No. 11-1069

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IN THE UNITED STATES COURT OF APPEALS

FOR THE THIRD CIRCUIT

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PPL CORPORATION AND SUBSIDIARIES,

Petitioners-Appellees

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

---

ON APPEAL FROM THE DECISION OF
THE UNITED STATES TAX COURT

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# BRIEF FOR AMERICAN ELECTRIC POWER COMPANY, INC. AS *AMICUS CURIAE* IN SUPPORT OF THE APPELLEES SUPPORTING AFFIRMANCE

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## CORPORATE DISCLOSURE STATEMENT

Amicus American Electric Power Company, Inc. (AEP) has no parent corporation, and no publicly held corporation owns 10% or more of its stock.

The companies listed below are subsidiaries of AEP that have outstanding publicly owned preferred stock. The common stock of these companies is not publicly held.

AEP Texas Central Company

AEP Texas North Company

Appalachian Power Company

Columbus Southern Power Company

Indiana Michigan Power Company

Ohio Power Company

Public Service Company of Oklahoma

Southwestern Electric Power Company

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## INTEREST OF THE AMICUS CURIAE

American Electric Power Company, Inc. (AEP) is a public utility holding company. Through its affiliates, AEP ranks among the nation's largest generators of electricity, and it owns the nation's largest electricity transmission system. It services approximately 5.3 million U.S. customers in eleven states.

During 1997, AEP owned, indirectly through its subsidiaries, a 50% interest in Yorkshire Electricity Group, PLC, one of the twelve privatized British regional electricity companies that were liable for the U.K. Windfall Tax. AEP has claimed foreign tax credits for its share of that liability in computing its consolidated U.S. corporate income tax liability. In 2000, AEP completed its merger with Central and South West Corp. (CSW), another public utility holding company. During 1997, CSW owned SEEBOARD Group PLC, another British regional electricity company that was liable for the U.K. Windfall Tax. In computing its U.S. corporation income tax liability, CSW claimed foreign tax credits for the Windfall Tax paid by SEEBOARD. The IRS disallowed the credits by AEP and CSW on the ground that the U.K. Windfall Tax is not a creditable tax under Internal Revenue Code (26 U.S.C.) § 901. AEP is currently disputing that disallowance in administrative proceedings before the IRS.

The issue presented in this case concerning the creditability of the U.K. Windfall Tax under section 901 is the same issue that AEP is contesting with the

IRS in its dispute. AEP therefore has a strong interest in the outcome of this case, which will serve as a judicial precedent on that issue.

This brief was not authored in whole or in part by a party to this case, nor did any person other than amicus curiae contribute funds for the preparation of this brief.

## INTRODUCTION AND SUMMARY OF ARGUMENT

As framed by the government, the critical issue for decision is whether it was appropriate for the trial court to consider evidence beyond the text of the foreign tax statute to determine the predominant character of the tax and thus whether it is a creditable income tax for purposes of section 901. All the relevant authorities support the conclusion that the Tax Court correctly resolved this issue. The Commissioner's own regulations confirm that it is both necessary and appropriate to consider the actual operation and effect of the foreign tax. This view is fully in accord with the criterion for creditability established in earlier court decisions that were expressly adopted in the regulations. Further, later cases interpreting those regulations have continued to consider evidence of the operation and effect of a foreign levy, as well as the evident purposes of the foreign country in enacting the levy and the context in which it did so. Here, too, the trial court acted appropriately in considering extrinsic evidence to determine the predominant character of the U.K. Windfall Tax. Finally, the Tax Court's determination that the

Windfall Tax is creditable in light of that evidence was faithful to, rather than a rejection of, the three-part net gain test prescribed by the regulations.

## ARGUMENT

Section 901 permits a foreign tax credit for "income, war profits, and excess-profits taxes" imposed by a foreign country. The predecessor to this provision was enacted in substantially the same form in 1918. Revenue Act of 1918, ch. 18, § 238(a), 40 Stat. 1057, 1080 (1919). The acknowledged purpose of the credit is to mitigate double taxation of earnings from foreign sources. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932) ("primary design of the provision was to mitigate the evil of double taxation"). Final regulations adopted in 1983 provide that a foreign tax is a creditable income tax only if its predominant character is that of an income tax in the U.S. sense. Treas. Reg. § 1.901-2(a)(1)(i). Under the regulations, the predominant character of a foreign tax is that of an income tax in the U.S. sense if the foreign tax is likely to reach net gain in the normal circumstances. *Id.* § 1.901-2(a)(3). Whether the foreign tax is likely to reach net gain in the normal circumstances is measured by a three-part net gain test. *Id.* § 1.901-2(b).

