No. 11-1069

IN THE UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

PPL CORPORATION AND 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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TABLE OF CONTENTS

Page

Table of contents. i
Table of authorities. iii
Statement of subject matter and appellate jurisdiction. 1
Statement of the issue.. 2
Statement of the case. 2
Statement of facts. 4

A. Background of the U.K. windfall tax. 4

B. Enactment and provisions of the windfall tax. 7

C. SWEB's payment of the windfall tax. 9

D. The proceedings below. 10

1. The parties' arguments. 11

2. The Tax Court's opinion.. 12

Statement of related cases and proceedings. 15
Summary of argument. 15

Argument:

The Tax Court erred in ruling that the U.K. windfall tax was a creditable foreign tax under I.R.C. § 901. 18

Standard of review. 18

A. Treas. Reg. § 1.901-2(b) defines a creditable income tax for purposes of I.R.C. § 901.. 18

B. The U.K. windfall tax does not meet any of the three subtests of Treas. Reg. § 1.901-2(b)(1). 21

Page

1. The windfall tax does not meet the realization test. 23

2. The windfall tax does not meet the gross-receipts test or the net-income test. 30

3. The regulatory test cannot be satisfied merely by comparing the final foreign tax liability to the taxpayer's net income. 33

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. 34

1. The Tax Court gave virtually no weight to the actual text of the windfall-tax statute.. 35

2. The Tax Court erred by relying on the mathematical reformulation of the windfall-tax computation proffered by taxpayer's expert. 41

3. The Tax Court erred in relying on Parliamentary intent and in according probative weight to the trial testimony of a single legislator and his paid consultants regarding the legislative purpose of the windfall tax. 47

Conclusion. 53
Certificate of bar membership. 54
Certificate of compliance.. 55
Joint appendix (Volume I).. 56
Statutory addendum. 57
Certificate of service. 58

TABLE OF AUTHORITIES

Cases: **Page(s)**

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). 37, 38, 40
Aluminum Co. of America v. United States,
123 F.2d 615 (3d Cir. 1941).. 19
Banco Mexicano de Commercio e Industria v. Deutsche Bank, 263 U.S. 591 (1924).. 48
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). 19
Berens v. Ludwig, 160 F.3d 1144 (7th Cir. 1998). 26
Bread Political Action Committee v. FEC,
455 U.S. 577 (1982). 49, 51
Burnet v. Chicago Portrait Co., 285 U.S. 1 (1932).. 19
Cottage Sav. Association v. Commissioner,
499 U.S. 554 (1991). 23, 24
Covalt v. Carey Canada, Inc., 860 F.2d 1434
(7th Cir. 1988). 50, 51
Eastern Service Corp. v. Commissioner,
650 F.2d 379 (2d Cir. 1981).. 40
Entergy Corp. v. Commissioner, T.C. Memo. 2010-197
(2010), *appeal pending*, 5th Cir. No. 10-60988.. 15
F.W. Woolworth Co. v. United States,
91 F.2d 973 (2d Cir. 1937).. 25
Graham Co. Soil & Water Conservation District v. United States, 130 S. Ct. 1396 (2010).. 49
Graves v. New York ex rel. O'Keefe, 306 U.S. 466 (1939). 25
Hills v. Commissioner, 691 F.2d 997 (11th Cir. 1982). 40
Holmes v. Bateson, 583 F.2d 542 (1st Cir. 1978).. 26
Inland Steel Co. v. United States,
677 F.2d 72 (Ct. Cl. 1982). 22, 25
Lamborn v. Dittmer, 873 F.2d 522 (2d Cir. 1989).. 26
Mayo Foundation for Medical Education & Research v. United States, 131 S. Ct. 704 (2011).. 22

Cases (cont'd): Page(s)

Missouri Pac. R.R. Co. v. United States,
392 F.2d 592 (Ct. Cl. 1968). 30
New York ex rel. Cohn v. Graves, 300 U.S. 308 (1937). 25
Pittsburgh Terminal Corp. v. Baltimore & Ohio R.R.,
875 F.2d 549 (6th Cir. 1989). 26
Riggs National Corp & Subsidiaries v. Commissioner,
163 F.3d 1363 (D.C. Cir. 1999). 18
S.C. Education Association v. Campbell,
883 F.2d 1251 (4th Cir. 1989). 50
San Antonio Sav. Association v. Commissioner,
887 F.2d 577 (5th Cir.1989). 28
Schmitt v. Commissioner, 208 F.2d 819 (3d Cir. 1954). 23, 24
South Carolina v. Baker, 485 U.S. 505 (1988).. 25
Sullivan v. Finkelstein, 496 U.S. 617 (1990). 50
Szehinskyj v. Attorney General, 432 F.3d 253 (3d Cir. 2005). . . . 49
Texasgulf, Inc. v. Commissioner, 172 F.3d 209 (2d Cir. 1999). . . 22
United States v. Clintwood Elkhorn Mining Co.,
553 U.S. 1 (2008). 36
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).. . . . . 38, 40
United States v. Knox, 32 F.3d 733 (3d Cir. 1994). 50
United States v. Miss. Chemical Corp.,
405 U.S. 298 (1972). 39, 40
United States v. O'Brien, 391 U.S. 367 (1968).. 48
United States v. United Foam Corp.,
618 F.2d 577 (9th Cir. 1980). 26
United States v. Waterman Steamship Corp.,
330 F.2d 128 (5th Cir. 1964). 30
W. Air Lines v. S.D. Board of Equalization,
480 U.S. 123 (1987). 50
Weiss v. Stearn, 265 U.S. 242 (1924). 28
Weiss v. Wiener, 279 U.S. 333 (1929). 23
Williams v. Wells Fargo Home Mortgage, Inc.,
2011 U.S. App. LEXIS 2539 (3d Cir. Feb. 8, 2011). . . . 36, 47
Winn-Dixie Montgomery, Inc. v. United States,
444 F.2d 677 (5th Cir. 1971). 26-27

Statutes: **Page(s)**

26 U.S.C. (Internal Revenue Code of 1986):

§ 1.. 20
§ 63.. 20
§ 63(a). 32
§ 118.. 37
§ 361.. 28
§ 368.. 28
§ 901.. . . . . 2, 10, 15, 18, 19, 33, 41
§ 901(a). 18, 19
§ 901(b)(1). 18
§ 902.. 10
§ 1001.. 23
§ 6213(a). 2
§ 6214.. 2
§ 7482(a)(1). 2
§ 7483.. 2

Rules and Regulations:

26 C.F.R. (Treasury Regulations):

§ 1.901-2.. . . . . 11, 13, 15, 19
§ 1.901-2(a). 57
§ 1.901-2(a)(1)(ii). 20
§ 1.901-2(a)(3)(i). 20
§ 1.901-2(b). 18, 34, 47, 57
§ 1.901-2(b)(1). 20
§ 1.901-2(b)(2)(i)(A). 23, 28
§ 1.901-2(b)(2)(i)(C). 29
§ 1.901-2(b)(3). 34
§ 1.901-2(b)(4). 34
§ 1.901-2(b)(3)(i)(A). 30
§ 1.901-2(b)(3)(ii). 31
§ 1.901-2(b)(4)(i)(A). 32

Rules and Regulations (cont'd): Page(s)

Fed. R. App. P. 13(a)(1). 2

T.D. 7918, 48 Fed. Reg. 46272 (Oct. 12, 1983). 19, 21

Miscellaneous:

Boris I. Bittker & Lawrence Lokken,
Federal Taxation of Individuals, Estates, and Trusts, ¶ 5.2 (3d ed. 1999). 23-24

Boris I. Bittker, Martin J. McMahon, Jr., &
Lawrence A. Zelenak, *Federal Income Taxation of Individuals*, ¶2.01[4] (3d ed. 2002). 20

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STATEMENT OF SUBJECT MATTER AND APPELLATE JURISDICTION

On October 25, 2007, the Internal Revenue Service ("IRS") sent to PPL Corporation and its consolidated group of subsidiaries (collectively "taxpayer") a notice of deficiency for the 1997 tax year. (JA130.)[1] On

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[1] "JA" refers to the joint appendix, and "Doc." refers to the Tax Court docket sheet. Unless otherwise indicated, all section references herein are to the Internal Revenue Code of 1986, as amended ("I.R.C.").

November 5, 2007, taxpayer timely filed a petition in the United States Tax Court contesting the notice of deficiency. (JA72.) *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 14, 2010, the Tax Court entered its decision. (JA2-3.) The decision resolved all claims of all parties. On January 4, 2011, the Commissioner timely filed a notice of appeal. (JA1.) 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 tax year. Taxpayer filed a petition in the Tax Court contesting the following determinations in the notice of deficiency: (i) taxpayer was not entitled to a foreign tax credit for a U.K. windfall tax paid by its U.K. subsidiary, (ii) taxpayer had dividend income from its U.K. subsidiary, notwithstanding taxpayer's claim that the dividend was

rescinded, and (iii) taxpayer was not entitled to depreciation deductions for certain street lighting assets.

The street-lighting-assets issue was resolved in taxpayer's favor (Doc. 75) and is not at issue in this appeal. With respect to the dividend-rescission issue, taxpayer maintained that if the windfall-tax issue were decided in its favor, then the court need not decide the dividend-rescission issue. (JA65.) The windfall-tax issue was decided in taxpayer's favor, as discussed below, and the Tax Court accordingly treated taxpayer as having conceded the dividend-rescission issue. (JA64-65.) The dividend-rescission issue 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 October 2008, they submitted additional factual and expert testimony. Following post-trial briefing, in September 2010, the Tax Court (Halpern, J.) issued an opinion reported at 135 T.C. No. 15 in favor of taxpayer. In October 2010, the Tax Court entered a decision determining that taxpayer had an overpayment of tax for 1997. The Commissioner appealed.

STATEMENT OF FACTS

The taxpayer, PPL Corporation, is a Pennsylvania corporation with headquarters in Allentown, Pennsylvania. (JA72.) It is the parent company of an affiliated group of corporations that produce and provide electricity. (JA89.) In 1997, one of its indirect subsidiaries was a U.K. company named South Western Electricity plc ("SWEB"), which provided electricity to approximately 1.5 million customers in the southwestern region of England. (JA66, 93-94.)

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. (JA100-01, 108.) 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. (JA100-01.) Twelve regional electric companies, including SWEB, were privatized in December 1990. (JA101.) In the flotation process, all 101,473,000 ordinary shares of SWEB's stock were offered at £2.40 per share. (JA102.)

After the companies were privatized, the U.K. Government regulated the prices they could charge the public. (JA846-48.) 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. (JA854-58.) 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. (JA268, 1194-95, 1339.)

In its 1997 Election Manifesto, the British Labour Party made a campaign promise to impose a windfall tax on the privatized utilities. (JA103.) Such a tax, the party believed, could fund a welfare-to-work youth employment training program it hoped to enact. (JA103.) 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. (JA104.)

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. (JA736-43, 1107-08.) 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). (JA321-23, 736-43, 1112-15.)

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. (JA323-24, 743-73, 1114-17.)

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"). (JA106, 292-313.) 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. (JA105, 1200-01.)

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." (JA292 (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." (JA297 (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." (JA263-64, ¶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." (JA297 (Sch. 1, ¶2).) The applicable price-to-earnings ratio (for all companies subject to the tax) was 9. (JA297 (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. (JA111; JA258, ¶4; JA264, ¶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)). (JA297, 300 (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. (JA298 (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. (JA297 (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. (JA304 (Sch. 2, ¶3).)

C. SWEB's payment of the windfall tax

For purposes of determining its windfall-tax liability, SWEB's initial period was four full financial years (the years ending March 31, 1992, 1993, 1994, and 1995), which totaled 1,461 days. (JA125, ¶201.) Its total profits for the initial period was £306,200,000, making its

average annual profit £76,497,604 (*i.e.,* 365 x (£306,200,000 ÷ 1461)).[2] (JA125-26, ¶¶202-203.) SWEB's profit-making value was thus £688,478,439 (*i.e.*, its average annual profit x 9). (JA126, ¶204.)

SWEB's flotation value was £295,351,200 (*i.e.,* 123,063,000 shares multiplied by £2.40 per share). (JA126, ¶205.) Its windfall was thus £393,127,239 (*i.e.,* its profit-making value minus its flotation value). (JA126, ¶206.) This resulted in a windfall tax liability of £90,419,265 (*i.e.,* 23 percent of the windfall). (JA126, ¶207.) As required by the Act, SWEB paid the tax in two installments, in December 1997 and December 1998. (JA125, ¶199.)

D. The proceedings below

In May 2000, taxpayer filed a refund claim with the IRS, claiming that it was entitled to a foreign tax credit of $786,804 for the windfall tax paid by SWEB pursuant to I.R.C. §§ 901 and 902. (JA127-28, 142.) In a notice of deficiency issued to taxpayer, the IRS disallowed the claimed credit. (JA142.) Taxpayer filed a petition in the Tax Court contesting the notice of deficiency. (JA72.)

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[2] In 1997, prior to filing its windfall tax return, SWEB was permitted to restate its published profits (*i.e.,* stated earnings) for the fiscal year ending March 31, 1995, to take account of approximately £12 million in tree-trimming costs. (JA75, 122.)

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 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 the testimony of two members of the Andersen team, Chris Osborne and Christopher Wales, 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 and economics experts established that the windfall tax fell on the excess profits that the windfall companies had realized during their initial periods. Relying on a 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

On September 9, 2010, the Tax Court issued an opinion in favor of taxpayer. The court first rejected the Commissioner's contention that it 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." (JA51.) 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 (JA52-56).

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." (JA58.) 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." (JA59-60, 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. (JA60-61.) 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." (JA61.)

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. (JA61.) The court dismissed the Commissioner's objection to taxpayer's mathematical reformulation of the tax, stating 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." (JA62.) 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. (JA63.)

