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

REPLY BRIEF FOR THE APPELLANT

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This reply brief addresses only those points contained in the answering brief of PPL Corporation ("taxpayer") and the amicus brief of American Electric Power Company, Inc. ("AEP") that we believe warrant a response. With respect to points not addressed, we rely on our opening brief.

In our opening brief, we argued that the Tax Court erred in ruling that the United Kingdom windfall tax was a creditable foreign tax

under I.R.C. § 901 (26 U.S.C.). We pointed out that the applicable Treasury regulation, Treas. Reg. § 1.901-2 (26 C.F.R.), provides that a foreign levy is a creditable tax if its predominant character is that of a U.S. income tax, and that 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. We argued that the Tax Court failed to apply the three-part test and that, when the test is applied, it is apparent that the windfall tax was not a creditable foreign income tax. We also argued that the Tax Court erred because it improperly substituted consideration of Parliamentary intent and a mathematical reformulation of the windfall tax for an evaluation of the tax base as set forth in the U.K. statute.

A. The three-part test of Treas. Reg. § 1.901-2(b) governs this case

The three-part test of Treas. Reg. § 1.901-2(b) controls the outcome of this case by setting forth the governing standard for determining whether a foreign tax has the predominant character of a U.S. income tax and, thus, is creditable. Taxpayer states that the Tax Court "did not dwell" on the three-part test because it spent the "majority of [its] analysis, as the Regulation demands, examining the

predominant character of the Tax." (Br. 42.) But taxpayer fails to recognize that the predominant-character test is met *only if* the three-part test is met. *See* Treas. Reg. § 1.901-2(a)(3) & (b)(1). Thus, an inquiry into predominant character and an analysis of the three-part test should be one and the same. It is clear from the Tax Court's opinion that there is no analysis of whether the windfall tax met any of the three regulatory subtests, all of which had to be met for the tax to be creditable. *See Mayo Found. for Med. Educ. & Research v. United States*, 131 S. Ct. 704 (2011) (Treasury regulation provided the standard that governed the outcome of the case).[1]

Notwithstanding that the three-part test governs this case, taxpayer's brief contains virtually no discussion of how the windfall tax purportedly satisfied each prong. Indeed, in the proceedings below, taxpayer made no arguments at all attempting to show that the three-

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[1] Taxpayer errs in contending that *Mayo* "has no relevance here" because "[t]here is no dispute regarding the validity of the Regulation." (Br. 39, n.15.) *Mayo* is relevant because, after determining that the Treasury regulation at issue in that case was valid, the Court treated the regulation as having the force of law and as establishing the legal rule that determined the outcome of the case. Here, taxpayer's concession that Treas. Reg. § 1.901-2(b) is valid means that it provides the governing legal standard, *i.e.,* a foreign tax has the predominant character of a U.S. income tax *only if* the three-part test is met.

part test was satisfied. (Doc. 58 at 77-174; Doc. 61 at 36-110.) Taxpayer now attempts to show that the test is satisfied by borrowing proposed findings from the parties' briefs in *Entergy Corp. v. Commissioner*, Tax Ct. No. 25132-06.[2] (Br. 40-42.) The proposed findings relate to U.K. companies' publicly reported profits as determined under the U.K. Companies Act 1985. Those publicly reported profits were a component in determining a windfall company's "total profits for the initial period," which was one of several elements for determining profit-making value. (JA297-99.) Taxpayer also cites to the testimony of its expert, Mark Ballamy, for the proposition that publicly reported profits reflect realized net income, and it emphasizes that "the profits used in the Tax satisfy [the] three-prong test." (Br. 42.)

Whether publicly reported profits under the U.K. Companies Act reflect realized net income, however, is completely beside the point.

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[2] Taxpayer repeatedly relies (Br. 40-42, 49-50) on evidence from the *Entergy* case that is not contained in the record in this case. This, of course, is improper. "The general rule is that the Court will not travel outside the record of the case before it in order to take notice of the proceedings in another case, even between the same parties and in the same court, unless the proceedings are put in evidence." *Wilson v. Volkswagen of Am.,* 561 F.2d 494, 510 n.38 (4th Cir. 1977); *see* FRAP 10(a).

"Total profits" was merely one component in determining a company's profit-making value, which, in turn, was merely one element used to determine the taxable windfall amount. The Treasury regulation does not ask whether one element of one component of the tax base satisfies the three-part test. Rather, it requires that the tax base itself satisfy the three-part test. Specifically, the regulation states that a foreign tax has the predominant character of a U.S. income tax *only if* "it is imposed on the basis of . . . gross receipts" (§ 1.901-2(b)(3)(i)(A)), and if "the base of the tax is computed by reducing gross receipts" by expenses attributable to those receipts (§ 1.901-2(b)(4)(i)). As taxpayer stipulated (JA114), and as is clear from the windfall-tax statute, the base upon which the windfall tax was imposed was profit-making value less flotation value. Taxpayer has not even attempted to argue (because it cannot do so) that the base of the windfall tax was computed in a manner that satisfies the three-part test.