There is no dispute that the regulations reflect the governing principles. Instead, the dispute here concerns what evidence can be considered in determining whether the foreign tax is likely to reach net gain in the normal circumstances in

which it applies under the three-part regulatory test and, thus, whether the predominant character of the foreign tax is that of an income tax in the U.S. sense. In determining that the Windfall Tax meets the predominant character standard, the Tax Court considered not only the statutory text enacted by Parliament, but also evidence of the actual operation and effect of the foreign tax, as well as evidence explaining the background of the foreign tax and why it took a particular form.

The government insists that the predominant character of a foreign levy must be determined solely from the text of the foreign statute, attaching great weight to the label that the foreign legislation assigns to its tax. Indeed, the government's affirmative argument is largely contained in a single paragraph of its brief: the Windfall Tax is not creditable because "[b]y its terms," the tax was imposed on "value," and a tax on "value" is not a tax on "income." Gov't Br. at 24. According to the government, it is irrelevant whether that statutory label corresponds with, or instead obscures, the actual operation and effect of the tax. Therefore, the government argues it was reversible error for the trial court to consider extrinsic evidence, including an algebraic analysis of the Windfall Tax and statements and testimony by government officials and consultants involved in the U.K. legislation. *See id*. at 34. But the government's crabbed reading of the predominant character test would undermine the statutory purpose, and it finds no support in the 1983 regulations themselves or in relevant caselaw. This Court

should reject the government's argument and uphold the Tax Court's determination to make a complete inquiry into the predominant character of the tax.

In evaluating whether a foreign tax satisfies the predominant character test, it is, of course, appropriate to start with the statutory language adopted by the foreign country. But the government's position that the creditability inquiry should start *and stop* with the text of the foreign tax statute is unfounded. Relying exclusively on the statutory text is particularly inappropriate where a tax like the U.K. Windfall Tax is concerned. The Windfall Tax is a unique tax, imposed as a one-time charge on a limited number of companies, that employs unusual terminology having no obvious counterpart in U.S. law, such as the phrase "value in profit-making terms." Windfall Tax, Schedule 1.1(2)(a) (*quoted at* JA17). But extrinsic evidence of its operation and effect introduced by the parties reveals that the Windfall Tax is in substance a tax on excess profits. Such a tax readily satisfies the predominant character standard.[1] In addition, evidence establishing the context in which the Windfall Tax was enacted and the reasons for its

[1] Excess profits taxes are typically imposed on a portion of net income in excess of some threshold amount of standard or normal profits. *See, e.g.,* Rev. Rul. 68-318, 1968-1 C.B. 342 (credit allowed for Italian tax imposed on income in excess of 6% of taxable capital). For purposes of the predominant character standard, the 1983 regulations use the term "income tax" to refer to all taxes creditable under section 901. Treas. Reg. § 1.901-2(a)(1).

particular form confirms that the operation and effect of the tax is that of a creditable excess profits tax.

### A. The Regulatory "Predominant Character" Standard Invites Examination of Operation and Effect

The regulation's use of the "predominant character" language to describe the governing standard itself implies an evaluation of the foreign tax based on its actual operation and effect. This point is further underscored by the mandate of the regulations that the predominant character of a tax is that of an income tax in the U.S. sense only if it is "likely" to reach net income in "the normal circumstances in which it applies." Treas. Reg. § 1.901-2(a)(3)(i). Moreover, each of the three net gain tests used to assess whether a foreign tax is likely to reach net gain in the normal circumstances demands an evaluation of the actual operation and effect of the foreign tax. The text of the foreign taxing statute is the natural and logical place to start in making these determinations, but it is not the ending point. The entire framework of the predominant character inquiry described in the regulations suggests that resort to extrinsic evidence of operation and effect is entirely appropriate, if not essential. Indeed, like a recurring melodic phrase in a musical score, the predominant character theme is repeated throughout the regulations and at each turn invites consideration of evidence beyond the face of the foreign statute.