STATEMENT OF RELATED CASES AND PROCEEDINGS

The following case involves the identical windfall-tax issue as the present case: *Entergy Corp. v. Commissioner*, T.C. No. 25132-06, *appeal pending*, 5th Cir. No. 10-60988. *Entergy* was tried before the same judge who presided over the present case, and the Tax Court's opinion in *Entergy* relied on the opinion in this case. *See* T.C. Memo 2010-197 (Sept. 9, 2010). The Commissioner filed a notice of appeal in *Entergy*, and venue for that appeal lies in the Fifth Circuit. The Commissioner's opening brief in *Entergy* was filed on April 13, 2011.

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, SWEB's taxable windfall amount exceeded its total profits during the initial period by

almost £90 million. Thus, the windfall tax was—in fact—imposed on something other than SWEB'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 PPL claimed a foreign tax credit for the U.K. windfall tax paid by SWEB. (JA74-76.)

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); *Aluminum Co. of Am. v. United States,* 123 F.2d 615, 619 (3d Cir. 1941). 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* Statutory 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 A. Zelenak, *Federal Income Taxation of Individuals*, ¶2.01[4] at 2-7 (3d ed. 2002) ("Taxable income is the base to which the statutory rates are 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 (JA51, 63-64), 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 (JA27-29), 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; *Schmitt v. Commissioner*, 208 F.2d 819, 821 (3d Cir. 1954) ("increase in value is not a subject for tax until there is some sale or other disposal to make a taxable 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. (*See* JA744.) 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; *Schmitt*, 208 F.2d at 821 (stating that it "is hornbook law of taxation" that a property owner "is not subject to income taxation upon the annual increase in value" of the property).

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, 977 (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" (JA687), 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 (JA688-89). Even taxpayer's expert, Stewart Myers, acknowledged that multiplying earnings by a price-to-earnings ratio is a recognized method for estimating the economic value of a company. (JA1054, 1443-44.) And U.S. case law is replete with instances in which a company's value was determined by computing a multiple of net earnings, where the multiple was a price-to-earnings ratio. *See, e.g., Berens v. Ludwig*, 160 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); *Winn-*

Dixie Montgomery, Inc. v. United States, 444 F.2d 677, 685 n.13 (5th Cir. 1971). 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." (JA258, ¶3; JA264, ¶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.[3]

Moreover, it is noteworthy that SWEB's total profits for the initial period was £306.2 million, but its taxable windfall amount was approximately £393.1 million—almost £90 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,

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[3] Even the Tax Court acknowledged at trial that the windfall tax is "expressed [ ] in a way that . . . resembles a value tax or a tax on an increase in value." (JA1342.) And during the Parliamentary debate of the windfall tax, one critical Member of Parliament, who had been an accountant at KPMG, stated that "the nature of the calculations of the tax set out in the schedule make it a tax on capital rather than a tax on income." (JA484-85.) He further stated that "[b]ecause of the way in which schedule 1 is drafted, the windfall tax taxes the increase in value of the company during those four years. It is effectively a capital gains tax on a company's increase in value." (JA528.)

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. (*See* JA744.) 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." (JA292 (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. *See San Antonio Sav. Ass'n v. Commissioner,* 887 F.2d 577, 584 (5th Cir. 1989) ("a formal change in ownership is not enough to trigger realization"); *see, e.g.,* I.R.C. §§ 361, 368; *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).[4]

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[4] Moreover, under U.K. law, the privatization was a tax-free event for the windfall companies. Although the companies ordinarily would have been subject to a U.K. tax on their unrealized built-in gains upon privatization (and would have received a stepped-up basis for purposes of determining future taxable gain or loss), *see* U.K. Taxation of Chargeable Gains Act 1992 (March 6, 1992), Section 179, *available in*, http://www.legislation.gov.uk/ukpga/1992/12/contents/enacted, Parliament exempted the companies from that particular tax when it privatized them, *see* U.K. Electricity Act 1989 (July 27, 1989), Schedule 11, *available in,* http://www.legislation.gov.uk/ukpga/1989/29/schedule/11.

Evidence in the record suggests that the windfall tax may have been intended to recapture the tax revenue lost as a result of this exemption. (JA746-50.) Although the Tax Court suggested (JA49, n.25) that viewed in this manner the windfall tax would be creditable as a tax on "previously realized but unrecognized gain," that suggestion was erroneous for two reasons. First, while the transfer of the utilities' assets to the public companies may have been a realization event to the U.K. government, neither the receipt of those assets nor the flotation of their stock was a realization event to the public companies as to the built-in gain in their assets. Second, because the companies received no basis step-up as a result of paying the windfall tax—and so would be subject to a second corporation tax on the disposition of the appreciated assets—a tax on unrealized built-in gain would fail the realization test. *See* Treas. Reg. § 1.901-2(b)(2)(i)(C) (providing that a tax on a pre-realization event satisfies the realization test only if the foreign country does not impose a second tax on the same income upon the occurrence of a later event).

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 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, SWEB's taxable windfall amount exceeded its total profits during its initial period by almost £90 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. Moreover, those total profits, after being averaged over a four-year period, were multiplied by 9, resulting in a profit-making value far in excess of the company's realized gross receipts. The windfall tax was then imposed on the *difference* between profit-making value and

flotation value, and a tax on the value of property does not have the predominant character of an income tax in the U.S. sense. 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. (JA63-64.) 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. (JA61-62, 64.) 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." (JA58, 62.)

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 Tax 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." (JA57-58.) 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, not to a hypothetical tax base that could have been, but was not, enacted.

Moreover, to the extent the Tax Court believed that legislative intent was relevant, it is beyond cavil that "the foremost indication of legislative intent is the plain language of the statute." *Williams v. Wells Fargo Home Mortgage, Inc.*, 2011 U.S. App. LEXIS 2539, *11-12 (3d Cir. Feb. 8, 2011); *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).

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. (JA58-59.) As the court stated, "[t]he reasons are equivalent because each subsumes the other." (JA58.) 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, recent decisions from the Fifth and Eleventh Circuits are instructive. 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), the issue 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. The Fifth Circuit 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. The court 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. (JA736.)) 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. (JA62, 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 set forth in the report of taxpayer's accounting expert, Edward Maydew.[5] In his report, he expressed the windfall tax as an algebraic equation, *i.e.*,

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[5] As Maydew acknowledged at trial, he borrowed this mathematical reformulation from Raymond Ball, the accounting expert relied on by the taxpayer in *Entergy*. (JA1389-90.)

$$\text{Tax} = \left\{ \left[\frac{P_1 + P_2 + P_3 + P_4}{4} \text{ x } 9 \right] - \text{FV} \right\} \text{ x } 23\%$$

which, through various mathematical iterations, he reorganized (for each year of the initial period) as:

$$\text{Tax} = (P_1 - 11.1\%\text{FV}) \text{ x } 51.75\%$$

(JA1011-12.) Critical to this reformulation is that 51.75% equals 1/4 x 9 x 23%, which causes the price-to-earnings ratio of 9 to be cancelled out of the equation. (*Id.*) Maydew thus opined that "the U.K. Windfall Profit tax is, in substance, a tax on the annual accounting profits of the initial period to the extent they exceed an average annual return of approximately 11.1% of the flotation value of the firm." (JA1012.)

In its opinion, the Tax Court latched on to this analysis, emphasizing that "for 29 of the 31 windfall tax companies that paid tax, the effective rate of tax on deemed annual excess profits was at or near 51.7 percent." (JA61.) 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." (JA62, 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." (JA61.) Rather, Parliament enacted a 23% tax on the difference between a deemed profit-making value and actual flotation value.

Second, the 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. 26-27, *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." (JA258, ¶3; JA264, ¶¶8-9.) The 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. 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." (JA264, ¶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."[6] (JA390; JA344, 386.) He stated that "[t]he figure of nine is not arbitrary," explaining how it was selected, and stated that "a balance was struck between the rate at which the tax should be charged on one hand and the PE ratio on the other." (JA415.) 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." (JA370-71, 390.) And the Commissioner's expert on U.K. tax law, Philip Baker, explained that the simple formula likely was intended to avoid valuation disputes. (JA1482.) 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

[6] As set forth above (pp. 23-33), 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 rely on legislative history here only to rebut taxpayer's arguments and the Tax Court's analysis.

critical factors is a fundamental departure from what Parliament actually did.

Finally, the mathematical reformulation of the windfall-tax statute cannot be ascribed to 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"). (JA297 (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"). (JA60; JA343.) 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.” (JA344.) 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 relying on Parliamentary intent and in according probative weight to the trial testimony of a single legislator and his paid consultants regarding the legislative purpose of the windfall tax

The Tax Court improperly substituted consideration of Parliamentary intent for the evaluation of the statutory tax base that is required under Treas. Reg. § 1.901-2(b). Resort to the legislative history was not necessary here, as there is no ambiguity in how the windfall-tax statute defined the tax base, *i.e.,* profit-making value less flotation value, where both values were expressly defined by the statute. *See Williams*, 2011 U.S. App. LEXIS 2539 at *11-12. Compounding this error, the Tax Court further erred in relying on the trial testimony of Geoffrey Robinson and two members of the Andersen team, Christopher Wales and Chris Osborne, to elucidate the purpose of the windfall tax.[7] For example, the court cited their testimony that

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[7] Wales and Osborne testified at the trial in this case. Robinson

(continued...)

Parliament enacted the windfall tax—as opposed to a straightforward tax on income— for "presentational" reasons. (JA37-38, 63 n.35.) The court also twice cited the testimony of Osborne as supporting taxpayer's position. (JA57, n.29; JA59, 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 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.

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[7](...continued)
testified at the trial in *Entergy*, and his testimony was admitted as an exhibit in this case.

591, 602 (1924) ("an act of legislation is not the act of one legislator, and its meaning and purpose must be expressed in words"); *Szehinskyj v. Attorney General*, 432 F.3d 253, 256-60 (3d Cir. 2005) (discussing at length "the well-known admonition that what individual legislators say a statute will do, and what the language of the statute provides, may be far apart indeed," and stating that "[t]he law is what Congress enacts, not what its members say on the floor"). 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." (JA59-60.)

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); *United States v. Knox*, 32 F.3d 733, 749 n.14 (3d Cir. 1994) ("Arguments based on subsequent legislative history, like arguments based on antecedent futurity, should not be taken seriously, not even in a footnote.") (quoting *Sullivan v. Finkelstein*, 496 U.S. 617, 631-32 (1990) (Scalia, J., concurring in part)); *Covalt v. Carey Canada, Inc.*, 860 F.2d 1434, 1438-39 (7th Cir. 1988) ("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.[8] 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. (JA 37-38, 59-62, 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 not only improperly substituted consideration of Parliamentary intent for the required evaluation of the statutory tax base, but it went far beyond what could properly be considered in determining that legislative intent.

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[8] To the contrary, Wales testified that although the Andersen team presented its proposed legislation to the U.K. Treasury, the U.K. government drafted its own windfall-tax legislation (and devised the statutory term "value in profit-making terms," which was not proposed by Andersen), and that no one from Inland Revenue or Parliament contacted Andersen to ask what it had in mind in designing the proposed legislation. (JA1200-01, 1209-13.)

CONCLUSION

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

Respectfully submitted,

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MAY 2011

CERTIFICATE OF BAR MEMBERSHIP

Pursuant to Local Appellate Rule 28.3(d), it is hereby certified that because the attorneys on this brief represent the Federal Government, the requirement that at least one attorney must be a member of the bar of this Court is waived.

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1. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because:

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s/ Francesca U. Tamami
FRANCESCA U. TAMAMI
Attorney for the Appellant
Dated: May 5, 2011

JOINT APPENDIX

VOLUME I

Docket No.	Document	JA Page No.
80	Notice of Appeal	1
79	Tax Court Decision	2
76	Tax Court Opinion	4

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UNITED STATES TAX COURT

PPL CORPORATION & SUBSIDIARIES	)
Petitioner,	)
v.	) Docket No. 25393-07
COMMISSIONER OF INTERNAL REVENUE,	)
Respondent.	)

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NOTICE OF APPEAL

Notice is hereby given that the Commissioner of Internal Revenue appeals to the United States Court of Appeals for the Third Circuit from the decision of this Court entered in the above-captioned proceeding on October 14, 2010.

Petitioner's principal office and principal place of business were located in Allentown, PA, at the time the petition was filed with the Tax Court. Accordingly, appellant venue properly lies in the United States Court of Appeals for the Third Circuit.

Dated: JAN - 4 2011

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A True Copy
Attest: Robert R. Di Trolio
Clerk of the Court
By ________
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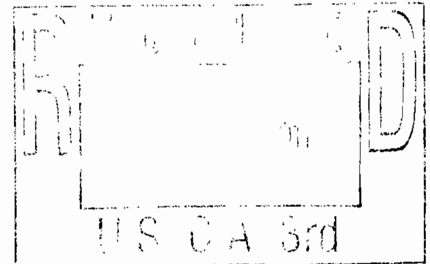

UNITED STATES TAX COURT

PPL CORPORATION AND SUBSIDIARIES,)
Petitioner,)
v.) Docket No. 25393-07.
COMMISSIONER OF INTERNAL REVENUE,)
Respondent.)

DECISION

Pursuant to the Court's Opinions filed July 28, 2010 (135 T.C. No. 8), and September 9, 2010 (135 T.C. No. 15), and incorporating herein the facts recited in the parties' Computation Statement as the findings of the Court, it is

ORDERED AND DECIDED: That there is an overpayment in income tax due to petitioner for the taxable year ended December 31, 1997 in the amount of $1,778,519.07, which was paid on December 5, 2007; and

That for the taxable year ended December 31, 1997 a claim for refund was filed before or could have been filed under I.R.C. § 6511(c) on October 25, 2007, the date of the mailing of the notice of deficiency, for $1,778,519.07 and the overpayment for the taxable year ended December 31, 1997 is allowed under I.R.C. § 6512(b)(3)(A).

(Signed) J. S. Halpern
Judge.

