No. 10-60988

IN THE UNITED STATES COURT OF APPEALS

FOR THE FIFTH CIRCUIT

ENTERGY CORPORATION AND
AFFILIATED SUBSIDIARIES,

Petitioners-Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ON APPEAL FROM THE DECISION OF THE
UNITED STATES TAX COURT

OPENING BRIEF FOR THE APPELLANT

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STATEMENT REGARDING ORAL ARGUMENT

Oral argument would be helpful in this case because it involves complex and technical questions of federal tax law and U.K. tax law.

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JURISDICTIONAL STATEMENT

On November 16, 2006, the Internal Revenue Service ("IRS") sent to Entergy Corporation and its affiliated subsidiaries (collectively "taxpayer") a notice of deficiency for the 1997 and 1998 tax years. (Doc. 1 at 2.)[1] On December 7, 2006, taxpayer timely filed a petition in the

[1] "Doc." references are to the documents comprising the original
(continued...)

United States Tax Court contesting the notice of deficiency. (Doc. 1.) *See* I.R.C. § 6213(a) (26 U.S.C.). The Tax Court had jurisdiction pursuant to I.R.C. §§ 6213(a) and 6214.

On October 4, 2010, the Tax Court entered its decision. (Doc. 60.) The decision resolved all claims of all parties. On December 20, 2010, the Commissioner timely filed a notice of appeal. (Doc. 61.) Fed. R. App. P. 13(a)(1); I.R.C. § 7483. This Court has jurisdiction pursuant to I.R.C. § 7482(a)(1).

STATEMENT OF THE ISSUE

Whether the Tax Court erred in ruling that the United Kingdom windfall tax was a creditable foreign tax under I.R.C. § 901.

STATEMENT OF THE CASE

The IRS sent a notice of deficiency to taxpayer for its 1997 and 1998 tax years. Two issues underlying the deficiency determinations were that taxpayer was not entitled to a foreign tax credit for a U.K.

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[1](...continued)
record on appeal, as numbered by the clerk of the Tax Court and transmitted to this Court, and "Tr." references are to the trial transcript. Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended ("I.R.C.").

windfall tax its U.K. subsidiary paid in 1997 and 1998, and that taxpayer was not entitled to depreciation deductions and other tax adjustments for certain street lighting assets. Taxpayer filed a petition in the Tax Court contesting both issues. The street-lighting-assets issue was resolved in taxpayer's favor (Doc. 58) and is not at issue in this appeal.

With respect to the windfall-tax issue, the parties stipulated to certain facts, and, in a trial held in April 2008, they submitted additional factual and expert testimony. Following post-trial briefing, the Tax Court (Halpern, J.) issued a memorandum opinion in favor of taxpayer, citing to its published opinion in *PPL Corp. v. Commissioner*, 135 T.C. No. 15 (Sept. 9, 2010), which involved the identical windfall-tax question and was issued the same day. (Doc. 59 at 2.) In October 2010, the Tax Court entered a decision determining that taxpayer had no tax deficiencies for the years at issue. (Doc. 60.) The Commissioner appealed.[2] (Doc. 61.)

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[2] The Commissioner also filed a notice of appeal in *PPL*, and venue for that appeal lies in the Third Circuit. *See* 3d Cir. No. 11-1069. The Commissioner's opening brief in *PPL* is due on May 5, 2011.

STATEMENT OF FACTS

The taxpayer, Entergy Corporation, is a Delaware corporation with headquarters in New Orleans. It is the parent company of an affiliated group of corporations that produce and provide electricity. In 1997, one of its indirect subsidiaries was a U.K. electric company named London Electricity plc. (Doc. 31 at 2-4.)

A. Background of the U.K. windfall tax

Between 1984 and 1994, the U.K. Government, under the control of the Conservative Party, privatized ownership of 32 state-owned utility companies by "flotation" (*i.e.,* public offering) of their stock. (Doc. 31 at 7.) The public flotation process involved the transfer of the companies' assets to newly created "public limited companies," followed by the offering of their shares to the public at a fixed price. (*Id.*) Twelve regional electric companies, including London Electricity, were privatized in December 1990. (*Id.* at 7-8.) In the flotation process, all 218,059,000 ordinary shares of London Electricity's stock were offered at £2.40 per share. (*Id.* at 8.)

After the companies were privatized, the U.K. Government regulated the prices they could charge the public. Because the

privatized utilities were able to increase efficiency and reduce operating costs to a greater degree than had been expected when the initial price controls were established, the companies realized substantially higher profits than had been anticipated. It was thus widely believed in the U.K. that the utilities had been sold too cheaply, and that their profits were excessive in relation to their flotation value. (Doc. 31, Ex. 17-P, ¶42.) *See PPL Corp. v. Commissioner*, 135 T.C. No. 15 (2010), slip op. 6-9 (hereinafter "PPL Op.").

In its 1997 Election Manifesto, the British Labour Party made a campaign promise to impose a windfall tax on the privatized utilities. (Tr. 63.) Such a tax, the party believed, could fund a welfare-to-work youth employment training program it hoped to enact. (Doc. 31, Ex. 15-P, ¶188.) The Labour Party began preparations for its proposed windfall tax legislation in 1996. To that end, Geoffrey Robinson, a Member of Parliament and the Labour Party's Paymaster General, hired Arthur Andersen to assist the Labour Party's shadow treasury team in developing a proposal for the tax. (Tr. 63-64, 71-74.)

During its study, the Andersen team considered three "simple" and three "complex" solutions for structuring the tax. The three simple

solutions were to tax either (i) gross receipts, (ii) assets, or (iii) profits. The complex solutions were to tax (i) excess profits, (ii) excess shareholder returns, or (iii) a "windfall" amount. (Tr. 77-78.) The team rejected all three simple solutions and the first two complex solutions. A tax on future profits was rejected for fear that the targeted companies might be tempted to manipulate their earnings, with the result that the revenue generated from the tax would be insufficient to fund the proposed employment training program. A tax on past profits was rejected out of concern of criticism that the same profits were being taxed twice, which might cause the legislation to fail. And a tax on either excess profits or excess shareholder returns was rejected because the team concluded that the positive aspects were outweighed by the negative ones (*i.e.*, the difficulty in computing the excess amounts, the need for a retrospective tax to be assured of raising a target amount, and, in the case of a tax on shareholder returns, the possibility of taxing the wrong shareholders, that is, the ones who did not realize the returns being taxed). (Tr. 81-85; Doc. 31, Ex. 27-R at 71-73.)

Geoffrey Robinson and the Andersen team settled on a tax that would be charged one time only on the "windfall" to the utilities at

privatization. The windfall would be the amount by which an imputed value for each company at privatization (to be determined by applying a selected price-to-earnings ratio to each company's average annual profits over a five-year period) exceeded the actual flotation price of the company. In other words, the proposal was to tax the difference between the price at which each company was actually sold and an estimated value at which it should have been sold. (Tr. 84-87; Doc. 31, Ex. 27-R at 73-74.)

B. Enactment and provisions of the windfall tax

In 1997, the Labour Party gained control of the U.K. Government and followed through on its promise to enact a windfall tax on the privatized utilities. In July 1997, Parliament enacted "The Windfall Tax" as part of the Finance (No. 2) Act 1997 (the "Act"). (Doc. 31, ¶9 & Ex. 18-J.) The proposal that the Andersen team developed was essentially similar to the windfall tax that was enacted, though the legislation was drafted by the U.K. Treasury, Inland Revenue, and the Office of Parliamentary Counsel. (Ex. 67-P at 19.)

The Act provided that "[e]very company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking

whose privatisation involved the imposition of economic regulation shall be charged with a tax (to be known as the 'windfall tax') on the amount of that windfall." The amount of the tax was 23 percent of the "windfall." (Doc. 31, ¶40 & Ex. 18-J (Part I, ¶1(1)).)

The "windfall" was defined in the statute as the amount by which (i) "the value in profit-making terms of the disposal made on the occasion of the company's flotation" exceeded (ii) "the value which for privatisation purposes was put on that disposal." (Doc. 31, ¶41 & Ex. 18-J (Sch. 1, ¶1).) In other words, as explained by Inland Revenue, "[t]he taxable amount [was] calculated by taking the value of the company in profit-making terms and deducting the value placed on the company at the time of flotation." (Doc. 31, Ex. 17-P, ¶7.) The first of these values (referred to as the profit-making value) was to be determined "by multiplying the average annual profit for the company's initial period by the applicable price-to-earnings ratio." (Doc. 31, ¶42 & Ex. 18-J (Sch. 1, ¶2).) The applicable price-to-earnings ratio (for all companies subject to the tax) was 9. (Doc. 31, Ex. 18-J (Sch. 1, ¶2(3).) This figure was selected because it approximated the lowest average price-to-earnings ratio, during the relevant periods, of the 32 companies

that would be subject to the tax. (Doc. 31, ¶43 & Ex. 16-P, ¶4 & Ex. 17-P, ¶11.)

A company's "average annual profit" for its "initial period" (which generally was the first 4 years following flotation) was equal to 365 times the company's "total profits" for the initial period divided by the number of days in its initial period (*i.e.,* average annual profit = 365 x (total profits for initial period ÷ number of days in initial period)). (Doc. 31, ¶¶44, 51 & Ex. 18-J (Sch. 1, ¶2(2) & ¶6).) "Total profits," in turn, referred to the company's "profit on ordinary activities after tax," as determined under U.K. financial accounting principles and as reflected in the company's profit and loss accounts prepared in accordance with the U.K. Companies Act 1985. (Doc. 31, ¶50 & Ex. 18-J (Sch. 1, ¶5).)

The second value for determining the windfall amount (referred to as the flotation value) was determined by multiplying the highest price per share at which shares in the company were offered during flotation by the number of shares that were offered. (Doc. 31, ¶52 & Ex. 18-J (Sch. 1, ¶3).)

The windfall tax was a "one-off" (*i.e.,* one time) tax that was required to be paid in two installments: one-half by December 1, 1997,

and the other half by December 1, 1998. (Doc. 31, ¶13 & Ex. 18-J (Sch. 2, ¶3).)