For example, the first prong of the three-part net gain test, realization, generally is satisfied if, "judged on the basis of its predominant character," the foreign tax is imposed on events that would trigger the realization of income under U.S. tax principles. Treas. Reg. § 1.901-2(b)(2)(i)(A). The regulations also specify that under the predominant character standard, a foreign tax may satisfy the realization test even if it is imposed on some events that do not constitute realization events under U.S. principles, such as imputed rental income from the use of a personal residence or upon the receipt of stock dividends, so long as certain conditions are met. *Id*. § 1.901-2(b)(2)(i)(B), (C). At the same time, the regulations caution that a foreign tax "based only or predominantly" on such events does not satisfy the test. *Id*. § 1.901-2(b)(2)(i)(C). Determining if this type of "some, but not too much" test is met will in many instances necessitate going beyond the statutory text to examine how the tax works in practice.

Similarly, the gross receipts prong of the net gain test asks whether, "judged on the basis of its predominant character," the foreign tax is imposed on the basis of actual gross receipts rather than, say, some notional or imputed amount in excess of fair market value. *Id*. § 1.901-2(b)(3)(i); *see id*. § 1.901-2(b)(3)(ii), Ex. 3 (tax not creditable when gross receipts from extraction of petroleum were deemed to equal 105% of fair market value of petroleum extracted). Like the realization test, the regulations provide that a foreign tax does not flunk the gross receipts test

if it is based to some extent on non-qualifying amounts, thus requiring an inquiry into the extent to which those non-qualifying amounts affect the tax. Treas. Reg. § 1.901-2(b)(3)(i).

The third prong of the net gain test likewise asks whether, "judged on the basis of its predominant character," the foreign tax essentially permits the recovery of significant costs and expenses attributable to the gross receipts, either directly or under a method that approximates such recovery. *Id*. § 1.901-2(b)(4)(i). The test can be satisfied even if some such costs and expenses are not recovered. *Id*. Further, the regulations specifically provide that a foreign tax meets this net income prong even if it does not allow the recovery of one or more significant costs or expenses but also provides additional allowances that "effectively compensate for nonrecovery of such significant costs or expenses." *Id.*

Nowhere does the regulatory test attach any importance to the label placed on the tax by the foreign country; the focus is entirely on how the tax operates. Thus, the regulatory framework reflected in the three-part net gain test clearly contemplates that in many, if not all, instances, resort to extrinsic evidence is appropriate. As the Tax Court correctly concluded, "[i]n 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 reflected in the statute." JA51-52.

## B. The Regulations Were Designed to Adhere to Court Decisions That Approve Reliance on Extrinsic Evidence

The predominant character test in the regulations is rooted in a series of earlier court decisions that confirm the importance of evidence establishing the actual operation and effect of a foreign tax. Early on, the Supreme Court in *Biddle v. Commissioner*, 302 U.S. 573, 579 (1938), confirmed that for purposes of the foreign tax credit, the term "income tax" should be construed to mean an income tax in the U.S. sense. Later, a triad of influential cases elaborated on the meaning of an income tax in the U.S. sense, holding that in order to qualify as a creditable income tax, the foreign tax must in essence be intended to reach some net gain in the normal circumstances in which it applies. *See Bank of Am. Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d 513 (Ct. Cl. 1972); *Bank of Am. Nat'l Trust & Sav. Ass'n v. Comm'r*, 61 T.C. 752 (1974), *aff'd*, 538 F.2d 334 (9th Cir. 1976), and *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982). The preamble to the 1983 final regulations specifically provides that the predominant character "standard, found in § 1.901-2(a)(3)(i), adopts the criterion for creditability set forth in" these three cases. T.D. 7918, 48 Fed. Reg. 46272, 46273 (Oct. 12, 1983).

Contrary to the government's position in this case, these seminal foreign tax credit cases endorse reference to extrinsic evidence of the operation, effect, and

purpose of a foreign levy. The first *Bank of America* case is particularly instructive. In that case, the taxpayer, a U.S. bank, sought to credit various foreign taxes generally levied on a base consisting of gross income. If the government's position in this case were correct, it would have required little analysis for the court to conclude in *Bank of America* that the tax was not creditable; the face of the foreign statutes showed a tax on gross income, not on net gain. But the court correctly recognized that it was not such a simple case. In evaluating the creditability of these taxes, the court specifically refused to be bound by the label or form of the taxes, relying instead on the operation, effect, and purpose of the tax:

> 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.

