fifth Circuit recognized, the Commissioner's plea for a limited and largely unexplained exception to the general rule is "easy to dispatch." *Entergy Corp. & Affiliated Subsidiaries v. Comm'r,* 683 F.3d 233, 236 (5th Cir. 2012).

There is certainly no reason why foreign tax bases and rates should be the lone exceptions to the prevailing preference for substance over form. To the contrary, determination of the domestic tax consequences of foreign taxes enacted in myriad different languages and in the context of varying tax schemes and political and economic environments is the last place where such a rule would make sense. *See* Op.Br.26–27. Moreover, the Commissioner's proposed approach produces absurd results. There is self-evidently no substantive difference between a 30% tax on income and a 15% tax on a base of two-times-income. Nonetheless, by the Commissioner's logic only the first formulation is creditable because the "base" of the tax in the second formulation (which must be "taken as given") would be "*greater* than" income. Resp.Br.38–39.

This is not the *reductio ad absurdum* of the Commissioner's position; it is his position in this very case. He is, after all, defending a Court of Appeals decision that deemed the difference between a 23% tax on 225% of profit and a 51.75% tax on 100% of profit outcome determinative despite their mathematical equivalence.[1] The Commissioner

[1] Relatedly, the Commissioner repeatedly emphasizes that the base windfall amount to which the 23% nominal tax rate is applied is greater than the companies' reported profits. Resp.Br.13–14, 36–39. But that comparison has no substantive relevance. The U.K government could have achieved the exact same result with a smaller base and a higher rate, and then reported profits would have exceeded the base. The substantively relevant comparison is not between the base and net profits (which reveals nothing of substance) but between the revenue generated by the tax and net profit (which confirms that the tax is not on something *greater than* profits). *See infra*

recognizes that "[f]or purposes of computing a particular privatized company's windfall-tax liability," *i.e.*, as a matter of substance, a 51.75% tax on profits above a threshold and 23% tax on "windfall value," which is determined by profits, "are indeed equivalent." Resp.Br.27. But according to the Commissioner, that substantive equivalence is "just a matter of algebra." Resp.Br.27. What matters—indeed, all that matters—in his view is the foreign country's "choice between the two" mathematically equivalent formulations; that choice "determines whether the … tax is properly viewed as a tax *on* income." Resp.Br.27.

The Commissioner does not even attempt to explain why a statute designed "to mitigate the evil of double taxation," *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932), would function in such a bizarre fashion. He instead insists that his arbitrary interpretation is compelled by the regulation because its net income requirement refers to how "the *base* of the tax is computed." Resp.Br.38. (quoting 26 C.F.R. § 1.901-2(b)(4)(i) (emphasis added)). But the regulation explicitly rejects a form-over-substance approach both generally, *see* Op.Br.32–35, and specifically when it comes to the base of a foreign tax. Indeed, the very provision on which the Commissioner relies directs an inquiry that looks beyond formalism: "A foreign tax satisfies the net income requirement if, *judged on the basis of its*

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p. 21. And the tax bill for every company that paid the windfall tax was substantially less than its actual, realized profits for the relevant period. Pet.App.79.

predominant character, the base of the tax is computed by reducing gross receipts … to permit [r]ecovery of … significant costs and expenses[.]" 26 C.F.R. § 1.901-2(b)(4)(i) (emphasis added). As that language makes clear, the "base" of a foreign tax, just like the rest of it, is to be "judged on the basis of its predominant character," not the labels or form the foreign country gives it.