C. London Electricity's payment of the windfall tax

For purposes of determining its windfall-tax liability, London Electricity's initial period was four full financial years (the years ending March 31, 1992, 1993, 1994, and 1995), which totaled 1,461 days. (Doc. 31, ¶71.) Its total profits for the initial period was £503.4 million, making its average annual profit £125,763,860 (*i.e.,* 365 x (£503.4 million ÷ 1461)). (*Id.* ¶¶72-73.) London Electricity's profit-making value was thus £1,131,874,760 (*i.e.*, its average annual profit x 9). (*Id.* ¶74.)

London Electricity's flotation value was £523,341,600 (*i.e.,* 218,059,000 shares multiplied by £2.40 per share). (*Id.* ¶75.) Its windfall was thus £608,533,140 (*i.e.,* its profit-making value minus its flotation value). (*Id.* ¶76.) This resulted in a windfall tax liability of £139,962,622 (*i.e.,* 23 percent of the windfall). (*Id.* ¶77.) As required by the Act, London Electricity paid the tax in two installments, in December 1997 and December 1998. Based on the exchange rate in

effect on the payment dates, London Electricity's total windfall tax payment was approximately $234 million. (*Id.* ¶13.)

D. The proceedings below

In an amended federal income tax return filed for 1998, taxpayer claimed that it was entitled to a foreign tax credit of $234,290,431 for the windfall tax paid by London Electricity pursuant to I.R.C. §§ 901 and 902. (Doc. 31, ¶18.) In a notice of deficiency issued to taxpayer, the IRS disallowed the claimed credit. (Doc. 31, Ex. 9-R.) Taxpayer filed a petition in the Tax Court contesting the notice of deficiency. (Doc. 1.)

1. The parties' arguments

The Commissioner argued that the windfall tax was not a creditable foreign tax because it did not satisfy any of the requisite factors set forth in the pertinent Treasury regulation, Treas. Reg. § 1.901-2 (26 C.F.R.), for a foreign levy to qualify as an income tax in the U.S. sense, *i.e.,* the realization test, the gross-receipts test, and the net-income test. The Commissioner further argued that, in applying the regulatory test, the court should consider only the language of the windfall-tax statute, and not extrinsic evidence, such as the opinions of

Geoffrey Robinson and the Andersen team as to the intention of the drafters and the actual effect of the tax on the windfall companies. The Commissioner argued that the base of the windfall tax, as set forth in the statute, was the difference between two values (*i.e.,* the actual flotation value and an imputed value that should have been placed on the companies at the time of flotation). Thus, the Commissioner argued, the tax was not imposed upon or after the occurrence of events that would result in the realization of income under U.S. tax principles. And because the windfall-tax base was the difference between these values, the Commissioner argued, it was not a tax that was imposed on the basis of gross receipts or net income.

Taxpayer argued that in applying the regulatory test, the court should consider extrinsic evidence to determine both the intent and the actual effect of the windfall tax, which, taxpayer argued, showed that the windfall tax was in substance a tax on net income or excess profits. Taxpayer offered Geoffrey Robinson's testimony to the effect that the rationale for the windfall tax was the perceived excess profits that the privatized utilities had earned during their initial period and that the actual form of the tax was adopted merely for "presentational"

purposes. Taxpayer also argued that the testimony of its accounting expert established that the windfall tax fell on the excess profits that the windfall companies had realized during their initial periods. Relying on its expert's mathematical reformulation of the windfall-tax computation, taxpayer submitted that, in almost every case in which it applied, the windfall tax was equal to 51.7% of those profits of a windfall company that exceeded one-ninth of the flotation price of the company.

2. The Tax Court's opinion

The Tax Court issued a short opinion in favor of taxpayer, in which it expressly relied on its much longer opinion in *PPL,* 135 T.C. No. 15, issued the same day. (Doc. 59.) *PPL* also involved a U.S. energy company that had claimed a foreign tax credit for its British subsidiary's payment of the U.K. windfall tax. The court's opinion in this case (*Entergy*) stated that the windfall-tax issue "is identical to the issue in PPL Corp. & Subs. v. Commissioner, 135 T.C. _ (2010), which we also decide today. Moreover, the material facts with respect to that issue are identical to the corresponding facts in PPL. . . . We rely on

PPL in holding for petitioner on the windfall tax issue."[3] (Doc. 59 at 2-3.)

In the *PPL* opinion, the Tax Court first rejected the Commissioner's contention that the court should not consider extrinsic evidence of legislative purpose and the actual effect of the windfall tax in determining whether the tax was creditable. The court observed that the relevant Treasury regulation defines a creditable foreign tax as one whose "predominant character" is that of an income tax in the U.S. sense, and further states that a foreign levy satisfies the predominant-character test if it is "likely to reach net gain in the normal circumstances in which it applies." (PPL Op. 48.) The court reasoned that the drafters of the regulation "clearly signaled their intent that factors extrinsic to the text of the foreign tax statute play a role in the determination of the tax's character" (*id.*), and it believed that this conclusion was consistent with the case law both preceding and following the issuance of the regulation in 1983 (*id.* at 49-53).

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[3] Both *PPL* and this case were tried before the same judge. The trial in *PPL* was held approximately six months after the trial in this case.

The Tax Court next considered both "the design and incidence" of the windfall tax and was persuaded that its "predominant character" was "a tax on excess profits." (PPL Op. 55.) As for the design of the tax, the court placed great emphasis on the statements of Peter Lilley, the Conservative Party's Shadow Chancellor of the Exchequer, who said, during the Parliamentary debate of the legislation, that the British Government "had taken average profits over four years after flotation," and "[i]f those profits exceeded one-ninth of the flotation value, the company will pay windfall tax on the excess." (*Id.* at 56-57, internal quotations omitted.) The Tax Court was thus of the view that even though, by its terms, the windfall tax was ostensibly imposed on the difference between two values, that did not foreclose its predominant character from being directed at net gain or income. (*Id.* at 57-58.) At bottom, the court said, the "architects and drafters of the tax knew (1) exactly which companies the tax would target, (2) the publicly reported after-tax financial profits of those companies, which were a crucial component of the tax base, and (3) the target amount of revenue the tax would raise." (*Id.* at 58.)

The court also thought that Parliament was aware that the effect of the legislation, for 29 of the 31 companies that paid the tax, was to impose a tax at a rate of approximately 51.7% on deemed annual excess profits. (PPL Op. 58.) The court dismissed the Commissioner's objection to PPL's algebraic reformulation of the tax (which was identical to the algebraic reformulation offered by taxpayer's expert in the instant case). The court said that the reformulation was not an impermissible rewrite of the statute, but instead was "a legitimate means of demonstrating that Parliament did, in fact, enact a tax that operated as an excess profits tax for the vast majority of the windfall tax companies." (*Id.* at 59.) The court concluded that the tax reached net gain in the normal circumstances in which it applied, and that its predominant character was that of an income tax in the U.S. sense. (*Id.* at 60.)

SUMMARY OF ARGUMENT

The Tax Court erred in ruling that the U.K. windfall tax was a creditable tax under I.R.C. § 901. The applicable Treasury regulation, Treas. Reg. § 1.901-2, provides that a foreign levy is a creditable income tax if its predominant character is that of U.S. income tax. The regulation sets forth a mandatory three-part test for determining whether the predominant-character standard is met, *i.e.,* the realization test, gross-receipts test, and net-income test. The Tax Court acknowledged this regulatory test but then wholly failed to apply it in ruling that the predominant character of the windfall tax was that of an excess profits tax. As we shall demonstrate, the windfall tax failed to meet each of the three tests, all of which had to be met for the tax to be creditable.

The realization test requires a foreign levy to be imposed on or subsequent to the occurrence of an event that would result in the realization of income under the Internal Revenue Code. By its plain terms, the windfall tax was imposed on a statutorily determined "windfall" amount, equal to the difference between a company's profit-making value and its flotation value. Thus, the windfall tax was

imposed on company *value*, and not on a company's *income*. As this Court has recognized, the Internal Revenue Code generally does not tax unrealized appreciation in property value. And even though a company's total profits during its initial period was a factor in determining profit-making value, the windfall tax was not imposed on those past profits. As discussed herein, a tax on income-producing property does not become an income tax simply because the property's value is calculated for tax purposes by reference to the amount of income the property generates. And in this case, London Electricity's taxable windfall amount exceeded its total profits during the initial period by more than £100 million. Thus, the windfall tax was—in fact—imposed on something other than London Electricity's previously realized income. In short, the windfall tax failed to meet the realization test.

The windfall tax also failed to meet the gross-receipts and net-income tests of the Treasury regulation. The gross-receipts test requires the foreign tax to be imposed "on the basis of gross receipts," and the net-income test requires the "base of the tax" to be computed by reducing gross receipts by the expenses attributable to such receipts.

In determining whether these two tests are met, it is clear that the actual tax base of the foreign tax must be examined. Here, the base of the windfall tax was the difference between a company's profit-making value and its flotation value. Neither gross receipts nor expenses were components of the tax base. Thus, the windfall tax failed to meet the gross-receipts and net-income tests.

Instead of applying the three-part test mandated by the Treasury regulation, the Tax Court applied its own test for determining the predominant character of the windfall tax. As discussed in detail below, the court relied heavily on what it perceived to be the legislative purpose of the tax, and on a mathematical reformulation of the windfall-tax computation proffered by taxpayer's expert, in ruling that the windfall tax was a tax on excess profits. The court dismissed the actual text of the windfall-tax statute as political window dressing, instead basing its determination almost entirely on extrinsic evidence of Parliament's purported intent. This was legal error.

The Tax Court's decision is wrong and should be reversed.

ARGUMENT

The Tax Court erred in ruling that the U.K. windfall tax was a creditable foreign tax under I.R.C. § 901

Standard of review

The Tax Court's ruling that the U.K. windfall tax was a creditable tax under I.R.C. § 901 is a legal ruling reviewed *de novo*. *See, e.g., Riggs Nat'l Corp & Subsidiaries v. Commissioner*, 163 F.3d 1363 (D.C. Cir. 1999).