459 F.2d at 519 (emphasis added).

The *Bank of America* court then thoroughly examined earlier authorities in light of this analytical framework and found that "in each instance the core of the holding harmonizes with the principle that a direct income tax is creditable, even though imposed on gross income, if it is very highly likely, or was reasonably intended, always to reach some net gain in the normal circumstances in which it

applies." *Id*. at 519-20. On the record before it, the Court of Claims found that the taxpayer had failed to establish that the foreign taxes at issue were likely to reach net income. *Id*. at 524 ("Plaintiff has presented no proof to this effect and does not very strongly urge that proposition."). In addition to finding a failure of proof as to the actual effect and operation of the tax, the court noted the absence of evidence that the foreign country actually intended to tax net income. *Id.* ("Nor can one say on this record that the three governments felt that net gain would always (or nearly so) be reached by these special banking levies, or that they designed these particular taxes to nip such net profit.").

The Tax Court reached the same result in a case involving Bank of America's claims for other years, praising the "thorough and lucid analysis" of the Court of Claims. *Bank of Am. Nat'l Trust & Sav. Ass'n v. Comm'r*, 61 T.C. at 759.

Several years later, in *Inland Steel*, the Court of Claims revisited the standards for creditability in the context of a tax imposed by the Province of Ontario on profits from mining. The court began by reiterating the *Bank of America* test, stating that "[t]o 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 the tax applies." 677 F.2d at 80. The court then emphasized that the "label and form of the foreign tax is not determinative" in

this analysis. *Id*. Accordingly, the court undertook an examination of the Ontario mining tax by looking to the operation, history and purpose of the levy.

The profits subject to tax under the Ontario mining tax were determined by deducting a "processing allowance" and other costs from gross revenue from mineral production, but the formula did not expressly allow for deduction of some expenses that would ordinarily be deductible under U.S. tax law. After examining the history and purpose of the tax, the court concluded that, "[n]otwithstanding its nominal objective to reach a defined net profit, the OMT was not intended to reach a concept of net gain in the United States tax sense, even when restricted to the limited business activity to which it applies." *Id*. at 82. The evidence considered by the court included a government report issued in 1967, long after the Ontario tax was first enacted, as well as a published paper discussing the nature of the tax by an official of the Ontario department of mines. *Id.* at 83-84. On this record, the Court of Claims found that the "taxpayer has failed to show that the OMT fits our concept of an income tax, or the concept spelled out in *Bank of America*." *Id.* at 87. Accordingly, the Court of Claims held that the Ontario mining tax was not creditable under section 901 of the Code.

Thus, the principal court decisions that formed the predicate for the predominant character standard in the regulations clearly acknowledge that evidence of the operation, effect, and purpose of a foreign tax is relevant in

determining creditability. Yet the government brief mentions these prior court cases only in passing. The 1983 regulations may have been issued "to provide greater clarity as to what constitutes a creditable foreign tax" (Gov't Br. at 19), but they do not purport to hamstring the inquiry by restricting the information a court can consider in determining the predominant character of a foreign tax. If anything, the net gain tests described in the 1983 regulations embrace resort to extrinsic evidence of operation and effect to a greater extent than the earlier court decisions.[2]

This regulatory focus on operation and effect was underscored in *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209 (1999), where the Second Circuit revisited the same Ontario mining tax at issue in *Inland Steel* and found it to be a creditable income tax under the 1983 regulations. The dispute in *Texasgulf* centered upon whether the Ontario mining tax flunked the "net income" prong of the net gain test

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[2] The three-part net gain test in the 1983 regulations was introduced in temporary regulations issued in 1980. T.D. 7739, 45 Fed. Reg. 75,647 (Nov. 17, 1980). The net gain test of the temporary regulations also looked to whether the foreign tax was imposed on realization events and whether its base consisted of actual gross receipts reduced by allocable costs and expenses. However, rather than considering whether these tests were met based on the "predominant character" of the foreign tax, the temporary regulations provided that the net gain tests be satisfied "without substantial deviation." *See* Temp. Treas. Reg. § 4.901-2T(c), 45 Fed. Reg. at 75,649. This liberalization of the net gain test in the final regulations is a further indication that satisfaction of that test may depend on evidence of the actual operation and effect of the foreign tax.