Entered: OCT 14 2010

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The parties stipulate that the foregoing Decision is in accordance with the Court's Opinions filed July 28, 2010 (135 T.C. No. 8), and September 9, 2010 (135 T.C. No. 15) and the parties' Computation Statement, and that the Court may enter this Decision, without prejudice to the right of either party to contest the correctness of the Decision entered herein including without prejudice to respondent's right to appeal this Decision.

It is further stipulated that the overpayment in income tax due to petitioner for petitioner's taxable year ended December 31, 1997 does not include statutory interest.

It is further stipulated that statutory interest will be credited or paid as provided by law on the overpayment in income tax due to petitioner for petitioner's taxable year ended December 31, 1997.

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Date: October 7, 2010

135 T.C. No. 15

UNITED STATES TAX COURT

PPL CORPORATION & SUBSIDIARIES, Petitioner v.
COMMISSIONER OF INTERNAL REVENUE, Respondent

Docket No. 25393-07. Filed September 9, 2010.

Held: The United Kingdom windfall tax enacted on July 2, 1997, and imposed on certain British utilities is a creditable tax under sec. 901, I.R.C.

Richard E. May, Mark B. Bierbower, and Timothy L. Jacobs, for petitioner.

Melissa D. Arndt, Allan E. Lang, Michael C. Prindible, and R. Scott Shieldes, for respondent.

HALPERN, Judge: PPL Corp. (petitioner) is the common parent of an affiliated group of corporations (the group) making a consolidated return of income. By notice of deficiency,

respondent determined a deficiency of $10,196,874 in the group's Federal income tax for its 1997 taxable (calendar) year and also denied a claim for refund of $786,804. The issues for decision are whether respondent properly (1) denied the claim for the refund, which is related to the creditability of the United Kingdom (U.K.) windfall tax paid by petitioner's indirect U.K. subsidiary (the windfall tax issue), (2) included as dividend income a distribution that petitioner received from the same indirect U.K. subsidiary, but which, within a few days, the subsidiary rescinded and petitioner repaid (the dividend rescission issue), and (3) denied depreciation deductions that petitioner's U.S. subsidiary claimed for street and area lighting assets. We disposed of the third issue in a previous report, PPL Corp. & Subs. v. Commissioner, 135 T.C. ___ (2010), and we dispose of the remaining issues here.

Unless otherwise stated, all section references are to the Internal Revenue Code in effect for 1997, and all Rule references are to the Tax Court Rules of Practice and Procedure. With respect to the two issues before us here, petitioner bears the burden of proof. See Rule 142(a).[1]

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[1]Petitioner has not raised the issue of sec. 7491(a), which shifts the burden of proof to the Commissioner in certain situations. We conclude that sec. 7491(a) does not apply because petitioner has not produced any evidence that it has satisfied the preconditions for its application. See sec. 7491(a)(2).

FINDINGS OF FACT

Stipulations

The parties have entered into a first, second, and third stipulation of facts. The facts stipulated are so found. The stipulations, with accompanying exhibits, are incorporated herein by this reference.

Petitioner's Business and Its U.K. Operation

Petitioner is a Pennsylvania corporation that was known during 1997 as PP&L Resources, Inc. It is a global energy company. Through its subsidiaries, it produces electricity, sells wholesale and retail electricity, and delivers electricity to customers. It provides energy services in the United States (in the Mid-Atlantic and the Northeast) and in the United Kingdom. During 1997, South Western Electricity plc (SWEB), a U.K. private limited liability company, was petitioner's indirect subsidiary.[2] Its principal activities at the time included the distribution of electricity. It delivered electricity to approximately 1.5 million customers in its 5,560-square-mile service area from Bristol and Bath to Land's End in Cornwall. SWEB also owned electricity-generating assets.

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[2]SWEB was originally incorporated as a U.K. public limited liability company in 1987, but, as described infra, it was privatized in 1990. The appendix shows SWEB's relationship to petitioner in 1997.

Privatization of U.K. Companies

The Conservative Party won control of the U.K. Parliament in the 1979 elections. It retained control through May 1997, under the leadership of Margaret Thatcher and John Major.

Between 1979 and 1983, the Conservatives privatized mostly companies that were not monopolies (e.g., manufacturing companies) and, for that reason, did not require specific economic regulation. Between 1984 and 1996, however, the U.K. Government privatized more than 50 Government-owned companies, many of which were monopolies.

The U.K. Government privatized those companies largely through public flotations (share offerings) at fixed price offers, which involved the transfer of those Government-owned enterprises to new public limited companies (plcs), followed by what was essentially a sale of all or some of the shares in the new plcs to the public.[3] The plcs then became publicly traded

[3]The U.K. Government hired investment banks and other advisers to assist it in setting the initial share prices, structuring the offers, and marketing the shares to investors. The new plcs were not subject to a gains tax on transfers of stock to the general public, a result made possible by an amendment to the then-existing U.K. law.

Under sec. 171 of the U.K. Taxation of Chargeable Gains Act, 1992 (TCGA), companies within a group (generally, a parent and its 75-percent-owned subsidiaries) may transfer assets between members of the group without incurring a capital gains charge. The effect of TCGA sec. 171 is to defer the chargeable gain on asset appreciation until a group member transfers the asset outside the group, at which point the gain becomes chargeable to
(continued...)

companies listed on the London Stock Exchange. In most cases, the floated shares opened for trading at a substantial premium over the price the flotation investors paid for the shares.

In December 1990, the U.K. Government privatized 12 regional electric companies (RECs), including SWEB. The ordinary shares of each REC were offered to the public at £2.40 per share in connection with the flotation of those shares.

The 32 U.K. Government-owned companies that were privatized and that ultimately became liable for the windfall tax (the privatized utilities or windfall tax companies) and the years in which they were privatized are as follows:

Year	Company
1984	50.2 percent of British Telecommunications plc (British Telecom)
1986	British Gas plc
1987	British Airports Authority

[3](...continued)
that transferor. Under the TCGA as originally enacted, however, the transfer outside the group of the stock of a group member holding an appreciated asset would not trigger any capital gains charge to the transferor. (The nongroup transferee, meanwhile, would receive a basis in the stock that would reflect the value of the underlying asset.) TCGA sec. 179 was enacted to make the tax consequences of the stock transfer similar to those of the asset transfer, although only if the transfer of the stock of the group member holding the asset occurred within 6 years of that member's acquisition of the asset. Because the transfers of the stock of the privatized utilities to the general public pursuant to the flotations of that stock would have triggered the application of TCGA sec. 179 and taxation of the appreciation inherent in the assets the companies received from the various U.K. Government-owned enterprises, Parliament specifically exempted the privatization share transfers from the application of that provision.

1989	10 water and sewerage companies (the WASCs)
1990	The 12 RECs
1991	60 percent of National Power plc and Powergen plc (the generating companies)
1991	Scottish Power plc and Scottish Hydro-Electric plc (the Scottish electricity companies)
1993	Northern Ireland Electricity (NIE)
1996	Railtrack plc (Railtrack)
1996	88.5 percent of British Energy plc (British Energy) (which owned U.K. nuclear generating stations)

Regulation of the Windfall Tax Companies

The Electricity Act of 1989, c. 29, sec. 1, created the position of U.K. Director General of Electricity Supply, a position that Professor Stephen C. Littlechild (Professor Littlechild) held from its creation in 1989 through 1998.[4]

Before that appointment, in 1983, the U.K. Secretary of State asked Professor Littlechild for his advice on how to regulate British Telecom in the light of its impending privatization. Professor Littlechild recommended a regulatory scheme which regulated prices rather than, as in the United States, maximum profits or rates of return. The premise of the scheme, which became known as “RPI - X”,[5] was that, if the Government fixed prices (but not profits) for a set number of

[4]Professor Littlechild was professor of commerce and head of the Department of Industrial Economics and Business Studies, University of Birmingham (on leave, 1989 to 1994) from 1975 to 1994 (and honorary professor from 1994 until 2004).

[5]RPI, which stands for retail price index, is comparable to the CPI (consumer price index) used for various purposes in the United States.

years, the privatized companies would have an incentive to reduce costs to maximize profits during that period. Prices would be reset (presumably downward) at the start of the next regulatory period, to garner for consumers the fruits of the prior period's cost reductions. Profits might in a sense become excessive during any regulatory period (because a company achieved greater-than-anticipated savings and there was no mechanism for mid-period correction), but balance would be reestablished at the start of the next period. The goal was to increase efficiency, encourage competition, and protect consumers. Under RPI - X, prices were not allowed to increase during the regulatory period, except to allow for inflation (i.e., increases in RPI) less an amount (the X factor, which did not vary during the period) intended to reflect expected, increasing efficiency.

The U.K. Government set the X factors for the first regulatory periods, just before the initial privatization, to be effective for what was, in most cases, the 5-year period after privatization. Industry regulators subsequently reset the X factors, typically every 4 or 5 years. In some cases, particularly where investment requirements were high (e.g., in the case of companies that had underinvested while under public ownership), the X factor might be positive (RPI + X). That was the case for most of the RECs and WASCs.

Each of the regulatory bodies for the privatized utilities followed the RPI - X regulatory method, which was adopted for 29 of the 32 windfall tax companies, the exceptions being the generating companies. On March 31, 1990, the RPI - X methodology as applied to the RECs came into effect for the 5-year period ending March 31, 1995. As noted supra, because the RECs were in need of large capital expenditures during the initial 5-year period, the U.K. Government set price controls for the RECs in the form of RPI + X; i.e., it provided for annual increases in electricity distribution charges above the rate of inflation rather than reductions in those charges.

Utility Profits, Share Prices, and Executive Compensation During the Initial Postprivatization Period

During the initial postprivatization period (the initial period), 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. That ability led to higher-than-anticipated profits,[6] which, in turn, led to higher-than-anticipated dividends and share price increases for the privatized utilities. The large profits, dividends, and share price increases resulted

[6]Among the privatized utilities, the RECs and the WASCs were particularly profitable during the initial period in that they recovered nearly all (over 90 percent for the WASCs and over 80 percent for the RECs) of their shareholders' initial investment at flotation within the first 4 years.

in sharply increased compensation for utility directors and executives, which, in some cases, arose through their share ownership and through bonus schemes. The popular press referred to those executives as “fat cats”.

The public viewed the privatized utilities’ initial period profits as excessive in relation to their flotation values. It also viewed the initial period compensation paid to the directors and executives of those companies as excessive. Those concerns, as well as the increases in dividends and share prices, resulted in considerable public pressure on the utility industry regulators to intervene and take action that would result immediately in lower prices, before the expiration of the initial 5-year period. But because the incentive for increased efficiency (and, ultimately, lower prices) depended on the regulators’ not intervening until the end of the defined price control period, the regulators resisted that pressure and did not act until the end of the initial period, at which point they did tighten price controls and thereby transfer the benefit of reduced prices to utility customers. Despite those price adjustments, the public retained a strong feeling that the privatized utilities had unduly profited from privatization and that customers had not shared equally in the gains therefrom.

Development of the Windfall Tax

Although the Labour Party had been fundamentally opposed to privatization, particularly with respect to the utilities, by 1992 the party reasoned that, because it would be costly and, given that much of the voting public had embraced share ownership, potentially unpopular, renationalization of those companies (when the party regained control of the Government) was unrealistic. The issue, then, was how the party might best channel the public concerns into developing policy.

As early as 1992, the British press reported that the policy of an incoming Labour Party might include "a 'windfall' tax on the profits of privatized utilities such as gas and electricity." By 1994 the idea of a windfall tax had become a regular feature in all Labour Party speeches and programs, and, in 1997, the party campaigned on a platform promising that it would (1) impose a windfall tax on the previously privatized utilities and (2) implement a welfare-to-work youth employment training program that the windfall tax would fund. Specifically, the Labour Party's 1997 Election Manifesto contained the following promise:

> We will introduce a Budget * * * to begin the task of equipping the British economy and reforming the welfare state to get young people and the long-term unemployed back to work. This welfare-to-work programme will be funded by a windfall levy on the excess profits of the privatised utilities * * *.

In May 1996, before the issuance of that manifesto, certain members of the Labour Party's shadow treasury team, which

included Geoffrey Robinson (Mr. Robinson), a Member of Parliament, began designing the U.K. windfall tax legislation that the party would introduce to Parliament in the likely event that it won the 1997 election. To that end, Mr. Robinson commissioned members of the tax consulting firm Arthur Andersen (the Andersen team) to assist the Labour Party's shadow treasury team in developing the tax. The Andersen team consisted principally of Stephen Hailey, Christopher Osborne (Mr. Osborne), and Christopher Wales (Dr. Wales). The tax that the Andersen team devised was essentially the windfall tax that Parliament enacted in July 1997. Mr. Osborne and Dr. Wales were the most involved members of the Andersen team.

During their initial consideration of the design of the windfall tax, the Andersen team proposed three "simple" and three "complex" solutions for structuring the tax. The "simple" solutions were to tax either (1) turnover (gross receipts), (2) assets, or (3) profits. The "complex" solutions were to tax (1) excess profits, (2) excess shareholder returns, or (3) a "windfall" amount. The team members rejected the three "simple" solutions and the first two "complex" solutions for a variety of reasons. For example, they considered that a straightforward tax on profits, if prospective, would pose a risk of financial manipulation by the target companies (and, therefore, uncertainty as to its yield), a risk of public perception that it would

compromise existing corporate tax reliefs, and, if retrospective, a risk of criticism that it constituted a second tax on the same profits. And although Mr. Robinson and the Andersen team considered that there was ample rationale for a straightforward tax on either excess profits or excess shareholder returns, they concluded that the negative aspects (e.g., 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 excess shareholder returns, the likelihood of taxing the wrong shareholders, i.e., shareholders who did not realize those returns) outweighed the positive ones.