Apparently recognizing that the windfall tax does not pass muster under the three-part test, taxpayer focuses on pre-regulation case law to set forth the standards for determining whether a foreign tax is creditable. (Br. 31-34.) Although the Treasury regulations incorporate certain general standards from those cases, the regulation establishes

specific criteria for determining if those standards are met. As stated in the preamble of the regulations:

> Under these final 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 in which it applies. This standard, found in § 1.901-2(a)(3)(i), 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). The regulations set forth three tests for determining if a foreign tax is likely to reach net gain: the realization test, the gross receipts test, and the net income test. All 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 (Oct. 12, 1983) (underline added). Thus, as the Second Circuit explained, "[a]lthough § 1.901-2's preamble reaffirms *Inland Steel*'s general focus upon the extent to which a tax reaches net gain, both the preamble and § 1.901-2 introduce three detailed tests for conducting the net gain inquiry." *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209, 216 (2d Cir. 1999). And inasmuch as the foreign tax credit is "a privilege extended by legislative grace," the regulation must be "strictly construed." *Id.* at 214. Therefore, taxpayer cannot rely on pre-regulation case law—to the exclusion of the specific regulatory test—to make its case. *See, e.g., E.I. du Pont de Nemours &*

Co. v. Commissioner, 41 F.3d 130, 139 (3d Cir. 1994) (rejecting taxpayer's reliance on pre-regulation case law, stating that "[o]nce the Treasury Department adopted the regulation . . . the landscape changed").

Taxpayer further claims that the dispute in this case is whether the windfall tax was an excess-profits tax, and it contends that the Treasury regulation is "of no help" in determining "what a creditable excess profits tax looks like." (Br. 35.) Taxpayer claims that the regulation "is silent" in this regard and that "[o]ne must search elsewhere to determine the predominant character of an excess profits tax." (Br. 36.) This argument (which taxpayer does not support with any legal citation) patently lacks merit. I.R.C. § 901 allows a credit for "the amount of income, war profits or excess profits tax . . . paid to any foreign country." Treas. Reg. § 1.901-2(a)(1) sets forth the "Definition of income, war profits, or excess profits tax" for purposes of § 901, and it plainly states that an "excess profits tax" is "referred to as [an] 'income tax' for purposes of this section and §§ 1.901-2A and 1.903-1" (as even taxpayer acknowledges at Br. 36). Thus, a foreign excess-profits tax must meet the very same predominant-character test applicable to income taxes—in particular, the three-part test of Treas. Reg. § 1.901-

2(b). *See Exxon Corp. v. Commissioner*, 113 T.C. 338, 350 (1999) ("Under regulations applicable to the years in issue, foreign levies are to be regarded as income or excess profits taxes if they satisfy two tests: (1) The foreign levies constitute taxes, and (2) the predominant character of the taxes is that of an income tax in the U.S. sense.").

Taxpayer and AEP further argue that the windfall tax is similar to historical U.S. and U.K. excess-profits taxes, citing to various cases and revenue rulings that predate the regulations. (Br. 36-39; AEP Br. 20.) But structural similarity to historical excess-profits taxes is insufficient to establish creditability. The foreign tax must meet the realization, gross-receipts, and net-income tests of Treas. Reg. § 1.901-2(b). *See Mayo, supra.* In any event, it is only the mathematical reformulation of the windfall tax—and not the enacted tax itself—that appears structurally similar to an excess-profits tax. Both taxpayer and AEP acknowledge this. (Br. 38; AEP Br. 20.) The enacted windfall tax does not impose a 51.7% tax on income exceeding an "11.1% [ ] rate of return" on "[i]nvested capital," as taxpayer contends. (Br. 25-26, 38.) Rather, it imposes a 23% tax on the difference between profit-making

value and flotation value. (JA292, 297.) Taxpayer's argument relies on a complete rewrite of the statute.[3]

Moreover, to the extent it is relevant, taxpayer wholly fails to mention that the Andersen team specifically considered structuring its proposed windfall tax as an excess-profits tax but ultimately rejected the idea. (JA320-23, 740, 1107-14, 1340-45.) Geoffrey Robinson testified that an excess-profits tax was rejected because "it could have impacted quite variously on the different companies involved and could have impacted very severely on perhaps even the very survivability of some of them." (JA1113-14.) If that was the case, then it cannot be true that the windfall tax was in substance an excess-profits tax, as taxpayer contends.