under the regulations. As previously noted (*supra* p. 8), a foreign tax may meet this standard even if it does not permit the recovery of significant costs and expenses, provided that the tax affords additional allowances that effectively compensate for the disallowed deductions. The taxpayer in *Texasgulf* introduced industry-wide evidence comparing the special processing allowance under the Ontario mining tax with disallowed expenses. On this record, the Tax Court found the Ontario tax to be creditable, a finding upheld by the Second Circuit:

> 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 as enacted and interpreted during the relevant years is such that the processing allowance effectively compensates for any nonrecoverable costs.

172 F.3d at 215-16. Rejecting the government's contention that the evidence of the actual operation of the Ontario tax was not relevant to the creditability determination, the Second Circuit found that under the regulations "quantitative empirical evidence may be just as appropriate as qualitative analytic[al] evidence in determining whether a foreign tax meets the net income requirement." *Id.* at 216.

Other cases that have considered the predominant character standard subsequent to the regulations also have considered evidence of the operation, effect, and purpose of the foreign tax in question. In *Exxon Corp. v.*

*Commissioner*, 113 T.C. 338 (1999), the Tax Court evaluated the creditability of a U.K. Petroleum Revenue Tax, a special tax imposed on petroleum profits, under the 1983 regulations. The court found that 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. With regard to the net income test, the court found, based on "[c]redible expert witness testimony, industry data, and other evidence" that certain allowances available under the PRT effectively compensated for disallowed expenses such that the predominant character of the tax was that of an excess profits tax under U.S. law. *Id*. at 359.[3]

Similarly, in *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995), the Tax Court found creditable a Norwegian levy imposed on petroleum profits.[4] Relying in part on legislative history, the *Phillips* court found that the Special Tax was a tax enacted in response to surging oil prices and to capture for the country a share of high and unforeseen profits. *Id*. at 292. Among other things, the government argued that the basis on which gross receipts were determined under

[3] In apparent contravention of the government's position here, the IRS formally acquiesced in the *Exxon* decision, expressing its agreement that "quantitative data" can be used in applying the regulatory test to a foreign tax "in situations involving specialized taxes that apply to a limited number of taxpayers." Action on Decision, 2001-004, 2001 WL 931605 (July 30, 2001).

[4] *Phillips* was decided under the temporary regulations. The Tax Court stated that both the temporary and final regulations embody the creditability principles established by earlier case law. 104 T.C. at 284.

the Norwegian special tax – a "norm price" system established by the government rather than actual sales by each taxpayer – failed to approximate fair market value as required to satisfy the gross receipts test. To evaluate this claim, the court considered expert testimony and quantitative evidence offered by the parties. *Id*. at 303-11. On the evidence presented, the court was satisfied that the norm price determinations approximated fair market value. *Id*. at 312.

Thus, as with cases decided before the 1983 regulations, subsequent cases have continued to consider evidence of operation, effect, and purpose in determining whether the predominant character standard has been met. No case suggests the contrary. And like its approach to those earlier cases, the government's response to these post-regulation cases is essentially deafening silence. Before the Tax Court, the Commissioner argued that *Texasgulf* and *Exxon* should be limited to their particular facts, namely where the parties dispute whether additional allowances permitted by the respective Ontario and U.K. taxes "effectively compensate" for disallowed deductions. JA45-46. But as the Tax Court correctly observed, "[n]othing 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." JA55.

### C. The Tax Court Properly Applied These Creditability Principles When It Considered Extrinsic Evidence of the Operation, Effect, and Purpose of the Windfall Tax

The Tax Court thus acted in accordance with established law in considering the evidence presented by PPL to demonstrate the actual operation and effect of the tax. Moreover, the government's broad objection to that evidence goes beyond urging this Court to depart from settled precedent; it departs from the government's own prior positions and asks the Court to reject previously undisputed principles of how to conduct an inquiry into the creditability of a foreign tax. In *Texasgulf*, for example, the government objected to the "quantitative, empirical evidence" that the courts relied upon, arguing that the courts should limit themselves to consideration of "qualitative analytic evidence." 172 F.3d at 216. The Second Circuit and the Tax Court correctly dismissed that objection, and those holdings strongly support the relevance of all of the evidence considered here, including quantitative evidence.

