No. 11-1069

IN THE UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

PPL CORPORATION AND SUBSIDIARIES,

Petitioner-Appellee

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant

ON APPEAL FROM THE DECISION
OF THE UNITED STATES TAX COURT

BRIEF OF THE APPELLEE

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1 and Local Rule 26.1, Appellee PPL Corporation makes the following disclosure.

1. Is party/amicus a publicly held corporation or other publicly held entity? Yes.

2. Does party/amicus have any parent corporations? No.

3. Is 10% or more of the stock of a party/amicus owned by a publicly held corporation or other publicly held entity? No.

4. Is there any other publicly held corporation or other publicly held entity that has a direct financial interest in the outcome of the litigation? No.

5. Is party a trade association? No.

6. Does this case arise out of a bankruptcy proceeding? No.

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COMMISSIONER OF INTERNAL REVENUE,

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BRIEF OF THE APPELLEE

STATEMENT OF ISSUE

Whether the U.K. Windfall Tax ("Windfall Tax" or "Tax") constitutes a creditable excess profits tax under I.R.C. § 901.[1] (JA26)

STATEMENT OF RELATED CASES

The issue in this case has not been before this Court previously. This case was tried by the same judge and decided on the same day as *Entergy Corp. v. Commissioner*, T.C. Memo. 2010-197 ("*Entergy*"), on appeal to the Fifth Circuit,

[1] All section (§) references are to the Internal Revenue Code of 1986, as amended, "JA" refers to the Joint Appendix, and "Br" refers to the Commissioner's brief.

No. 10-60988 (5th Cir.). The appeals in both cases are based on the same record and 62-page opinion in *PPL*.[2] *PPL* was the "lead case." The Commissioner's opening brief and reply brief have been filed in *Entergy*.

STATEMENT OF CASE

This case involves a determination of the creditability of a foreign tax enacted by the United Kingdom. The Tax Court held that the Windfall Tax paid by South Western Electricity ("SWEB"), an indirect U.K. subsidiary of PPL, constitutes an excess profits tax creditable under § 901. (JA64) The Tax Court applied the Commissioner's foreign tax credit regulation, Treas. Reg. § 1.901-2 ("Regulation"), which interprets § 901, and well-established case law, in reaching this conclusion.

The Tax Court defined the parties' dispute as follows: "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." (JA50) The Commissioner contended that the court was not permitted to consider evidence other than the text of the U.K. Windfall Tax statute. (JA50) Consequently, he presented essentially no other evidence. PPL contended that the court was permitted to consider evidence beyond the text of the foreign statute to determine

[2] The 3-page opinion in *Entergy* states that "the material facts" to the Windfall Tax issue "are identical to the corresponding facts in *PPL*."

the "predominant character" of the Tax. (JA50-51) PPL presented both qualitative and quantitative evidence. The Tax Court found the Commissioner's contention "unpersuasive." (JA57)

The Commissioner now appears to be shifting ground from his position in the Tax Court and from his opening appellate briefs filed in *Entergy* and *PPL*. In his *Entergy* reply brief, he states: "In discussing the appropriate role of extrinsic evidence in the foreign-tax credit context, taxpayer misunderstands 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)." Appellant's Reply Br. 15, No. 10-60988 (5th Cir. May 31, 2011) (emphasis added).

In the Tax Court, there was no real dispute as to the facts presented by PPL, only whether those facts could be considered by the court and what weight they should be accorded. Most of the quantitative evidence, including PPL's evidence relating to the Regulation's three-prong realization, gross receipts, and net income test, came into evidence unrebutted.

STATEMENT OF FACTS

A. Introduction

The Commissioner's Statement of Facts is remarkable for what it does not tell this Court about the evidence proffered to, and accepted by, the Tax Court.

The Commissioner does not want to focus on this evidence because it would illuminate, as it did for the Tax Court, the "predominant character" of the Windfall Tax.[3] Accordingly, PPL offers a fuller description of the facts and testimony, largely in the sequence presented at trial. Epigrams, taken from the record, appear at various points for emphasis.

In addition to 150 stipulated paragraphs of fact and 51 exhibits, the Tax Court determined "predominant character" of the Tax by reference to the testimony of PPL's six expert witnesses and single fact witness:

- Professor Stephen Littlechild (British) ─ expert in economics and the regulation of privatized utilities. (JA1232)

- Chris Osborne (British) ─ expert in economic regulation, valuation, and accounting. (JA1308-09)

- Dr. Christopher Wales (British) ─ expert on U.K. tax policy under the U.K. Windfall Tax. (JA1152-53)

- Mark Ballamy (British) ─ expert in U.K. accounting principles. (JA1351)

- Professor Edward Maydew (American) ─ expert in U.S. taxation and accounting and comparison between U.S. and U.K. accounting principles and taxation. (JA1363-64)

[3] It also does not tell this Court that Tax Court Rule 146, like its mirror provision in the Federal Rules of Civil Procedure, Rule 44.1, permits a court, in determining an issue of foreign law, to "consider any relevant material or source, including testimony, whether or not submitted by a party or otherwise admissible," trusting a court to determine credibility and weight. Even more remarkable, the Commissioner offers no meaningful discussion of *any* foreign tax credit case.

- Professor Stewart Myers (American) ─ expert in financial economics and valuation of businesses and stock in companies. (JA1409)
- Charl Oösthuizen (British) ─ fact witness who testified that excess profits were the only real variable in the Windfall Tax. (JA1258-1305)

B. History Leading to Windfall Tax

The story of the Windfall Tax does not start with its Parliamentary enactment. It has its origins in privatizations accomplished under the Conservative Governments of Margaret Thatcher and John Major. It has its origins in the "RPI-X" regulatory scheme, devised by Professor Littlechild and imposed on the monopolistic utilities that were privatized. It has its origins in public resentment of both the excess profits made by the utilities in their initial regulatory period after privatization and the "fat cat" executives who were public employees before privatization and who subsequently enjoyed handsome compensation. It has its origins during the period when the Labour Party was in an 18-year wilderness and Tony Blair and Gordon Brown were fashioning their idea of "New Labour," as Labour was positioning itself for the 1997 General Election. It has its origins in Labour's 1997 Manifesto "welfare-to-work program" to be paid for by a "one-off windfall levy on the excess profits of the privatized utilities." It has its origins in the London offices of Arthur Andersen, where the Tax was designed, tested, and presented to Brown, the incoming Chancellor of the Exchequer, and Geoffrey Robinson, the incoming Paymaster General and responsible minister for the Tax.