A. Treas. Reg. § 1.901-2(b) defines a creditable income tax for purposes of I.R.C. § 901

Section 901 of the Internal Revenue Code allows a domestic corporation to claim a credit against its United States income tax liability for "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." I.R.C. § 901(a) & (b)(1). Section 902 of the Code provides that if a domestic corporation owning at least 10 percent of the stock of a foreign corporation receives a dividend from the foreign corporation, the domestic corporation is deemed to have paid a portion of any foreign income tax that the foreign corporation paid on the earnings and profits out of which the dividend was paid. It is under this latter provision

that Entergy claimed a foreign tax credit for the U.K. windfall tax paid by London Electricity. (Doc. 31, ¶¶14-18.)

The goal of the foreign tax credit is to eliminate double taxation of foreign-source income. *Burnet v. Chicago Portrait Co.,* 285 U.S. 1, 7 (1932); *Anderson, Clayton & Co. v. United States*, 562 F.2d 972, 978 (5th Cir. 1977). What constitutes a creditable foreign income tax under I.R.C. § 901 is a question that has given rise to frequent litigation. As the Tax Court said in *Bank of Am. Nat'l Trust & Savings Ass'n v. Commissioner*, 61 T.C. 752, 759 (1974), *aff'd,* 538 F.2d 334 (9th Cir. 1976), "[t]he reaches of the word 'income' in section 901(b)(1) have been the subject of a long and tortuous history" "permeated" with "vagaries, confusion, and seeming contradictions." In 1983, the Treasury issued a regulation, Treas. Reg. § 1.901-2, to provide greater clarity as to what constitutes a creditable foreign tax. *See* T.D. 7918, 48 Fed. Reg. 46272 (Oct. 12, 1983).

As relevant in this case, under the regulation, a foreign levy is a creditable income tax "if and only if . . . [t]he predominant character of that tax is that of an income tax in the U.S. sense." Treas. Reg. § 1.901-2(a)(1)(ii) (*see* Addendum for full text). The predominant

character of the U.S. income tax is a familiar concept. In the United States, the base of the income tax is net, or "taxable" income, *see* I.R.C. § 1, which is defined as gross income minus allowable deductions, *see* I.R.C. § 63. The statutory rate of the income tax is then applied to that tax base. I.R.C. § 1. *See also* Boris I. Bittker, Martin J. McMahon, Jr., & Lawrence Zelnick, *Federal Income Taxation of Individuals*, ¶2.01[4] at 2-7 (3d ed. 2002) ("Taxable income is the base to which the statutory rate is applied.").

Consistent with this familiar concept of the U.S. income tax, the regulation provides that the predominant-character standard is met if "within the meaning of [Treas. Reg. § 1.901-2(b)], the foreign tax is likely to reach net gain in the normal circumstances in which it applies." Treas. Reg. § 1.901-2(a)(3)(i). To meet this "net gain" standard, a foreign tax *must* satisfy each of the three tests set forth in the regulation; a realization test, a gross-receipts test, and a net-income test. Section 1.901-2(b)(1) thus states that:

> A foreign tax is likely to reach net gain in the normal circumstances in which it applies *if and only if* the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income

> requirements set forth in paragraphs (b)(2), (b)(3), and (b)(4), respectively, of this section.

(Emphasis added.) The Treasury Decision adopting the regulation emphasizes that "[a]ll of these tests must be met in order for the predominant character of the foreign tax to be that of an income tax in the U.S. sense." T.D. 7918, 48 Fed. Reg. 46272-01. Each test is discussed below.

B. The U.K. windfall tax does not meet any of the three subtests of Treas. Reg. § 1.901-2(b)(1)

As the Tax Court recognized (PPL Op. 48, 60-61), the ultimate question in this case is whether the U.K. windfall tax was "likely to reach net gain in the normal circumstances in which it applies" within the meaning of the Treasury regulation. In making that determination, the court was required to apply the three-part test set forth in Treas. Reg. § 1.901-2(b)(1). Indeed, the regulation states—in mandatory terms—that a "foreign tax is likely to reach net gain in the normal circumstances in which it applies *if and only if* the tax . . . satisfies each of the realization, gross receipts, and net income requirements[.]" Treas. Reg. § 1.901-2(b)(1) (emphasis added). There was no suggestion in this case that the regulation is inapplicable or invalid, and the Tax

Court was required to accord the regulation *Chevron* deference. *See Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704 (2011). Moreover, "[b]ecause § 901's exemption from taxation is 'a privilege extended by legislative grace,'" the regulation had to be "strictly construed." *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209, 214 (2d Cir. 1999) (quoting *Inland Steel Co. v. United States*, 677 F.2d 72, 79 (Ct. Cl. 1982)).

Instead, the Tax Court paid only lip service to the regulation. Although it discussed the regulation in summarizing the relevant legal principles (PPL Op. 24-26), the court went on to apply its own test for determining the predominant character of the windfall tax. Thus, the court considered at length the historical background and purpose of the windfall tax and its effect on the companies subject to the tax. It made no effort whatsoever to explain whether the windfall tax met any of the three regulatory subtests, all of which had to be met for the tax to be creditable. As explained below, the windfall tax does not meet any of the three subtests.

1. The windfall tax does not meet the realization test

As relevant here, a foreign tax satisfies the realization test if "it is imposed upon or subsequent to the occurrence of events ('realization events') that would result in the realization of income under the income tax provisions of the Internal Revenue Code." Treas. Reg. § 1.901-2(b)(2)(i)(A). Under U.S. tax principles, the concept of realization generally comes into play in the case of property held by the taxpayer (such as stock or real property) that has appreciated in value from one tax period to the next. Although economists may consider this increase in value to be income, mere "unrealized" appreciation (with rare exceptions) is not subject to tax under U.S. law. *See Cottage Sav. Ass'n v. Commissioner,* 499 U.S. 554, 559 (1991); *Weiss v. Wiener*, 279 U.S. 333, 335 (1929). Rather, the Internal Revenue Code taxes gain from property when the gain has been realized (and, more precisely, "recognized") through a sale or other disposition of the property. *See* I.R.C. § 1001; *Cottage Sav. Ass'n,* 499 U.S. at 559; *Cox v. Commissioner*, 68 F.3d 128, 134 (5th Cir. 1995) (foreclosure sale was the "definitive event that establishes gain or loss") (internal quotations omitted); *San*

Antonio Sav. Ass'n v. Commissioner, 887 F.2d 577, 581-92 (5th Cir. 1989) (discussing at length whether an exchange of properties is a realization event); *see generally* 1 Boris I. Bittker & Lawrence Lokken, *Federal Taxation of Individuals, Estates, and Trusts,* ¶ 5.2 (3d ed. 1999).

In this case, the windfall tax was not imposed upon or subsequent to any realization event. By its terms, the windfall tax was imposed upon a deemed "windfall" amount, equal to the difference between a company's profit-making value and its flotation value. In other words, the tax was imposed on the company's statutorily determined foregone value. It is well-established that under U.S. tax law, a tax on value or appreciation is not a tax on realized income (and thus does not have the predominant character of an income tax in the U.S. sense). *See Cottage Sav. Ass'n*, 499 U.S. at 559; *Tatum v. Commissioner*, 400 F.2d 242, 247 (5th Cir. 1968) ("Thus far Congress has not seen fit to tax unrealized appreciation in property value.").

Nor was the windfall tax a tax upon previously realized income. The fact that a company's profit-making value was determined by reference to past profits does not convert the windfall tax into a tax on

those past profits. Indeed, a tax on income-producing property does not become an income tax simply because the property's value is calculated for tax purposes by reference to the amount of income the property generates. As the Court of Claims stated in *Inland Steel*, "[t]axes plainly on subjects other than income, even though measured to some extent by income, are not income taxes." 677 F.2d at 80. *See also F.W. Woolworth Co. v. United States*, 91 F.2d 973, 976 (2d Cir. 1937) ("A tax levied upon the use of land -- however described -- is not an 'income tax' of the kind here intended; it is not paid upon accumulated profits except by the fiction of treating the value of the land when occupied as a profit."). And the Supreme Court recognized long ago that a tax on the value of property is fundamentally different from a tax on income from property. *See New York ex rel. Cohn v. Graves*, 300 U.S. 308, 314 (1937) ("The incidence of a tax on income differs from that of a tax on property. . . . The two taxes are measured by different standards, the one by the amount of income received over a period of time, the other by the value of the property at a particular date."); *see also South Carolina v. Baker*, 485 U.S. 505, 519-20 (1988) & *Graves v. New York ex*

rel. O'Keefe, 306 U.S. 466, 480-81 (1939) (repudiating the notion "that a tax on income is legally or economically a tax on its source").

Here, the windfall-tax statute employed "average annual profit" solely as a component in determining profit-making *value*. Specifically, the statute provided that profit-making value was to be determined by multiplying the "the applicable price-to-earnings ratio" of 9 by "average annual profit." As the Commissioner's accounting expert, Peter Ashton, explained, this formulation is widely used in determining company value. He stated that the statutory formula for profit-making value "is identical to the market multiples method for computing the value of a firm, or more precisely the equity (stock) value of the firm" (Ex. 75-R at 13), and that "[m]ultiples such as the P/E [price-to-earnings] ratio are frequently used in valuation analyses and are viewed as an accurate means to determine value," citing to numerous valuation treatises and articles in support (*id.* at 14-15). Indeed, U.S. case law is replete with instances in which a company's value was determined by computing a multiple of net earnings, where the multiple was a price-to-earnings ratio. *See, e.g., Winn-Dixie Montgomery, Inc. v. United States,* 444 F.2d 677, 685 n.13 (5th Cir. 1971); *Berens v. Ludwig*, 106 F.3d 1144, 1146

(7th Cir. 1998); *Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R.*, 875 F.2d 549, 552-53 (6th Cir. 1989); *Lamborn v. Dittmer*, 873 F.2d 522, 533-34 (2d Cir. 1989); *United States v. United Foam Corp.*, 618 F.2d 577, 580-81 (9th Cir. 1980); *Holmes v. Bateson*, 583 F.2d 542, 562-63 (1st Cir. 1978). And Inland Revenue's bulletin summarizing the windfall tax confirms that the statutory formula for profit-making value was intended to yield company value: "Company value will be calculated by multiplying average annual profits after tax over the period by a price/earnings ratio of 9."[4] (Doc. 31, Ex. 16-P, ¶3 & Ex. 17-P, ¶9.) Thus, it is clear that "average annual profit" was merely a factor in determining value, and was not the direct object of the windfall tax.