Here, the government goes even farther and argues that the Tax Court erred in considering the fact demonstrated by an algebraic reformulation of the tax calculation – namely, that the effect of the U.K. tax for almost all companies was to impose a 51.7% marginal tax rate on an amount of excess profits. That demonstration was not a "rewrite" of the statute as the government argues (Gov't Br. at 41), nor was it even empirical or quantitative evidence on which experts

might disagree. It was simply an undisputable mathematical fact of how the U.K. tax operates, which is a paradigmatic example of "qualitative analytic evidence" that the government has previously recognized as relevant.

The government's asserted reasons for insisting that the Tax Court should have closed its eyes to this analytic evidence are insubstantial, amounting to little more that a restatement of its basic mantra that creditability under U.S. law should be governed by the labels that a foreign country uses in its statute. First, the government explicitly repeats its "label" argument, stating that because the statute describes a tax on "value," that must be the end of the inquiry. *Id*. at 43. As discussed above, that argument flies in the face of the regulations and case law and would undermine the statute.

Second, the government asserts that the algebraic reformulation "rewrote the U.K. statute by eliminating key terms, in particular, profit-making value and the price-to-earnings ratio." *Id*. This assertion reflects a fundamental misunderstanding, or deliberate obfuscation, of the nature of algebra. An algebraic expression is simply a mathematical tool that uses symbols, rather than words, to describe a relationship between different quantities, in this case, the relationship that determines the amount of U.K. Windfall Tax liability for a particular company. Typically, an algebraic expression uses three kinds of symbols: 1) numbers to represent "constants," that is, quantities that do not change; 2) letters to

represent "variables," that is, quantities that could change; and 3) other symbols like "=" or "+" to represent relationships. *See, e.g., The American Heritage Dictionary of the English Language* 32 (1981).

Thus, the algebraic expression used by the Tax Court (JA42-43) does not "eliminate" any terms; it just uses symbols for those terms. For "the price-to-earnings ratio," the expression uses the symbol "9" because that quantity is a constant that is the same for every taxpayer regardless of its individual value or earnings. The only thing "eliminated" is the label used in the statute, which equates the phrase "applicable price-to-earnings ratio" in the statutory calculation with the number 9. *See* Windfall Tax, Schedule 1.2(3) (*quoted at* JA18). Similarly, the term "profit-making value" is not eliminated from the algebraic expression; it is represented by the variable "P." The "reformulation" to which the government objects is just a simplification of the equation by combining the constants that relate the excess profits to the tax liability; surely, the Tax Court is not prohibited from observing that 23% x 9/4 = 51.7%. In no way does the Tax Court's algebra lesson "substantively change[ ] the statute" (Gov't Br. at 44); on the contrary, it preserves and illuminates the substance of the statute.[5]

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[5] The government's third objection, that the mathematical reformulation "cannot be ascribed to Parliament as a whole" (Gov't Br. at 46) also appears to be a version of the argument that the courts are bound by the label attached to the tax by Parliament in the statute itself. The Tax Court's algebra discussion is a

(footnote continued on next page)

What the government truly finds objectionable about the algebraic reformulation is the uncomfortable fact that it highlights – namely, that the key variable in the U.K. Windfall Tax calculation is the net profits of the taxpayer. Once the "excess" return is identified and subtracted from those profits, the U.K. tax operates exactly like a U.S. excess profits tax, imposing a marginal tax rate of 51.7% on a quantity of net profits that exceed a specified threshold. *See, e.g.,* Revenue Act of 1918, ch. 18, tit. III, 40 Stat. 1057, 1088-96 (1919) (war profits and excess profits tax imposed on net income in excess of a specified percentage of invested capital). The government baldly asserts that, "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." *Id*. at 16. Simple algebra shows that this linchpin of the government's argument is wrong. The Windfall Tax *was* imposed on those past profits, to the extent they were "excess" because they exceeded a specified threshold.

