NO. 10-60988

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

ENTERGY CORPORATION & AFFILIATED SUBSIDIARIES,

Petitioners-Appellees,

- vs.-

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

APPELLEES' BRIEF

On Appeal from United States Tax Court

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May 11, 2011

CERTIFICATE OF INTERESTED PERSONS

The undersigned counsel of record certifies that the following listed persons and entities as described in the fourth sentence of Fifth Circuit Rule 28.2.1 have an interest in the outcome of this case. These representations are made so that the judges of this Court may evaluate possible disqualification or recusal.

1. Commissioner of Internal Revenue, Appellant.
2. Entergy Corporation & Affiliated Subsidiaries, Appellees.
3. Stephen D. Gardner, John P. Steines, Jr., and Benjamin P. Oklan (of Cooley LLP), attorneys for Entergy Corporation and Affiliated Subsidiaries.
4. Michael C. Prindible, Melissa D. Arnt, Gilbert S. Rothberg, Thomas J. Clark, and Francesca U. Tumami, attorneys for the Commissioner of Internal Revenue.

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STATEMENT REGARDING ORAL ARGUMENT

In view of the complexity of the case and the significant implications the case has for the administration of federal income tax laws, Entergy Corporation & Affiliated Subsidiaries ("Entergy") believe the Court will benefit from oral argument.

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STATEMENT OF FACTS[1]

None of the facts adduced at Entergy's trial or recited in *PPL Corp. v. Commissioner*, 135 T.C. 304 (2010), *appeal pending* (3d Cir.), are in dispute.[2] Entergy does not object to the Commissioner's statement of facts. The facts recited below are intended as a supplement to the Commissioner's statement of facts.[3]

A. History of the Windfall Tax.

Between 1984 and 1996, the United Kingdom privatized over 50 government-owned companies, many of which were monopolies subject to economic regulation. *PPL Corp.*, 135 T.C. at 306. The government privatized the companies by selling shares to public investors at a fixed offering price in a "flotation" (public offering). *Id.* Offering prices were set in consultation with investment advisors to maximize offering proceeds. Ex. 14-P at 1-2, 9-10. In

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1 Entergy does not disagree with the Commissioner's Jurisdictional Statement, Statement of the Issue, or Statement of the Case.

2 As discussed in the Commissioner's Statement of the Case, the Tax Court's memorandum opinion in *Entergy Corp.* v. *Commissioner*, T.C. Memo 2010-197 (2010), relied on its published opinion in *PPL Corp.*, which involved the identical issue and material facts and was issued on the same day. Both cases were tried before the same Judge. Appellant Br. at 3. Therefore, Entergy's Statement of Facts refers to both the *Entergy* record and the *PPL* opinion.

3 Citations to the trial transcript appear herein as "Tr. at __." Citations to Entergy's Record Excerpts appear as "R.E. __."

most cases, however, the shares immediately traded on the London Stock Exchange at a premium over the flotation price. *PPL Corp.*, 135 T.C. at 307.

Of the 32 privatized companies that would become subject to the Windfall Tax (the "Windfall Companies"), 12 were regional electric companies ("RECs"). First Stip. Facts and Exs. ¶ 23. London Electricity plc ("London Electricity"), a U.K. subsidiary of Entergy, was a REC. *Id.*

In the years after privatization, 29 of the 32 Windfall Companies operated under government price controls, which limited the price increases that the companies could charge. *PPL Corp.*, 135 T.C. at 308. Prices were not adjusted until the end of the five-year period after flotation, regardless of the company's performance. *Id.* at 309. Despite those controls, many of the companies became considerably more efficient and profitable than had been expected. *Id.* at 309. Notably, during the first four years after privatization, the RECs earned post-tax profits of over 80 percent of the flotation proceeds. *Id.* at 309 n.6. Substantial profits led to unexpectedly high dividends, executive compensation, and share price increases, which fueled public outcry that shareholders and executives of the privatized companies had profited unduly to the detriment of the U.K. fisc and consumers. *Id.* at 309-10.