Moreover, it is noteworthy that London Electricity's total profits for the initial period was £503.4 million, but its taxable windfall

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[4] Ashton also pointed out in his report that London Electricity's profit-making value of £1.13 billion (as determined under the windfall-tax statute) was very close to the actual price Entergy paid in 1997 to acquire London Electricity (*i.e.* £1.23 billion). (Ex. 75-R at 6.) He stated that "[t]his is an indication that the profit-making value may reflect a reasonable estimate of the value of the company based on 1992-1995 earnings, i.e., at a period in time slightly before Entergy's purchase of London Electricity in 1997." (*Id.*)

amount was £608.5 million—over £100 million *more* than its total profits. The fact that the tax base for the windfall tax substantially *exceeded* total profits for the initial period refutes any notion that the windfall tax was imposed upon past profits (or upon excess profits, which necessarily would be less than total profits). Clearly, the windfall tax was imposed upon something else. As previously discussed, it was imposed upon a company's statutorily determined foregone value. Even though income was taken into account in determining that value, that does not convert the windfall tax into an income tax.

Finally, the windfall tax also was not imposed "subsequent to" any realization event. Treas. Reg. § 1.901-2(b)(2)(i)(A). By its terms, it was imposed upon "[e]very company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation." (Doc. 31, Ex. 18-J (Part 1, ¶1(1)).) The relevant event thus was the company's privatization, but the sale of shares was not a realization event to the company under U.S. tax law. As this Court has stated, "a formal change in ownership is not enough to trigger realization." *San Antonio*

Sav., 887 F.2d at 584; *see also Weiss v. Stearn*, 265 U.S. 242 (1924) (no realization event where the assets of a corporation were transferred to a new corporation formed under the same state law, money was transferred from new investors to the old shareholders, and at the end, the old shareholders and the new investors each held 50% of the stock in the new corporation).[5]

2. The windfall tax does not meet the gross-receipts test or the net-income test

As relevant here, a foreign tax satisfies the gross-receipts test if "it is imposed on the basis of gross receipts." Treas. Reg. § 1.901-2(b)(3)(i)(A). The regulation thus requires that, consistent with the predominant character of a U.S. income tax, gross receipts (or gross income) be the starting point for determining the base of the foreign tax. *See, e.g., United States v. Waterman Steamship Corp.,* 330 F.2d

[5] Moreover, under U.K. tax law, the privatization was a tax-free event for the windfall companies. Although the companies ordinarily would have been subject to a U.K. tax on their unrealized built-in gains upon privatization, with a stepped-up basis for purposes of determining future taxable gain or loss, Parliament exempted the companies from that particular tax when it privatized them. U.K. Electricity Act 1989 (July 27, 1989), Schedule 11, *available in,* http://www.legislation.gov.uk/ukpga/1989/29/schedule/11.

128, 130 (5th Cir. 1964) ("In the interpretation of the term 'income tax,' the Commissioner, the Board, and the courts have consistently adhered to a concept of income tax rather closely related to our own, and if such foreign tax was not imposed upon a basis corresponding approximately to net income it was not recognized as a basis for such credit.") (quoting S. Rep. No. 77-631, at 131 (1942)); *Missouri Pac. R.R. Co. v. United States*, 392 F.2d 592, 597 (Ct. Cl. 1968) ("to be creditable . . . the foreign tax must be the substantial equivalent of an income tax as the term is understood in the United States"). As discussed above, the basis of the windfall tax was the difference between a company's profit-making value and its flotation value. The windfall-tax statute makes no mention at all of gross receipts or gross income.

And, again, although a company's total profits during its initial period was a component in determining profit-making value, the windfall tax was not imposed on those total profits. As explained above, London Electricity's taxable windfall amount exceeded its total profits during its initial period by over £100 million. *See, e.g.,* Treas. Reg. § 1.901-2(b)(3)(ii), Ex. 3 (in a hypothetical tax on "income from the extraction of petroleum," if "gross receipts from extraction income are

deemed to equal 105 percent of the fair market value of petroleum exacted," the gross receipts test is not met because the "computation is designed to produce an amount that is greater than the fair market value of actual gross receipts"). It is also of no moment that total profits, which referred to a company's book earnings as reflected in its U.K. financial statements for the years comprising the initial period, presumably was calculated by reference to gross receipts when the financial statements were prepared. As previously discussed, total profits was only a factor in computing a company's profit-making value, and a tax on the value of property is fundamentally different from a tax on income. Moreover, the windfall tax was imposed on the *difference* between profit-making value and flotation value. Thus, the tax base for the windfall tax was completely divorced from any traditional concept of gross receipts.

Based on the foregoing, the windfall tax also fails to meet the net-income test. As relevant here, a foreign tax satisfies the net-income test if "the base of the tax is computed by reducing gross receipts . . . to permit recovery of the significant costs and expenses . . . attributable, under reasonable principles, to such gross receipts." Treas. Reg.

§ 1.901-2(b)(4)(i)(A). In other words, like the U.S. income tax, where taxable income is computed by reducing gross income by allowable deductions, *see* I.R.C. § 63(a), so too must the foreign tax base be computed by reducing gross receipts by expenditures, to yield net income. Here, the base of the windfall tax was profit-making value less flotation value. Neither gross receipts nor allowable expenditures were elements of the tax base. Thus, the windfall tax cannot meet the net-income test of the regulation.

In sum, because the Treasury regulation *requires* a foreign tax to satisfy the realization, gross-receipts, and net-income tests in order to be creditable, the Tax Court committed legal error by deciding this case without any consideration of those tests. As explained above, the windfall tax does not satisfy *any* of the tests, and therefore it is not a creditable income tax under I.R.C. § 901.

3. The regulatory test cannot be satisfied merely by comparing the final foreign tax liability to the taxpayer's net income

The Tax Court did understand, to be sure, that whether the windfall tax was likely to reach net gain in the normal circumstances in which it applied is the standard set forth in the regulation. (PPL Op.

60-61.) But rather than follow the regulatory requirements for determining whether that standard was met, the Tax Court compared the actual tax liabilities of the privatized utilities to their book income during the initial period and concluded that because the windfall tax liability did not exceed any company's book income, the windfall tax "reached" net gain. (*Id.* at 58-59, 61.) The effect of the court's opinion thus was to disregard how the windfall tax liability was calculated (*i.e.,* the actual base of the tax), and look merely to the final, absolute number and compare that number to book income. Because the final number was less than book income (such that the tax was not confiscatory of net gain), the tax was treated as "reaching" net gain. Thus, the court observed twice that "none of the 31 companies that paid windfall tax had a windfall tax liability in excess of its total profits over its initial period." (*Id.* at 55 & 59.)

But the test for creditability cannot be reduced to a simple determination of whether the tax imposed exceeds the total amount of net gain. If so, virtually any foreign tax could be creditable—regardless of how it is computed—as long as it does not exceed net gain. The regulation, in contrast, requires inquiry into *how* the tax is computed,

in particular, whether the tax base is gross receipts reduced by the expenses attributable to those receipts. *See* Treas. Reg. § 1.901-2(b)(3) & (4). Indeed, that is the essence of an income tax in the U.S. sense.

C. The Tax Court improperly substituted consideration of Parliamentary intent and a mathematical reformulation of the windfall tax for evaluation of the statutory tax base

The Tax Court wholly failed to apply Treas. Reg. § 1.901-2(b) and instead applied its own test for determining the predominant character of the windfall tax. In particular, the court relied heavily on what it perceived to be the legislative purpose of the tax, and on a mathematical reformulation of the windfall-tax computation proffered by taxpayer's expert, in ruling that the windfall tax was a tax on excess profits. The court dismissed the actual text of the windfall-tax statute as political window dressing. The court's inquiry into legislative purpose, however, cannot displace an analysis of whether the base of the windfall tax was calculated on the basis of net gain—which is the only way the tax could have the predominant character of an income tax in the U.S. sense.

1. The court gave virtually no weight to the actual text of the windfall-tax statute

After acknowledging that "the amount of the windfall for purposes of determining the windfall tax is, in mathematical terms, the excess (if any) of one value (value in profit-making terms) over another (flotation value)," the Tax Court immediately dismissed this statutory formulation, stating that "however we describe the form of the windfall tax base, our inquiry as to the design and incidence of the tax convinces us that its predominant character is that of a tax on excess profits." (PPL Op. 54-55.) It is thus fair to say that the Tax Court gave little—if any—weight to the actual text of the windfall-tax statute as enacted by Parliament in determining its predominant character. This was legal error, as the governing regulations require the three-part test to be applied to the tax base as defined by the foreign statute. And on this point, it is beyond cavil that the strongest indicator of legislative intent is the plain language of a statute. *See United States v. Clintwood Elkhorn Mining Co.*, 553 U.S. 1, 11 (2008) ("The strong presumption that the plain language of the statute expresses congressional intent is rebutted only in rare and exceptional circumstances.") (internal

quotations omitted); *Johnson v. Sawyer*, 120 F.3d 1307, 1319 (5th Cir. 1997) ("[W]e follow the plain meaning of a statute unless it would lead to a result so bizarre that Congress could not have intended it.") (internal quotations omitted).