The government briefly responds to the evidence of the actual operation of the tax by citing a series of Supreme Court cases to support the proposition that measuring the Windfall Tax by the amount of past profits "does not convert the

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(footnote continued from previous page)
"qualitative analytic" tool for examining the operation of the statute, not something that would reasonably be expected to be found in the statutory text or passed upon by the full Parliament.

windfall tax into a tax on those past profits." Gov't Br. at 24. But the cited authority in fact contradicts the government's position. For example, the government correctly notes that *New York ex rel. Cohn v. Graves*, 300 U.S. 308, 314 (1937), holds that a tax on income is different from a tax on property. But the government fails to mention that the differences identified by the Court show that the U.K. Windfall Tax is a tax on income. An income tax is "measured . . . by the amount of income received over a period of time," like the U.K. Windfall Tax. *Id*. And a hallmark of a property tax is that the "property may be taxed although it produces no income." *Id*. A company's Windfall Tax liability would have been zero in the absence of net profit during the four years after privatization, an attribute identified by *Cohn* as indicative of an income tax, not a property tax. *See* JA24, JA43 (British Energy had no Windfall Tax liability "because of low initial profits"). The other cited cases generally confirm that a tax that is actually imposed on income is properly regarded as an income tax, not as a tax on something else like the underlying source or property.

It should be equally clear that the Tax Court appropriately considered evidence of the Labour Government's reasons for enacting the Windfall Tax in a particular form, as well as the context in which it acted. The reasons why a foreign government acted, just like the labels it uses to describe a foreign taxing statute, may not control the predominant character inquiry. However, evidence

illuminating the foreign government's motivations and the context in which it acted is particularly relevant for a tax statute like the Windfall Tax, whose text obscures, rather than illuminates, its true nature. In this case, that evidence shows that there were political considerations that explain why U.K. legislators would have wanted to use the term "value" to describe a quantity that essentially consists of net profits and bears little resemblance to standard concepts of "value." *Cf. Inland Steel Co. v. United States*, 677 F.2d 72, 83 (Ct. Cl. 1982) (noting that legislature used "artificial concept" of "net profit" to satisfy possible constitutional objections in holding that statutory "net profit" label did not control creditability). Such evidence of purpose and context is useful to confirm, or contradict, other evidence of operation and effect, such as the algebraic restatement offered by PPL. The record here reveals that at times overlapping or even conflicting statements were made by government officials about the purpose and nature of the Windfall Tax. JA58-59. But the government does not argue that the Tax Court failed to reasonably weigh the evidence; instead, the government claims it was legal error to consider the evidence at all.

Moreover, the government misstates the extent to which the Tax Court relied on evidence of Parliamentary intent. The government claims that the Tax Court "substituted consideration of Parliamentary intent for the evaluation of the statutory tax base." Gov't Br. at 47. It would be more accurate to state that the

Tax Court considered Parliamentary intent as an aid to the evaluation of the statutory tax base. The Tax Court looked to the evidence of purpose simply to confirm that features of the Windfall Tax showing that it operated as an excess profits tax were not "unintentional or fortuitous." JA61.

In this connection, it is preposterous for the government to claim that the Tax Court "gave virtually no weight to the actual text" of the Windfall Tax. Gov't Br. at 35. In fact, the court made detailed findings about the statutory text. JA17-19. The court also reiterated and summarized the Commissioner's contentions that, based on an analysis of the statutory text, the Windfall Tax is not creditable. JA44-49. While giving due consideration to the statutory provisions, the Tax Court rejected the notion that the predominant character inquiry is "text bound." JA57-58. But the court relied on the operation of the tax, which is reflected in the algebraic analysis, and the operation of the tax flows directly from the statutory text. The Tax Court was faithful to the statutory text; the government's complaint is simply that the court did not blindly adopt the statute's labeling of net profits as "value."