Thatcher and Major Privatizations	*"The winter of 1978/79 was known as the Winter of Discontent. The Conservative Party, led by Mrs. Thatcher, contested and won the 1979 election under the slogan 'Britain isn't working.'" (Littlechild, JA845)*

The Conservative Governments of Prime Ministers Thatcher and Major commenced their privatization efforts in 1979, first privatizing non-utility companies, including Rolls Royce, British Leyland, and British Steel. (JA845-46) There were more than 50 privatizations, but only 32 companies were subjected to the Tax. (JA100, 108) They are:

1984	British Telecommunications ("BT")
1986	British Gas
1987	British Airports Authority
1989	10 water and sewerage companies ("WASCs")
1990	12 regional electricity companies ("RECs")
1991	National Power and PowerGen
1991	Scottish Power and Scottish Hydro-Electric
1993	Northern Ireland Electricity
1996	Railtrack
1996	British Energy

(JA8-9) SWEB was privatized as one of the RECs. (JA101) The privatizations occurred through public "flotations" (i.e., share offerings) at fixed prices. (JA7) The privatized companies became publicly-traded companies on the London Stock Exchange, making the value of their shares readily available and known. (JA7-8)

Labour Party members anguished over the privatizations but were powerless to stop them. Some Labour Party members vowed to renationalize. None were renationalized. (JA930-33)

Incentive Regulation: RPI-X

"[T]he control was on prices, and not on profits or rate of return as in US utility regulation. . . . High profits would be a sign of increased efficiency, which was to be encouraged." (Littlechild, JA848)

Privatization of BT in 1984 prompted the Thatcher Government to inquire whether BT and other privatized utilities should be regulated because of their monopolistic positions. (JA846) The U.K. Secretary of State turned to Professor Littlechild for recommendations. He recommended a regulatory scheme called "RPI-X." This scheme, unlike a U.S. regulatory scheme specifying rates of return on capital investment, set prices with an annual adjustment, plus or minus. (JA847-48) An initial period of control, 4 or 5 years, would apply after which prices would be reset, presumably lower. (JA847, 853)

RPI-X provided an incentive to cut costs and maximize efficiencies. The utility could keep all profits it realized during the control period. Littlechild explained, "the regulator would be expected not to intervene until the end of the specified price control period, regardless of the profits that were being made." (JA848) The Government adopted RPI-X recommended by Littlechild for all subsequently privatized utilities except the three generating companies. (JA863)

In 1987, the Secretary for Energy asked Littlechild to advise on regulation of the entire electricity industry. He recommended RPI-X. (JA849) In 1989, Littlechild was appointed Director General of Electricity Supply, and he established the Office of Electricity Regulation. (JA849) As Director General, Littlechild was the single regulator of 17 of 32 privatized utilities, including the 12 RECs, subject to the Tax. (JA842)

Government departments, rather than the regulators, established prices for the initial period following privatization. (JA864) The "X" factor for the RECs was positive in recognition of the cost of capital additions and uncertainty whether operating costs would be reduced by efficiencies during the initial period. (JA852) This meant prices would rise annually during the first control period. (JA852) Littlechild testified that RPI-X, in contrast to the U.S. rate-of-return approach,

> gave the regulated company greater incentive to increase efficiency because the company could keep the resulting profits during the specified (four or five year) price control period. (JA853)

High Profitability in Initial Control Period *"In this climate the Windfall Tax was born." (Littlechild, JA861)*

Littlechild testified, "profits of the utilities were increasing to a greater extent than had been envisaged at the time of privatisation." (JA854) Regulated utilities found ways of operating more efficiently, especially through force reductions and less capital expenditure. (JA855) Profits grew large, and, for the RECs, rates increased annually due to the positive X factor. (JA855) Higher-than-anticipated profits had predictable impacts on share price and dividends — they went up, and the public noticed. (JA855)

The public also noticed that executive compensation grew large, due principally to share ownership and bonuses. (JA855) The public thought the executives were over-compensated for performing the same jobs they performed under Government ownership. The popular press labeled them "fat cats." (JA855)

Customers and others objected to the excess profits. (JA856) There was considerable pressure on Littlechild to intervene prematurely and reset prices lower before the end of the initial control period. He steadfastly refused. (JA856-57) Public resentment grew. (JA856) After the close of the initial control period, he reduced prices, not once but twice, by nearly a third. (JA857) He observed:

> Even though the regulator resets the control after five years, the damage is done, in terms of public perception. . . . In these circumstances, a windfall tax to remove some of the excess profits in the first price control period may seem an appropriate remedy. (JA861)

Littlechild was consulted in early 1997 by Geoffrey Robinson to determine whether the 17 companies he regulated could afford specified levels of tax. (JA862) Relying on his experience as Director General, Littlechild testified:

> As for the rationale for the tax, I have referred to the evidence that profits were indeed greater than expected and the widespread concern about excessive profits. In my own experience, customers writing to complain to the regulator, and commentators making critical comments in the media, covered a range of issues but mainly focused on excess profits and associated phenomena. (JA862)

In classic British understatement, Littlechild concluded:

> In my view, therefore, it is plausible to see the Windfall Tax as a tax on excessive profits, as the most senior Labour Ministers always stated it to be. It is not plausible to see it as a means of addressing a concern that the privatized utilities were sold too cheaply. (JA864)

"New Labour"

> *"Over the course of successive Conservative administrations, Labour policy therefore evolved from a strong leaning towards renationalisation to what became the proposal for a one-off tax on the privatised utilities." (Wales, JA930)*

Dr. Wales was one of the two Andersen partners, along with Chris Osborne ("Andersen"), who designed the Windfall Tax. (JA105) He joined the Blair Government in the Fall 1997, after the Windfall Tax was enacted, and he served as Gordon Brown's top tax advisor at Treasury until 2003. (JA927)

In his testimony,[4] Wales succinctly describes the political background "to what became the proposal for a Windfall Tax on the excess profits of the privatised utilities." (JA930) He describes the anguish of Labour members concerning privatization, their calls for renationalization, the political and public outcry over excessive profits, the vilification of the "fat cats," and the movement toward Blair's concept of "New Labour." (JA930-32)

Wales also describes the first references to a Labour call for a windfall tax on the utilities in the run-up to the 1992 General Election. (JA932-33) Brown was reported in the press as "suggesting a 'windfall' tax on the profits of the privatised utilities such as gas and electricity." The press reported: "Some of the £10bn could be raised through a one-off 'windfall' tax on the profits of the privatised utilities." Major won the election, and Labour continued its journey in the wilderness. (JA887)

By early 1996, it became increasingly clear that Labour would win the 1997 General Election and that Blair would be Prime Minister. On July 4, 1996, Labour's draft Manifesto called for a windfall tax on the utilities' "excess profits." (JA933) The Tax was made a central plank in Labour's 1997 Manifesto. (JA934) The entire cover was a portrait photograph of Blair and the words, "New Labour because Britain deserves better." (JA185) In the section of the Manifesto entitled "We will get the unemployed from welfare to work," Blair promised:

> Labour's welfare-to-work programme will attack unemployment and break the spiral of escalating spending on social security. A one-off windfall levy on the excess profits of the privatised utilities will fund our ambitious programme. (JA204-05)

[4] The transcript of Wales' testimony is a separate exhibit in the Joint Appendix. (JA1141-1217)

Labour, Blair, and Brown were thus committed to a windfall tax on the excess profits of the privatized utilities.[5]

Andersen Assignment

"No speech of Gordon's was complete without reference to the utilities, their fat cats and the excess profits that would fund the youth training programme." (Robinson Book, JA317)

Robinson has been a member of Parliament since 1976 and was the Labour leader responsible for hiring Andersen in Summer 1996 to design the Windfall Tax. (JA104, 1092) When Labour came to power in May 1997, Robinson was tapped to be Paymaster General in the Blair Government and was the "responsible minister" assigned to shepherd the Tax through Parliament in June 1997. (JA106) In 2000, his book, *The Unconventional Minister: My Life Inside New Labour*, was published. (JA107, 315) Chapter Six, entitled "To Tax and to Please" recounts his participation in the Tax's design. (JA316-33) Robinson's testimony in *Entergy* was admitted into evidence in *PPL*, and his book is an exhibit in both cases. (JA315, 1086) He testified that he directed Andersen to design a tax on the excess profits of the privatized utilities and "[t]he whole thing is about the profits. Had there been no excess profit, there would be no tax." (JA1137)

[5] In his political autobiography, *A Journey: My Political Life*, released September 2010, Blair described his and Brown's thinking about the Windfall Tax in a chapter entitled "New Labour." Describing the jobs program, he recollects: "We chose a windfall tax on the privatised utilities as the means for paying for it (being often in a monopoly position, the utilities had ended up with bumper profits)." Tony Blair, *A Journey: My Political Life* 95 (2010). *See Addendum* at 69.