If the base of a foreign tax were sacrosanct, then a tax nominally levied on "gross receipts" or "wages" could never be credited as a tax on income or profits. Yet the regulations expressly permit "[a] foreign tax whose base is gross receipts" to be creditable "where that tax is almost certain to reach some net gain in the normal circumstances in which it applies." *Id.* § 1.901-2(b)(4)(i). The regulation also provides a tax nominally on wages as an example of a creditable tax reaching net income. *Id.* § 1.901-2(b)(4)(iv), ex. 3.[2]

The incompatibility of the Commissioner's formalism and the regulation is reinforced by the substance-over-form case law the regulation was designed to memorialize. The Commissioner erroneously contends that those decisions do not

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[2] The Commissioner thus focuses on the wrong "Example 3." Example 3 of what constitutes "gross receipts" in the U.S. sense is, as even the Commissioner concedes (at 37), irrelevant because it deals with *imputed* gross receipts, which are not at issue here. *See* Op.Br.46–47; *Entergy,* 683 F.3d at 237–38; American Elec. Power Co. ("AEP") *Amicus* Br. 24–29. Example 3 of the regulation's explanation of "net profits," by contrast, is relevant because it makes clear that the tax base is not sacrosanct; even a tax nominally on gross wages is creditable if it reaches net gain.

allow courts to "adopt an understanding of the applicable tax base different from that specified in the relevant foreign law." Resp.Br.31–32. In fact, that is exactly what those cases did. Many involved taxes nominally levied on "gross receipts," which quite obviously are not the same thing as net profits. Yet the courts went beyond labels to examine the practical operation of the taxes.

Nowhere is that more obvious than in *Seatrain Lines, Inc. v. Commissioner*, 46 B.T.A. 1076 (1942). There, Cuba replaced a 6% tax on net profits (which clearly was creditable) with a 3% tax on gross income (which just as clearly would not be creditable if the nominal tax base were sacrosanct, as posited by the Commissioner). Rather than treat the tax base as a given, the court looked beyond labels and form and held the tax creditable because the combination of an expanded base and a reduced rate meant the tax would continue to reach net gain in practical operation. *Id.* at 1081; *see also Bank of Am. Nat'l Trust & Sav. Assoc. v. United States*, 459 F.2d 513, 520–21 (Ct. Cl. 1972) (citing *Seatrain* for proposition that "a gross income tax which embodies within itself (*via the rate or otherwise*) consideration of the taxpayer's relevant costs and expenses" is creditable (emphasis added)). The Commissioner's approach cannot be reconciled with *Seatrain* or the other pre-regulation cases; it would treat the 3% tax on gross income as non-creditable, just like the hypothetical 15% tax on two-times-income (or the not-so-hypothetical 23% tax on 225% profits), by looking to form, not substance, when it comes to the tax base.

To be sure, neither the regulation nor the case law it memorializes deals specifically with a tax that looks exactly like the windfall tax. But that does nothing to undermine the venerable substance-over-form principle. The Commissioner cannot point to *a single* situation in which the statute, regulation, or case law instructs courts to confine the creditability analysis to the labels and form used by a foreign country, rather than to consider the foreign tax's practical operation and predominant character. That is because it would make no sense to allow a foreign country's "choice" between different formulations of a tax with the same practical effect to be outcome determinative when it comes to the U.S. tax consequences.

II. The Predominant Character Of The Windfall Tax Is That Of A Tax On Income.

There can be no serious question that the practical operation of the windfall tax is as an excess profits tax. *See* Op.Br.37–40; Entergy Corp. *Amicus* Br. 11–14. The Commissioner concedes that the tax is the mathematical equivalent of a 51.75% tax on profits in excess of the floor (4/9 of flotation value). Resp.Br.27. He concedes that SWEB confirmed the direct correlation between its profits and the amount of the tax when it was permitted to make an after-the-fact downward adjustment to its reported profits during one of the four relevant years and reduced its windfall tax liability by 51.75% of the adjustment. Resp.Br.25 & n.2. And he concedes that the initial-period profits used to calculate the windfall tax consist of "net gain" as defined by the regulation's three-part test—*i.e.*, they were measured by subtracting significant costs and expenses from realized gross receipts. Resp.Br.21. In other words, the Commissioner concedes every factor that proves the predominant character of the windfall tax is that of an income tax in the U.S. sense.