Beginning in the early 1990's, the Labour Party stated publicly that, in order to finance social programs, it would impose a windfall tax on the excess

profits of the privatized companies. *Id.* at 310. By 1994, the idea of an excess profits tax had become a principal feature of the Labour Party's speeches and programs leading up to the 1997 Parliamentary election. *Id.* In 1996, the Labour Party retained Arthur Andersen to assist in drafting a tax on the excess profits of the privatized companies. *Id.* at 310. Gordon Brown, then the shadow Chancellor of the Labour Party, instructed Arthur Andersen to draft proposals for the imposition of a tax on the privatized companies' excess profits that would meet Parliamentary requirements, would be sustainable by the companies, and would not conflict with U.K. or European Union law. Tr. at 74-77, R.E. Tab A. In addition to the windfall tax approach that was eventually enacted, the Andersen team considered and rejected several alternatives. *PPL Corp.*, 135 T.C. at 311. A one-time windfall tax could achieve the desired revenue goal without encountering the problems associated with the other approaches. Tr. at 84-86, R.E. Tab A.

The Windfall Tax was enacted on July 31, 1997. First Stip. Facts and Exs. ¶ 31. Statements by various government officials and Parliamentary debate described the tax simultaneously as a tax on excess profits and as a means of recouping the perceived undervaluation of the companies reflected in cheap flotation prices. Ex. 15-P ¶ 190-192.

B. Description of the Windfall Tax.

The Windfall Tax Act (the "Act") identified the 32 Windfall Companies and set the tax rate at 23 percent. First Stip. Facts and Exs. ¶¶ 38-40. Schedule 1, an integral part of the Act, defined the "windfall" as the excess (if any) of:

> (a) "the value in profit-making terms of the disposal made on the occasion of the company's flotation" ("*value in profit-making terms*"), over
> (b) "the value which for privatisation purposes was put on that disposal" ("*flotation value*").

Id. ¶ 41.

Value in profit-making terms was defined in Schedule 1 of the Act as the "average annual profit" for the company's "initial period" multiplied by the "applicable price-to-earnings ratio." *Id.* ¶ 42. Average annual profit equaled 365 multiplied by a fraction the numerator of which was the company's profits during the initial period ("Initial Period Profits") and the denominator of which was the number of days in the initial period (generally, 1,461 days, or 4 years). *Id.* ¶ 51.

Initial Period Profits were equal to "profit on ordinary activities" net of regular U.K. corporate tax, as determined under U.K. financial accounting principles ("U.K. Financial Profits"). *Id.* ¶ 50. U.K. Financial Profits are in all material respects the same as net income determined under generally accepted accounting principles applicable in the United States. Ex. 69-P ¶ 28, R.E.

Tab B. U.K. Financial Profits are based on actual realized gross receipts with an allowance for the deduction of all related expenses and depreciation or amortization of wasting assets. Ex. 68-P ¶ 3.13, R.E. Tab C; Ex. 69-P ¶¶ 31-32, R.E. Tab B.

The initial period was the company's four financial years immediately following flotation. For companies that did not have four full financial years after flotation and before April 1, 1997, the initial period was shorter (beginning at flotation and ending on the last day of the last financial year ending prior to April 1, 1997). First Stip. Facts and Exs. ¶¶ 44-45. The applicable price-to-earnings ratio was nine. *Id.* ¶¶ 42-43.

Flotation value equaled the product of the per-share flotation price and the number of ordinary shares issued in the flotation. *Id.* ¶ 52.

The following formula sets out the Windfall Tax calculation:

$$WT = 23\% \times [\{(365 \times (P/D)) \times 9\} - FV]$$

where

WT = Windfall Tax P = initial period profits

D = days in initial period FV = flotation value

Id. ¶ 54.

Twenty-seven of the 32 Windfall Companies had an initial period of 1,461 days, or 4 years. *Id.* ¶ 55. For those companies, the formula may be restated in the following steps:

WT =	23%	x	[{(365 x (P/1,461)) x 9}	–	FV]
WT =	23%	x	[{(P/4) x 9}	–	FV][4]
WT =	{23% x (9/4)}	x	[P	–	{(4/9) x FV }][5]
WT =	51.71%	x	[P	–	(44.47% x FV)]

Id. ¶¶ 55-58. Thus, 27 of the 32 Windfall Companies had a Windfall Tax liability of 51.71% of initial period profits in excess of a floor equal to 44.47% of flotation value.