Although Labour had announced it would enact, early in its Government, a windfall tax on the utilities' excess profits, the tax had not been designed. (JA317) Robinson's book recounts his concern that the Tax be designed and ready for enactment before Labour came to power:

> To me one thing was clear: if we were to have an early budget and if the youth training programme was to be the centerpiece of it, then the sooner we got on with preparing the windfall tax that was to pay for it the better. (JA317)

Robinson expressed his concerns to Brown, Shadow Chancellor of the Exchequer, in May 1996, recommending that Andersen be hired to evaluate and design the Tax. (JA317-20) Brown assented, and Andersen was retained in June. Andersen assigned two top London partners to lead the effort ─ Osborne and Wales. (JA319, 888, 901)

Andersen Design *"The premise for the tax was therefore related to profits made in the first control period." (Osborne, JA905)*

Osborne was accepted as an expert in "[e]conomic regulation, valuation, and accounting." (JA1308-09) He understood the economics and finances of the privatizations, and he held particular qualifications in economic regulation of utilities. (JA885-87) Osborne's qualifications dovetailed exceptionally well with Wales' tax and political qualifications.

Wales testified:

> The project parameters were set in the early discussions and meetings with Geoffrey Robinson . . . . From the start, there was never any doubt that our task was to design a windfall tax on the excess profits of the privatised utilities. That phraseology was extensively used and it defined our mission. That is what we all believed the "Windfall Tax" to be. (JA938)

As a threshold matter, Andersen had to identify a class of taxpayers that matched the rhetoric and underlying political rationale for the Tax. Not all privatized companies were to be in the taxpayer class. (JA940-41) Labour's rhetoric had focused on the excess profits of the privatized utilities, which had benefitted from a generous price control in their initial control period.[6] (JA941-42)

Andersen determined that the tax would be imposed only on the privatized utilities, and that only the excess profits during the first control period — before the regulators could adjust prices downward — would be taxed. (JA904-05) This meant that if a privatized company was not subject to economic regulation, it would not be included in the class of taxpayers, no matter the scale of profits. It also meant that the Tax would be on previously realized profits, those realized in the first control period. (JA904-05)

[6] Wales testified: "There was early consensus around the need to include references to both privatisation and regulation by statute but we were aware that the legislation would have to be more tightly framed than that." (JA941)

Utilities had been privatized at different times and, as a consequence, their control periods varied, depending on privatization dates. (JA112) Most of the privatized companies had already completed their initial control periods. (JA112, 909) Thus, Labour knew with certainty the universe of profits subject to tax, and because the tax would reach, retroactively, profits realized in the first control period, the tax would not affect current or future taxpayer behavior. (JA114, 946) It would also not affect a regulator's behavior. (JA904)

The selection of the "profits" to be taxed was simple enough for Andersen. They "debated what profit measure to use but concluded that the figures from the published accounts were the best ones." (JA944) "The published figures from the companies' financial statements took into account all the relevant income and deductions, including financing costs. . . ." (JA945)

Given the assignment to design a tax on excess profits, Andersen was required to design a tax that reached only the "excess" portion of the profits. As Osborne testified: "The scale of profits also needed to be set against some benchmark ─ since profits can only be judged to be excessive in relation to some measure of a level of profitability that would be judged to be normal." (JA903) This is the classic feature of an excess profits tax.

Osborne observes: "Many excess profits taxes have taken as a benchmark a percentage rate applied to the book value of the company's assets." (JA905) He explains that "economists define a *normal* rate of return as one by which the company earns its cost of capital; and rates in excess of that as being *supernormal.*" (JA905) For the Tax, Andersen used the privatized companies' "flotation value" as the benchmark.[7] (JA906-07) "Flotation value" was the highest fixed price at which the shares of each privatized company were offered at flotation. (JA111)

Acceptance of Andersen Design	*"There is, in conclusion, no doubt in my mind that the character of the tax that Chris Wales and I designed was that it was taxing excess profits: that was in reality what we were asked to do and it is what we did." (Osborne, JA911)* *"The Windfall Tax, as we designed it, was a tax on historical profits." (Wales, JA944)*

Andersen worked through the Summer and early Autumn of 1996, and by November the design of the tax had been stable for some time. (JA937-38) A private presentation was made to Brown at Andersen's office in early November 1996, and intended to obtain Brown's sign-off. It centered on a 58-page power point. (JA909, 1327) Osborne testified, "It was not in any sense a *working* meeting." (JA909) He elaborated:

> There is in the presentation a brief review of potential alternative designs. Although we had by then analysed the impact of some of these, we had never seriously contemplated recommending them. The

[7] Osborne and Littlechild testified that flotation values ultimately evolved into the "regulatory asset base" in subsequent regulatory reviews. (JA857, 906)

> reason for including them in the presentation was therefore not to promote discussion of them, but rather to *prevent* discussion of them. We did not want a situation to arise in which Gordon Brown asked *"but what about..?"* in relation to an alternative, because it might have taken the meeting off track. (JA909)

Osborne did not recall Brown "asked any questions at all." (JA910)

One feature of the presentation is notable. The Tax was intended to raise revenue, and the amount to be raised was central. (JA939) Pages 40-42 show "tax yields" using "multiples" of 6, 7, 8. (JA755-57) These multiples were place-holders for the so-called "P/E" ratio to be used in the Tax computation. The "multiples" were simply factors to be applied to realized profits in order to flex a certain level of tax revenue. (JA758)

The Commissioner stipulated: "The tax that the Andersen team devised essentially became the Windfall Tax that Parliament enacted in July 1997." (JA105)

C. Enactment of Windfall Tax

Budget Day and Debate *"The Chancellor today announced the introduction of the proposed windfall tax on the excess profits of the privatised utilities." (Inland Revenue, JA 258)*

Following Labour's victory in May 1997, the new Chancellor of the Exchequer, Gordon Brown presented Labour's first budget to Parliament on July 2, 1997. (JA241-57) Brown described the welfare-to-work program and characterized the Tax as follows:

> Our reform of the welfare state — with 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*. The tax will apply to companies privatised by flotation, and subject to economic regulation under specified acts of Parliament. (Emphasis added) (JA253)

Reflecting the Parliamentary system of government, Brown spoke not only as a senior leader of the majority party in the House of Commons, but also as the senior Treasury Minister in the Blair Government.