The Commissioner nonetheless maintains that the tax is not an excess profits tax. He argues, first, that it is in substance a tax on "value" and, second, that it does not satisfy the regulation's three-part test. Both contentions are meritless.

A. The Windfall Tax Does Not Tax Any Recognizable Concept of Value but Clearly Taxes Income.

Cobbling together different features of taxes on real property and closely held companies—*i.e.*, situations in which a measure of value is not readily available on a stock exchange—the Commissioner asserts that the U.K. statute is not creditable because its notion of "value in profit-making terms" resembles "familiar" and "well-established" methods of measuring value. Resp.Br.15, 20. Both the legal and factual premises underlying this argument are incorrect. The ultimate legal question under the foreign tax credit statute is whether a foreign tax is in practical operation an income or excess profits tax, not whether it can be characterized as a value tax. There is nothing talismanic about the label "value tax." While a true value tax clearly is not a tax on income, if a foreign nation adopts an idiosyncratic definition of "value," such that "value" is measured exclusively in terms of realized income, the tax is creditable. Moreover, as a matter of fact, there is nothing remotely "familiar" about the method by which the windfall tax measures "undervaluation." By focusing on past profits (rather than future income-producing potential), imposing the tax on the income-generating company (rather than the asset-holding shareholders), and ignoring a readily available measure of value, the U.K. government imposed a tax that looks nothing like any "well-established" means of taxing value.

The Commissioner largely glosses over the most anomalous feature of the windfall tax, which is that the *sui generis* concept "value in profit-making terms" purports to measure a retrospective value by using profits already earned during a four-year period that *pre-dates* imposition of the tax. Valuation of an asset or a company turns on, *inter alia*, its ability to produce income in the future. A measure of value based exclusively on past profits is thus highly anomalous, if not an outright oxymoron.

As every prospective investor is warned, past performance is no guarantee of future results. For that basic reason, any traditional effort at valuing a company focuses on its future income-producing potential. John A. Bogdanski, *Federal Tax Valuation* ¶ 3.05[4][d][i] (2012) ("Income-based valuation techniques look to the future; thus, the goal is to project the future income of the asset or entity."). Past earnings and profits are relevant only to the extent they shed light on future income-producing potential. Even then, other considerations, such as the value of a company's assets, are factored into the calculation. This is well-illustrated by the familiar stock market phenomena that companies with no established earnings sometimes trade at higher prices than more established companies, and that price-to-earnings and even price-to-predicted-earnings ratios vary among sectors and companies within sectors. In contrast, as one of its principal drafters opined, the windfall tax incorporates "an underlying concept of value (based on actual ex-post earnings) that would be alien to any valuer." JA292.

The Commissioner suggests that the atypical valuation method here reflects the unusual circumstance that the U.K. government was not trying to assess or tax current value. Instead, according to the Commissioner, the U.K. government was trying to measure the "undervaluation" of the companies' stock at a particular past moment (namely, the point of flotation), and therefore it made sense to consider actual reported profits in the years after flotation.

There are several difficulties with this argument, not the least of which is that it wholly undermines the Commissioner's argument that holding this anomalous tax creditable would "greatly expand the universe of" creditable taxes. Resp.Br.15. Precisely because a traditional value tax is assessed on the basis of a current value that at best indirectly reflects *future* income-producing potential, there is no risk that such traditional value taxes can be restated as the algebraic equivalent of taxes on *past* profits. And because the Commissioner's regulation requires a foreign tax to be imposed on *realized* income, it already excludes taxes on anticipated *future* income. 26 C.F.R. § 1.901-2(b)(1)–(2).