B. The form of the windfall-tax statute reflects its substance as a tax on the difference between two statutorily defined values

Taxpayer and AEP criticize our analysis of the windfall tax as elevating form over substance and as hinging on labels. (Br. 42-43;

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[3] Taxpayer is wrong in suggesting that the Commissioner stipulated that the windfall tax fits "the paradigm of prior U.S. [and U.K.] excess profits taxes." (Br. 25.) The Commissioner made no such stipulation, and taxpayer's citation to JA41-42 does not support its contention.

AEP Br. 4.) Taxpayer cites to the familiar principle that "[t]he incidence of taxation depends upon the substance of a transaction." This case, however, does not involve a transaction. Rather, it involves the proper construction of legislation. In the context of a transaction structured by taxpayers, the substance-over-form doctrine is important because "the legitimate operation of the tax laws is not to be frustrated by forced adherence to the mere form in which the parties may choose to reflect their transaction." *Commissioner v. Danielson*, 378 F.2d 771, 774 (3d Cir. 1967). But in the context of duly enacted legislation, the legislature "must be taken at its word." *Bifulco v. United States*, 447 U.S. 381, 401 (1980) (Burger, C.J., concurring). As the Tax Court stated in determining that Norwegian special charges were creditable income taxes (and not royalties), "the distinction between a royalty interest and a tax can only be determined by an examination of the particularities involved in the imposition of the charges. While labels should not be determinative in the question of creditability, *the declaration of the lawmaking power is entitled to much weight*. We cannot close our eyes to the fact that the legislation Norway enacted was entitled the P[etroleum] T[ax] A[ct]." *Phillips Petroleum Co. v. Commissioner,* 104 T.C. 256, 295-96 (1995) (emphasis added). *See*

Thomas More Law Center et al. v. Obama et al., No. 10-2388, _ F.3d _, slip op. 29 (6th Cir. June 27, 2011) (in ruling that the individual-mandate to purchase health insurance is not a "tax," the court stated, "Words matter, and it is fair to assume that Congress knows the difference between a tax and a penalty . . . making it appropriate to take Congress at its word.").

In any event, our argument does not rest on form or labels, but on the plain language of the Treasury regulation, which the Tax Court was required to apply. *See Mayo, supra.* Under the regulation, the essential substance and structure of the windfall tax, as set forth in the U.K. statute, is not that of a U.S. income tax. In other words, in this case, the windfall-tax statute's form reflects its substance. As explained in our brief (at 20), the base of the U.S. income tax is gross income less allowable deductions, and the tax rate is then applied to the resulting amount of taxable income. The base of the windfall tax, in contrast, is the difference between two *values*, and the tax rate is then applied to that difference. Each value in the formula accords with a recognized method of computing company value, *i.e.,* price-to-earnings ratio multiplied by company profits, on one side, and share price at flotation multiplied by the number of shares, on the other. Neither side

of the equation seeks to approximate gross receipts or allowable expenditures, while using alternate labels. The windfall tax is thus qualitatively different from a U.S. income tax.

In our opening brief (at 24-25), we pointed out that the Supreme Court long ago recognized that a tax on value is fundamentally different from a tax on income. Taxpayer has not disputed this point. AEP concedes this point, but it argues that the windfall tax falls under the Supreme Court's description of an income tax in *New York ex rel. Cohn v. Graves*, 300 U.S. 308 (1937), because "[a] company's Windfall Tax liability would have been zero in the absence of net profit during the four years after privatization." (AEP Br. 21.) That is true, but only because profit-making value was based, in part, on profits. The fact that the value of property may be measured by the income it produces does not convert a tax on income-producing property into a tax on income. Moreover, in *Graves*, the Supreme Court described a property tax as a tax measured "by the value of the property at a particular date." *Id.* at 314. Considering that the windfall tax was measured by the difference between profit-making value and flotation value as of the company's flotation date (JA297, 634-35, 1478-79), the windfall tax is more akin to a property tax than an income tax.

Taxpayer argues that the windfall tax is not what it purports to be because, according to taxpayer, profit-making value is not a "real value," the utility companies were not sold too cheaply, and "profits are the only real variable and driver of the Windfall Tax." (Br. 44-52.) Taxpayer further argues that the mathematical reformulation of the windfall tax reflects its substance as an excess-profits tax. We address these points in turn.