As the Tax Court acknowledged, whether the windfall tax was intended to be a tax on excess profits or a tax on the undervaluation of the windfall companies when they were privatized is largely semantic. (PPL Op. 55-56.) As the court stated, "[t]he reasons are equivalent because each subsumes the other." (*Id.* at 55.) Both types of tax would have achieved the same overarching goal of recouping for British taxpayers funds that were perceived to be rightfully theirs. In that case, what *does* matter is the manner in which Parliament chose to recoup those funds, and it plainly did so by enacting a 23 percent tax on the difference between two imputed values. The federal tax consequences depend on what was actually done, and not on what could have been done.

In this regard, this Court's recent decision in *AT&T, Inc. v. United States*, 629 F.3d 505 (5th Cir. 2011), *petition for cert. filed,* 2011 WL 1296145 (S. Ct. April 4, 2011) (No. 10-1204), is instructive. The

issue in that case was whether government subsidies paid to telecommunications carriers pursuant to the Telecommunications Act of 1996 were taxable income to the carriers or non-taxable contributions to capital under I.R.C. § 118. The proper tax treatment turned on the intent of the payor—Congress. AT&T argued that the subsidies were intended to induce investment in the telecommunications network infrastructure and, thus, were capital contributions. The Government, relying primarily on the regulatory orders establishing the payment mechanisms, argued that the subsidies were intended to supplement carriers' operating income and, thus, were taxable.

The district court had granted summary judgment for the Government, and on appeal, AT&T argued that a genuine issue of material fact existed as to Congress's intent in paying the subsidies. 629 F.3d at 510. This Court rejected the argument and affirmed. *Id.* at 511. The Court stated at the outset that "[w]hen the transferor is a governmental entity, its intent may be manifested by the laws or regulations by which it effectuates the payment to the corporation." *Id.* at 511 & 514. The Court then reviewed the relevant statutes,

administrative orders, regulations, and payment formulas, and it held that those legal authorities demonstrated a governmental intent to supplement carriers' income. *Id.* at 514-17. *AT&T* stands for the clear proposition that the legislature's intent is reflected in the law as enacted.

This point was expressly made by the Eleventh Circuit in a similar case involving the federal income tax treatment of the same telecommunications subsidies. *See United States v. Coastal Utilities*, 514 F.3d 1184 (11th Cir. 2008), *adopting and aff'g,* 483 F. Supp. 2d 1232 (S.D. Ga. 2007). There, the court acknowledged that Congress hoped to induce investment in the telecommunications network, as urged by the taxpayer, but it observed that the *way* Congress chose to do so was by supplementing income, rather than by making a direct capital contribution. The court stated that "[t]here is more than one strategy that Congress and the FCC could have used to expand the network. The issue here is whether the universal service funds were directly paying for the infrastructure (capital), or whether the funds were providing an incentive to develop the network by offering a rate of return on the taxpayer's investment (income)." 483 F. Supp. 2d at

1247. The court observed that "the end result is the same–citizens in rural areas are offered telephone service," but that the precise "characterization of the payments" would yield different tax results. *Id.* at 1248. Like this Court in *AT&T*, the court in *Coastal Utilities* concluded that the payment formulas showed that the "payments are made as subsidies to income, not contributions to capital." *Id.*

Similarly, in *United States v. Miss. Chemical Corp.,* 405 U.S. 298 (1972), the Supreme Court was faced with the question whether stock in federally established farm banks was a capital asset, such that its cost was nondeductible, or whether some portion of the cost represented deductible interest. In making this determination, the Court focused on the features of the stock as designed by Congress, stating that "the stock was intentionally given these characteristics by a Congress with definite goals in mind." *Id.* at 308. The Court concluded that the "congressional scheme makes it clear that [the stock] has value over the long run," such that it was a capital asset for tax purposes. *Id.* at 310. Significantly, the Court stated that:

> *the form in which a transaction is cast must have considerable impact.* Congress chose to make the taxpayers buy stock; Congress determined that the stock was worth

> $100 a share; and this stock was endowed with a long-term value. While Congress might have been able to achieve the same ends through additional interest payments, it chose the form of stock purchases. *This form* assures long-term commitment and *has a bearing on the tax consequences of the purchases*.

Id. at 311-12 (emphasis added & internal citation omitted). *See also Eastern Service Corp. v. Commissioner*, 650 F.2d 379 (2d Cir. 1981) (applying the same rationale in ruling that Fannie Mae stock that mortgage seller-servicer was required to buy and retain was not a tax-deductible business expense); *Hills v. Commissioner*, 691 F.2d 997, 1005 (11th Cir. 1982) (rejecting the argument that theft loss should not be tax-deductible because it is the economic equivalent of paying insurance premiums, which are not tax-deductible, and stating that "Congress has seen fit to treat out-of-pocket losses differently from insurance coverage" and has "chosen to focus on the form of payment rather than economic substance").

In *AT&T*, *Coastal Utilities*, and *Mississippi Chemical*, the specific form chosen by Congress mattered and—for federal tax purposes—was determinative. So too here, the specific form chosen by Parliament matters. There was more than one strategy that Parliament could

have used to recoup the windfall enjoyed by the privatized companies, including a direct tax on excess profits or a tax on a specified windfall amount. (Indeed, the Andersen team identified at least six strategies. (Tr. 77-78.)) Parliament ultimately enacted a tax on the difference between a company's profit-making value and its flotation value. This chosen form should have been given primacy by the Tax Court, but the court dismissed it as mere political show. (PPL Op. 59, nn. 34 & 35.) This was legal error, and it opens the door for taxpayers to rewrite any foreign statute to mold it into a creditable income tax under I.R.C. § 901.

2. The Tax Court erred by relying on the mathematical reformulation of the windfall-tax computation proffered by taxpayer's expert

In this case, the Tax Court relied on a literal rewrite of the windfall-tax computation in ruling that the windfall tax was an excess-profits tax. This rewrite was created by taxpayer's accounting expert, Raymond Ball. (Tr. 157.) In his expert report, he expressed the windfall tax as an algebraic equation, *i.e.,*

Tax = [Initial Period Profit/4 x 9 - Flotation Value] x 23%,

which, through various mathematical iterations, he reorganized as:

$$\begin{aligned} \text{Tax} = \; & [\text{Profit}_{1992} - \text{Flotation Value}/9] \times 51.75\% \\ + \; & [\text{Profit}_{1993} - \text{Flotation Value}/9] \times 51.75\% \\ + \; & [\text{Profit}_{1994} - \text{Flotation Value}/9] \times 51.75\% \\ + \; & [\text{Profit}_{1995} - \text{Flotation Value}/9] \times 51.75\%. \end{aligned}$$

(Ex. 69-P at 7-9 & Ex. 70-P.) Critical to this reformulation is that "51.75% = 1/4 x 9 x 23%" (Ex. 69-P at 9 & Ex. 70-P), which causes the price-to-earnings ratio of 9 to be "cancelled out" of the equation. (*See* PPL Op. 39 & n.22, where the Tax Court further restated this equation with 9 completely factored out.) Ball opined that "this simple arithmetical rearrangement of the formula used to describe the calculation of the U.K. Windfall Tax shows that the tax in fact is levied on the utility's excess profits over four years, at the rate of 51.75 percent." (Ex. 69-P at 10.)

In its opinion,[6] the Tax Court latched on to this analysis, emphasizing that "for 29 of the 31 windfall tax companies that paid tax,

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[6] *I.e.,* the *PPL* opinion. In *PPL*, the taxpayer relied on the same mathematical reformulation of the windfall tax.

the effective rate of tax on deemed annual excess profits was at or near 51.7 percent." (PPL Op. 58.) The court rejected the Commissioner's argument that this mathematical reformulation of the windfall tax constitutes "an impermissible hypothetical rewrite" of the statute, stating that it represents "a legitimate means of demonstrating that Parliament did, in fact, enact a tax that operated as an excess profits tax for the vast majority of the windfall tax companies." (*Id.* at 59, internal quotations omitted.)

There are several problems with the Tax Court's approach. First, as discussed above, the court should have based its analysis on the statute as actually written by Parliament, not on a post-hoc reformulation by an expert witness in litigation eleven years later. Parliament could have—but did not—enact a direct 51.7% tax on, in the court's words, "deemed annual excess profits." (PPL Op. 58.) Rather, Parliament enacted a 23% tax on the difference between a deemed profit-making value and actual flotation value.

Second, Ball's reformulation did not merely reorganize statutory terms. Rather, it rewrote the U.K. statute by eliminating key terms, in particular, profit-making value and the price-to-earnings ratio. The

windfall-tax statute required multiplying the "the applicable price-to-earnings ratio" by "average annual profit" to determine a company's profit-making value. As previously discussed on pp. 28-29, *supra*, price-to-earnings ratios commonly are used in valuing a company, and Inland Revenue's bulletin summarizing the windfall tax confirms that the applicable price-to-earnings ratio was intended to yield company value: "Company value will be calculated by multiplying average annual profits after tax over the period by a price/earnings ratio of 9." (Doc. 31, Ex. 16-P, ¶3 & Ex. 17-P, ¶¶8-9.) Ball's reformulation factors out the price-to-earnings ratio (and the entire concept of profit-making value) so that the tax appears to be based solely on average annual profit. Removing the value concept from the windfall tax, however, substantively changes the statute. As previously discussed, a tax on property value is inherently different from a tax on income, and merely because a tax may be determined by reference to income does not make it an income tax. But the reformulation seeks to do just that; it isolates and spotlights the reference to income to make the windfall tax look like an income tax.