The windfall tax is thus critically different from any normal (and non-creditable) value tax because unlike such traditional value taxes—and unlike any other tax the Commissioner identifies—the windfall tax uses a company's actual, realized profits to measure tax liability. *Compare id.* §§ 20.2031-2(f)(2) & 25.2512-2(f)(2) (considering "prospective earning power"), *id.* §§ 20.2031-3(b) & 25.2512-3(a)(2) (considering "demonstrated earning capacity"); Resp.Br.18 (collecting state taxes that consider "ability to generate income"); Rev. Rul. 59–60 § 4.02(d) ("[p]otential future income is a major factor in many valuations of closely-held stocks"). Therefore, recognizing that this highly unusual tax operates in substance as a tax on actual, realized profits will not affect the creditability of more traditional value taxes. There is no slippery slope.

But the problems with the Commissioner's position do not end there. Efforts to reconstruct a historical value are unusual but not unprecedented, and the cardinal rule in such valuation efforts is to avoid hindsight bias. The basic concept of fair market value is "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge of relevant facts." 26 C.F.R. § 20.2031-1(b). For the obvious reason that one cannot have reasonable knowledge of facts that do not yet exist, income earned or events occurring after the valuation date may not be considered. *See* Bogdanski ¶ 3.05[4][d][i] & n.387 (collecting cases applying "general rule against use of hindsight evidence in valuation matters"). With the benefit of 20/20 hindsight, it is obvious that companies like Apple and Google "should have been" valued more highly at their initial public offerings, but any actual effort to fairly value those companies at the time would have to avoid such biases. Indeed, the Commissioner conspicuously fails to identify any U.S. tax or valuation method that uses hindsight evidence to assess after-the-fact value.

Relying on the four years immediately after flotation is problematic as a true measure of value for yet another reason: Those years were marked by an unusual regulatory regime with a known expiration date. Op.Br.6–7. In any traditional effort to value a company, the existence of an anomalous and soon-to-be-eliminated regulatory environment would require profits for those years to be taken with a large grain of salt, either heavily discounted or discarded entirely. In short, while unexpectedly large profits during a highly unusual and discontinued regulatory regime may be a tempting target for an excess profits tax, they are a particularly flawed measure of value.

Moreover, the windfall tax is fundamentally unlike any traditional value tax because it is not assessed on the taxpayers who own (or owned) the valuable asset. If the windfall tax were really directed at recapturing undervaluation of the companies at the time of flotation, it logically would be assessed on the individuals who paid "too little" for the floated shares, not on the companies that subsequently earned "too much."

The windfall tax is also clearly something other than a traditional value tax because it ignores a ready measure of the companies' value: the price at which they traded on the London Stock Exchange. Some assets are difficult to value precisely because of the absence of a highly liquid and efficient market in which willing buyers and sellers set prices that reflect value. That is not a problem with publicly traded companies because their value is readily ascertainable by reference to their stock price. Indeed, because stock price typically "presents such impressive evidence of value that it is deemed to be conclusive," more speculative valuation methods are considered "inappropriate" for such companies. Bogdanski ¶ 3.05[3]; *see also* Rev. Rul. 59–60 § 3.03.

It is thus no accident that the Commissioner's collection of various tax provisions that reference using future income projections to estimate current value all involve difficult-to-value assets like real estate and closed corporations, not publicly traded companies. *See, e.g.*, Rev. Rul. 59–60 (valuation method for "stock of closely held corporations, or the stock of corporations where market quotations are not available"); 26 C.F.R. §§ 20.2031-2(f)(2) & 25.2512-2(f)(2) (valuation method for stock "[i]f … actual sale prices and bona fide bid and asked prices are lacking"); Resp.Br.18–19 (collecting state real estate taxes). Tellingly, the sole tax the Commissioner cites that permits use of income-based valuation in lieu of more accurate indicia of value (like recent sales prices) is an estate tax designed to subsidize owners of farm land and avoid the break-up of family farms by taxing their property at below fair market value. *See* 26 U.S.C. § 2032A.