1. It is irrelevant whether profit-making value is a "real value" and whether the privatized utilities were actually sold too cheaply

As to the first two points, even if they are true, they are irrelevant. First, it simply does not matter whether the utilities were actually sold too cheaply. The record is clear that the British public's perception was both that the utilities had been sold too cheaply and that their profits had been excessive. (JA268.) As the Tax Court stated, and as taxpayer's own witness testified, these perceptions are two sides of the same coin. (JA58, 1197-1200.) Taxpayer seeks to disprove that the utilities were sold too cheaply by citing to the NAO report (Br. 46), but, by the same token, there is no evidence that the utilities' post-privatization profits were *actually* excessive. As Stephen Littlechild explained, the utilities were able to increase efficiency and

reduce operating expenses, which led to profits that were higher than anticipated when initial price controls were set. It was the public's *perception* that these profits were "excessive." (JA854-58.) In short, the political rhetoric is irrelevant. What *does* matter is that Parliament recouped the funds perceived by British taxpayers to be rightfully theirs by imposing a tax on the difference between two statutorily defined values.

With respect to the profit-making-value formula, it is irrelevant whether it reflects an economically perfect formula for ascertaining company value. This is not a valuation case in which the court had to determine the "best" valuation method. As the Supreme Court has stated, "tax laws do not profess to embody perfect economic theory. They ignore some things that either a theorist or a business man would take into account in determining the pecuniary condition of the taxpayer." *Weiss v. Wiener*, 279 U.S. 333, 335 (1929). For this reason, Stewart Myers's analysis of the profit-making-value formula—on which taxpayer heavily relies—fails to see the forest for the trees. The fact that valuation experts might have crafted a more precise formula for determining the windfall companies' values has no bearing on whether Parliament intended its profit-making-value formula to estimate

company value. As is clear from the windfall-tax statute and the U.K. government's descriptions of the windfall tax, profit-making value clearly was intended to approximate company value. (JA258-59, 263-64.)

Taxpayer essentially argues that it would be nonsensical for Parliament to think its formula approximated company value considering the purported flaws in the formula. (Br. 50-52.) For example, taxpayer complains that the profit-making-value formula is overly simplistic and that the price-to-earnings ratio of 9 was arbitrary and did not account for variations among the windfall companies. But there were bona fide governmental reasons for enacting a simple formula and for using a single price-to-earnings ratio. During the Parliamentary debate of the windfall tax, these matters were extensively discussed. The profit-making-value formula was criticized by some members of Parliament for being too simplistic and unfair, but Geoffrey Robinson defended the formula, stating that "simplicity has great merits," including reducing the opportunities for tax avoidance and valuation disputes. (JA460.) He explained that a more tailored formula (*e.g.,* that used a different price-to-earnings ratio for each sector) would have increased the windfall tax burden from a projected

£5 billion to £17 billion. (JA415, 530-31.) And he repeatedly defended the price-to-earnings ratio of 9, stating 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." (JA390; JA344, 386.)

Indeed, the Tax Court apparently recognized that whether profit-making value yielded a precise economic value was irrelevant, as it declined to decide the question. (JA57.) Rather, the issue in this case is simply understanding the statutory term, and this Court need not look any farther than the windfall-tax statute itself, as Parliament clearly defined the term in Schedule 1 of the statute. For this reason, AEP's observation that the windfall tax "employs unusual terminology having no obvious counterpart in U.S. law, such as the phrase 'value in profit-making terms'" is irrelevant. (AEP Br. 5.) Where a term is specifically defined by statute, there is no need to look elsewhere to discern its meaning. *See Colautti v. Franklin*, 439 U.S. 379, 393 n.10 (1979); *Wilson v. U.S. Parole Comm'n*, 193 F.3d 195, 198 (3d Cir. 1999).

And to the extent it is relevant, the profit-making-value formula does correspond to an accepted method of computing company value, *i.e.,* the market-multiples method. Contrary to taxpayer's statement

(Br. 44) that "[t]he Commissioner makes no attempt to explain how the term 'value in profit-making terms' describes a real value," this is discussed on pages 25-27 of our brief, along with citations to the expert report of Peter Ashton[4] and cases from six different federal circuit courts. Taxpayer emphasizes Myers's testimony that "[v]aluing a company based on four years of past earnings, which was known only with hindsight, makes no economic sense." (Br. 45.) But—again—this misses the fundamental point that the windfall tax was a unique, retrospective tax. When valuing a company, it is, to be sure, not uncommon to estimate the company's *prospective* earnings, and to multiply those earnings by a price-to-earnings ratio. (JA685.) In this case, however, Parliament sought to determine a company's value at a specific time in the past, and it thus did not have to estimate earnings; it could rely, instead, on actual, historical earnings.