Moreover, the price-to-earnings ratio of 9 was not merely a random number in an algebra equation. Rather, it served a legislative purpose—a fact that Ball, who is not a lawyer or tax expert (Tr. 122), may not have grasped when he opined that the windfall tax could be mathematically rewritten (with the 9 factored out) and yet retain its original character. (Indeed, he stated in his report that "[w]hy the U.K. government formulated the tax calculation in the fashion it chose is unknown to me." (Ex. 69-P at 10.)) The U.K. Treasury's explanatory notes state that "the price-to-earnings ratio" of 9 was chosen because it "approximates to the lowest average sectoral price-to-earnings ratio of the companies liable to the tax." (Doc. 31, Ex. 17-P, ¶11.) During the Parliamentary debate of the windfall tax, Geoffrey Robinson repeatedly explained that "the basis of the tax – setting the price-to-earnings ratio at nine, slightly below the lowest sectoral average – shows a Government who are trying to be reasonable and fair in all respects."[7]

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[7] As set forth above (pp. 25-36), we maintain that the predominant character of the windfall tax is properly evaluated by applying the regulatory tests to the tax base of the windfall tax, which is unambiguously set forth in the plain language of the U.K. statute, and that resort to the legislative history is therefore unnecessary. We (continued...)

See House of Commons Hansard, vol. 298, col. 246 & col. 205, 243 (July 15, 1997).[8] Another Member of Parliament, Ross Cranston, whose comments were expressly endorsed by Robinson, also explained that the "Government have rightly taken the approach of a simple formula, as set out in the schedule" because "[a]ny other approach would open opportunities for [tax] avoidance." *Id.* at col. 229 & 246. Thus, there were bona fide governmental reasons for basing the windfall tax on the simple difference between two values and for using a price-to-earnings ratio of 9 in determining profit-making value. Rewriting the statute in a manner that eliminates these critical factors is a fundamental departure from what Parliament actually did.

Finally, the mathematical reformulation of the windfall-tax statute, which was conceived by Ball (Tr. 157), cannot be ascribed to

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[7](...continued)
rely on legislative history here only to rebut taxpayer's arguments and the Tax Court's analysis.

[8] House of Commons debates are officially recorded in the House of Commons Hansard (similar to the Congressional Record). Hansard is publicly available at http://www.parliament.uk/business/publications/parliamentary-archives/archives-electronic/parliamentary-debates/. The July 15, 1997 debate of the windfall tax also is included as an attachment to Robinson's expert report (Ex. 67-P, Tab 2).

Parliament as a whole. There is no evidence that this reformulation was in Parliament's collective mind when it enacted the statute (or even in the Andersen team members' minds when they developed a proposal for the tax). The statute itself contains no algebraic expressions of the windfall tax, other than a formula for determining "average annual profit" (*i.e.,* "A = 365 x P/D"). (Doc. 31, Ex. 18-J (Sch. 1, ¶2(2)).) The Tax Court seemed to think that Parliament understood that this mathematical reformulation properly reflected the windfall tax based on a single Parliament member's characterization of the tax during the debate (*i.e.,* Peter Lilley's comment that the Government had "taken average profits over four years after flotation" and "[i]f those profits exceed one ninth of the flotation value, the company will pay windfall tax on the excess"). (PPL Op. 57.) *See* House of Commons Hansard, vol. 298, col. 204 (July 15, 1997). But during the debate, Robinson specifically disavowed that characterization, stating that "[t]he windfall gain is not that in excess of nine, but that measured between the funds realised by the sale of shares on flotation day and the application of nine—which is the lowest—to the profits. We could not be fairer on any account." *Id.* at col. 205. And in any event, as

discussed in the next section, the views of a single Member of Parliament during a legislative debate cannot be ascribed to Parliament as a whole.

3. The Tax Court erred in according probative weight to the trial testimony of a single legislator and his paid consultants regarding the legislative purpose of the windfall tax

In elucidating the purpose of the windfall tax, the Tax Court took the unorthodox approach of relying upon the trial testimony of Geoffrey Robinson and two members of the Andersen team, Christopher Wales and Christopher Osborne.[9] For example, the court cited their testimony that Parliament enacted the windfall tax—as opposed to a straightforward tax on income— for "presentational" reasons. (PPL Op. 34-35, 60 n.35.) The court also twice cited the testimony of Osborne as supporting taxpayer's position. (PPL Op. 54 n.29, 56, n.30.) Reliance on that testimony was error.

It is elementary that legislative intent is to be determined from the plain language of a statute, and where the plain language is

[9] Robinson testified at the trial in this case, and his testimony was admitted as an exhibit in the *PPL* case. Wales and Osborne testified at the trial in *PPL*.

ambiguous, resort to the legislative history is permissible. In consulting the legislative history, however, there are limits. Courts look first to the committee reports that accompany a bill. To a lesser degree, they will consider the statements of individual legislators from the floor debates. Courts have cautioned that such statements often represent the views of only that legislator and cannot be attributed to Congress as a whole. *See United States v. O'Brien,* 391 U.S. 367, 384 (1968) ("What motivates one legislator to make a speech about a statute is not necessarily what motivates scores of others to enact it"); *Banco Mexicano de Commercio e Industria v. Deutsche Bank*, 263 U.S. 591, 602 (1924) ("an act of legislation is not the act of one legislator, and its meaning and purpose must be expressed in words"); *In re Davis*, 170 F.3d 475, 480 (5th Cir. 1999) ("Isolated statements of individual legislators represent neither the intent of the legislature as a whole nor definitive interpretations of the language enacted by Congress."). For this reason, the Tax Court's reliance on the statement of Peter Lilley, who was not even a member of the party that pushed for the windfall tax, is suspect, as is the court's unfounded attribution of Lilley's understanding to other "members of Parliament." (PPL Op. 56-57.)

Rarely, however, if ever, do courts give probative weight to the testimony of a legislator given years after enactment, such as the testimony of Robinson here, in determining legislative intent. *See Graham Co. Soil & Water Conservation District v. United States*, 130 S. Ct. 1396, 1409 (2010) (rejecting senator's post-enactment letter, stating that "this letter does not qualify as legislative 'history,' given that it was written 13 years after the amendments were enacted. It is consequently of scant or no value for our purposes."); *Bread Political Action Comm. v. FEC*, 455 U.S. 577, 582 n.3 (1982) (refusing to give probative weight to after-the-fact affidavit of amendment sponsor); *Foreman v. Dallas County, Tex.,* 193 F.3d 314, 322 (5th Cir. 1999) (rejecting district court's reliance on affidavits from legislators, stating that "[n]o one legislator, or even a group of three legislators, has sufficient personal knowledge to declare the overall intent of the Texas legislature"); *In re Davis*, 170 F.3d at 480 (senator's statements that post-date legislation by 12 years not probative of legislative intent); *Covalt v. Carey Canada, Inc.*, 860 F.2d 1434, 1438-39 (7th Cir. 1998) ("Legislative history generated in the course of litigation has even less utility, for it may be designed to mislead, to put an advocate's slant on

things."); *S.C. Educ. Ass'n v. Campbell*, 883 F.2d 1251, 1261-62 (4th Cir. 1989) (rejecting extensive testimony of legislative intent and collecting cases). And there is no principled basis for a federal court to consider the opinions of congressional staffers, lobbyists, and paid consultants (such as Osborne and Wales of the Andersen team) to determine what the legislature intended. Those opinions clearly cannot be attributed to the legislature, and they necessarily are tainted by the political and personal motives of a select few. *See W. Air Lines v. S.D. Bd. of Equalization*, 480 U.S. 123, 131, n. (1987) (rejecting affidavit of lawyer involved in legislative process, stating that "[a]ppellants' attempt at the creation of legislative history through the post hoc statements of interested onlookers is entitled to no weight"); *Bread Political Action Comm.*, 455 U.S. at 582 n.3 (1982) (giving no weight to affidavit by senator's executive assistant, who originally drafted legislation); *Covalt*, 860 F.2d at 1438-39 (rejecting affidavit by lobbyist, stating that "[l]egislative history is valuable only to the extent it reveals the background of the law and the assumptions shared by those who wrote and voted on the bills").

But that is precisely the sort of evidence that the Tax Court considered here. The court did not merely consider what Parliament intended in enacting the windfall tax. Instead, it considered the views of the individual Anderson employees who were paid to draft proposed legislation that met Robinson's stated objectives. And even if the views and objectives of Robinson and the Andersen team could be attributed to the Labour Party as a whole—which is refuted by the record—they certainly cannot be attributed to Parliament as a whole. (The notion that the views of a single congressman's staff in drafting a bill could be attributed to the entire Congress is patently ridiculous.) Indeed, despite all the evidence regarding the windfall-tax proposals considered by Robinson and the Andersen team, there is a complete dearth of evidence that any of these back-room discussions and drafting-table ideas were made known to Parliament as a whole. Based in part on the testimony of Robinson and the Andersen team, the court opined that the windfall tax was intended to be an excess-profits tax, and that it was packaged as a windfall tax solely for political "presentational" purposes. (PPL Op. 34-35, 56-59 & nn. 30, 35.) But there is no

evidence that in enacting the tax, Parliament was privy to that understanding between Robinson and the Andersen team.

In sum, the Tax Court went far beyond what could properly be considered in determining the legislative intent of the windfall tax.

CONCLUSION

Based on the foregoing, the Tax Court's decision is wrong and should be reversed.

Respectfully submitted,

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APRIL 2011

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ADDENDUM

Full text of Treas. Reg. § 1.901-2(a) & (b)

Treas. Reg. § 1.901-2

C

Effective: July 16, 2008

Code of Federal Regulations Currentness
Title 26. Internal Revenue
Chapter I. Internal Revenue Service, Department of the Treasury
Subchapter A. Income Tax
Part 1. Income Taxes (Refs & Annos)
Normal Taxes and Surtaxes
Tax Based on Income from Sources Within or Without the United States
Income from Sources Without the United States
Foreign Tax Credit
→ **§ 1.901-2 Income, war profits, or excess profits tax paid or accrued.**

(a) Definition of income, war profits, or excess profits tax--(1) In general. Section 901 allows a credit for the amount of income, war profits or excess profits tax (referred to as "income tax" for purposes of this section and §§ 1.901-2A and 1.903-1) paid to any foreign country. Whether a foreign levy is an income tax is determined independently for each separate foreign levy. A foreign levy is an income tax if and only if--

(i) It is a tax; and

(ii) The predominant character of that tax is that of an income tax in the U.S. sense.