The Commissioner suggests that the windfall tax ignores stock price "because Parliament was attempting to value the companies as of the date of flotation," and stock price at any later time would be "an inadequate proxy." Resp.Br.22. But the stocks of privatized companies began trading at a premium over their flotation value almost immediately. JA86–90, 456–57. The market thus provided a measure of undervaluation at flotation that was far more compatible with traditional valuation methods. Instead, the windfall tax uses a formula with at best only a "very weak relationship" to each company's increase in value as measured by its stock price in the months or years following flotation. JA471–76. The prerogative to choose a formula based on realized profits rather than more traditional valuation methods obviously belonged to the U.K. government. But there is no reason for U.S. tax authorities to ignore the substance of that choice and treat the windfall tax as if it were a more traditional value tax.

In any event, whether the windfall tax is properly classified as a "value tax" is ultimately not the relevant question. The tax is certainly unlike traditional value taxes, but what matters under the statute and regulation is that in practical operation it reaches net gain. If a country adopted an idiosyncratic concept of value and imposed a "value tax" on companies where the sole measure of taxable value was net income in the previous year, surely that tax would be treated as an income tax. The windfall tax differs from that hypothetical tax only in the details, and those details all stem from the reality that the windfall tax is an excess profits tax, not an ordinary income tax. The windfall tax looks back four years, rather than one, because there was a four-year period marked by an unusual regulatory regime that resulted in profits perceived to be "too high." And it employs a more complicated formula—23% of the difference between two values, one of which is a product of profits over the four-year period—because every excess profits tax must have a threshold to determine which profits are "excessive," and the windfall tax builds the threshold into the formula. At the end of the day, both the hypothetical tax and the windfall tax impose a tax on something labeled value, but in reality calculate the tax based solely on net gain. In any system in which creditability does not turn exclusively on labels, both taxes are creditable taxes on income and excess profits.

B. The Windfall Tax Is in Substance an Excess Profits Tax.

The Commissioner's attempts to demonstrate that the windfall tax fails the regulation's realization, gross receipts, and net income requirements suffer from the same fatal flaw as his broader argument: He erroneously assumes the "base" is sacrosanct and thus applies the regulation to the form of the foreign tax. *See* Resp.Br.42 ("There are infinite ways to express the algebraic formula that is the windfall tax, but the classification of the tax should be based on the iteration selected by Parliament."). But the regulation—and the substance-over-form principles it reflects—commands the opposite approach. The Commissioner stresses that a tax is creditable "*if and only if*" it satisfies each regulatory requirement, Resp.Br.34, but he emphasizes the wrong regulatory language. The key point is not that all three requirements must be satisfied, but that each must be applied to the tax "*judged on the basis of its predominant character*." 26 C.F.R. § 1.901-2(b)(1) (emphasis added). The predominant character of the windfall tax is a 51.75% tax on initial-period profits in excess of the floor (4/9 of flotation value). Because there is no dispute that a 51.75% tax on those profits satisfies the three-part regulatory test, this should be a straightforward case.

The Commissioner protests that the windfall tax is not a *true* tax on profits because it uses flotation value and a fixed price-to-earnings ratio to determine how much profit to tax. Resp.Br.24–25.[3] But that is just what makes it an *excess* profits tax rather than a simple income tax. Excess profits taxes routinely use something other than income to set the floor above which profits will be deemed excessive, and application of the regulation necessarily must focus on the tax above the floor, not the factors used to determine the floor. *See* AEP *Amicus* Br. at 6–9; 13–16. For example, the Commissioner identifies as paradigmatic excess profits taxes both a 1917 tax on profits in excess of the sum of $5,000 and 8% of the taxpayer's "actual capital invested," and a 1940 tax on profits in excess of either the taxpayer's average profits during the three previous years or a specified percentage of return on its capital investment. Resp.Br.25–26. The use of factors that clearly would not satisfy the three regulatory requirements (such as a percentage of invested capital) to set the floor did not make those taxes any less taxes on income.

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[3] The Commissioner understandably does not take up his *amici*'s meritless argument (at 31–32) that the windfall tax is not a tax at all; he correctly conceded in the Tax Court that the windfall tax was not a payment "in exchange for any specific economic benefit." JA31.