Taxpayer also cites to the testimony of Philip Baker, the Commissioner's U.K. law expert, as confirming that profit-making value was not a real value (Br. 28, 44), but taxpayer takes his

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[4] Although we inadvertently stated (p.26) that Peter Ashton was an "accounting" expert, he was, in fact, an expert in economics and valuation methodologies.

testimony out of context. When asked by the Tax Court whether "independent of the statute, can you say in any other context that [profit-making value] would be a fair measure of the value of the company at privatization," Baker (who was not a valuation expert) stated that "you keep on saying independent of the statute; and I come back to say, I'm here as a lawyer to say it's a deterrent to the statute to tell you what the definition of the tax base is. Parliament defined it in terms of the difference between two values, and it explained what those two terms were." (JA1486.) Thus, Baker reaffirmed the fundamental point here—it is unhelpful to analyze the meaning of profit-making value separate and apart from the statute that specifically defines the term.

2. There were no "real" variables in the windfall tax, and flotation value was just as much a "driver" of the tax as profit-making value

Taxpayer repeatedly states that publicly reported profits were "the only real variable" in and the "driver" of the windfall tax. (Br. 39, 48-49.) In an attempt to downplay the role of flotation value, taxpayer states that "[i]nitial period profits are the only component that moves after the flotation date," whereas "[f]lotation value . . . was fixed as of the flotation date." (Br. 48.) Taxpayer wholly fails to explain the

significance of this point, and, indeed, there is no significance. The reality is that *all* of these components were fixed as of the time the U.K. government enacted the windfall tax in July 1997. Indeed, Myers confirmed that there was "no question" as to what the windfall companies' earnings were at the time of enactment, stating, "They were fixed. They were history." (JA1429-30; *see also* JA1477.)

Once again relying on evidence that is not contained in the record, taxpayer cites to the trial testimony of Philip Baker in *Entergy* to bolster its argument that profits were the only real variable. (Br. 49-50.) This is inappropriate, particularly because taxpayer takes his testimony out of context. In order to reply to taxpayer's argument, the Commissioner must cite to additional portions of Baker's testimony from the *Entergy* trial. This Court does not have the benefit of reviewing any of the testimony for itself and, thus, it should disregard taxpayer's arguments in this regard. *See* n.2, *supra.*

In any event, to put the testimony in context, Baker was asked, on cross-examination, whether he agreed with the four points listed on page 49 of taxpayer's brief. He agreed with the four points, but then clarified that "[t]he [profit-making value] formula is more than just looking at the profits shown in the accounts. There are other elements,

as His Honor, the Judge, pointed out. There are other elements that go into computing the tax." (*Entergy* Trial Tr. 227-30.) Baker further pointed out that if two companies had the same profits, but they had different flotation values, they would not have paid the same amount of windfall tax "because the difference between the two values would have been different for the two companies." (*Entergy* Trial Tr. 231.)

Moreover, the four points do not establish that profits were the only real variable in the windfall tax, as taxpayer contends. With respect to the first point (that "[i]f a company had no net profits during its four year initial period, the company would have no Tax"), this is hardly a smoking gun. Clearly there would be no tax if there had been no windfall. As to the second point (that "[o]nce a company's average annual profits during the initial period, multiplied by nine, exceeded its flotation value, the greater the profits and the greater its Tax"), this is merely the mathematical consequence of basing profit-making value, in part, on profits. As to the third and fourth points (regarding the effect of increases or decreases in a company's stock price), they are irrelevant. The windfall-tax computation did not take into account increases or decreases in stock price, so those fluctuations obviously would not affect windfall tax liability. The reality is that profit-making

value and flotation value varied for each company and were equally significant "drivers" of the windfall tax.

3. The mathematical reformulation of the windfall tax does not reflect its substance

Taxpayer and AEP contend that the mathematical reformulation of the windfall tax reveals its true substance to be an excess-profits tax, and they disagree that the reformulation is an impermissible rewrite of the statute. (Br. 43, 54; AEP Br. 17-19.) At the outset, taxpayer claims that "[t]he Commissioner stipulated that it is mathematically equivalent." (Br. 54.) The Commissioner made no such stipulation, and, indeed, the parties' stipulation of facts states *eight* times, in bold lettering: "Respondent does not agree that the equation is the statutory equivalent of the equation set forth in the Act, nor that it is an appropriate application of the equation in the Act." (JA115-20.) Taxpayer's statement is thus patently false.[5]

Taxpayer contends that the mathematical reformulation "does not factor out [the] 'P/E ratio'" because "[t]he 11.1% rate of return in the