Except to the extent otherwise provided in paragraphs (a)(3)(ii) and (c) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Paragraphs (a), (b) and (c) of this section define an income tax for purposes of section 901. Paragraph (d) of this section contains rules describing what constitutes a separate foreign levy. Paragraph (e) of this section contains rules for determining the amount of tax paid by a person. Paragraph (f) of this section contains rules for determining by whom foreign tax is paid. Paragraph (g) of this section contains definitions of the terms "paid by," "foreign country," and "foreign levy." Paragraph (h) of this section states the effective date of this section.

(2) Tax--(i) In general. A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax. Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto. Notwithstanding any assertion of a foreign country to the contrary, a foreign levy is not pursuant to a foreign country's authority to levy taxes, and thus is not a tax, to the extent a person subject to the levy receives (or will receive), directly or indirectly, a specific economic benefit (as defined in paragraph (a)(2)(ii)(B) of this section) from the foreign country in exchange for payment pursuant to the levy. Rather, to that extent, such levy requires a compulsory payment in exchange for such specific economic benefit. If, applying U.S. principles, a foreign levy requires a compulsory payment pursuant to the authority of a foreign country to levy taxes and also requires a compulsory payment in exchange for a specific economic benefit, the levy is considered to have two distinct elements: A tax and a requirement of compulsory payment in exchange for such specific economic benefit. In such a situation, these two distinct elements of the foreign levy (and the amount paid pursuant to each such element) must be separated. No credit is allowable for a payment pursuant to a foreign levy by a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) unless the

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person claiming such credit establishes the amount that is paid pursuant to the distinct element of the foreign levy that is a tax. See paragraph (a)(2)(ii) of this section and § 1.901-2A.

(ii) Dual capacity taxpayers--(A) In general. For purposes of this section and §§ 1.901-2A and 1.903-1, a person who is subject to a levy of a foreign state or of a possession of the United States or of a political subdivision of such a state or possession and who also, directly or indirectly (within the meaning of paragraph (a)(2)(ii)(E) of this section) receives (or will receive) a specific economic benefit from the state or possession or from a political subdivision of such state or possession or from an agency or instrumentality of any of the foregoing is referred to as a "dual capacity taxpayer." Dual capacity taxpayers are subject to the special rules of § 1.901-2A.

(B) Specific economic benefit. For purposes of this section and §§ 1.901-2A and 1.903-1, the term "specific economic benefit" means an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general. Thus, a concession to extract government-owned petroleum is a specific economic benefit, but the right to travel or to ship freight on a government-owned airline is not, because the latter, but not the former, is made generally available on substantially the same terms. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls (within the meaning of paragraph (a)(2)(ii)(D) of this section); or a reduction or discharge of a contractual obligation. It does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.

(C) Pension, unemployment, and disability fund payments. A foreign levy imposed on individuals to finance retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for some substantially similar purpose, is not a requirement of compulsory payment in exchange for a specific economic benefit, as long as the amounts required to be paid by the individuals subject to the levy are not computed on a basis reflecting the respective ages, life expectancies or similar characteristics of such individuals.

(D) Control of property. A foreign country controls property that it does not own if the country exhibits substantial indicia of ownership with respect to the property, for example, by both regulating the quantity of property that may be extracted and establishing the minimum price at which it may be disposed of.

(E) Indirect receipt of a benefit. A person is considered to receive a specific economic benefit indirectly if another person receives a specific economic benefit and that other person--

(1) Owns or controls, directly or indirectly, the first person or is owned or controlled, directly or indirectly, by the first person or by the same persons that own or control, directly or indirectly, the first person; or

(2) Engages in a transaction with the first person under terms and conditions such that the first person receives, directly or indirectly, all or part of the value of the specific economic benefit.

(3) Predominant character. The predominant character of a foreign tax is that of an income tax in the U.S. sense--

(i) If, within the meaning of paragraph (b)(1) of this section, the foreign tax is

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likely to reach net gain in the normal circumstances in which it applies,

(ii) But only to the extent that liability for the tax is not dependent, within the meaning of paragraph (c) of this section, by its terms or otherwise, on the availability of a credit for the tax against income tax liability to another country.

(b) Net gain--(1) In general. A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

(2) Realization--(i) In general. A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed--

(A) Upon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the Internal Revenue Code;

(B) Upon the occurrence of an event prior to a realization event (a "prerealization event") provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer; or

(C) Upon the occurrence of a prerealization event, other than one described in paragraph (b)(2)(i)(B) of this section, but only if the foreign country does not, upon the occurrence of a later event (other than a distribution or a deemed distribution of the income), impose tax ("second tax") with respect to the income on which tax is imposed by reason of such prerealization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the prerealization event) and--

(1) The imposition of the tax upon such prerealization event is based on the difference in the values of property at the beginning and end of a period; or

(2) The prerealization event is the physical transfer, processing, or export of readily marketable property (as defined in paragraph (b)(2)(iii) of this section).

A foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even if it is also imposed in some situations upon the occurrence of events not described in this paragraph (b)(2)(i). For example, a foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even though the base of that tax also includes imputed rental income from a personal residence used by the owner and receipt of stock dividends of a type described in section 305(a) of the Internal Revenue Code. As provided in paragraph (a)(1) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax; therefore, a foreign tax described in the immediately preceding sentence satisfies the realization requirement even though some persons subject to the tax will on some occasions not be subject to the tax except with respect to such imputed rental income and such stock dividends. However, a foreign tax based only or predominantly on such imputed rental income or only or predominantly on receipt of such stock dividends does not satisfy the realization requirement.

(ii) Certain deemed distributions. A foreign tax that does not satisfy the realization requirement under paragraph (b)(2)(i) of this section is nevertheless considered to meet the realization requirement if it is imposed with respect to a deemed distribution (*e.g.,* by a corporation to a shareholder) of

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amounts that meet the realization requirement in the hands of the person that, under foreign law, is deemed to distribute such amount, but only if the foreign country does not, upon the occurrence of a later event (*e.g.,* an actual distribution), impose tax ("second tax") with respect to the income on which tax was imposed by reason of such deemed distribution (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid with respect to the deemed distribution).

(iii) Readily marketable property. Property is readily marketable if--

(A) It is stock in trade or other property of a kind that properly would be included in inventory if on hand at the close of the taxable year or if it is held primarily for sale to customers in the ordinary course of business, and

(B) It can be sold on the open market without further processing or it is exported from the foreign country.

(iv) Examples. The provisions of paragraph (b)(2) of this section may be illustrated by the following examples:

Example 1. Residents of country X are subject to a tax of 10 percent on the aggregate net appreciation in fair market value during the calendar year of all shares of stock held by them at the end of the year. In addition, all such residents are subject to a country X tax that qualifies as an income tax within the meaning of paragraph (a)(1) of this section. Included in the base of the income tax are gains and losses realized on the sale of stock, and the basis of stock for purposes of determining such gain or loss is its cost. The operation of the stock appreciation tax and the income tax as applied to sales of stock is exemplified as follows: A, a resident of country X, purchases stock in June, 1983 for 100u (units of country X currency) and sells it in May, 1985 for 160u. On December 31, 1983, the stock is worth 120u and on December 31, 1984, it is worth 155u. Pursuant to the stock appreciation tax, A pays 2u for 1983 (10 percent of (120u-100u)), 3.5u for 1984 (10 percent of (155u-120u)), and nothing in 1985 because no stock was held at the end of that year. For purposes of the income tax, A must include 60u (160u-100u) in his income for 1985, the year of sale. Pursuant to paragraph (b)(2)(i)(C) of this section, the stock appreciation tax does not satisfy the realization requirement because country X imposes a second tax upon the occurrence of a later event (*i.e.,* the sale of stock) with respect to the income that was taxed by the stock appreciation tax and no credit or comparable relief is available against such second tax for the stock appreciation tax paid.

Example 2. The facts are the same as in example 1 except that if stock was held on the December 31 last preceding the date of its sale, the basis of such stock for purposes of computing gain or loss under the income tax is the value of the stock on such December 31. Thus, in 1985, A includes only 5u (160u-155u) as income from the sale for purposes of the income tax. Because the income tax imposed upon the occurrence of a later event (the sale) does not impose a tax with respect to the income that was taxed by the stock appreciation tax, the stock appreciation tax satisfies the realization requirement. The result would be the same if, instead of a basis adjustment to reflect taxation pursuant to the stock appreciation tax, the country X income tax allowed a credit (or other comparable relief) to take account of the stock appreciation tax. If a credit mechanism is used, see also paragraph (e)(4)(i) of this section.

Example 3. Country X imposes a tax on the realized net income of corporations that do business in country X. Country X also imposes a branch profits tax on corporations organized under the law of a country other than country X that do business in country X. The branch profits tax is imposed when realized net income is remitted or deemed to be remitted by branches in country X to home offices outside of country X. The branch profits tax is imposed subsequent to the occurrence of events that would result in realization of income (*i.e.,* by corporations subject to such tax) under the income tax provisions of the Internal Revenue Code; thus, in accordance with paragraph (b)(2)(i)(A) of this section, the branch profits tax satisfies the realization

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requirement.

Example 4. Country X imposes a tax on the realized net income of corporations that do business in country X (the "country X corporate tax"). Country X also imposes a separate tax on shareholders of such corporations (the "country X shareholder tax"). The country X shareholder tax is imposed on the sum of the actual distributions received during the taxable year by such a shareholder from the corporation's realized net income for that year (*i.e.,* income from past years is not taxed in a later year when it is actually distributed) plus the distributions deemed to be received by such a shareholder. Deemed distributions are defined as (A) a shareholder's pro rata share of the corporation's realized net income for the taxable year, less (B) such shareholder's pro rata share of the corporation's country X corporate tax for that year, less (C) actual distributions made by such corporation to such shareholder from such net income. A shareholder's receipt of actual distributions is a realization event within the meaning of paragraph (b)(2)(i)(A) of this section. The deemed distributions are not realization events, but they are described in paragraph (b)(2)(ii) of this section. Accordingly, the country X shareholder tax satisfies the realization requirement.