What matters is not whether the *floor* satisfies the net gain test, but whether the amount *in excess* of the floor—*i.e.*, the amount that is actually being taxed—consists of net gain. *See* AEP *Amicus* Br. 6–9 (collecting examples of foreign excess profits taxes treated as creditable despite non-creditable factors used to calculate floor).

The practical operation of the windfall tax is no different from those paradigmatic examples of excess profits taxes that Congress intended to make creditable. It imposes a floor (4/9 of flotation value) and then imposes a 51.75% tax on any actual, realized profits above that floor. To be sure, the windfall tax looks slightly different on its face from those other taxes because, rather than state the floor and tax base in excess of the floor separately, it essentially builds the floor into one of the "values." But once the floor is separately identified, the tax looks exactly like a traditional excess profits tax. In other words, while the formula in the windfall tax statute multiplies profits by 9/4 and subtracts flotation value (and then multiplies by 23%), all agree that is the mathematical equivalent of multiplying flotation value by 4/9 and subtracting it from profits (and then multiplying by 51.75%). Only the most extreme devotee of form-over-substance could treat those substantively identical taxes differently.

The Commissioner's emphasis on the fact that profits are not the only variable in the tax is therefore both misleading and irrelevant. The only other "variable" (flotation value, which was known) is used solely to determine the floor above which profits are excessive. And, as demonstrated, factors other than profits are commonly used in setting floors for paradigmatic excess profits taxes. But once the floor is reached, the *only* thing that determines tax liability is how much initial-period profit a company made. That is why SWEB was able to reduce its tax liability by 51.75% of every pound by which it reduced its reported profits—once its profits exceeded the floor (4/9 of its flotation value), all that mattered (*i.e.*, the actual base of the tax) was how many pounds of profit it reported.[4]

For similar reasons, the Commissioner gets no further by pointing out that two companies could have made the same amount of initial-period profit yet paid different amounts of windfall tax if they had different flotation values. Resp.Br.24. That is true of any excess profits tax (including the Commissioner's 1917 and 1940 examples) where the floor is measured by a taxpayer-specific figure other than current-period profits, such as invested capital or past profits. What matters is that once a company is above the floor, every additional pound of profit is taxed, and nothing other than the amount of profit above the

[4] While "flotation value" may not be a common feature of U.S. excess profits taxes, Resp.Br.25, that is largely a product of the historical reality that the United States has not had nationalized companies it then decided to privatize. In that context, flotation value is an appropriate proxy for invested capital, JA70–72; *see also Entergy*, 683 F.3d at 238, which has been used as a floor for U.S. excess profits taxes. In all events, no matter how novel the mechanism for calculating the floor, what matters is whether the taxed amount in excess of the floor is income or profits, which it clearly is here.

floor and the effective rate determines the amount of tax.[5]

The Commissioner suggests that a tax is not "necessarily" an income tax just because it "is calculated using profits as a variable" or "is not confiscatory of net gain." Resp.Br.23, 28. PPL has not suggested otherwise. Rather, it has emphasized that once a company reaches the floor (4/9 of flotation value), actual, realized profits are not just "a variable"; they are the sole variable that determines the amount of the tax. That reality, which the Commissioner does not and cannot dispute, ensures that the windfall tax is not just "likely," but certain, "to reach net gain in the normal circumstances in which it applies." 26 C.F.R. § 1.901-2(a). That distinguishes the windfall tax from every true value tax the Commissioner cites, *see supra* pp. 11–12, and ensures that it is creditable.