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[5] The Tax Court's statement that "Respondent does not object to the mathematical equivalence of the reformulations" reflects only the Commissioner's acknowledgment that there were no mathematical errors in the reformulation. (JA41, n.20.)

expression is the reciprocal of the 'P/E ratio.'" (Br. 54.) AEP similarly claims that we have misunderstood the nature of algebra and that the only thing eliminated is the statutory "labels." (AEP Br. 18-19.) Both have missed the fundamental point that by uncoupling the price-to-earnings ratio from average annual profit, the entire concept of the price-to-earnings ratio—and profit-making value—is eliminated from the equation. (AEP appears to have misunderstood the algebra, because it states that profit-making value continues to be "represented by the variable 'P.'" But the Tax Court's opinion states that "P" represents "total initial period profits," *not* profit-making value. (JA41.)) The price-to-earnings ratio of 9 was not just a random number that could be moved around as a matter of algebra. Rather, its significance was as a multiplier of average annual profit to yield a value. By divorcing the price-to-earnings ratio from average annual profit, the reformulation substantively changes the statutory formula from one centered on value to one centered on profits (which is, of course, precisely how taxpayer and AEP would have preferred the statute to have been written). The fact that numbers and variables can be rearranged as a matter of mathematics does not mean that the reformulation reflects the substance of the statute.

C. Taxpayer would have this Court accord no weight to the text of the windfall-tax statute

Unable to escape the fact that the windfall tax is, by its terms, a tax on the difference between two values—and, thus, not an income tax in the U.S. sense—taxpayer relies almost exclusively on extrinsic evidence of the design and operation of the windfall tax to make the case that it was a tax on excess profits. For its part, AEP views this entire case as turning on the appropriate role of extrinsic evidence. (AEP Br. 3-4.) In this regard, both taxpayer and AEP misunderstand the Commissioner's argument on appeal. The Commissioner does not contend (as he did below) that extrinsic evidence has *no* relevance in determining creditability under Treas. Reg. § 1.901-2(b). Rather, our argument is that it was improper for the Tax Court to *supplant* an analysis of the windfall-tax statute with an analysis of extrinsic evidence. (Comm'r Br. 34-35, 47-48.) Even if extrinsic evidence is relevant, it cannot entirely displace consideration of the plain language of the windfall-tax statute. Moreover, we argued that the *type* of extrinsic evidence at issue here (*i.e.,* the mathematical reformulation

and the post-enactment testimony of Geoffrey Robinson and members of the Andersen team) lacks probative value.[6] (Comm'r Br. 47-52.)

1. The creditability analysis required by the Treasury regulation and case law begins with the tax base as set forth in the foreign statute

Taxpayer and AEP argue that the regulation's use of the phrase "predominant character" calls for a consideration of extrinsic evidence (Br. 34, AEP Br. 6), but they entirely ignore the fact that the regulation sets forth a three-part "if and only if" test for determining whether the predominant character of a foreign tax is that of a U.S. income tax. Treas. Reg. § 1.901-2(a)(3)(i) & (b)(1). AEP also cites to various provisions of the regulation that set forth alternative tests for meeting

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[6] Thus, taxpayer and AEP's reliance on Tax Ct. R. 146 is misplaced. (Br. 55-57; AEP Br. 23-24.) Rule 146 states that "[t]he Court, in determining foreign law, may consider any relevant material or source, including testimony, whether or not submitted by a party or otherwise admissible." The rule "was intended to provide flexible procedures for presenting and utilizing material on issues of foreign law." *Owens-Illinois, Inc. v. Commissioner*, 76 T.C. 493, 496 (1981) (internal quotations omitted). But we are not arguing that the extrinsic evidence supplied by taxpayer was inadmissible. Instead, our argument is that the Tax Court erred in focusing exclusively on extrinsic evidence—to the exclusion of the windfall-tax statute itself—in determining the predominant character of the windfall tax. And we dispute the probative value of the particular type of extrinsic evidence offered here. Rule 146 does not speak to either of these points.

the realization, gross-receipts, and net-income requirements, noting that they explicitly call for a consideration of operation and effect. (AEP Br. 7-8.) But none of those alternative tests are applicable here.

The regulatory test applicable here makes clear that the inquiry is directed to the tax base as set forth in the foreign statute: "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 recovery of the significant costs and expenses . . . attributable, under reasonable principles, to such gross receipts." Treas. Reg. § 1.901-2(b)(4)(i) (emphasis added). AEP is thus wrong in contending that "the focus is entirely on how the tax operates." (AEP Br. 8.) Instead, the regulation explicitly focuses on how "the base of the tax is computed." Treas. Reg. § 1.901-2(b)(4)(i). Thus, the analysis must center on how the tax base is defined in the foreign statute.