As a result of the perceived difficulties with the other approaches, Mr. Robinson and the Andersen team settled on the idea of a tax that would be a one-time (or, in U.K. parlance, a "one-off") tax on the "windfall" to the privatized utilities on privatization. The approach would be to impute a value to each company at privatization, using an appropriate price-to-earnings ratio for each company's profits during the first 5 years after flotation, recognize the "windfall" (the difference between the imputed value and the flotation price) as value forgone by taxpayers, and tax the privatized utilities on that "windfall" using established principles from capital gains tax legislation.[7]

[7]In November 1996, in a presentation to Gordon Brown (Labour's next Chancellor of the Exchequer) and the Labour (continued...)

They reasoned that such a tax would factor in the privatized utilities' "excess" profitability, the discount on privatization, the unanticipated efficiency gains, and the perceived weakness of the initial regulatory regime.

In November 1996, the foregoing proposal was reviewed and approved by Gordon Brown (who became Chancellor of the Exchequer when Labour returned to power in 1997) and the Labour Party's shadow treasury team, and, after the Labour Party regained power in 1997, by the U.K. Treasury Department, Inland Revenue, and the Parliamentary drafters (who drafted the actual legislative language), after which the draft legislation was disseminated to members of Parliament and enacted in July 1997.

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[7](...continued)
Party's shadow treasury team, the Andersen team set forth the average price-to-earnings ratios for the various privatized utility groups during the first 5 years after privatization, which ranged from a high of 12.7 after-tax and 9.4 pre-tax (both for the Scottish Electricity companies) to a low of 9.4 after-tax (for the WASCs) and 7.3 pre-tax (for the RECs). The presentation also set forth the potential revenue yield from using price-to-pre-tax earnings ratios of 6 through 8 to ascertain the imputed values of the companies and showed that a potential revenue yield of £6.4 billion could be achieved by using for that purpose either a pre-tax ratio of 6 or an after-tax ratio of 8.25 coupled with a 33-percent windfall tax rate on the excess of the imputed value over the flotation price.

Description of the Windfall Tax

On July 31, 1997, Parliament enacted the windfall tax. It constituted part I of chapter 58, Finance (No. 2) Act 1997 (the Act), and provided, in clause 1, as follows:

> 1.--(1) Every 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.
>
> (2) Windfall tax shall be charged at the rate of 23 per cent.
>
> (3) Schedule 1 to this Act (which sets out how to quantify the windfall from which a company was benefitting on 2nd July 1997) shall have effect.

Clause 2 makes clear that the windfall tax is to apply to the 32 privatized utilities, clause 3 provides for the administration of the tax by the Commissioners of Inland Revenue, clause 4 covers the relationship between the windfall tax and profit-related pay schemes under the then-existing U.K. law, and clause 5 sets forth the definitions of terms used in part I.

Paragraphs 1 and 2 of schedule 1, referred to in clause 1(3), provide in pertinent part as follows:

> 1.--(1) * * * where a company was benefitting on 2nd July 1997 from a windfall from the flotation of an undertaking whose privatisation involved the imposition of economic regulation, the amount of that windfall shall be taken for the purposes of this Part to be the excess (if any) of the amount specified in sub-paragraph (2)(a) below over the amount specified in sub-paragraph (2)(b) below.

(2) Those amounts are the following amounts * * *, that is to say--

(a) the value in profit-making terms of the disposal made on the occasion of the company's flotation; and

(b) the value which for privatisation purposes was put on that disposal.

<u>Value of a disposal in profit-making terms</u>

2.--(1) * * * the value in profit-making terms of the disposal made on the occasion of a company's flotation is the amount produced by multiplying the average annual profit for the company's initial period by the applicable price-to-earnings ratio.

(2) For the purposes of this paragraph the average annual profit for a company's initial period is the amount produced by the following formula--

$$A = 365 \times P/D$$

Where--

A is the average annual profit for the company's initial period;

P is the amount * * * of the total profits for the company's initial period; and

D is the number of days in the company's initial period.

(3) For the purposes of this paragraph the applicable price-to-earnings ratio is 9.

Paragraph 3 defines "value put on a disposal for privatisation purposes"; i.e., the flotation value. Paragraph 4 provides for an appropriate percentage reduction of a company's "value in profit-making terms" and its flotation value where less than 85 percent of the company's ordinary share capital was "offered for disposal on the occasion of the company's

flotation." Paragraph 5 sets forth the criteria for determining a company's "total profits for a company's initial period" and generally provides that those profits are its after-tax profits for financial reporting purposes as determined under relevant provisions of the U.K. Companies Act 1985.[8] Paragraph 6 defines the term "initial period" in relation to a company as the period encompassing the company's 4 financial years after flotation or such lesser period of existence for companies operating for less than 4 financial years after privatization and before April 1, 1997.[9] Paragraph 7 provides for the apportionment of the windfall amount subject to tax between companies that previously had been a single privatized company. Lastly, paragraph 8 defines the term "financial year" and other terms for purposes of the windfall tax legislation.

The Act required that affected companies pay the windfall tax in two installments: one-half on or before December 1, 1997, and the other half on or before December 1, 1998.

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[8]The parties stipulate that profit for a windfall tax company's initial period was equal to the company's "profit on ordinary activities after tax" as determined under U.K. financial accounting principles and standards and as shown in the company's profit and loss accounts prepared in accordance with the U.K. Companies Act of 1985, as amended.

[9]From this point forward, the term "initial period" refers to the 4-year windfall tax initial period rather than the 5-year initial postprivatization period under the RPI - X regulatory regime.

Public Statements Regarding the Windfall Tax

On July 2, 1997, Gordon Brown, then Chancellor of the Exchequer, gave the Budget Speech announcing the windfall tax, and he described the windfall tax as follows:

> Our reform to the welfare state--and the programme to move the unemployed from welfare to work--is funded by a new and one-off windfall tax on the excess profits of the privatised utilities.
>
> * * * * * * *
>
> In determining the details of the tax, I believe I have struck a fair balance between recognising the position of the utilities today and their under-valuation and under-regulation at the time of privatisation.
>
> The windfall tax will be related to the excessively high profits made under the initial regime.
>
> A company's tax bill will be based on the difference between the value that was placed on it at privatisation, and a more realistic market valuation based on its after-tax profits for up to the first 4 full accounting years following privatisation.

Also on July 2, 1997, Inland Revenue issued an announcement describing the tax as follows:

> The Chancellor today announced the introduction of the proposed windfall tax on the excess profits of the privatised utilities. The one-off tax will apply to companies privatised by flotation and regulated by statute. The tax will be charged at a rate of 23 per cent on the difference between company value, calculated by reference to profits over a period of up to four years following privatisation, and the value placed on the company at the time of flotation. The expected yield is around 5.2 billion Pounds.

The Inland Revenue announcement also stated that the price-to-earnings ratio of 9 "approximates to the lowest average

price/earnings ratio of the taxpaying companies during the relevant periods, grouped by sector."

Around that same time, Her Majesty's Treasury issued a publication entitled "Explanatory Notes: Summer Finance Bill 1997", which describes in detail the various clauses of the windfall tax, and which contains a section entitled "Background", stating:

> The introduction of the windfall tax is in accordance with the commitment in the Government's Election Manifesto to raise a tax on the excess profits of the privatised utilities.
>
> The profits made by these companies in the years following privatisation were excessive when considered as a return on the value placed on the companies at the time of their privatisation by flotation. This is because the companies were sold too cheaply and regulation in the relevant periods was too lax.
>
> The windfall tax will raise around £5.2 billion and fund the Government's welfare to work programme.

Parliamentary Debate Preceding Enactment of the Windfall Tax

Mr. Robinson, in opening the debate in the House of Commons on the windfall tax legislation, offered the following introductory observations:

> Clause 1 heads a group of provisions that together introduce the windfall tax, thus meeting the commitment that we made in our election manifesto to introduce a windfall levy on the excess profits of the privatised utilities. Those companies were sold too cheaply, so the taxpayer got a bad deal. Their initial regulation in the period immediately following privatisation was too lax, so the customer got a bad deal.
>
> As a result, the companies were able to make profits that represented an excessive return on the value

> placed on them at the time of their flotation. We are now putting right the failures of the past by levying a one-off tax. The yield of around £5.2 billion will fund our welfare-to-work programme, and the new deal that we have announced for the young long-term unemployed and schools.
>
> Clause 1 provides a one-off charge, set at a rate of 23 per cent. It also gives effect to schedule 1, which will be debated in Standing Committee. It may be helpful if I set the clause in context by explaining briefly how the windfall tax works.
>
> Windfall tax is charged on the difference between the value of the company, calculated by reference to the profits made in the initial period after privatisation, and the value placed on the company at the time of privatisation. The value of the company is calculated by multiplying the average annual profit after tax for, normally, the first four financial years after flotation, by a price-to-earnings ratio of nine. That ratio approximates to the lowest average * * * sectoral price-to-earnings ratio of the companies liable to the tax. * * *

The Conservative Party Shadow Chancellor of the Exchequer, Peter Lilley, MP (Mr. Lilley), summarized his party's opposition to the windfall tax, and, in particular, clause 1 imposing the tax, as follows:

> We have four major criticisms of the clause and the windfall tax that it initiates. First, the clause makes it clear that the tax will not be borne by the so-called fat cats and speculators, criticisms of whom justified its introduction. Secondly, it makes no meaningful attempt to define what is a windfall and should therefore bear the tax. Thirdly, it increases instead of reduces cost to customers; any improved profitability should be passed on to customers in the form of lower prices. Finally, it is retrospective, arbitrary and symptomatic of the Government's belief in arbitrary government, rather than in government by known and predictable rules.

Mr. Lilley's comments during the debate illustrate his understanding of how the tax would affect the privatized utilities:

> They [the government] have taken average profits over four years after flotation. If those profits exceed one ninth of the flotation value, the company will pay windfall tax on the excess. * * *

And further:

> Essentially, the windfall tax boils down to a tax on success. Companies that failed to improve their profitability over the said period will pay much less or even no windfall tax. * * *

Other members of the Conservative Party repeated the idea that the windfall tax was a tax on profits or on success.

Several Labour Party members defended the tax as a legitimate method of recouping the difference between what should have been charged for the privatized utilities at the time of the various privatizations and the actual flotation prices. For example, one such member, Mr. Hancock, observed:

> The overwhelming majority of people have embraced the tax because most think that they were ripped off in the first place when the companies were sold. The companies were sold at hopelessly undervalued prices at a time when most people felt that the companies were better and safer in the hands of the public sector. The legitimacy of the tax among the general public is that they feel that they are getting back what they should have had in the first place.

Another, Mr. Stevenson, echoed Mr. Hancock's remarks:

> I asked the Library to do some research on the difference between the proceeds from privatization of the utilities, not including the railways, and their stock market share price the minute they were floated.

> I asked the Library to tot up the difference. It was almost £6 billion at the outset of privatisation and it has increased over the years. So the snapshot figure of £6 billion by which the Government undersold public assets, and therefore robbed the public, is a conservative estimate.

Overall Effect of the Windfall Tax on the Windfall Tax Companies

Thirty-one of the thirty-two windfall tax companies had a windfall tax liability. None of the 31 companies that paid windfall tax had a windfall tax liability that exceeded its total profits over its initial period. Twenty-nine of those thirty-two companies had initial periods of 4 full financial years. Twenty-seven of those twenty-nine companies had initial periods consisting of 1,461 days, i.e., three 365-day years and one 366-day (leap) year. The other 2 of those 29 companies had initial periods of 1,456 days and 1,463 days,[10] respectively. The remaining three companies had initial periods of less than 4 full financial years, consisting of 1,380 days, 316 days, and (in the case of British Energy, which because of low initial profits, paid no windfall tax) 260 days, respectively.

Effect of the Windfall Tax on SWEB

Before the enactment of the windfall tax, SWEB met with members of the shadow treasury team (which included Mr. Robinson) and the Andersen team in an effort to influence the development

[10] The parties stipulated an initial period of 1,463 days, although that would seem to exceed 4 years, even taking into account a leap year.

of the windfall tax. SWEB's then treasurer, Charl Oösthuizen (Mr. Oösthuizen), was the SWEB officer principally engaged in that effort. Upon the announcement of the windfall tax, SWEB realized that its liability for the tax would greatly exceed its prior estimates thereof, and it investigated ways of reducing that liability. SWEB determined that it could reduce its windfall tax liability if it could reduce its earnings for the 4-year initial period. To that end, SWEB identified a theretofore unidentified liability of £12 million for tree-trimming costs (trees interfered with its distribution network) that SWEB should have taken account of in determining its earnings for its fiscal year ended March 31, 1995. SWEB's outside auditor approved a restatement of its 1995 earnings and, after an initial objection, Inland Revenue did as well.

SWEB filed its windfall tax return with Inland Revenue on November 7, 1997, and paid its £90,419,265 windfall tax liability (which was based on 4 full financial years totaling 1,461 days), as required, in two installments, on December 1, 1997 and 1998. The first installment was paid 1 day after the close of SWEB's tax year (for U.S. Federal income tax purposes) ending November 30, 1997.

OPINION

I. The Windfall Tax Issue

A. Principles of Creditability

Pursuant to section 901(a) and (b)(1), a domestic corporation may claim a foreign tax credit against its Federal income tax liability for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country". We must decide whether the windfall tax constitutes a creditable income or excess profits tax under section 901.