Although not directly argued by the government in its opening brief, it is useful to note that the creditability of a foreign tax statute clearly involves a question of foreign law and, thus, the extrinsic evidence offered by the parties was properly admitted into the record. Tax Court Rule 146 provides that when an issue

of foreign law is raised, the court can "consider any relevant material or source, including testimony, whether or not submitted by a party or otherwise admissible." The text of Rule 146 was taken "almost verbatim" from Rule 44.1 of the Federal Rules of Civil Procedure. Note to T.C. Rule 146, 60 T.C. 1137 (1973). By treating issues of foreign law as legal determinations rather than issues of fact, Rule 44.1 gives the courts wide latitude to consider various forms of proof of foreign law, including expert testimony, *Grupo Protexa, S.A. v. All Am. Marine Slip*, 20 F.3d 1224, 1239 (3d Cir. 1994) (Rule 44.1 permits reference to "any relevant information, including that provided by expert witnesses" to determine issue of Mexican law), opinions of foreign law experts, *Bhatnagar by Bhatnagar v. Surrendra Overseas, Ltd.*, 52 F.3d 1220, 1234 (3d Cir. 1995) (opinion of former judge considered in determining issue of Indian law), or even letters from foreign government officials. *Sidali v. INS*, 107 F.3d 191, 198 & n.10 (3d Cir. 1997) (diplomatic note, affidavit of local prosecutor, and statement of local attorney general considered in determining issues of Turkish criminal law and procedure). Given the latitude afforded by Rule 44.1 and Tax Court Rule 146, there is no sound evidentiary basis for challenging the Tax Court's consideration of the extrinsic evidence here.

For the same reason, the government's reliance on authorities dealing with the role of legislative history in construing U.S. domestic statutes is misplaced.

Gov't Br. at 48-52. Whether a taxpayer is entitled to foreign tax credits is a question to be determined under domestic law, including section 901 and the predominant character standard of the regulations. But that determination requires an examination of the actual operation and effect of foreign law. The government's attempt to constrain how that inquiry is conducted should be rejected.

Finally, this Court should dismiss any suggestion that the Tax Court failed to apply the 1983 regulations. There is no dispute that under those regulations, the predominant character of the U.K. Windfall Tax is that of an income tax in the U.S. sense, and therefore creditable, only if it meets a three-part net gain test. But there is no legitimate basis for the government's contentions that the Tax Court failed to apply that test, applied a different test, or gave the regulation only "lip service." Gov't Br. 15-16, 17, 22. The Tax Court acknowledged the Commissioner's argument that the "actual terms of the windfall tax statute" do not satisfy the three-part net gain test because a tax on "value" is not inherently, or even usually, a tax on income. JA45. At the same time, the Tax Court recognized that there was no legitimate basis for disputing that a tax imposed on the companies' excess profits would satisfy the test. Accordingly, the court focused on the central dispute in the case, which is not over the governing legal standard for determining creditability, but instead over the actual operation and effect of the

tax and what evidence may be considered in making the necessary determination of "predominant character." The Tax Court plainly, and correctly, determined that the inquiry demanded by the regulation is not limited to examining the labels used in the statute, and that in light of the evidence presented, the Windfall Tax is in substance an excess profits tax that is creditable under the regulations. JA63.

## CONCLUSION

The judgment of the Tax Court should be affirmed.

Respectfully submitted,

s/ Alan I. Horowitz

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**CERTIFICATE OF BAR MEMBERSHIP**

Purusant to Local Appellate Rule 28.3(d), it is hereby certified that at least one of the attorneys whose names appear on the brief is a member of the bar of this Court, or has filed an application for admission to that bar.

s/ Alan I. Horowitz
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## CERTIFICATE OF COMPLIANCE

1. This brief complies with the type-volume limitation of Fed. R. App. P. 32(a)(7)(B) because the brief contains 6,161 words, excluding the parts of the brief exempted by Fed. R. App. P. 32(a)(7)(B)(iii) and L.A.R. 29.1(b).

2. This brief complies with the typeface requirements of Fed. R. App. P. 32(a)(5) and the type style requirements of Fed. R. App. P. 32(a)(6) because the brief has been prepared in a proportionally spaced typeface using Microsoft Word in 14 point Times New Roman.

3. The undersigned further certifies that the foregoing brief filed electronically with the Court is in PDF searchable format, that the text of the PDF copy is identical to the text of the paper copy, that the PDF version has been electronically scanned for viruses using Trend OfficeScan 10.0, and that, according to the program, no viruses were detected.

s/ Alan I. Horowitz
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I hereby certify that on June 10, 2011: (1) ten copies of this brief as amicus curiae 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 appellant and counsel for the appellee by CM/ECF and by hand delivery at the following addresses:

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