Taxpayer and AEP's discussion of the case law also overstates the extent to which extrinsic evidence was determinative. In none of the cases did the foreign statute purport to tax the difference between two values, as the windfall tax does. In *Texasgulf* and *Exxon,* in particular, the base of the tax as set forth in the foreign statute was gross receipts

less certain expenses, just as the Treasury regulation requires. The question in those cases was whether the expense allowance was sufficient to meet the net-income test. Thus, extrinsic evidence was used to further understand specific components of the statutory tax base. Extrinsic evidence was *not* used—as it was in this case—to show that the tax base was something completely different from what was set forth in the foreign statute.

For example, in *Texasgulf*, the issue was whether the Ontario Mining Tax was creditable. As the Second Circuit observed, the foreign statute expressly imposed tax on a mine's "profit" to the extent it exceeded a statutory exemption. 172 F.3d at 211. "Profit" was defined in the statute as the difference between gross receipts from mine output and certain mine expenses. *Id.* at 211-12. The parties stipulated that the mining tax met the realization and gross-receipts tests of the regulation. *Id.* at 215.

The only question was whether the net-income test was met in light of the fact that the mining-tax statute did not allow certain significant expenses to be deducted in computing the tax base. *Id.* at 212 & 215. The Second Circuit applied an alternative net-income test set forth in the regulation (that is not at issue here), which looks at

whether any allowances "effectively compensate for [the] nonrecovery of [ ] significant costs or expenses." Treas. Reg. § 1.901-2(b)(4)(i). The court stated that "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 analytical evidence in determining whether a foreign tax meets the net income requirement." 172 F.3d at 216. The court concluded that the alternative net-income test was met based on industry data showing that a processing allowance effectively compensated for the nonrecoverable expenses. *Id.* at 215-16.

Thus, contrary to taxpayer's contention, the extrinsic evidence used in *Texasgulf* is not the same type of extrinsic evidence that was offered in this case. Whereas in *Texasgulf*, extrinsic evidence was used to establish that the statutory processing allowance effectively compensated for nondeductible expenses, here, extrinsic evidence was used to argue that the base of the windfall tax was entirely different from what was set forth in the statute.[7]

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[7] Contrary to taxpayer's contention (Br. 52-53), nothing in our briefs on appeal conflicts with our position in *Texasgulf*.

Similarly, in *Exxon*, the issue was whether the U.K. petroleum revenue tax was a creditable foreign tax. The Tax Court observed that the petroleum tax "replaced the U.K. corporation income tax as it otherwise would have applied to activities of oil and gas companies" and was "structured as" a corporate income tax. 113 T.C. at 344. The court also observed that the express statutory provisions of the tax "include in the tax base, with limited exceptions, income earned from North Sea-related activity and permit allowances, reliefs, and exemptions." *Id.* at 356. Thus, the parties had stipulated that the tax met the realization and gross-receipts tests, and the only remaining question was whether the net-income test was met in light of the statute's disallowance of certain expense deductions. *Id.* at 352-53. As in *Texasgulf*, extrinsic evidence showed that certain allowances effectively compensated for the nonrecoverable expenses, such that the alternative net-income test was met. *Id.* at 357-59. Extrinsic evidence was not used to fundamentally transform a non-creditable tax on foregone company value into a tax on net income, as it was here.

In *Phillips Petroleum,* the issue was whether Norwegian "special charges" on petroleum exploitation were creditable. The Commissioner had conceded that the realization test was met. The court went on to

conclude that the gross-receipts test was met under an alternative provision of the regulation (also not at issue in the present case) that looked at whether gross receipts were "computed under a method that is designed to produce an amount that is not greater than fair market value and that, in fact, produces an amount that approximates, or is less than, fair market value." 104 T.C. at 297-98. The court also determined that the net-income test was met because—in contrast to the windfall tax—the Norwegian taxes were "computed, without substantial deviation, by reducing a taxpayer's gross receipts with the expenses and capital expenditures attributable thereto." *Id.* at 315.

In sum, the case law does not support the approach taken by the Tax Court here. In *Texasgulf, Exxon,* and *Phillips Petroleum*, the courts expressly found that the foreign tax satisfied the gross-receipts and net-income tests of the regulation. The Tax Court made no such finding in this case. The court's holding that a tax that a foreign statute imposes on the difference between two values is a creditable income tax is unprecedented, and is contrary to I.R.C. § 901.