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[5] The Commissioner's *amici* emphasize (at 15–16) that a handful of companies had different effective tax rates due to their shorter initial periods. But the predominant character test requires courts to disregard outliers and focus on the practical operation of a tax "in the normal circumstances in which it applies." 26 C.F.R. § 1.901-2(b)(1); *see also* Op.Br.38 n.3; *Exxon Corp. v. Comm'r*, 113 T.C. 352 (1999) (disregarding circumstances of a few small oil producers in rejecting an earlier effort of the Commissioner to deny creditability to a U.K. excess profits tax). In any event, the portion of each company's initial-period profits taxed was (by design) sufficiently low that no company's tax liability exceeded its net profits. For example, while Railtrack Group's effective tax rate was about 239%, the tax was imposed on only roughly a quarter of its £253 million in initial-period profits, resulting in a windfall tax liability of approximately £156 million.

Likewise, PPL did not contend that the undisputed fact that the actual windfall tax imposed (as opposed to its base) was less than actual, realized profits for every company that paid the tax (*i.e.*, that it is not confiscatory of net gain) *sufficed* to make it creditable. Rather, PPL made that point only to demonstrate conclusively that the tax does not reach something *more* than income in the U.S. sense. While not alone determinative of creditability, the comparison between revenue collected and net profits is, unlike the Commission's repeated comparison of the tax base and net profits, at least relevant. *See supra* n.1. What is ultimately determinative of creditability is the undeniable fact that, once the floor is met, the windfall tax is a straight-line tax on actual, realized profits.

The Commissioner is equally off base in dismissing the repeated recognition of everyone involved in the creation and passage of the windfall tax that it was in substance an excess profits tax. Resp.Br.43–46. As the Tax Court explained, those constant characterizations of the tax as an excess profits tax matter not as part of some effort to use legislative history to demonstrate that Parliament really wanted to impose an "excess profits tax," and not a "value tax," or because Parliament's "political motivation for the windfall tax" is controlling. Pet.App.80. Rather, those statements matter because they demonstrate that everyone involved—from the drafters of the tax, to the Labour government members who presented it, to the Parliament members who enacted it—"understood" that the tax, "by its terms, represented one of two equivalent explanations" of the same practical effect.

Pet.App.80. In other words, everyone understood that there was no substantive difference between describing flotation value as "too low" vis-à-vis profits (and taxing the "undervaluation") and describing profits as "too high" vis-à-vis flotation value (and taxing the "excess profits").

That is why, even after the Labour government settled on the "undervaluation" framing as superior for presentational purposes, it continued to describe the windfall tax as a tax "on the excess profits" of the companies. *See* Op.Br.13–14 (collecting statements from Labor government referring to windfall tax as a tax on "excess profits"). Those repeated references are not examples of public officials being "off message"; rather they underscore that those who knew the tax best understood that it could accurately be described, consistent with its substance and practical operation, as a tax on excess profits.[6]

Even the Commissioner concedes that if these U.K. officials had chosen a different "presentational" form and expressly imposed a tax on profits in excess of a threshold measured by 4/9 of flotation value, the tax would be creditable. *See* Resp.Br.27. The Commissioner's position really is just that formalistic. But the mathematical equivalence

[6] Whether members of Parliament believed the windfall tax would be creditable is irrelevant. It was, after all, the *opponents* of the tax who questioned its creditability, raising concerns that it might violate treaties designed to prohibit double taxation and invite retaliatory taxes. JA162, 169–70. Geoffrey Robinson took no position, responding only that the "question is one for the US authorities." JA163.

between two formulas that impose the same tax on the same companies cannot be dismissed as "just a matter of algebra." Resp.Br.27. As the Tax Court correctly recognized, allowing the U.S. tax consequences of two substantively identical taxes to turn on the labels employed by foreign sovereigns runs counter to the entire thrust of the statute, regulation, and case law. *See* Pet.App.71–85.

In short, what matters is not "foreign characterizations or classifications," but predominant character, practical operation, and whether a foreign tax is in substance the equivalent of a U.S. income or excess profits tax. *Biddle v. Comm'r*, 302 U.S. 573, 579 (1938). In substance, the windfall tax operated as a 51.75% tax on profits in excess of a floor. It is creditable.

CONCLUSION

The Court should reverse the decision below and hold the windfall tax creditable.

Respectfully submitted,

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