Two other companies (National Power plc and PowerGen plc) had initial periods of four full financial years, but under U.K. accounting conventions the day counts were 1,456 and 1,463, respectively. *Id.* ¶ 48. As to those two companies, the algebraic restatement set forth above differed by miniscule fractions of one percent. *Id.* ¶¶ 63 n.5, 65 n.6.

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[4] For simplicity, the denominator of "4" in the restatement derives from the fraction 365/1461, which reduces to approximately 1/4. First Stip. Facts and Exs. ¶ 56.

[5] Step 3 in the restatement multiplies the 23% by 9/4 and the bracketed terms by 4/9. Because 9/4 x 4/9 = 1, this step does not change the Windfall Tax amount. *PPL Corp.*, 135 T.C. at 328 n.22.

Three companies (Northern Ireland Electricity plc, Railtrack Group plc, and British Energy plc), whose privatization occurred later than others, had initial periods of 1,380 days, 316 days, and 260 days, respectively. *Id.* ¶ 49. British Energy plc had no windfall tax liability. *Id.* ¶ 47. As to the other two companies, the algebraic restatement yields the following:

Northern Ireland: $WT = 54.75\% \times [P - (42.01\% \times FV)]$

Railtrack: $WT = 239.10\% \times [P - (9.62\% \times FV)]$

Id. ¶¶ 67, 69.

C. Effect of the Windfall Tax.

London Electricity had an initial period of 1,461 days, and its Initial Period Profits were £503.4 million. *Id.* ¶¶ 71-72. Thus, its value in profit-making terms was 9 x £503.4 x 365/1461, or £1,131,874,760. *Id.* ¶ 74. Its flotation value was £523,341,600. *Id.* ¶ 75. Therefore, its "windfall" was £1,131,874,760 minus £523,341,600, or £608,533,140. Its Windfall Tax was £139,962,622 (translated into $234,290,431). *Id.* ¶¶ 13, 77.

Subject to rounding differences caused solely by expressing percentages in hundredths (*i.e.*, by carrying only to two decimal places), the algebraically restated tax equals the actual tax calculated under the Windfall Tax statute.

Substituting actual values for the variables in the algebraic restatement give the following:

51.71% x [£503,400,000 – (44.47% x £523,341,600)] = £139,962,622[6]

Id. ¶¶ 58, 77.

Of the 32 Windfall Companies, 31 had a Windfall Tax liability. *PPL Corp.*, 135 T.C. at 317. The aggregate tax burden of the 31 companies equaled 20.27 percent of the aggregate Initial Period Profits. Ex. 68-P at Scheds. 4A-4B, R.E. Tab H. No Windfall Company had a Windfall Tax liability in excess of its Initial Period Profits. *PPL Corp.*, 135 T.C. at 317.

In the financial year that the tax accrued, all 31 of the companies with a Windfall Tax liability accounted for the tax within each company's "ordinary activities." Ex. 68-P ¶8.3. Thus, for financial accounting purposes, those companies treated the Windfall Tax as an ordinary charge against profits. *Id.* ¶10.3. Additionally, the companies treated the Windfall Tax as a charge against profits in the year the tax accrued, not in the year of flotation. Tr. at 116-117.

Witnesses for both parties agreed that (i) Windfall Tax liability could arise only if there was sufficient income during the initial period to cause the value in profit-making terms to exceed flotation value; (ii) once the flotation value threshold was exceeded, Windfall Tax liability increased in the same

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[6] For ease of presentation, the percentages have been rounded.

proportion as income increased; (iii) a company with no initial period income incurred no Windfall Tax liability regardless of how much its stock value increased; and (iv) a company with sufficient income would incur Windfall Tax liability regardless of how much its stock value deteriorated. Tr. at 219-222, R.E. Tab D; Tr. at 256-258, R.E. Tab E; Tr. at 265-266, R.E. Tab F.

SUMMARY OF THE ARGUMENT

The Tax Court's decision should be affirmed.