2. The extrinsic evidence relied on by taxpayer lacks probative value and should not have been accorded determinative weight

In our opening brief (at 47-52), we also argued that the Tax Court erred in according probative weight to the mathematical reformulation of the windfall tax and to the post-enactment testimony of legislative intent offered by Geoffrey Robinson and the Andersen team (Christopher Osborne and Christopher Wales). We argued that under well-established U.S. case law, neither type of evidence is a reliable indication of Parliament's intent in enacting the windfall tax. (AEP is thus flatly wrong in contending that "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." (AEP Br. 22.))

In response, taxpayer and AEP argue that U.S. principles of statutory construction do not apply in the context of determining creditability. (Br. 54-55; AEP Br. 24-25.) This position is untenable. First, in *Biddle v. Commissioner,* 302 U.S. 573, 578-79 (1938), the Supreme Court made clear that the determination whether a foreign tax meets the criteria for creditability under the Internal Revenue Code turns on "our own revenue laws." *See Bank of Am. Nat'l Trust & Sav.*

Ass'n v. United States, 459 F.2d 513, 515 (Ct. Cl. 1972) ("It is now settled that the question of whether a foreign tax is an 'income tax' within § 901(b)(1) must be decided under criteria established by our revenue laws and court decisions[.]"). Thus, it is entirely appropriate to utilize U.S. principles of statutory interpretation to interpret the U.K. windfall tax for federal tax purposes.

Second, taxpayer and AEP misunderstand our reliance on the case law. We did not cite to the case law to provide the framework for interpreting the windfall-tax statute; rather, we cited to that case law to emphasize the elementary points that Parliament's intent is best reflected in the language of its statute, and that the post-enactment testimony of legislators and expert witnesses regarding legislative intent is "of scant or no value." *Graham Co. Soil & Water Conservation Dist. v. United States*, 130 S. Ct. 1396, 1409 (2010).

Taxpayer argues that the Tax Court properly considered the testimony of Osborne and Wales, in particular, regarding the intent of the windfall tax, stating that they "were not mere staff members." (Br. 57.) But their own testimony establishes that they were not involved in the legislative process at all. As Wales testified, the Andersen team's proposal was approved by Geoffrey Robinson and Gordon Brown and

then was submitted to the U.K. Treasury. (JA1209-10.) After meeting with the U.K. Treasury to discuss the "concept of the tax," the Andersen team had no further involvement. (JA1212.) Wales testified that the Andersen team came up with the "architecture" for the windfall tax, but that the actual legislation was drafted by Parliamentary counsel, which "guard very jealously their right to draft legislation." (JA947-48, 1200-01, 1209-11.) He testified that "[t]he way Parliamentary counsel works suggests that [the legislation] would be entirely their language" (JA1211), and he confirmed that it was Parliamentary counsel, and not the Andersen team, that devised the term "value in profit-making terms" (JA948, 1201). Wales specifically testified that no one from Parliament contacted him to ask what the Andersen team had in mind in designing the windfall-tax proposal. (JA1213.)

Thus, it is clear from the record that Wales and Osborne were paid consultants hired to develop a concept and draft a proposed bill, but once the concept was turned over to Parliamentary counsel, they played no further role. They had no involvement in drafting the actual legislation, nor did they influence Parliament members' views of the legislation. As such, there is simply no principled basis for inferring

Parliamentary intent from their testimony. In particular, the fact that Wales and Osborne viewed the "value" construct for the windfall tax as purely "presentational" (Br. 45-46) does not mean that Parliament shared that view. Indeed, taxpayer's claim that the "value" construct was needed to "sell" the idea of the windfall tax suggests that the legislation was successful because it was viewed by others as a value tax, consistent with its terms. The plethora of possible views demonstrates precisely why legislative intent is to be determined from statutory text.

Finally, taxpayer claims that no one called the windfall tax "a tax on value" (Br. 58), but—to the extent it is relevant—the Andersen team did just that. In the final presentation that was made to Gordon Brown, the Andersen team listed the following "windfall principles":

- Impute *value* of businesses on privatisation
- Recognise the windfall as *value foregone* by the taxpayer
- *Tax the companies on the value foregone* using established principles from capital gains tax legislation
- *Value* could be estimated as profit before tax (PBT) x a multiple
- Windfall at privatisation could be defined as *estimated value* less sales proceeds

- Positive windfall would imply that *companies were sold at less than their imputed value*.

(JA713, 744-46 (emphasis added)). Thus, taxpayer's own evidence undermines its claim that the "value" construct was purely presentational.

CONCLUSION

Based on the foregoing and on our opening brief, the Tax Court's decision should be reversed.

Respectfully submitted,

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Dated: July 5, 2011

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