Robinson, as a senior member of the House of Commons and Paymaster General, discharged his role as "responsible minister" in managing the Tax through Parliament. (JA106) On July 15th, he opened debate:

> 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. (Emphasis added)
>
> 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." (JA339-40)

There followed a lively political debate on privatization, lax regulation, excess profits, and fat cats. Peter Lilley, Shadow Chancellor of the Exchequer for the Conservative Party, captured the character of the Tax that even the Conservative Party opponents could understand:

> Instead, the Government have come along and defined excess profits arbitrarily. They 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. The factor of nine seems to have been plucked from the air. (JA343)

The Tax was quickly enacted, becoming law at the end of July. (JA106)

Windfall Tax Statute *"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." (Statute, JA292)*

The Tax applied only to companies that were subject to "economic regulation." The other privatized companies were engaged in competitive markets and hence were not subject to economic regulation. (JA292) Economic regulation was the central thread to the Tax because of the excessive profits realized under RPI-X during the initial period following privatization. (JA905, 942)

The statute provided that the Tax "shall be charged at the rate of 23 per cent." (JA110) The amount of the "windfall" was defined as the excess (if any) of (1) "the value in profit-making terms of the disposal made on the occasion of the company's flotation," over (2) "the value which for privatisation purposes was put on that disposal" (i.e., flotation value). (JA110) The term "value in profit-making terms" was defined according to the "*average annual profit*" for a company's "*initial period*," multiplied by the "applicable price-to-earnings ratio" — set at 9 for all the companies. (JA110)

"*Average annual profit*" was defined by reference to "*total profits for the initial period*," derived from each company's profits reported in its published financial accounts prepared under the Companies Act 1985 ("Companies Act"). (JA112-13) The Companies Act prescribed U.K. accounting principles for the preparation of financial statements for U.K. companies. (JA121) The statute defined the term "initial period," generally, as the companies' first four years after privatization corresponding to the initial period following privatization when profits were excessive. (JA110, 904-05)

D. Quantitative Evidence

SWEB Response to Tax

"In effect, the way the tax works is to say that the amount of profits you're allowed in any year before 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." (Oösthuizen, JA1291)

Charl Oösthuizen was SWEB's treasurer in 1997, and is now its chief financial officer. (JA1259) Oösthuizen's testimony echos Lilley's observation in Parliament. He was able to calculate SWEB's Tax as soon as he read Inland Revenue's July 2nd press release:

> It was clear from the formula for how the tax is calculated that once you've thought about it for a few seconds, that for every pound you can reduce profits in a year by, you get 51 [pence] back because of the reduction in the tax. (JA1281-82)

Oösthuizen recognized that if he could increase expenses in any of the four years after privatization, thus reducing Companies Act profits, SWEB would realize a reduction in its Tax. (JA1285-86)

Oösthuizen identified expenses in the fourth year that should have been reflected in SWEB's profits. (JA1286) After complying with applicable procedures, and overcoming initial resistance from Inland Revenue, SWEB was allowed to restate its net profits, taking into account £12.6 million in expenses, and realized approximately £6.5 million reduction in its Tax.[8] (Ex. 54-J (SWEB Financial Statement) at 03586, JA609-15) The percentage reduction was exactly 51.7%, thus producing a directly proportional reduction in the Tax as SWEB's profits were reduced.

Realization, Gross Receipts, Net Income	*"[T]he Companies Act 1985 required that 'only profits realised at the balance sheet date shall be included in the profit and loss account.'" (Ballamy, JA964)*

The Windfall Tax statute required that profits reported under the Companies Act be used in calculating the Tax. (JA121) PPL introduced the testimony of Mark Ballamy that Companies Act profits are *realized* profits and that calculation of profits starts with gross receipts and moves to net income, satisfying the Commissioner's three-prong test. (JA996-97)

[8] After Wales joined Brown at Treasury, SWEB's proposed reduction was brought to him for his advice. He advised that, as a policy matter, the reduction should be approved. (JA946)

Ballamy, a name partner in his London accounting firm, had been a partner at Price Waterhouse, where he was twice seconded to the highly-regarded U.K. Serious Fraud Office, serving as an Assistant Director during his later secondment. He is an expert in rigorous application of U.K. accounting principles. (JA960)

Ballamy, in his expert testimony including a 196-page appendix, painstakingly describes the realization requirement central in accounting for Companies Act profits. Ballamy quotes from the U.K. Statement of Standards of Accounting Practice No. 2 to demonstrate that, for Companies Act accounting, realization concepts are used for revenue and costs:

> *The "accruals" concept*
> *Revenue and costs are accrued (that is recognised as they are earned or incurred, not as money is received and paid) . . . .*
>
> *The "prudence" concept*
> *Revenue and profits are not anticipated, but are recognised by inclusion in the profit and loss account only when realised in the form either of cash or of other assets the ultimate cash realisation of which can be assessed with reasonable certainty . . . .* (JA964)

With respect to gross receipts, Ballamy cited U.K. Accounting Standards to conclude:

> The definitions of both the accruals concept and the prudence concept commence with the word "*Revenue*". The word "*revenue*" is no different in meaning from the word "*turnover*" — this being the word which Schedule 4 to the Companies Act 1985 requires to be used in companies' and groups' financial statements to describe *revenue*. The words *revenue* and *turnover* are synonymous, and they have the same meaning as gross sales. (JA964)

With respect to net income, Ballamy concludes:

> Consequently, amounts of profit shown by profit and loss accounts which have been prepared in accordance with the accruals concept are no different from amounts of net income — i.e. revenues less all associated costs. (JA965)

Ballamy's testimony demonstrates that Companies Act profits, used in calculating the Tax, satisfied the Commissioner's three-prong realization, gross receipts, and net income test. *The Commissioner offered no accounting expert or rebuttal testimony and asked no questions of Ballamy on cross-examination.*

In comparing U.K. and U.S. accounting and taxation principles, Professor Maydew, the David E. Hoffman Distinguished Professor of Accounting at the University of North Carolina (JA1004), testified:

> [T]he concepts of income in the U.S. and U.K. are fundamentally the same given the common language and deep historical and economic ties between the two countries. U.S. accounting in large part originated from the U.K. (JA1015)
>
> Both the U.S. and U.K. concepts of income reflect the net gain (or loss) that obtains from adding up gross revenues and subtracting expenses. Realization is important for both concepts of income, as both generally record (or "recognise" in the parlance of accounting) revenues when they have been realized and earned. Both concepts of income start with gross revenues and then subtract expenses attributable to those revenues to arrive at net income. (JA1017)
>
> The concept of income or profit in [the] U.K. is fundamentally the same as in the U.S. The concepts of income for U.S. tax and U.S. accounting purposes are related to each other. (JA1024)

The Commissioner offered no accounting expert or testimony to rebut the conclusions expressed by Professor Maydew above. There was no cross-examination on these conclusions.

Excess Profits Taxes

> *"The U.K. Windfall Tax is similar in substance to other excess profits taxes." (Maydew, JA1012)*
>
> *"'Normal profits' are typically calculated as some stated rate of return times invested capital, or as average earnings over some prior period in which corporate performance was deemed ordinary." (Myers, JA1064)*

Maydew and Myers both examined U.S. excess profits taxes, and Maydew also examined U.K. taxes determined to be creditable for U.S. tax purposes. Both countries' excess profits taxes follow a similar pattern.