In Phillips Petroleum Co. v. Commissioner, 104 T.C. 256, 283-284 (1995), we described the background, purpose, and function of the foreign tax credit provisions of the Internal Revenue Code as follows:

> The foreign tax credit provisions were enacted primarily to mitigate the heavy burden of double taxation for U.S. corporations operating abroad who were subject to taxation in both the United States and foreign countries. Burnet v. Chicago Portrait Co., 285 U.S. 1, 9 (1932); F.W. Woolworth Co. v. Commissioner, 54 T.C. 1233, 1257 (1970). These provisions were originally designed to produce uniformity of tax burdens among U.S. taxpayers, irrespective of whether they were engaged in business abroad or in the United States. H. Rept. 1337, 83d Cong., 2d Sess. 76 (1954). A secondary objective of the foreign tax credit provisions was to encourage, or at least not to discourage, American foreign trade. H.R. Rept. 767, 65th Cong., 2d Sess. (1918), 1939-1 C.B. (Part 2) 86, 93; Commissioner v. American Metal Co., 221 F.2d 134, 136 (2d Cir. 1955), affg. 19 T.C. 879 (1953).
>
> Taxes imposed by the government of any foreign country were initially fully deductible in computing

> net taxable income, pursuant to our income tax law of 1913. Revenue Act of 1913, ch. 16, 38 Stat. 114. Specific foreign taxes became creditable pursuant to the Revenue Act of 1918. The foreign taxes that are presently creditable pursuant to section 901, specifically, income, war profits, and excess profits taxes, have remained unchanged and are the same taxes that were creditable in 1918. Revenue Act of 1918, ch. 18, sec. 222(a)(1), 40 Stat. 1073.
>
> The definition of income, war profits, and excess profits taxes has evolved case by case. The temporary and final regulations, adopted relatively recently, outline the guiding principles established by prior case law. * * *

The Supreme Court in Biddle v. Commissioner, 302 U.S. 573, 579 (1938), established the principle, uniformly followed in subsequent caselaw and enshrined in the regulations, that, in deciding whether a foreign tax is an "income tax" for purposes of section 901, the term "income tax" will be given meaning by referring to the U.S. income tax system and measuring the foreign tax against the essential features of that system:

> The phrase "income taxes paid," as used in our own revenue laws, has for most practical purposes a well understood meaning * * *. It is that meaning which must be attributed to it * * *.

The final regulations referred to in Phillips Petroleum are the regulations that were issued in 1983, were in effect in 1997 (the year in issue), and remain in effect today (sometimes, the 1983 regulations).

Section 1.901-2, Income Tax Regs., is entitled "Income, war profits, or excess profits tax paid or accrued." Paragraph (a) thereof is entitled "Definition of income, war profits, or excess

profits tax", and, in pertinent part, it provides as follows (adopting the term "income tax" to refer to an "income", "war", or "excess profits" tax):

> (1) In general. * * * 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.

Paragraph (a) further provides that, with exceptions not relevant to this case, "a tax either is or is not an income tax, in its entirety, for all persons subject to the tax."

In pertinent part, section 1.901-2(a)(3), Income Tax Regs., defines the term "predominant character" as follows: "The predominant character of a foreign tax is that of an income tax in the U.S. sense * * * [i]f, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies".

In pertinent part, section 1.901-2(b)(1), Income Tax Regs., provides:

> 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.

Pursuant to section 1.901-2(b)(2)(i), Income Tax Regs. (as pertinent to this case), a foreign tax satisfies the realization requirement:

> if, judged on the basis of its predominant character, it is imposed * * * [u]pon 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 * * *

Pursuant to section 1.901-2(b)(3)(i), Income Tax Regs. (as pertinent to this case), a foreign tax satisfies the gross receipts requirement "if, judged on the basis of its predominant character, it is imposed on the basis of * * * [g]ross receipts".

Pursuant to section 1.901-2(b)(4)(i), Income Tax Regs., 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 * * * to permit--
>
> (A) Recovery of the significant costs and expenses * * * attributable * * * to such gross receipts; or
>
> (B) Recovery of such significant costs and expenses computed under a method that is likely to * * * [approximate or be greater than] recovery of such significant costs and expenses.

Section 1.901-2(b)(4)(i), Income Tax Regs., further provides:

> 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,[11] unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery. * * * 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. * * * A foreign tax whose base is gross receipts or gross income

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[11]E.g., items deductible under the Internal Revenue Code and capitalized and amortized under the foreign tax system.

> 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. * * *

The Secretary first adopted the "predominant character" standard in the 1983 regulations. In the preamble to those regulations (the preamble), the Secretary stated that the standard:

> adopts the criterion for creditability set forth in Inland Steel Company v. U.S., 677 F.2d 72 (Ct. Cl. 1982), Bank of America National Trust and Savings Association v. U.S., 459 F.2d 513 (Ct. Cl. 1972), and Bank of America National Trust and Savings Association v. Commissioner, 61 T.C. 752 (1974). [T.D. 7918, 1983-2 C.B. 113, 114.]

In the cases the Secretary cited in the preamble and in other, more recent, cases, the issue or test regarding the status of a foreign tax as a creditable income tax appears to be whether the foreign tax in question is designed to and does in fact reach net gain in the normal circumstances in which it applies. Thus, in Bank of Am. Natl. Trust & Sav. Association v. United States, 198 Ct. Cl. 263, 274, 459 F.2d 513, 519 (1972) (Bank of America I), which the Secretary cites in the preamble, the Court of Claims, in considering the creditability of a gross income tax that, on its face, was not a tax on net income or gain, concluded that such a tax could be creditable under certain circumstances:

> We do not, however, consider it all-decisive whether the foreign income tax is labeled a gross income or a net income tax, or whether it specifically allows the deduction or exclusion of the costs or expenses of realizing the profit. 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. In certain situations a levy can in reality be directed at net gain even though it is imposed squarely on gross income. That would be the case if it were clear that the costs, expenses, or losses incurred in making the gain would, in all probability, always (or almost so) be the lesser part of the gross income. In that situation there would always (or almost so) be some net gain remaining, and the assessment would fall ultimately upon that profit.[12]

In Inland Steel Co. v. United States, 230 Ct. Cl. 314, 325, 677 F.2d 72, 80 (1982), also cited in the preamble, the Court of Claims, relying on its earlier decision in Bank of America I, emphasized the purpose of the foreign country in designing the tax to reach net gain:[13]

> To qualify as an income tax in the United States sense, the foreign country must have made an attempt always to reach some net gain in the normal circumstances in which

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[12]The test the Court of Claims adopted for the creditability of a foreign gross income tax (the virtual certainty of net gain) is specifically incorporated in the regulations. See sec. 1.901-2(b)(4)(i), Income Tax Regs., quoted supra.

[13]As the Court of Appeals for the Second Circuit stated in Texasgulf, Inc. v. Commissioner, 172 F.3d 209, 216 (2d Cir. 1999) (Texasgulf II), affg. 107 T.C. 51 (1996) (Texasgulf I), the preamble to the 1983 regulations "reaffirms Inland Steel's general focus upon the extent to which a tax reaches net gain". In Texasgulf II, the Court of Appeals found creditable under the predominant character standard in the 1983 regulations a tax, the Ontario Mining Tax, that the Court of Claims, in Inland Steel Co. v. United States, 230 Ct. Cl. 314, 677 F.2d 72 (1982), had found noncreditable before the promulgation of those regulations. See discussion infra.

> the tax applies. * * * The label and form of the foreign tax is not determinative. * * *

In Bank of Am. Natl. Trust & Sav. Association v. Commissioner, 61 T.C. 752, 760 (1974), affd. without published opinion 538 F.2d 334 (9th Cir. 1976), the third case the Secretary cites in the preamble, we described the analysis of the Court of Claims in Bank of America I as "[distilling]" the governing test to determine whether a foreign income tax qualifies as a creditable income tax within the meaning of section 901(b)(1); i.e., whether the tax was "designed to fall on some net gain or profit". That test, we added, "is the proper one to apply". Id.

Moreover, courts have construed the 1983 regulations in a manner consistent with the analysis in Bank of America I. For example, the Court of Appeals for the Second Circuit, in Texasgulf, Inc. v. Commissioner, 172 F.3d 209 (2d Cir. 1999) (Texasgulf II), affg. 107 T.C. 51 (1996) (Texasgulf I), considered the creditability of the Ontario Mining Tax (OMT), which imposed a graduated tax on Ontario mines to the extent that "profit", as defined for OMT purposes, exceeded a statutory exemption. In determining "profit" for OMT purposes, taxpayers were allowed to deduct "an allowance for profit in respect of processing" (processing allowance) in lieu of certain expenses that were attributable to OMT gross receipts but that were not recoverable under the tax (nonrecoverable expenses). The taxpayer had presented empirical evidence to show that, across the industry,

the processing allowance was likely to exceed nonrecoverable expenses for the tax years at issue. In answer to the Commissioner's objection that the taxpayer had not shown anything more than an accidental relationship between the processing allowance and the nonrecoverable expenses, the Court of Appeals stated:

> At bottom, the Commissioner's argument is that the type of quantitative, empirical evidence presented in this case is not relevant to the creditability inquiry. However, the language of § 1.901-2--specifically, "effectively compensate" and "approximates, or is greater than"--suggests that quantitative empirical evidence may be just as appropriate as qualitative analytic evidence in determining whether a foreign tax meets the net income requirement. We therefore hold that empirical evidence of the type presented in this case may be used to establish that an allowance effectively compensates for nonrecoverable expenses within the meaning of § 1.901-2(b)(4).

Id. at 216 (fn. ref. omitted). The Court of Appeals concluded:

> Given the large size and representative nature of the sample considered, these statistics suffice to show that the Tax Court did not clearly err in finding that the processing allowance was likely to exceed nonrecoverable expenses for the tax years at issue. Texasgulf has therefore met its burden of proving that the predominant character of the OMT * * * is such that the processing allowance effectively compensates for any nonrecoverable costs.

Id. at 215-216.

In reaching their decisions, both the Court of Appeals and this Court distinguished Inland Steel Co. v. United States, supra (which held the same OMT to be noncreditable). The former distinguished that case on the ground that it was decided before

the promulgation of section 1.901-2, Income Tax Regs., and, in particular, before the adoption of the rule that a foreign tax law that "provides allowances that effectively compensate for non-recovery of * * * significant costs or expenses * * * is considered to permit recovery of such costs and expenses." Texasgulf II, 172 F.3d at 216-217. We distinguished Inland Steel not only on that ground but also on the ground that the case was governed by the "predominant character" test, which replaced the "substantial equivalence" test under which Inland Steel was decided. Texasgulf I, 107 T.C. at 69-70. In reaching that conclusion we stated that use of the "predominant character" and "effectively compensates" tests represented "a change from the history and purpose approach used in cases decided before the 1983 regulations applied a factual, quantitative approach." Id. at 70.

In Exxon Corp. v. Commissioner, 113 T.C. 338 (1999), we considered the creditability of the U.K. petroleum revenue tax (PRT) under section 901 and the 1983 regulations. We found that a purpose of the PRT was "to tax extraordinary profits of oil and gas companies relating to the North Sea." Id. at 344. With limited exceptions, the tax base subject to PRT was gross income relating to oil and gas recovery activities less "all significant costs and expenses, except interest expense".[14] Id. at 345. In

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[14]The denial of a deduction for interest was designed to prevent the use of intercompany debt to avoid or minimize (continued...)

lieu of an interest expense deduction, the law provided a deduction for "uplift"; i.e., "amounts equal to 35 percent of most capital expenditures relating to a North Sea field". Id. at 347.

With respect to the predominant character of the tax, we found: "The purpose, administration, and structure of PRT indicate that PRT constitutes an income or excess profits tax in the U.S. sense." Id. at 356. We stated that the evidence at trial showed "that special allowances and reliefs under PRT significantly exceed the amount of disallowed interest expense for Exxon and other oil companies", and we quoted the testimony of the U.K. Government official who first presented PRT to the U.K. House of Lords for formal consideration that "'of course, this tax [PRT] represents an excess profits tax.'" Id. at 357. We rejected as irrelevant the Commissioner's contention that a company-by-company analysis showed that most of the companies operating in the North Sea did not have uplift allowance greater than or equal to the disallowed interest expense, and we agreed with Exxon that the "PRT was designed to tax excess profits from North Sea oil and gas production[,] which generally were earned by major oil and gas companies[,] which owned the largest and most profitable fields in the North Sea." Id. at 359. We then noted that the vast majority of those companies "had uplift allowance in excess of nonallowed

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[14](...continued)
liability for the tax. Exxon Corp. v. Commissioner, 113 T.C. 338, 345 (1999).

interest expense."[15] Exxon Corp. v. Commissioner, supra at 359. Finally, we concluded that "the predominant character of PRT constitutes an excess profits or income tax in the U.S. sense" creditable under section 901. Id.

B. Arguments of the Parties

1. Petitioner's Arguments

Petitioner argues that, given the historical development, design, and actual operation of the windfall tax, it constitutes a creditable tax on excess profits.

Petitioner rejects respondent's view that, in determining the creditability of the windfall tax, we are constrained by the text of the statute. Rather, petitioner argues that we may consider extrinsic evidence of the purpose and effect of the tax as applied to the windfall tax companies. As petitioner states: "The determination of whether a foreign tax is designed to fall on some net gain or profit depends on the substance, and not the form or

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[15]Earlier in Exxon Corp. v. Commissioner, supra at 352, in discussing the predominant character standard, we made the following observation regarding sec. 1.901-2, Income Tax Regs.:

> The regulations * * * provide that taxes either are or are not to be regarded as income taxes in their entirety for all persons subject to the taxes. See sec. 1.901-2(a), Income Tax Regs. Respondent does not interpret this provision as requiring that, in order to qualify as an income tax, a tax in question must satisfy the predominant character test in its application to all taxpayers. Rather, respondent interprets this provision as requiring that in order to qualify as an income tax a tax must satisfy the predominant character test in its application to a substantial number of taxpayers.

label, of the tax." In support of its position, petitioner relies, in large part, on the decisions of this Court in Exxon Corp. v. Commissioner, supra, Texasgulf I, and Phillips Petroleum Co. v. Commissioner, 104 T.C. 256 (1995), in each of which we considered evidence of the purpose, design, and operation of the foreign tax in question in considering creditability.