The U.K. Windfall Tax was a creditable excess profits tax under Treasury Regulation § 1.901-2. Under the regulation, a foreign tax is creditable if its predominant character is that of an income or excess profits tax in the U.S. sense. This in turn requires that the foreign tax satisfy the regulation's realization, gross receipts, and net income tests. The regulation is clear: in determining whether those tests are satisfied, the foreign tax is judged on the basis of its predominant character.

The regulation's predominant character standard requires a court to examine the intent and effect of the tax. This standard evolved out of the case law beginning with the Supreme Court's decision in *Biddle v. Commissioner*, 302 U.S. 573 (1938). Every foreign tax credit case since has examined the intent and the effect of the foreign tax to determine whether it is creditable. Evidence admitted in those cases has included testimony of the drafters of the

foreign tax, expert reports regarding how the tax operated in fact, and quantitative data relating to taxpayer and industry experience in calculating and paying the foreign tax. *See, e.g.*, *Exxon Corp. v. Commissioner*, 113 T.C. 338 (1999), *acq. in result*, I.R.B. 2001-31. The case law uniformly states that the literal language of the foreign statute is not determinative.

The Tax Court properly applied the predominant character standard in holding that the Windfall Tax was creditable. It heard testimony and reviewed documents confirming that the purpose of the Windfall Tax was to tax the excess profits of the privatized companies. Tr. at 63-64, R.E. Tab A; Ex. 15-P ¶ 188. It heard testimony and admitted the algebraic restatement of the Windfall Tax formula confirming that the Windfall Tax was, in effect, a tax on profits above a floor. Ex. 68-P; Tr. at 161-163, R.E. Tab G. It admitted quantitative data confirming that the Windfall Tax operated as an excess profits tax with respect to each individual taxpayer and all of the taxpayers subject to the tax. Ex. 68-P at Scheds. 4A-4B, R.E. Tab H.

Faced with this evidence, the Commissioner argues that the creditability of a foreign tax can be determined only by the literal text of the foreign tax statute, and that the consideration of any other evidence is legal error. However, the Commissioner cannot escape the overwhelming authority that the predominant character of a foreign tax is measured by its intent and effect. Indeed, the

Commissioner cites no relevant authority for his contention that creditability is determined solely by the text of the foreign statute. At no point in the history of the foreign tax credit has a court articulated such a test. Instead, the Commissioner's strategy is to suppress the facts and marshal inapplicable case law in the hope that, if this Court ignores the evidence, it won't notice the true character of the Windfall Tax.

The Commissioner's refrain is that the literal text of the foreign statute is determinative. Every other court that has adjudicated this issue has held otherwise. The Commissioner's plain text arguments are erroneous.

ARGUMENT

I. Standard of Review.

The Tax Court's legal conclusions are reviewed *de novo*. *Whitehouse Hotel L.P. v. Commissioner*, 615 F.3d 321, 333 (5th Cir. 2010). Additionally, questions regarding foreign law are reviewed *de novo*. In considering the meaning of foreign law, the Circuit Court may rely on any factual material. *Karim v. Finch Shipping Co.*, 265 F.3d 258, 271 (5th Cir. 2001). Factual findings are reviewed for clear error. *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209, 214 (2d Cir. 1999).

II. The Tax Court Correctly Held That the U.K. Windfall Tax Qualified as a Creditable Excess Profits Tax Under the Code, Applicable Case Law, and Treasury Regulation § 1.901-2(a).

This Court should affirm the Tax Court's decision that the U.K. Windfall Tax was a creditable tax within the meaning of section 901 of the Internal Revenue Code.[7]

Section 1.901-2 of the Treasury Regulations, promulgated in 1983, controls the outcome of this case.[8] Under the regulation, a foreign levy is an income, war profits, or excess profits tax if (i) it is a tax and (ii) its predominant character is that of an income or excess profits tax in the U.S. sense. Treas. Reg. § 1.901-2(a). It is not disputed that the U.K. Windfall Tax was a tax. The sole

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[7] Unless otherwise indicated, all "section or "§" references are to the Internal Revenue Code of 1986 (26 U.S.C.) (the "Code"). All references to Treasury Regulations are to current provisions.