Maydew, examining U.S. and U.K. excess profits taxes, concluded:

> The common characteristic of these taxes is to tax profit to the extent it exceeds a threshold "normal" level of profitability. The thresholds are typically based on a specified return on the firm's invested capital or the firm's average profits over some prior period. (JA1012)

Maydew found this paradigm true for numerous U.S. excess profits taxes enacted during WWI, the New Deal, WWII, and the Korean War. (JA1012-14)

Myers, confining his review to U.S. excess profits taxes, reached the same conclusion. He expressed the typical U.S. form as:

$$\text{Excess Profits Tax} = [\text{Profits} - \text{Normal Profits}] \times \text{tax rate}$$

(JA1064) Excess profits taxes do not tax all profits. Rather, they only tax that portion of profits deemed excessive. As Myers stated:

> Defining excess profits requires answers to two questions: "What is a normal return above which profits could be deemed excessive or abnormal?" and "What is the investment base against which the normal returns are earned? . . .
>
> The basic economic concept for defining a normal return is the cost of capital.[9] (JA1065)

Algebraic Expression

"The Windfall Tax formula is equivalent to the formula for an excess profits tax." (Myers, JA1044)

"The U.K. Windfall Tax is a tax on realized income and is in substance a tax based on net income as that term is used in the U.S. This can be shown algebraically and by numerical example." (Maydew, JA1006)

The parties stipulated, and the Tax Court found, that the Tax can be expressed algebraically, (1) to fit the paradigm of prior U.S. excess profits taxes and (2) to fit the paradigm of creditable U.K. excess profits taxes. (JA41-42) The Tax Court described Myers' and Maydew's conclusions on algebraic expression as follows:

> 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. (JA41)

[9] Myers observes that defining a normal rate of return is like establishing rates under a U.S.-style regulatory rate-making scheme where a rate of return is applied against a capital investment base. (JA1065-66)

The Tax Court found,

> Respondent does not object to the mathematical equivalence of the reformulations. (JA41)

The Court characterized the substance of the algebraic expressions:

> Petitioner argues that the foregoing mathematical and algebraic reformulations of the windfall tax as enacted show that, 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]."[10] (JA42-43)

Financial Analysis

> *"If the U.K. government had wanted to measure value or changes in value, it could easily have done so. The privatized companies were valued daily on the London Stock Exchange." (Myers, JA1068)*

Myers is the Robert C. Merton Professor of Finance at MIT's Sloan School of Management and co-author of *Principles of Corporate Finance*, the leading text on finance used in top graduate business schools around the world. (JA1046)

Myers conducted an exhaustive analysis of the Tax from a financial and quantitative basis. (JA1044-68) He did not depend on qualitative evidence. Neither did he depend on statements by leading Labour Ministers such as Blair, Brown, or Robinson. Judge Halpern stated his methodology and findings:

> As part of his testimony, Professor Myers employed a series of scatter plot diagrams to demonstrate that there was, at best, a very loose

[10] The reciprocal of 9 is 1/9 = 11.1%. (JA1051)

> 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. (JA39)

Myers summarized his conclusions in bullet points:

- *"Value . . . in profit-making terms" is not a standard economic term or concept.*
- *The Windfall Tax formula is equivalent to the formula for an excess profits tax.*
- *The privatized companies' IPOs were normal. There was discounting but no unusual undervaluation.*
- *The Windfall Tax formula does not measure economic value.*
- *The Windfall Tax depended on net income, not value.*
- *The Windfall Tax operated as a tax on excess profits.*
- *Actual values were not used in the Windfall Tax formula.*

(JA1044-45)

* * *

The Commissioner urged the Tax Court below to ignore all this evidence and to confine examination of the Windfall Tax's predominant character to the text of the statute. The Tax Court declined the blinders offered by the Commissioner.

SUMMARY OF ARGUMENT

This case presents the issue whether a court may consider evidence beyond the text of a foreign taxing statute to determine its "predominant character." The Commissioner states, to the point of exhaustion, that the Windfall Tax imposes a tax on the difference between two "values" based solely on its form and its method of calculation. That is not its predominant character. There are strong signals, including in the statute, that the Tax is not so simply characterized.

The phrase "value in profit-making terms" has no meaning outside the Tax. It has never been used before or since enactment. PPL's experts, including Myers, Maydew, and Osborne, all testified that it is not a "real value." The Commissioner's expert, Phillip Baker, responded to Judge Halpern, "I don't think an expert in valuation would say it was fair measure of the value." The phrase is, at the very least, ambiguous.

The Tax can be calculated using an expression of the tax (1) that looks exactly like other U.K. excess profits taxes creditable in the U.S., and (2) that looks exactly like excess profits taxes the U.S., itself, has enacted. Both expressions of the tax yield precisely the same amount of tax. Both use initial period profits, and both use flotation value. One form of the calculation applies a tax rate of 23%, the other a rate of 51.7%.

SWEB reduced its net income for the fourth year of profits included in the Tax by £12.6 million, thereby realizing a reduction in tax of £6.5 million, a tax savings at a 51.7% rate. That circumstance proves the "reach" of the tax is 51.7% of profits above the level of "normal" profits. This proof is powerful. PPL's proof, however, went well beyond the algebra and its experience in reducing its Tax liability.

Questions abound. Among them are: Why does the statute only apply to the privatized utilities and not to other privatized companies? Were only the utilities undervalued? Why does the statute only use profits from the first four accounting years after privatization? Why doesn't the statute use values from the London Stock Exchange rather than a multiple of past profits? Why did the Andersen designers of the Tax describe it as an excess profits tax? Why did Blair, Brown, Robinson, and Inland Revenue all call it an excess profits tax? How does the tax operate in practice? What would a rigorous financial analysis of the Tax reveal about its predominant character?

PPL offered, and the Tax Court considered, a mountain of evidence. In determining foreign law, including "predominant character," Tax Court Rule 146 is generous. It provides that a "[c]ourt . . . may consider any relevant material or source, including testimony, whether or not otherwise admissible." Rule 44.1 is the exact mirror in the Federal Rules of Civil Procedure. Only relevance is required. Neither rule imposes a condition that ambiguity exist on the face of the statute before a court may consider extrinsic evidence. Even if ambiguity were required, it is plentiful in this statute.

The Commissioner is on strange ground in this case. It requires no citation to know that the Commissioner insists that substance trump form, especially in instances where the taxpayer is not responsible for the form. Yet, in this case, he hugs the form ─ as he sees it ─ and will not venture to examine the "predominant character" of the Windfall Tax, even though his regulation demands that examination. He wants no consideration of extrinsic evidence, whether it is qualitative or quantitative. He is content with form and labels.

If this Court determines that the predominant character of the Windfall Tax is that of an excess profits tax in the U.S. sense, there can be no doubt that the profits used in this statute comply with the Commissioner's three-prong realization, gross-receipts, and net-income test. That is the unrebutted ─ and unrebuttable ─ testimony of Ballamy and Maydew.

This Court, like the Tax Court below, is presented with both substantial *qualitative* evidence and substantial *quantitative* evidence. PPL's qualitative evidence and its quantitative evidence, standing alone or collectively, demonstrate that the Windfall Tax possesses the predominant character of an excess profits tax.

ARGUMENT

A. Statement of standard of review

The Tax Court held that the Windfall Tax paid by SWEB constituted an excess profits tax creditable under I.R.C. § 901. (JA64) This holding is treated as a ruling on a question of law under Fed. R. Civ. P. 44.1 and Tax Court R. 146, as a determination of foreign law, and is reviewable *de novo*. *Riggs Nat'l Corp. v. Commissioner*, 163 F.3d 1363, 1368 (D.C. Cir. 1999).

A court, in determining foreign law, may consider any relevant material or source, including testimony, whether or not otherwise admissible. Fed. R. Civ. P. 44.1; Tax Court R. 146. "Under Fed. R. Civ. P. 44.1, the determination of foreign law in the federal courts is a question of law to be resolved by reference to any relevant information, including that provided by expert witnesses." *Grupo Protexa, S.A. v. All Am. Marine Slip*, 20 F.3d 1224, 1239 (3d Cir. 1994).