With respect to the development and design of the tax, petitioner offers the trial testimony of Professor Littlechild, two members of the Andersen team (Mr. Osborne and Dr. Wales), and an exhibit constituting Mr. Robinson's trial testimony in Entergy Corp. v. Commissioner, T.C. Memo. 2010-198, filed today, which also involves the creditability of the windfall tax. Petitioner notes that Professor Littlechild's testimony establishes that he designed the regulatory system (RPI - X) that allowed the privatized utilities to realize the higher-than-anticipated profits during the initial period after flotation. Petitioner also notes that both Mr. Osborne and Dr. Wales (members of the Andersen team who testified as experts regarding the regulatory and political concerns that led to enactment of the windfall tax) stated that (1) the rationale for the tax was the perceived excess profits the privatized utilities earned during the initial period and (2) the actual form of the tax was adopted for

"presentational" reasons.[16] Mr. Robinson's testimony in Entergy is consistent with that of Mr. Osborne and Dr. Wales, and it reaches the same principal conclusion: The intent was to tax the excess profits of the privatized utilities.

Petitioner also offers the testimony of Mark Ballamy (Mr. Ballamy) and Edward Maydew (Professor Maydew), both experts in accounting, the former the founder of a U.K. accounting firm, the latter a professor of accounting at the University of North Carolina. Petitioner claims that the sum and substance of Mr. Ballamy's testimony (which dealt with U.K. financial accounting concepts under the windfall profits tax statute) "establishes that the windfall tax fell on the excess profits of the Windfall Tax Companies during their initial periods and that all of these profits represented realized profits". Professor Maydew testified regarding U.K. and U.S. financial accounting concepts and that the windfall tax was, in substance, a tax on income, similar in operation to prior U.S. and U.K. excess profits taxes. Petitioner claims that Professor Maydew's testimony confirms that of Mr. Ballamy that the U.K. and U.S. concepts of realization are fundamentally the same, thereby satisfying the regulations' realization requirement.

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[16]Dr. Wales testified that, during a Nov. 6, 1996, meeting with Gordon Brown, the Andersen team "demonstrated the presentational linkage that could be made between the mechanics of the tax, * * * the underlying rationale for the tax [i.e., a tax on the privatized utilities' initial period excess profits] and the popular notion of undervalue at privatisation."

Petitioner’s final expert witness was Stewart C. Myers (Professor Myers), professor of finance at MIT’s Sloan School of Management. Professor Myers’ research and teaching focus is, in part, on the valuation of real and financial assets. Petitioner points to Professor Myers’ testimony that the differences in windfall tax payments by the privatized companies cannot be explained by differences in flotation value or by changes in value after flotation and that the tax “operated as an excess-profits tax, not as a tax on value, change in value or undervaluation.”[17]

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[17]As part of his testimony, Professor Myers employed a series of scatter plot diagrams to demonstrate that there was, at best, a very loose relationship between the windfall tax the privatized utilities paid and changes in their actual market values after privatization, but very tight and direct relationships between (1) the windfall tax payments and the cumulative initial period earnings of those companies and (2) the windfall tax payments and what Professor Myers determined to be the cumulative initial period excess profits of the RECs and the WASCs.

Professor Myers also testified that the term “value in profit-making terms”, as defined in the windfall tax statute, is not a standard economic term or concept and it has no meaning in any other context. Moreover, he believes that it does not represent a true economic value of any of the privatized utilities; rather, he believes that it constituted “a one-off device created to determine tax liability.” He further testified:

> The privatized companies were valued daily on the London Stock Exchange. The designers of the Windfall Tax could have used stock-market values to identify (with hindsight) the “undervaluation” of the companies on or after their IPO dates. Instead they settled on a formula in which the chief moving part was not value but profits.

(continued...)

Petitioner also offered the fact testimony of Mr. Oösthuizen, SWEB's treasurer during the period leading up to the enactment of the windfall tax in 1997 and, before that, SWEB's tax manager. Mr. Oösthuizen recognized that, under the windfall tax formula, for every pound that profits were reduced in an initial period year, SWEB received 51 percent of that amount back as a reduction in its windfall tax liability. He also was involved in SWEB's decision to act on that knowledge by obtaining permission from its auditors (and, after an initial objection, Inland Revenue) to restate its accounts for its 1994-95 fiscal year (the final year of SWEB's initial period) by expensing (as a reserve) £12 million of projected tree-trimming costs, which saved SWEB over £6 million of projected windfall tax.[18] Petitioner also notes Mr. Oösthuizen's recognition that the windfall tax operated as an excess profits tax. In that regard, Mr. Oösthuizen testified as follows:

> In effect, the way the tax works is to say that the amount of profits you're allowed in any year before

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[17](...continued)
Professor Myers rejects respondent's argument (discussed infra) that value in profit-making terms, because it is calculated using a reasonable price-to-earnings multiple, is the product of an acceptable valuation technique. In Professor Myers' view, "9 is not an accurate P/E multiple, and it is not applied to current or expected future earnings * * * [Therefore,] 'value-in-profit-making terms' cannot measure the economic value that companies could, would, or should have had."

[18]Mr. Oösthuizen testified that a Government press release describing the windfall tax prompted SWEB to restate its accounts for its 1994-95 fiscal year.

> you're subject to tax is equal to one-ninth of the flotation price. After that, profits are deemed excess, and there is a tax. That's how the tax works. It has a definition of what is allowable profit and what is excess profits, and it taxes the excess.

Lastly, petitioner notes that it is possible to restate the windfall tax formula algebraically to make clear that it operates as an excess profits tax imposed (on 27 of the 32 windfall tax companies) at an approximately 51.7-percent rate.[19] In that regard, petitioner points to a series of stipulations in which the parties agree that that is in fact the case.[20] In particular, petitioner points to the parties' stipulation that the windfall tax formula (for companies with a full 1,461-day initial period) can be rewritten pursuant to the following steps (where P is the total initial period profits and FV is the flotation value).

Statutory Windfall Tax Formula

Tax = 23% x [{(365 x (P/1,461)) x 9} - FV]

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[19]Mr. Oösthuizen and Professors Maydew and Myers make the same point.

[20]Respondent objects to certain of those stipulations on the ground that the reformulations are neither (1) "the statutory equivalent of the equation set forth in the [Windfall Tax] Act" nor (2) "an appropriate application of the equation in the Act", and on the further ground that the stipulations are "irrelevant and immaterial." Respondent does not object to the mathematical equivalence of the reformulations.

Windfall Tax Formula--Modification (1)

Tax = 23% x [{(P/4[21]) x 9} - FV)]

Windfall Tax Formula--Modification (2)

Tax = 51.71% x {P - (44.47% x FV)}[22]

Petitioner also points out that, instead of a cumulative reformulation of the windfall tax for the entire initial period, the tax can be reformulated by showing its application with respect to each year of that period as follows (where P_1, P_2, etc. represent profits for year 1, year 2, etc.).

Tax = 51.71% x {P_1 - (11.11% x FV)}
+ 51.71% x {P_2 - (11.11% x FV)}
+ 51.71% x {P_3 - (11.11% x FV)}
+ 51.71% x {P_4 - (11.14% x FV)}[23]

Petitioner argues that the foregoing mathematical and algebraic reformulations of the windfall tax as enacted show that,

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[21]For the sake of simplicity here and in modification (2), 1,461 days divided by 365 days is deemed to equal 4 rather than the more accurate 4.0027397.

[22]Again, for the sake of simplicity, 44.47 percent represents (1,461/365)/9 or approximately 0.4447489 (which is approximately 4/9), and the 51.71 percent represents {9/(1,461/365)} x 23 percent or approximately 0.5171458 (which is approximately 9/4 of the 23-percent windfall tax rate). As Professor Myers points out, to get from modification (1) to modification (2), one need only multiply all terms inside the brackets (in modification (1)) by 4/9 and the 23 percent tax rate by 9/4 with the windfall tax amount remaining unchanged, because (4/9) x (9/4) = 1.

[23]The 11.14 percent reflects the multiplier for the leap year of 366 days, assumed, for demonstrative purposes, to be year 4.

in substance, it was a tax imposed at a 51.71-percent rate "on the profits for each Windfall Tax company's initial period to the extent those profits exceeded an average annual return of approximately 11.1 percent of [the company's flotation value]."

Petitioner acknowledges, and the parties have stipulated (with respondent lodging the same objections regarding lack of statutory equivalency, appropriateness, relevancy, and materiality), that 5 of the 32 windfall tax companies had initial periods longer or shorter than 1,461 days and that, for those companies, the reformulated rates are different. For two of those companies, because the number of days in the initial period was very close to 1,461 days, the rate of the reformulated windfall tax was very close to 51.71 percent, and the 4-year return on flotation value to be exceeded for there to be a tax was very close to 44.47 percent. For NIE, which had an initial period of 1,380 days, those two rates were 54.75 percent and 42.01 percent, respectively. As noted supra, British Energy had no windfall tax liability because of insufficient profits during the initial period. The fifth company, Railtrack, had an initial period of only 316 days, with the result that the effective tax rate on its excess profits (determined pursuant to the stipulated reformulation of the tax) was 239.10 percent, and the cumulative 4-year return on flotation value to be exceeded for there to be a tax was only 9.62 percent. Petitioner dismisses any concerns

regarding the effect of the reformulated windfall tax on those 5 companies as compared to its uniform effect on the other 27 companies on several grounds: (1) For 2 of the companies, the differences are negligible; (2) any differences in effective rates "are not significant or material in evaluating the overall incidence of the Windfall Tax" because the 5 companies are outliers and, therefore, must be ignored for purposes of determining creditability under the section 901 regulations as applied by the Court of Appeals for the Second Circuit in Texasgulf II and this Court in Texasgulf I; (3) as Mr. Osborne explained, the payment of relatively large amounts of windfall tax by companies with initial periods of substantially less than 1,461 days (i.e., NIE and Railtrack) was not a problem because profits earned over the balance of what would have been a full 1,461-day period (referred to by Mr. Osborne as "out performance") would not be subject to the tax; and (4) the tax did not exceed the realized, after-tax profits of any of the windfall tax companies.

2. Respondent's Arguments

Respondent argues that the 1983 regulations alone control the creditability of the windfall tax because those regulations subsume or supersede prior caselaw and "neither require nor permit inquiry into the purpose underlying the enactment of a foreign tax or the history of a foreign taxing statute." Applying those regulations to this case, respondent concludes that, according to

the actual terms of the windfall tax statute, the windfall tax failed to satisfy any of the tests that a foreign tax must satisfy to be considered "likely to reach net gain in the normal circumstances in which it applies"; i.e., the realization, gross receipts, and net income tests. Therefore, the windfall tax did not have the predominant character of an income tax in the U.S. sense. In essence, respondent's position is that, pursuant to the terms of the statute, the windfall tax "was not imposed upon or after the occurrence of a realization event for U.S. tax purposes because the * * * tax was not a direct additional tax on previously-realized earnings. Rather, the tax was imposed on the difference between two company values." As a tax imposed on a base equal to the unrealized difference between two defined values, rather than directly on realized gross receipts reduced by deductible expenses, respondent argues that it necessarily fails to satisfy any of the three tests.

Respondent flatly rejects petitioner's claim that, under the 1983 regulations, we may rely on extrinsic evidence "relating to * * * [the Windfall Tax's] purported purpose, design, and 'substance' revealed through petitioner's so-called 'algebraic reformulation' of the tax." Respondent argues that Texasgulf II, Texasgulf I, and Exxon Corp. v. Commissioner, 113 T.C. 338 (1999), which did admit extrinsic evidence to demonstrate the creditability of foreign taxes, should be limited to their facts;

i.e., a finding that the alternative cost allowances under consideration in those cases "effectively compensated" for the nondeductibility of certain actual expenses pursuant to the requirements of section 1.901-2(b)(4)(i)(B), Income Tax Regs., and "do not support the use of extrinsic evidence to satisfy a requirement not found in the regulations."

Respondent also argues that we should disregard petitioner's algebraic reformulations of the windfall tax statute as merely "a hypothetical rewrite" of the statute, which does not constitute "'quantitative' or 'empirical' evidence" that the tax actually touched net gain, "as contemplated by this Court in Texasgulf I or Exxon." That argument, like his argument that we may not consider extrinsic evidence that the actual incidence of the tax was on net income or excess profits, follows from what appears to be the crux of respondent's position: The windfall tax is unambiguously imposed on the difference between two values and, therefore, it cannot be a tax on income or profit.[24]

Because for respondent "the 'substance' of the tax is revealed on the face of the Windfall Tax statute itself"--i.e., "[t]he words of the U.K. statute are the 'substance' of this tax"--he believes that it is not necessary to look beyond those words

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[24]Respondent makes the point on brief as follows: "The key evidence in this case--the Windfall Tax statute itself--explicitly provides that the Windfall Tax is imposed on a base of the difference between two values, and such formulation fails to satisfy the section 901 regulations."

to give them meaning. Nevertheless, he argues that, even assuming the intent of the Andersen team and members of Parliament might be relevant in characterizing the nature of the windfall tax, their intent is as consistent with the statute as written (i.e., a tax on value in excess of flotation proceeds) as it is with petitioner's view that the windfall tax was intended as a tax on excess profits. In support of that argument, respondent refers to Mr. Robinson's 2000 book describing his life as a member of the Labour Party, entitled "The Unconventional Minister", and quotes the following portion of chapter 6, which describes the development and enactment of the windfall tax:

> Then in October 1996 Chris Wales had a stroke of inspiration. Chris simply turned the whole argument on its head: the problem was not that the companies had made too much profit, nor that they had paid out too much to shareholders and fat-cat directors, nor that they had been treated with kid gloves by the regulators. That was all true of course: but the genesis of the problem was that they had been sold too cheaply in the first place. Why not then, argued Chris, tax the loss to the taxpayer which arose from the sale of these companies at what was a knock-down price.

In further support of his position that the windfall tax was indeed a tax on the difference between two defined values, respondent offers the expert testimony of Peter K. Ashton (Mr. Ashton), a consultant who was qualified as an expert in economics and valuation methodologies, and Philip Baker QC (Queens Counsel; Mr. Baker), a U.K. tax lawyer offered as an expert in U.K. tax legislation and the U.K. tax system.