[8] Because there is no question that Treasury Regulation § 1.901-2 is a reasonable construction of a Congressional statute, *Mayo Foundation v. United States*, 131 S. Ct. 704 (2011), is inapplicable to this case. If the Commissioner's argument is that his interpretation of § 1.901-2 deserves deference, his interpretation is governed by *Christensen v. Harris County*, 529 U.S. 576 (2000). Under *Christensen*, deference to an administrative agency's interpretation of its own regulation is warranted only when the language of the regulation is ambiguous. *Id.* at 588. Under *Auer v. Robbins*, 519 U.S. 452 (1997), the agency's interpretation is not given deference when it is plainly erroneous or inconsistent with the regulation. *Id* at. 461. As discussed in this brief, Treasury Regulation § 1.901-2 is unambiguous, and the Commissioner's interpretation of § 1.901-2 in this case is both erroneous and inconsistent with the regulation.

issue in this case is whether the predominant character of the Windfall Tax was that of an income or excess profits tax in the U.S. sense.

Since the adoption of the forerunner of section 901 in the Revenue Act of 1918, every case deciding whether a foreign tax is creditable under the predominant character standard, including those governed by the regulation at issue in this case, has examined how the foreign tax operated in fact. No case has looked exclusively at the words of the foreign tax act. The established approach, requiring a factual analysis of how the foreign tax operates, is based on the Supreme Court's decision in *Biddle v. Commissioner*, 302 U.S. 573 (1938), in which the creditability of a British tax was determined by an analysis of how the tax operated. This factual inquiry was embraced by the predominant character standard in the Commissioner's own regulation. It was expounded upon by the case law, including two cases that were decided after the promulgation of the current regulation: *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209 (2d Cir. 1999), and *Exxon Corp.*, 113 T.C. 338, *acq. in result*, I.R.B. 2001-31.

Against that authority, the Commissioner makes essentially one argument, packaged as two, that the Windfall Tax fails the tests for creditability under the regulation. First, he argues that, regardless of whether the foreign tax operated as an income tax or excess profits tax in the U.S. sense, the text of the foreign

statute must slavishly track the literal words of the section 1.901-2 regulation. Second, he argues that the regulation prohibits consideration of evidence of foreign legislative intent or direct evidence of how the foreign tax actually operated. In short, the Commissioner insists that the particular words of the foreign statute that he emphasizes, and those words alone, determine creditability.

The administrative history, jurisprudence, and actual wording of the regulation itself refute the Commissioner's first argument. As a matter of simple logic, a regulation that bases creditability on the predominant character of a tax cannot ignore evidence of excess profits tax equivalence. As to the Commissioner's second argument, ample case law, without dissent, embraces inquiry into foreign legislative intent and how a foreign tax actually operates in order to determine creditability.

A. The Tax Court Correctly Held That the "Predominant Character" of the U.K. Windfall Tax Was That of an Income Tax in the U.S. Sense Under Treasury Regulation § 1.901-2(a)(3).

Under Treasury Regulation § 1.901-2, the "predominant character" of a foreign tax is that of an income, war profits, or excess profits tax in the U.S. sense if "the foreign tax is likely to reach net gain in the normal circumstances in which it applies." Treas. Reg. §§ 1.901-2(a)(1)(ii) and 1.901-2(a)(3).

The predominant character standard was incorporated into Treasury Regulation § 1.901-2 in 1983. The preamble to the regulation states that the predominant character language is an adoption of the judicial criteria established in *Bank of America Nat'l Trust & Savings Ass'n v. United States*, 459 F.2d 513 (Ct. Cl. 1972); *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982); and *Bank of America Nat'l Trust & Savings Ass'n v. Commissioner,* 61 T.C. 752 (1974), *aff'd*, 538 F.2d 334 (9th Cir. 1976). T.D. 7918, 1983-2 C.B. 113; Addenda A. Thus, the predominant character of the Windfall Tax was that of an income tax if it was "reasonably intended, always to reach some net gain," and "the key is the effect of the foreign tax on net gain." *Bank of America v. United States*, 459 F.2d at 519-520, 521. And, in determining the predominant character of the Windfall Tax, "... it is important, for the foreign tax credit, ... to see whether taxation of net gain is the ultimate objective or effect of that tax." *Inland Steel*, 677 F.2d at 80.