PPL presented the testimony of its six experts and one fact witness. Judge Halpern heard the testimony and questioned the witnesses. His findings and conclusions, based on this testimony, are entitled to considerable weight. *See Travelers Cas. & Sur. Co. v. Ins. Co. of N. Am.*, 609 F.3d 143, 156 (3d Cir. 2010).

B. Longstanding case law principles form the bedrock of the Regulation.

The operative provisions for the foreign tax credit in § 901 were enacted in the Revenue Act of 1918, ch. 18, § 222(a)(1), 40 Stat. 1057, 1073 (1919). They have remained unchanged since, and there is much case law applying and interpreting their meaning and reach. They were enacted because the U.S. taxes the world-wide income of its citizens and business enterprises. To avoid double taxation, the U.S. awards a credit for income taxes imposed by other countries.

The case law under § 901 includes the Supreme Court's opinion in *Biddle v. Commissioner*, 302 U.S. 573, 578 (1938), holding that creditability of a foreign tax, and whether it is an "income tax," is determined under U.S. tax principles. It includes the opinions of this Court in *H.H. Robertson Co. v. Commissioner*, 176 F.2d 704 (3d Cir. 1949) and *Keasby & Mattison Co. v. Rothensies*, 133 F.2d 894 (3d Cir. 1943). It includes cases decided by the Second Circuit, Court of Claims, and Tax Court before and after issuance of the Regulation: *Texasgulf, Inc. v. Commissioner*, 172 F.3d 209 (2d Cir. 1999), *aff'g* 107 T.C. 51 (1996) ("*Texasgulf*"); *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982) ("*Inland Steel*"); *Bank of Am. Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d 513 (Ct. Cl. 1972) ("*Bank of America*"); *Exxon v. Commissioner*, 113 T.C. 338 (1999) ("*Exxon*"); *Phillips Petroleum Co. v. Commissioner*, 104 T.C. 256 (1995) ("*Phillips*").

The Preamble to the Regulation incorporates the principles derived from this case law in adopting the "predominant character" standard:

> 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).

T.D. 7918, 1983-2 C.B. 113, 114; *see Robinson Knife Mfg. Co. v. Commissioner*, 600 F.3d 121, 134 n.11 (2d Cir. 2010) (emphasizing significance of Treasury preamble); *Connecticut Gen. Life Ins. Co. v. Commissioner*, 177 F.3d 136, 145 (3d Cir. 1999) ("the preamble to a regulation may be used as an aid in determining the meaning of a regulation").

In *Bank of America*, the Court of Claims refused to limit its determination to the labels and form of a foreign tax statute:

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

459 F.2d at 519. The predominant character standard in the Regulation adopts this same approach, requiring a determination of the substance of the foreign tax. Treas. Reg. § 1.901-2(a)(3).

In *Texasgulf*, the Second Circuit held, under the Regulation, that its determination of the creditability of a foreign tax was not confined to the text, history, and purpose of the statute (i.e., qualitative evidence), as advanced by the

Commissioner. 172 F.3d at 216. Consistent with PPL's position, the Second Circuit held that it was *also* entitled to consider quantitative evidence:

> 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 . . . 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.

Id. In *Texasgulf*, the quantitative evidence was determinative, as it is in this case.

The predominant character standard in the Regulation and this case law demonstrates that a court is entitled to consider *both qualitative evidence* — text, design, history, and purpose — *and quantitative evidence* — financial, economic, and mathematical evidence. The Tax Court considered this case law in the light of the Regulation to determine the predominant character of the Tax, considering both qualitative evidence and quantitative evidence.

The Commissioner does not discuss any of this case law, including case law applying his Regulation and Preamble, in his opening brief.

C. Windfall Tax is a creditable excess profits tax.

The Regulation requires a determination of the predominant character of the foreign tax and whether it reaches net income. In this case, the dispute is whether the Tax is an excess profits tax. An excess profits tax reaches a subset of net income and contains a number of components — some fixed, some movable — designed to reach the "excess" portion of total profits. In determining the predominant character of the Tax, it is important first to understand what a creditable excess profits tax looks like. The Commissioner's Regulation and his opening brief are no help on this.

1. Predominant character of the Windfall Tax is an excess profits tax.

Section 901 specifies three types of foreign taxes on income eligible for credit ─ income taxes, excess profits taxes, and war profits taxes. I.R.C. § 901(b)(1). Common to all three taxes is the requirement that the foreign tax must reach net income, and the concept of net income must be equivalent, in large measure, to net income in the U.S. sense.

There has been much litigation, and even greater administrative controversy, whether a foreign tax reaches net income in the U.S. sense. Cases have reached the Supreme Court and the Circuit Courts. The inquiry in these cases has been whether a foreign tax reaches net income and what evidence may be considered in determining the tax's reach.

Long before the Commissioner issued his Regulation, courts searched for the predominant character of a tax and whether it reached net income. In an attempt to bring some clarity to the concept of net income, the Commissioner issued his 1983 Regulation that embodies his three-prong test of realization, gross receipts, and net income. Treas. Reg. § 1.901-2(b)(1)-(4). Each prong repeats the predominant character standard. The overarching requirement declares that, "[a] foreign levy is [a creditable] tax if and only if it is a tax and [its] predominant character" is that of "an income tax in the U.S. sense." Treas. Reg. § 1.901-2(a)(1)(ii).

There can be no dispute that the profits — the net income — used in the Windfall Tax calculation meet the three-prong test of realization, gross receipts, and net income. That is the unrebutted — and unrebuttable — testimony of Ballamy and Maydew. The ultimate question is whether the predominant character of the Tax is that of an excess profits tax in the U.S. sense.

The Regulation treats an "excess profits tax" as an "income tax," Treas. Reg. § 1.901-2(a)(1), but does not address the elements necessary to identify "excess profits" from "normal profits." On this, the Commissioner's Regulation is silent. One must search elsewhere to determine the predominant character of an excess profits tax. To be sure, creditable excess profits taxes must reach net income. More, however, is required. Excess profits taxes impose additional tax only on a subset of net income, that income deemed to be excessive. Thus, an excess profits tax must take the additional step of separating profits which are "normal" from those that are "excess." This requires a methodology and a calculation.

The U.S. and the U.K. adopted excess profits taxes as early as WWI. Both U.S. excess profits taxes and creditable U.K. excess profits taxes have applied some acceptable rate of return against invested capital to determine "normal profits." The normal profits are then subtracted from all profits to determine "excess profits." That subset of profits ─ those determined to be excessive ─ are then subjected to a second layer of tax.[11]

The U.S. Revenue Act of 1917, ch. 159, 39 Stat. 1000, adopted an excess profits tax during WWI. It was imposed on the basis of net income shown on a taxpayer's income tax returns, at a rate of 8% of such net income that exceeded $5,000 plus the amount of capital the taxpayer had invested in the U.S. The Second Revenue Act of 1940, ch. 757, tit. II, 54 Stat. 974, 975-998, provided for a similar tax of up to 50% on "excess profits net income" relative to 95% of average profits during the period 1936-39, or 8% of invested capital.

In 1915, the U.K. enacted an excess profits tax requiring companies to pay tax at a rate of 50% on their excess profits, determined by comparing current profits to 6% of capital (sum of assets, valued at cost), as it existed in 1913, before WWI.[12] Profits were taxable only to the extent that they exceeded a percentage of the company's value. The Commissioner conceded that this tax was creditable. *Columbian Carbon Co. v. Commissioner*, 25 B.T.A. 456, 474 (1932). During WWII, the U.K. enacted a series of excess profits taxes levying a tax of 60% (later,

[11] The Tax Court, in *Phillips*, 104 T.C. at 315-16, described an excess profits tax as the "imposition of an additional layer of taxation specifically targeted at a particular industry" found to be "exceedingly profitable."