Mr. Ashton viewed the method of computing the statutory value in profit-making terms for each of the windfall tax companies as a generally accepted valuation methodology, which he referred to as the "market value multiples method for computing the equity value of a company." Although Mr. Ashton agreed that, in general, "valuation is a forward-looking proposition", he reasoned that the windfall tax methodology of fixing value retroactively was acceptable because the draftsmen selected a valuation date with respect to which they had "perfect foresight of what the income is going to be for * * * [the windfall tax companies] that you can plug in to the valuation formula."

The substance of Mr. Baker's testimony was that, by its terms, the windfall tax was for each windfall tax company a tax on a tax base equal to the difference between two defined values, and that, as such, it was distinguishable from prior or existing U.K. taxes on excess profits or capital gains.

Respondent echoes Mr. Baker's view that the windfall tax was intentionally imposed on a tax base measured, in part, by a value (the "value in profit-making terms") derived (retrospectively) from known initial period earnings and, for that reason, criticizes Professor Myers' reliance on "equity value or market capitalization value" as his standard for concluding that, in relying on "value in profit-making terms", the windfall tax was not a tax on value, as that term is conventionally understood. In

respondent's view, we "need not determine whether the Profit-Making Value formula resulted in a 'realistic' valuation of the Windfall Tax Companies in order to determine whether the Windfall Tax is a creditable tax." That is because, in respondent's view, profit-making value "represented a reasonable approximation of how the Windfall Tax Companies might have been valued at the time of flotation if subsequent earnings could have been known at that time."[25]

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[25]Relying on a point that the Andersen team made in a November 1996 presentation to Gordon Brown, respondent also argues, presumably as an alternative ground for denying a foreign tax credit for the windfall tax, that the tax was, in substance, a reenactment of TCGA sec. 179 (see the discussion of that provision in note 3 of this report); i.e., a retroactive tax on the unrealized appreciation of the windfall tax companies at the time of privatization. Respondent argues that, because the tax necessarily fails the realization test of the 1983 regulations, it is noncreditable. We find respondent's arguments unpersuasive for two reasons. First, respondent's own expert, Mr. Baker, specifically disavowed those arguments by flatly stating that the windfall tax "was not corporation tax. It was a separate tax and it was at the rate of 23 percent instead [of the 33 percent corporate tax rate]." Second, we agree with petitioner that, even if the windfall tax had been intended as (in substance) a reenactment of TCGA sec. 179, it would not be a tax on unrealized appreciation; rather it would be a tax on previously realized but unrecognized gain and, therefore, creditable. As petitioner points out: "the operation of section 171 TCGA and section 179 TCGA is substantively similar to the gain deferral and recognition rules relating to intercompany transfers in our consolidated return regulations, section 1.1502-13, Income Tax Regs." Petitioner argues, however, that "[t]he Windfall Tax statute was not designed on the basis of Section 179 TCGA. Respondent's argument on this basis is unfounded." We accept what is, in effect, petitioner's concession that the windfall tax should not be considered an income tax because it resembled, or was a reinstatement of, TCGA sec. 179. Therefore, we do not decide the windfall tax issue on that ground.

C. Analysis

1. Introduction

The parties fundamentally disagree as to what we may consider in determining whether the windfall tax is a creditable tax for purposes of section 901. Respondent's view is that we need not (indeed, may not) consider anything other than the text of the windfall tax statute in determining whether that tax is an "income tax" within the meaning of section 1.901-2(a), Income Tax Regs. "[B]ased on * * * the simple formula employed to levy the tax", respondent argues, the windfall tax falls on the difference between two values--"Flotation Value" and "Profit-Making Value". It is, respondent continues, therefore a tax on value (and not on income). "Petitioner", respondent concludes, "cannot escape from the plain language of the [windfall tax] statute."[26]

Petitioner, points out that, under the cited regulation, it is the "predominant character" of the foreign tax in question that counts. To determine the predominant character of the windfall tax, petitioner argues that we may consider evidence beyond the

[26]"In construing a statute", respondent argues, "the 'preeminent canon of statutory interpretation requires a court to "presume that [the] legislature says in a statute what it means and means in a statute what it says there."'" (quoting BedRoc Ltd., LLC v. United States, 541 U.S. 176, 183 (2004) (quoting Conn. Natl. Bank v. Germain, 503 U.S. 249, 253-254 (1992))). Respondent insists that "'when the statute's language is plain, "the sole function of the courts"--at least where the disposition required by the text is not absurd-"is to enforce it according to its terms."'" (quoting Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 6 (2000) (quoting United States v. Ron Pair Enters., Inc., 489 U.S. 235, 241 (1989)).

text of the statute; viz, evidence of the design of the tax and its actual economic and financial effect as it applies to the majority of the taxpayers subject to it. In support of that argument, petitioner principally relies on three cases this Court has decided since the promulgation of the 1983 regulations: Exxon Corp. v. Commissioner, 113 T.C. 338 (1999), Texasgulf I, and Phillips Petroleum Co. v. Commissioner, 104 T.C. 256 (1995).

For the reasons that follow, we think that petitioner has the better argument, and we find that the windfall tax is a creditable income tax under section 901.

2. Nature of the Predominant Character Standard

Respondent's text-bound approach to determining the creditability of the windfall tax is inconsistent with the 1983 regulations' description of the predominant character standard for creditability under which "the predominant character of a foreign tax is that of an income tax in the U.S. sense * * * [i]f * * * the foreign tax is likely to reach net gain in the normal circumstances in which it applies". Sec. 1.901-2(a)(3)(i), Income Tax Regs. By implicating the circumstances of application in the determination of the predominant character of a foreign tax, the drafters of the 1983 regulations 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. In determining the predominant character of a foreign tax, we may

look to the actual effect of the foreign tax on taxpayers subject to it, the inquiry being whether the tax is designed to and does, in fact, reach net gain "in the normal circumstances in which it applies", regardless of the form of the foreign tax as reflected in the statute.

That interpretation of the regulations' predominant character standard is consistent with caselaw preceding the issuance of the 1983 regulations and, in particular, two of the cases cited in the preamble to those regulations as providing the "criterion for creditability" embodied in that standard: Inland Steel Co. v. United States, 230 Ct. Cl. 314, 677 F.2d 72 (1982), and Bank of America I (see supra p. 27 of this report). In the former case, the Court of Claims stated that a foreign tax will qualify as an income tax in the U.S. sense if the foreign country has "made an attempt always to reach some net gain in the normal circumstances in which the tax applies. * * * The label and form of the foreign tax is not determinative." Inland Steel Co. v. United States, supra at 325, 677 F.2d at 80 (emphasis added). The court noted that the issue, as framed under its analysis in Bank of America I, is "whether taxation of net gain is the ultimate objective or effect of * * * [the foreign] tax." Inland Steel Co. v. United States, supra at 326, 677 F.2d at 80 (emphasis added). In Bank of America I, 198 Ct. Cl. at 274, 459 F.2d at 519 (emphasis added), the Court of Claims stated: "The important thing is whether the

other country is attempting to reach some net gain, <u>not the form in which it shapes the income tax or the name it gives</u>."

The facts and analysis of the Court of Claims in Bank of America I nicely illustrate the prevailing pre-1983 standard. The case involved in part the creditability of foreign taxes on the taxpayer's gross income from the banking business its branch conducted in each of certain foreign countries. Clearly, a gross income tax is not, by its terms, a net income tax. Had the Court of Claims focused solely on the statutory language, which, in each case, levied a tax on the taxpayer's "gross takings" or "gross receipts" before deduction of any expenses, it would have been compelled to hold, on that ground alone, that none of the taxes under consideration constituted a creditable net income tax. The focus of the court's inquiry, however, was not on the text of the statute per se, but on the question of whether the tax was "attempting to reach some net gain". <u>Id.</u> The court specifically noted that "a levy can in reality be directed at net gain even though it is imposed squarely on gross income." <u>Id.</u> Relying on prior judicial decisions, Internal Revenue Service rulings, and gross income tax levies under Federal law (e.g., sections 871 and 1441), the court concluded that an income tax under section 901 "covers all foreign income taxes designed to fall on some net gain or profit, and includes a gross income tax if, but only if, that impost is almost sure, or very likely, to reach some net gain

because costs or expenses will not be so high as to offset the net profit." Id. at 281, 459 F.2d at 523.[27] Because the gross income taxes in Bank of America I failed to meet that test, the court held that they were noncreditable. Id. at 283, 459 F.2d at 524-525.

Also, as noted supra, the cases that have applied the 1983 regulations' predominant character standard are consistent with the Court of Claims' approach to creditability in Inland Steel and Bank of America I. Thus, in Texasgulf I, and in Exxon Corp. v. Commissioner, supra, we relied on quantitative, empirical evidence of the actual effect of the foreign tax on a majority of the taxpayers at whom it was directed and found that, in each case, the tax was designed to, and did, in fact, reach net gain and, therefore, constituted a creditable income or excess profits tax. In Texasgulf I, we distinguished the result in Inland Steel Co. v. United States, supra, which had held the tax under consideration (the Ontario Mining Tax) to be noncreditable, stating: "The use of the 'predominant character' and 'effectively compensates' tests in section 1.901-2(b)(4), Income Tax Regs., is a change from the history and purpose approach used in the cases decided before the 1983 regulations applied a

[27]As noted supra note 12, the Court of Claims' test for the creditability of a gross income tax is incorporated into the 1983 regulations. See sec. 1.901-2(b)(4)(i), Income Tax Regs.

factual, quantitative approach." Texasgulf I, 107 T.C. at 70 (emphasis added).

We reject respondent's argument that this Court, in Texasgulf I and Exxon, and the Court of Appeals for the Second Circuit, in Texasgulf II, "strictly limit the use of empirical data to an analysis under the alternative cost recovery method of the net income requirement of * * * [section 1.901-2(b)(4)(i)(B), Income Tax Regs.]." It is true that Texasgulf I, Texasgulf II, and Exxon involved the creditability of foreign taxes that started with a statutory tax base consisting of gross income, and that all three relied on extrinsic evidence to show that the foreign law's allowances in lieu of deductions for expenses actually incurred would "effectively compensate for nonrecovery of * * * significant costs or expenses", as required by section 1.901-2(b)(4)(i), Income Tax Regs. We disagree, however, with respondent's conclusion that those cases "do not support the use of extrinsic evidence to satisfy a requirement not found in the regulations." Nothing in those cases would so limit a taxpayer's right to rely on extrinsic evidence to demonstrate the creditability of a foreign tax and, specifically, that it satisfied the predominant character standard. In Texasgulf I, Texasgulf II, and Exxon, the narrow issue was whether the statutory allowances in question did, in fact, "effectively compensate" for the nondeductibility of "significant costs or

expenses” within the meaning of section 1.901-2(b)(4)(i), Income Tax Regs. But the overall issue for decision in those cases, as in this case, was whether the foreign tax was designed to and did, in fact, reach net gain. The only limitation on reliance on extrinsic evidence in any of the three opinions in those cases is the following observation by the Court of Appeals for the Second Circuit in Texasgulf II, 172 F.3d at 216 n.11:

> We note, however, that this case is exceptional, in that the relatively small number of taxpayers subject to the OMT made it practicable to compile and present broadly representative industry data spanning a lengthy period. We do not suggest that the reliance that we place on empirical evidence would be appropriate in cases where such comprehensive data is unavailable.

Far fewer taxpayers were subject to the windfall tax than were subject to OMT in Texasgulf II, and the data (after-tax financial profits)[28] for the taxpayers subject to the windfall tax were readily available in the published financial reports of those taxpayers.

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[28]Although respondent states that “[t]he use of financial book earnings, rather than ‘taxable income,’ in determining the Windfall Tax Companies[’] Profit-Making Value further distinguishes the Windfall Tax from a U.S. excess profits tax”, he does not argue that a foreign tax on financial profits is noncreditable for that reason alone. That argument would appear to be invalid, in any event, in the light of our own corporate alternative minimum tax, which at one time was calculated, in part, using financial or book earnings. See sec. 56(f), repealed in 1990 by the Omnibus Budget Reconciliation Act of 1990, Pub. L. 101-508, sec. 11801(a)(3), 104 Stat. 1388-520. Moreover, differences between book and taxable income are, with rare exception, attributable to timing differences, which are generally disregarded under the 1983 regulations. See sec. 1.901-2(b)(4)(i), Income Tax Regs.

Respondent’s argument that we should restrict our inquiry to the text of the windfall tax to determine its predominant character is unpersuasive.

3. The Predominant Character Standard as Applied to the Windfall Tax

The term “value” may mean, among other things, either “Monetary or material worth” or, in mathematics, “An assigned or calculated numerical quantity.” The American Heritage Dictionary of the English Language 1900 (4th ed. 2000). The parties do not disagree 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). Nor do they disagree that flotation value is real or actual value (a value in the first sense). They do disagree as to whether value in profit-making terms is a real or actual value. Relying on its experts’ testimony, petitioner argues that it is not “a real economic value”.[29] We need not settle that dispute because, even were we to agree with respondent that value in profit-making terms is a real or actual value, that would not necessarily be determinative since our inquiry as to the predominant character of the windfall tax is

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[29]Mr. Osborne, one of petitioner’s expert witnesses and a member of the Andersen team involved in designing the windfall tax, testified that value in profit-making terms “is not a real value: it is rather a construct based on realised profits that would not have been known at the date of privatisation, and a mechanism by which additional taxes on profits could be levied.”

not text bound. Indeed, 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. As an initial matter, we note that the parties have stipulated 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.

With respect to design, respondent reorders the usual notion (at least in architecture) that form follows function to argue, in essence, that form determines function; i.e., that the design of the tax base (the excess of one value over another) demonstrates Parliament's decision to enact a tax based on value (i.e., "to tax undervaluation on flotation of the Windfall Tax Companies") "rather than a tax based on income or excess profits." We disagree.