Furthermore, the words of the foreign taxing statute are not determinative. As stated by the Court of Federal Claims in the *Bank of America* case:

> We do not, however, consider it all-decisive whether the foreign income tax is labeled a gross income or a net income tax .... The important thing is whether the other country is attempting to reach some net gain, not the form in which it shapes the income tax or the name it gives.

459 F.2d at 519; *see also Inland Steel*, 677 F.2d at 80 (stating that to determine whether a foreign tax is creditable, "[t]he label and form of the foreign tax is not determinative.").

The 901 regulations establish three requirements to determine whether the predominant character of a foreign levy is that of an income tax in the U.S. sense. Under Treasury Regulations §§ 1.901-2(b)(2), (3), and (4), a foreign levy is likely to reach net gain if, judged on the basis of its predominant character, it satisfies (i) the realization requirement, (ii) the gross receipts requirement, and (iii) the net income requirement.

On appeal, the Commissioner argues that the Tax Court "invented" its own test for creditability. The Commissioner is wrong. The Tax Court heard evidence of the intent and effect of the Windfall Tax in order to judge the Windfall Tax based on its predominant character. The Tax Court then applied the regulation to the undisputed evidence. By ignoring the predominant character standard in his argument on appeal, it is the Commissioner, not the Tax Court, who is inventing a new test for creditability.

The Windfall Tax, judged on the basis of its predominant character, satisfied each of the three tests for creditability under Treasury Regulation § 1.901-2(b).

1. The Tax Court Correctly Held That the Windfall Tax Was Imposed on Realized Income.

A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, the tax is imposed on income subsequent to events that would result in the realization of income under the Code. Treas. Reg. § 1.901-2(b)(2)(i)(A). The Windfall Tax was imposed on U.K. Financial Profits (that is, profit on ordinary activities determined under U.K. financial accounting principles), which are equivalent to realized profits as determined under U.S. generally accepted accounting principles. First Stip. Facts and Exs. ¶ 50, Ex. 69-P ¶ 28, R.E. Tab B.

The calculation of the Windfall Tax was based on Initial Period Profits, which were equal to U.K. Financial Profits. First Stip. Facts and Exs. ¶¶ 50-51. In both the U.K. and U.S. accounting systems, the calculation of profits and losses is based on fundamental principles of revenue realization. Thus, in calculating U.K. Financial Profits, revenue is taken into account only when realized. Ex. 69-P ¶ 31, R.E. Tab B.

Moreover, it was factually impossible for the tax to be imposed prior to realization. In all cases, the Windfall Tax taxed profits earned before its enactment. First Stip. Facts and Exs. ¶¶ 31, 44. Initial Period Profits were earned between 1986 and, at the latest, a Windfall Company's last full financial

year ending before April 1, 1997. *Id.* ¶ 45. The Windfall Tax was enacted on July 31, 1997, after each Windfall Company's Initial Period Profits had been publicly reported. *PPL Corp.*, 135 T.C. at 332. Those profits could not have been known if they hadn't been realized. All the companies subject to the Windfall Tax charged the tax against profits in the year the tax was enacted. Ex. 68-P ¶8.3. They could not have known how much Windfall Tax to accrue unless the Initial Period Profits on which the tax was based had been realized. Furthermore, Gordon Brown's July 2, 1997 budget speech,[9] Inland Revenue's July 2, 1997 announcement of the Windfall Tax,[10] and the U.K. Treasury's July 1997 publication "Explanatory Notes: Summer Finance Bill 1997"[11] each stated that the Windfall Tax would yield around £5.2 billion. Gordon Brown, Inland Revenue, and Her Majesty's Treasury could not have known the Windfall Tax's yield if Initial Period Profits had not been realized. The Tax Court recognized that the architects of the Windfall Tax knew (1) exactly which companies the tax would target, (2) the publicly reported after-tax financial profits of those companies, and (3) the target amount of revenue the tax would raise. *PPL Corp.*, 135 T.C. at 332. Based in part on those undisputed facts, the court found that the Windfall Tax purposefully operated on excess profits. *Id.* Thus, the

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9 Ex. 15-P ¶ 194; *PPL Corp.*, 135 T.C. at 314.

10 *PPL Corp.*, 135 T.C. at 314-15.

11 *Id.* at 315.