[12] Munitions of War Act, 1915, 5&6 Geo. 5, c. 54, §§ 4-5; Finance (No. 2) Act, 1915, 5&6 Geo. 5, c. 89, §§ 38-41; Finance Act, 1916, 6&7, Geo. 5, c. 24, § 45.

100%) on profits in excess of "standard profits," generally computed as a percentage (8%) of average capital for the period being taxed.[13] Capital was computed as the sum of the assets of a company, generally valued at cost. In *H.H. Robertson Co. v. Commissioner*, 176 F.2d at 707, the Commissioner conceded in this Court that the WWII excess profits taxes "imposed the kind of tax recognized for credit."[14]

The pattern demonstrated by those U.S. and U.K. excess profits taxes is shared by the Windfall Tax. The equivalent mathematical expression makes the pattern clear. Profits are Companies Act profits. Invested capital is the flotation value. The reciprocal of the so-called "P/E ratio," 11.1%, is the rate of return. The mathematical expression of the Tax reveals all the elements necessary to impose an excess profits tax. It reveals the predominant character of the Tax.

2. PPL's evidence demonstrates that the Windfall Tax is a creditable excess profits tax.

PPL's evidence is presented in detail in the Statement of Facts. Most of that evidence, in particular PPL's quantitative evidence, was unrebutted and beyond

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[13] Finance Act, 1939, 2&3 Geo. 6, c. 41, §§ 20-28; Finance (No.2) Act, 1939, 2&3 Geo. 6, c. 109, § 12-14, 20, Sch. 7; Finance Act, 1940, § 26(1).

[14] *See also* Rev. Rul. 68-318, 1968-1 C.B. 342 (Italian tax at rate of 15% on income exceeding 6% of capital); Rev. Rul. 56-51, 1956-1 C.B. 320 (Cuban tax at rate of 15% on profits in excess of 10% of capital); IRS Field Service Advice 1998-296, 1992 WL 1354822 (May 21, 1992) (Swiss biennial income tax at rate of 15.5% on prior two years' net profit in excess of 5% of capital).

dispute. PPL's evidence leads to one conclusion: the Tax is a tax on excess profits. PPL's evidence demonstrates that the predominant character of the Tax conforms to a creditable excess profits tax. PPL's evidence of design and purpose of the Tax confirms this. PPL's evidence of the substance and operation of the Tax confirms this. PPL's evidence that Companies Act profits, the only real variable in the Tax, satisfy the Regulation's realization, gross receipts, and net income requirements, is irrefutable. Judge Halpern considered this evidence and concluded that the Tax was a creditable excess profits tax.

D. The Commissioner's arguments have no merit.

1. The Commissioner invents legal error under his three-prong test to distract from his failure of proof.

The Commissioner's brief repeatedly criticizes Judge Halpern's opinion for not marching through his Regulation's three-prong test.[15] Judge Halpern's ultimate finding could not be clearer:

> [W]e 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." (JA63)

Because the Commissioner is so strident and repetitive on this point, we deal with his complaint here.

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[15] The Commissioner cites *Mayo Foundation for Medical Education & Research v. United States*, 131 S. Ct. 704 (2011). (Br21-22) *Mayo* has no relevance here. There is no dispute regarding the validity of the Regulation.

The parties stipulated, and Judge Halpern found, 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." (JA19, 112-13)

Judge Halpern had the records of two tried cases ─ *Entergy* and *PPL* ─ before him when he wrote his opinion. Entergy presented two accounting experts, (1) Michael Taub, accepted as "an expert on U.K. accounting principles," and (2) Professor Raymond Ball, accepted as "an expert as to the meaning of net income in the United States" and on "U.S. accounting principles." Transcript at 114-15, 128, *Entergy*, No. 25132-06 (T.C. Apr. 7, 2008). PPL presented three accounting experts, (1) Mark Ballamy, accepted "as an expert in U.K. accounting principles," (2) Professor Maydew, accepted "as an expert in U.S. taxation and accounting and an expert in terms of being qualified to render a comparison between U.S. and U.K. accounting principles and taxation," and (3) Chris Osborne, the designer of the Tax, accepted "as an expert in economic regulation, valuation, and accounting." (JA1351, 1363-64, 1308-09)

In *Entergy*, the Commissioner agreed that the profits used in the Windfall Tax satisfied the Commissioner's three-prong test. He agreed to the following requested findings:

> In both the U.S. and U.K. accounting systems, the calculation of profits and losses is based on the fundamental principles of revenue realization and historical cost. [Realization]
>
> Under the revenue realization principle, revenues are recorded only when realized (that is, earned from the delivery of goods or services to arm's-length customers). [Gross Receipts]
>
> Under the historical cost principle, the costs of earning realized revenue are recorded from the obligations incurred to arm's-length suppliers and are matched against realized revenues to determine net income (that is, profit or loss). [Net Income]
>
> Both the U.S. and U.K. accounting systems record income as value added (realized revenue minus the cost of earning it) in arm's-length transactions. [Comparability of U.K./U.S. Accounting]

Brief for Petitioners at 17, No. 25132-06, 2008 WL 8070872 (T.C. July 9, 2008); Reply Brief for Respondent at 6, No. 25132-06, 2008 WL 8115016 (T.C. Aug. 29, 2008).

In *PPL*, Ballamy and Maydew provided expert testimony. Ballamy shouldered the accounting proof that the Companies Act profits used in the Tax met the requirements of realization, gross receipts, and net income. (JA964-65) Maydew's analysis "crossed the Atlantic," and he concluded that U.K. and U.S. accounting concepts are "fundamentally the same." (JA1024) The Commissioner offered no accounting expert, testimony, or exhibits. The Commissioner's counsel asked Ballamy no questions. His counsel asked Maydew no questions related to comparability of U.K. and U.S. accounting.

In *Entergy*, the Commissioner agreed that the profits used in the Tax satisfy his three-prong test. In *PPL*, there was unrebutted accounting testimony that the profits used in the Tax satisfy his three-prong test. Little wonder Judge Halpern did not dwell — at least to the Commissioner's satisfaction — on this element. Instead, he spent the majority of his analysis, as the Regulation demands, examining the predominant character of the Tax. If the predominant character of the Tax is an excess profits tax, there can be no doubt that it reaches net income under the Regulation.

2. The Commissioner elevates the form of the Windfall Tax statute over its substance.

The Commissioner argues that the "chosen form" of the Tax should have been given "primacy" by the Tax Court, thus elevating its form over its substance. (Br41) The "predominant character" standard, however, requires examination of the substance of the Tax.[16]

Under well-established tax principles, "[t]he incidence of taxation depends upon the substance of a transaction." *Commissioner v. Court Holding Co.*, 324

[16] The Commissioner devotes 4½ pages of his brief to *AT&T, Inc. v. United States*, 629 F.3d 505 (5th Cir. 2011). (Br37-41) That case has nothing to do with the foreign tax credit, and does not support a "form over substance" approach. Contrary to the Commissioner's reliance on form, the Supreme Court has focused on "substance" and has eschewed "labels" as "irrelevant" in applying federal income tax principles with respect to state laws. *United States v. Craft*, 535 U.S. 274, 279 (2002); *see also Virginia Historic Tax Credit Fund 2001 LP v. Commissioner*, 639 F.3d 129, 142 (4th Cir. 2011).