Gordon Brown's public statements in his July 2, 1997, Budget Speech, the Inland Revenue and U.K. Treasury announcements, and the debate in Parliament preceding enactment of the windfall tax make clear that the tax was justified for two essentially equivalent reasons: (1) It would recoup excessive profits earned by the privatized utilities during the initial period, and (2) it would correct for the undervaluation of those companies at flotation. The reasons are equivalent because each subsumes the other. That is the essence of the explanation of the windfall

tax by Her Majesty's Treasury in its 1997 publication entitled "Explanatory Notes: Summer Finance Bill 1997":

> The profits made by these companies in the years following privatisation were excessive when considered as a return on the value placed on the companies at the time of their privatisation by flotation. This is because the companies were sold too cheaply and regulation in the relevant periods was too lax.

Thus, profits were considered excessive in relation to the prices at which the windfall tax companies were sold to the public, which, in turn, were deemed to be too low.[30] One explanation implies the other. It follows, then, that both parties may be said to be correct in their assessment of the political motivation for the windfall tax.

Of greater significance, in terms of the creditability of the windfall tax, is the fact that the members of Parliament understood that they were enacting a tax that, by its terms, represented one of two equivalent explanations. That understanding is evidenced by the Conservative Party Shadow Chancellor of the Exchequer's, Mr. Lilley's, recognition that the

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[30]That rather obvious point was also made by Mr. Osborne:

> The rationale for the tax was rooted in * * * [the] initial period during which excessive profits were made, as judged against the companies' flotation values.
>
> The nature of the judgment means that there is a logical symmetry between the two available ways of describing the rationale for the tax -- that profits were high in relation to the flotation value, or that the flotation value was low in relation to profits.* * *

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." Mr. Lilly's understanding that the windfall tax could be characterized as a tax on excess profits is further indicated by his recognition that privatized utilities "that failed to improve their profitability over * * * [the initial period] will pay much less or even no windfall tax."

Just as "a levy can in reality be directed at net gain even though it is imposed squarely on gross income", Bank of America I, 198 Ct. Cl. at 274, 459 F.2d at 519, so too can a foreign levy be directed at net gain or income even through it is, by its terms, imposed squarely on the difference between two values.[31]

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[31]A classic definition of income from the economic literature is squarely so based: "Income is the money value of the net accretion to one's economic power between two points of time." Haig, "The Concept of Income–Economic and Legal Aspects", The Federal Income Tax 7 (Columbia University Press 1921).

Robert M. Haig's definition was subsequently expressed by another economist, Henry C. Simons, in a way that explicitly included consumption: "Personal income may be defined as the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in value of the store of property rights between the beginning and end of the period in questions." Simons, Personal Income Taxation 50 (1938). The Simons refinement has come to be known as the Haig-Simons definition of income and is widely accepted by lawyers and economists. Graetz & Schenk, Federal Income Taxation, Principles and Policies 97 (6th ed. 2009).

A foreign tax imposed on a base conforming to the Haig-Simons definition of income, viz, (1) the value of savings at the end of the period plus consumption during the period minus (2)
(continued...)

And that is what we conclude in the case of the windfall tax. 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,[32] and (3) the target amount of revenue the tax would raise. Therefore, it cannot have been an unintentional or fortuitous result that, (1) for 29 of the 31 windfall tax companies that paid tax, the effective rate of tax on deemed annual excess profits was at or near 51.7 percent,[33] and

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[31](...continued)
the value of savings at the beginning of the period, would seem to qualify as a tax on net gain under the 1983 regulations. That the tax base includes unrealized appreciation in property is no bar to such qualification. See sec. 1.901-2(b)(2)(i)(C), (iv) Example (2), Income Tax Regs.

[32]SWEB's ability to reduce retroactively its reported profits for one of its initial period years appears to have been a solitary aberration among the windfall tax companies and does not detract from the general conclusion that the initial period financial profits of the windfall tax companies were known before enactment.

[33]Because it had an initial period of only 316 days, Railtrack presents the sole exception to the overall conclusion that the windfall tax, viewed as a tax on excess profits, affected the targeted companies in a reasonable manner. As noted supra, the effective tax rate on Railtrack's excess profits was 239.10 percent and the cumulative 4-year return on flotation value to be exceeded for there to be a tax was only 9.62 percent. It is clear, however, that neither the regulations nor the cases interpreting them require that the foreign tax mimic the U.S. income tax for all taxpayers to achieve creditability under sec. 901, only that it satisfy that standard "in the normal circumstances in which it applies". See sec. 1.901-2(a)(3)(i), Income Tax Regs. See also Exxon Corp. v. Commissioner, 113 T.C. at 352, in which we noted the Commissioner's acknowledgment that, "to qualify as an income tax a tax must satisfy the predominant
(continued...)

(2) for none of the 31 companies did the tax exceed total initial period profits. What respondent refers to as "petitioner's algebraic reformulations of the Windfall Tax statute" do not, as respondent argues, constitute an impermissible "hypothetical rewrite of the Windfall Tax statute". Rather they represent 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.[34] The design of the windfall tax formula made certain that the tax would, in fact, operate as an excess profits tax for the vast majority of the companies subject to it.[35]

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[33](...continued) character test in its application to a substantial number of taxpayers." In that case we found that the U.K. Petroleum Revenue Tax (PRT) provided a sufficient allowance in lieu of a deduction for interest expense where, for the 34 companies responsible for 91 percent of the PRT payments, the allowance exceeded nonallowed interest expense.

[34]Respondent describes petitioner's algebraic reformulation of the windfall tax as an attempt "to rewrite the value-based Windfall Tax to convert it into a profit-based tax." Presumably, respondent would agree that, had the tax been enacted as a "profit-based tax" instead of as a tax on the difference between two values, it would have been creditable. Under that approach, the same tax is either creditable or noncreditable, depending on the form in which it is enacted, a result at odds with the predominant character standard set forth in the regulations and applied in the caselaw.

[35]If, as respondent suggests, the real goal of the windfall tax was to recoup, on behalf of the public, the windfall to the initial investors that arose by virtue of flotation prices well below actual value (as perceived with hindsight), why did the Labour Party majority not try to recoup the entire windfall or at least a substantial portion of it; i.e., why was the tax rate not (continued...)

Because both the design and effect of the windfall tax was to tax an amount that, under U.S. tax principles, may be considered excess profits realized by the vast majority of the windfall tax companies, we find that it did, in fact, "reach net gain in the normal circumstances in which it [applied]", and, therefore, that its "predominant character" was "that of an income tax in the U.S. sense." See sec. 1.901-2(a)(1), (3), Income Tax Regs.

We recognize that, in the cases that have either provided the foundation for the predominant character standard (e.g., Inland Steel Co. v. United States, 230 Ct. Cl. 314, 677 F.2d 72 (1982), and Bank of America I), or applied that standard (e.g., Texasgulf I, Texasgulf II, and Exxon Corp. v. Commissioner, 113 T.C. 338 (1999)), the tax base, pursuant to the statute, was a gross amount or a gross amount less expenses comprising, in part, allowances in lieu of actual costs or expenses, and the issue was whether the statutory tax base represented net gain for the

[35](...continued)
100 percent or something closer to it than the 23-percent rate actually imposed? Although there is no evidence in the record that would provide a direct answer to that question, we find the enactment of the relatively low 23-percent rate to be consistent with an awareness of the Labour Party that it was taxing the companies, not the investors who actually benefited from the allegedly low flotation prices, and a decision, on its part, that a tax on the companies, being, in effect, a second tax on their initial period profits, should be imposed at a reasonable, nonconfiscatory rate, which would be sufficient to raise the desired revenue. That view is, of course, consistent with petitioner's argument that the form of the tax was adopted for "presentational" reasons.

majority of taxpayers subject to the foreign tax. Nevertheless, the analysis that led the courts in those cases (with the exception of Inland Steel)[36] to determine creditability or noncreditability of the foreign tax in issue is equally applicable in determining the creditability of the windfall tax, the question being whether, according to an empirical or quantitative analysis, the tax was likely reach net gain in the normal circumstances in which it applied. Because the facts of this case provide an affirmative answer to that question, we find the windfall tax to be creditable.

D. Conclusion

The windfall tax paid by petitioner’s indirect U.K. subsidiary, SWEB, constituted an excess profits tax creditable under section 901.

II. The Dividend Rescission Issue

The parties submitted the dividend rescission issue fully stipulated. On brief, petitioner states that, if we resolve the windfall tax issue in its favor, then petitioner concedes the dividend rescission issue. Because we have done so, we need not

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[36]As we noted in Texasgulf I, 107 T.C. at 71, the Court of Claims in Inland Steel Co. v. United States, 230 Ct. Cl. 314, 677 F.2d 72 (1982) “did not have industry-wide data to consider, and the Secretary had not yet promulgated regulations using a quantitative approach”, and it held the Ontario Mining Tax to be noncreditable because it was not the “substantial equivalent” of an income tax, a standard for creditability that was modified by the 1983 regulations’ adoption of the predominant character standard.

address the dividend rescission issue. We accept petitioner's concession.[37]

III. Conclusion

Taking into account our prior Opinion in PPL Corp. & Subs. v. Commissioner, 135 T.C. ___ (2010),

Decision will be entered under Rule 155.

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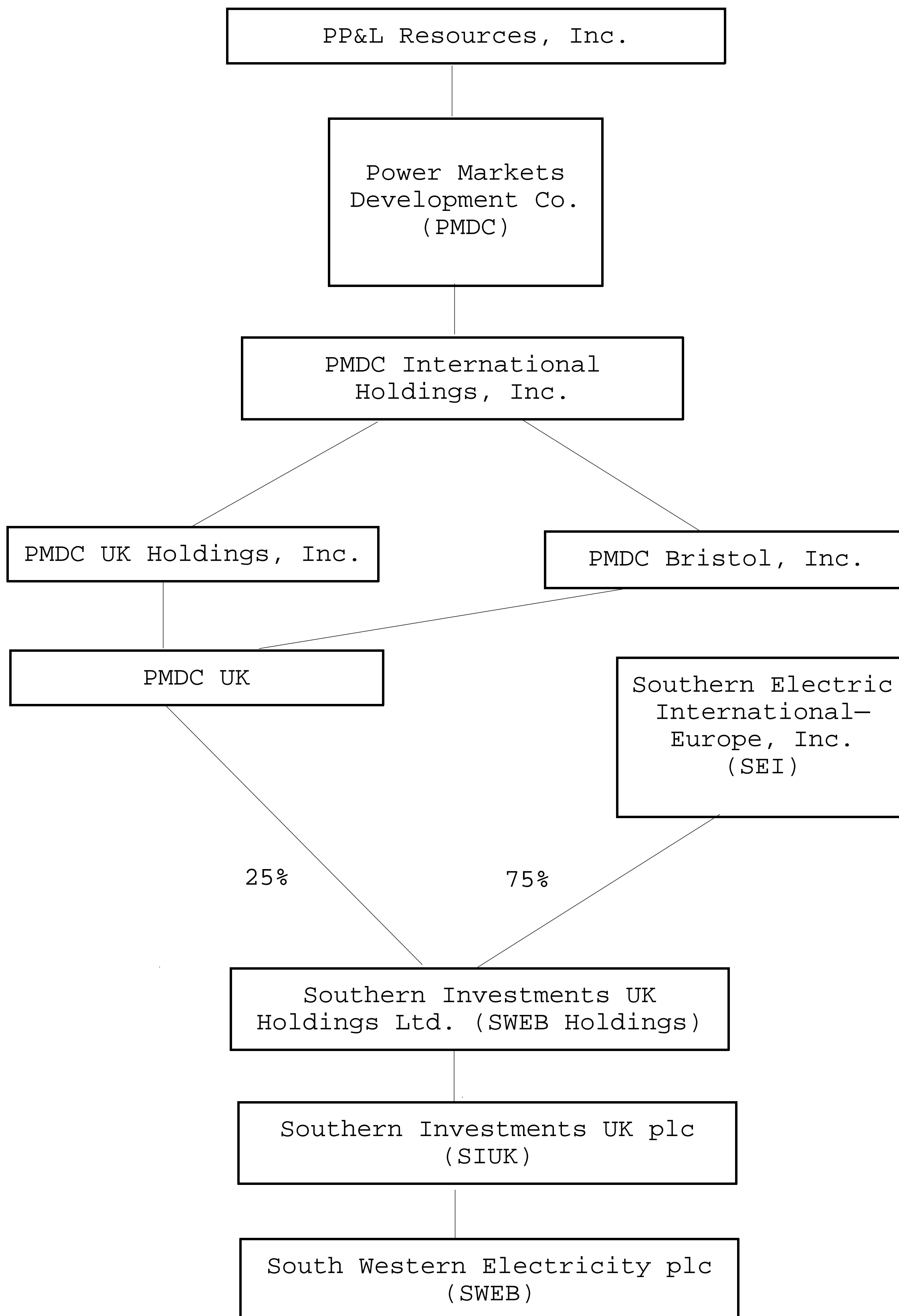
[37]Petitioner argues that if we resolve the windfall tax issue in its favor, then SWEB Holdings would not have had sufficient earnings and profits to pay a taxable dividend. Any distribution by SWEB Holdings would thus constitute a nontaxable return of capital. On brief, petitioner states that the "tax consequences [of such a nontaxable return of capital] would not, in petitioner's judgment, be material." For that reason, "[i]n the interest of judicial economy", petitioner does not ask that we decide the dividend rescission issue in its favor if we decide the windfall tax issue in its favor.

APPENDIX



STATUTORY 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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CERTIFICATE OF SERVICE

It is hereby certified that on May 5, 2011: (1) the original and nine copies of this brief were sent by First Class Mail to the Clerk; (2) a PDF copy was filed electronically by CM/ECF; and (3) service of the brief was made upon counsel for the appellees by CM/ECF.

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