(3) Gross receipts--(i) In general. A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of--

(A) Gross receipts; or

(B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.

A foreign tax that, judged on the basis of its predominant character, is imposed on the basis of amounts described in this paragraph (b)(3)(i) satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph (b)(3)(i).

(ii) Examples. The provisions of paragraph (b)(3)(i) of this section may be illustrated by the following examples:

Example 1. Country X imposes a "headquarters company tax" on country X corporations that serve as regional headquarters for affiliated nonresident corporations, and this tax is a separate tax within the meaning of paragraph (d) of this section. A headquarters company for purposes of this tax is a corporation that performs administrative, management or coordination functions solely for nonresident affiliated entities. Due to the difficulty of determining on a case-by-case basis the arm's length gross receipts that headquarters companies would charge affiliates for such services, gross receipts of a headquarters company are deemed, for purposes of this tax, to equal 110 percent of the business expenses incurred by the headquarters company. It is established that this formula is likely to produce an amount that is not greater than the fair market value of arm's length gross receipts from such transactions with affiliates. Pursuant to paragraph (b)(3)(i)(B) of this section, the headquarters company tax satisfies the gross receipts requirement.

Example 2. The facts are the same as in Example 1, with the added fact that in the case of a particular taxpayer, A, the formula actually produces an amount that is substantially greater than the fair market value of arm's length gross receipts from transactions with affiliates. As provided in paragraph (a)(1) of this section, the headquarters company tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Accordingly, the result is the same as in example 1 for all persons subject to the headquarters company tax, including A.

Example 3. Country X imposes a separate tax (within the meaning of paragraph (d) of this section) on income from the extraction of petroleum. Under that tax, gross receipts from extraction income are deemed to equal 105 percent of the fair market value of petroleum extracted. This computation is designed to produce an amount that is greater than the fair market value of actual gross receipts; therefore, the tax on extraction income is not likely to produce an amount that is not greater than fair market value. Accordingly, the tax on extraction income does not satisfy the gross receipts require-

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ment. However, if the tax satisfies the criteria of § 1.903-1(a), it is a tax in lieu of an income tax.

(4) Net income--(i) In general. A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts (including gross receipts as computed under paragraph (b)(3)(i)(B) of this section) to permit--

(A) Recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or

(B) Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.

A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be if the Internal Revenue Code applied, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery. For example, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery, the net income requirement is satisfied where items deductible under the Internal Revenue Code are capitalized under the foreign tax system and recovered either on a recurring basis over time or upon the occurrence of some future event or where the recovery of items capitalized under the Internal Revenue Code occurs less rapidly under the foreign tax system. A foreign tax law that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Internal Revenue Code (e.g., principles that apply under section 265, 465 or 861(b) of the Internal Revenue Code). A foreign tax whose base, judged on the basis of its predominant character, is computed by reducing gross receipts by items described in paragraph (b)(4)(i)(A) or (B) of this section satisfies the net income requirement even if gross receipts are not reduced by some such items. A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts or gross income, respectively, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax). In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether gross receipts are reduced, in the base of the tax, by another tax, provided that other tax satisfies the realization, gross receipts and net income requirements.

(ii) Consolidation of profits and losses. In determining whether a foreign tax satisfies the net income requirement, one of the factors to be taken into account is whether, in computing the base of the tax, a loss incurred in one activity (*e.g.,* a contract area in the case of oil and gas exploration) in a trade or business is allowed to offset profit earned by the same person in another activity (*e.g.,* a separate contract area) in the same trade or business. If such an offset is allowed, it is immaterial whether the offset may be made in the taxable period in which the loss is incurred or only in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset the loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial that no such offset is allowed if a loss incurred in one such activity may be

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applied to offset profit earned in that activity in a different taxable period, unless the period is such that under the circumstances there is effectively a denial of the ability to offset such loss against profit. In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether a person's profits and losses from one trade or business (*e.g.,* oil and gas extraction) are allowed to offset its profits and losses from another trade or business (*e.g.,* oil and gas refining and processing), or whether a person's business profits and losses and its passive investment profits and losses are allowed to offset each other in computing the base of the foreign tax. Moreover, it is immaterial whether foreign law permits or prohibits consolidation of profits and losses of related persons, unless foreign law requires separate entities to be used to carry on separate activities in the same trade or business. If foreign law requires that separate entities carry on such separate activities, the determination whether the net income requirement is satisfied is made by applying the same considerations as if such separate activities were carried on by a single entity.

(iii) Carryovers. In determining whether a foreign tax satisfies the net income requirement, it is immaterial, except as otherwise provided in paragraph (b)(4)(ii) of this section, whether losses incurred during one taxable period may be carried over to offset profits incurred in different taxable periods.

(iv) Examples. The provisions of this paragraph (b)(4) may be illustrated by the following examples:

Example 1. Country X imposes an income tax on corporations engaged in business in country X; however, that income tax is not applicable to banks. Country X also imposes a tax (the "bank tax") of 1 percent on the gross amount of interest income derived by banks from branches in country X; no deductions are allowed. Banks doing business in country X incur very substantial costs and expenses (e.g., interest expense) attributable to their interest income. The bank tax neither provides for recovery of significant costs and expenses nor provides any allowance that significantly compensates for the lack of such recovery. Since such banks are not almost certain never to incur a loss on their interest income from branches in country X, the bank tax does not satisfy the net income requirement. However, if the tax on corporations is generally imposed, the bank tax satisfies the criteria of § 1.903-1(a) and therefore is a tax in lieu of an income tax.

Example 2. Country X law imposes an income tax on persons engaged in business in country X. The base of that tax is realized net income attributable under reasonable principles to such business. Under the tax law of country X, a bank is not considered to be engaged in business in country X unless it has a branch in country X and interest income earned by a bank from a loan to a resident of country X is not considered attributable to business conducted by the bank in country X unless a branch of the bank in country X performs certain significant enumerated activities, such as negotiating the loan. Country X also imposes a tax (the "bank tax") of 1 percent on the gross amount of interest income earned by banks from loans to residents of country X if such banks do not engage in business in country X or if such interest income is not considered attributable to business conducted in country X. For the same reasons as are set forth in example 1, the bank tax does not satisfy the net income requirement. However, if the tax on persons engaged in business in country X is generally imposed, the bank tax satisfies the criteria of § 1.903-1(a) and therefore is a tax in lieu of an income tax.

Example 3. A foreign tax is imposed at the rate of 40 percent on the amount of gross wages realized by an employee; no deductions are allowed. Thus, the tax law neither provides for recovery of costs and expenses nor provides any allowance that effectively compensates for the lack of such recovery. Because costs and expenses of employees attributable to wage income are almost always insignificant compared to the gross wages realized, such costs and expenses will almost always not be so high as to offset the gross wages and the rate of the tax is such that, under the circumstances, after the tax is paid, employees subject to the tax are almost certain to have net gain. Accordingly, the tax satisfies the net income requirement.

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Example 4. Country X imposes a tax at the rate of 48 percent of the "taxable income" of nonresidents of country X who furnish specified types of services to customers who are residents of country X. "Taxable income" for purposes of the tax is defined as gross receipts received from residents of country X (regardless of whether the services to which the receipts relate are performed within or outside country X) less deductions that permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X tax satisfies the net income requirement.

Example 5. Each of country X and province Y (a political subdivision of country X) imposes a tax on corporations, called the "country X income tax" and the "province Y income tax," respectively. Each tax has an identical base, which is computed by reducing a corporation's gross receipts by deductions that, based on the predominant character of the tax, permit recovery of the significant costs and expenses (including significant capital expenditures) attributable under reasonable principles to such gross receipts. The country X income tax does not allow a deduction for the province Y income tax for which a taxpayer is liable, nor does the province Y income tax allow a deduction for the country X income tax for which a taxpayer is liable. As provided in paragraph (d)(1) of this section, each of the country X income tax and the province Y income tax is a separate levy. Both of these levies satisfy the net income requirement; the fact that neither levy's base allows a deduction for the other levy is immaterial in reaching that determination.

(c) Soak-up taxes--(1) In general. Pursuant to paragraph (a)(3)(ii) of this section, the predominant character of a foreign tax that satisfies the requirement of paragraph (a)(3)(i) of this section is that of an income tax in the U.S. sense only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the tax against income tax liability to another country. Liability for foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only if and to the extent that the foreign tax would not be imposed on the taxpayer but for the availability of such a credit. See also § 1.903-1(b)(2).

(2) Examples. The provisions of paragraph (c)(1) of this section may be illustrated by the following examples:

Example 1. Country X imposes a tax on the receipt of royalties from sources in country X by nonresidents of country X. The tax is 15 percent of the gross amount of such royalties unless the recipient is a resident of the United States or of country A, B, C, or D, in which case the tax is 20 percent of the gross amount of such royalties. Like the United States, each of countries A, B, C, and D allows its residents a credit against the income tax otherwise payable to it for income taxes paid to other countries. Because the 20 percent rate applies only to residents of countries which allow a credit for taxes paid to other countries and the 15 percent rate applies to residents of countries which do not allow such a credit, one-fourth of the country X tax would not be imposed on residents of the United States but for the availability of such a credit. Accordingly, one-fourth of the country X tax imposed on residents of the United States who receive royalties from sources in country X is dependent on the availability of a credit for the country X tax against income tax liability to another country.

Example 2. Country X imposes a tax on the realized net income derived by all nonresidents from carrying on a trade or business in country X. Although country X law does not prohibit other nonresidents from carrying on business in country X, United States persons are the only nonresidents of country X that carry on business in country X in 1984. The country X tax would be imposed in its entirety on a nonresident of country X irrespective of the availability of a credit for country X tax against income tax liability to another country. Accordingly, no portion of that tax is dependent on the availability of such a credit.

Example 3. Country X imposes tax on the realized net income of all corporations incorporated in country X. Country X allows a tax holiday to qualifying corporations incorporated in country X that are owned by non-

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