U.S. 331, 334 (1945). "Substance over form" is a steady and routine chant for the Commissioner. As surely as transactions, in form, may "'exalt artifice above reality'" and the form of a transaction may act "'as a disguise for concealing its real character'," *ACM Partnership v. Commissioner*, 157 F.3d 231, 247 (3d Cir. 1998) (quoting *Gregory v. Helvering*, 293 U.S. 465, 469-70 (1935)), so too can the words of a foreign tax statute conceal its "predominant character." For this reason, courts look beyond the form of a foreign statute to its substance. This approach has been applied in cases decided before the Regulation's issuance — *Bank of America* and *Inland Steel* — and after — *Texasgulf*, *Exxon*, and *Phillips*.

The Commissioner argues that the Tax Court's holding in *PPL* "opens the door for taxpayers to rewrite any foreign statute to mold it into a creditable income tax under I.R.C. § 901." (Br41) On the contrary, the Tax Court's examination of the substance of the Tax ensures that its true character is "likely to reach net gain in the normal circumstances in which it applies."

The Commissioner's approach seeks to avoid the evidence offered by PPL on the substance of the Tax. In particular, Myers' testimony, based on a financial analysis, was focused on the operation and reach of the Tax. He concluded that the Tax was, in substance, "a tax on profits, specifically on excess profits." (JA1068) Maydew, separately, reached the same conclusion. (JA1012)

3. PPL's experts and the Commissioner's expert Philip Baker confirmed "value in profit-making terms" is not a real value.

The Commissioner argues that the Tax was imposed "on *company value* and not on a company *income*." (Br16) The Commissioner makes no attempt to explain how the term "value in profit-making terms" describes a real value. PPL's experts and his own expert, Baker, confirmed it is not a real value.

Osborne testified, as a regulatory and valuation expert, 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 those profits could be levied." (JA884)

Myers testified, as a financial and valuation expert, that the term is "*not a standard economic term or concept*. It has no meaning in other contexts. It does not appear in the financial, accounting or management literature. It is an ad-hoc, one-off term that cannot reveal the economic substance or predominant character of the tax." (JA1044)

Maydew testified, as a tax and accounting expert, that "it's hard to interpret that as anything other than just a number. So when I say value it's really just value as a number, it's not market value or fair market value. . . . It's a mathematical value. It would be accidental if it was an actual fair market value." (JA1398)

Baker responded to questioning from Judge Halpern that "I don't think an expert in valuation would say it was fair measure of the value." (JA1486) His testimony refuted the Commissioner's principal argument and the testimony of his fellow expert, Peter Ashton, that the Windfall Tax was a tax on value.

Wales testified, based on his experience as a senior Treasury official, as to the origin of "value in profit-making terms" in the statute:

> I suspect that it reflects an understanding on the part of parliamentary counsel that the relationship between the tax and the taxpayer companies' profits was of some importance. There could have been no other purpose in putting in the words "in profit-making terms" than to direct the mind towards the profits issue. (JA948)

In his *Entergy* Reply Brief, the Commissioner asserts: "Whether profit-making value was an economically perfect formula for ascertaining company value is not the point." Appellant's Reply Br. 12, No. 10-60988 (5th Cir. May 31, 2011). It did not measure value either perfectly or imperfectly. As Myers testified, "Valuing a company based on four years of past earnings, which was known only with hindsight, makes no economic sense." (JA1068)

4. References to "value" were political spin designed to appeal to the Labour Party Faithful.

The "presentational" elements of the Tax are the type of "labeling" that *Bank of America* cautioned should not be determinative.[17] Osborne and Wales testified that they were instructed to design a tax on the excess profits of the privatized utilities and that they did, in fact, design an excess profits tax. Yet the

[17] An American might be more likely to use the term "spin," rather than "presentational."

Tax does not follow the form of a typical excess profits tax. They explained the "presentational" reasons for the form of the tax. Wales had one presentational perspective, and Osborne had another. The perspectives coalesced.

Wales testified, from his political perspective, that Labour faithful were against privatization and wanted renationalization. (JA931) The form of the tax played to that disgruntled wing of the Party. (JA934) Wales testified that when Brown introduced the Tax on Budget Day:

> He also added what had become, from a presentational standpoint, an important aspect of the proposal, to link the measure to the popular view among Labour Supporters that the utility companies had been sold off too cheaply: "*In determining the details of the tax, I believe that I have struck a fair balance between recognising the position of the utilities today and their undervaluation and under-regulation at the time of privatisation. The windfall tax will be related to the excessively high profits made under the initial regime.*" (JA934)

The notion that the privatized utilities were "sold too cheaply" had no basis in reality. Following privatization, the U.K. National Audit Office ("NAO") published reports concerning the privatization process employed by the Government, including an analysis whether it maximized proceeds from the sale of the companies. (JA102, 152) The NAO concluded that the Government had generally achieved its objectives, including maximizing proceeds.[18] (JA850)

[18] Wales testified, "It was politically irrelevant that the [NAO] had made it clear that the companies had not been privatised too cheaply." (JA934)

Osborne testified, from his regulatory perspective, that a "benchmark" for determining normal profits from excess profits was necessary. (JA905) In a typical excess profits tax, that benchmark is established by applying an acceptable rate of return against some form of invested capital. That approach resembles rate-of-return regulation in the U.S. (JA1065-66) The U.K. had adopted RPI-X. Osborne was reluctant to have the form of the Tax appear as though a rate-of-return calculation had been established, and he worried this might compromise U.K. regulation. He testified:

> I felt that even framing a tax in such terms would mean that the entire academic and consulting community working in this [regulated industries] area would feel obliged to comment adversely (since it was their clients, or companies that they would like to have as clients, who would be adversely affected), and that this would provide a foundation for criticism that might easily endure. (JA906)

Judge Halpern added his own "presentational" reason for the form of the Tax, namely "the relatively low 23-percent rate" reflected an awareness by Labour that it was taxing the companies and not the investors who actually benefited from the alleged undervaluation. (JA62-63)

While it was clear that the reach of the tax was excess profits in the initial period, Osborne observed: "The solution that we identified was in effect an alternative expression of the basic rationale for the tax (the excess profits made in the period immediately subsequent to privatisation)." (JA907) He continued:

So in framing the justification for the tax, one might say:

> *"The profits earned by the privatised monopoly utilities in the period after privatisation were high in relation to those companies' flotation values".*

But one might equally say:

> *"The flotation values of the privatised monopoly utilities were low in relation to the profits subsequently earned by those companies."* (JA907)

The latter justification played to the "presentational" elements of the Tax, and either expression uses both initial period profits and flotation value. This steered the form of the Tax, but the object of the Tax remained excess profits.[19]

5. Companies Act profits are not "merely a factor" ─ profits are the only real variable and driver of the Windfall Tax.

The Commissioner characterizes Companies Act profits as a mere "factor" in determining "value in profit-making terms." (Br16) The testimony of PPL's witnesses demonstrated that profits were the only real variable and the driver in the Tax calculation.

The Tax calculation contains two components based on actual company information ─ initial period profits and flotation value. Initial period profits are the only component that moves after the flotation date. Flotation value differed among the companies to reflect their different sizes, but was fixed as of the flotation date.

[19] The Commissioner's discussion of Section 179 is an unhelpful diversion. U.K. Taxation of Chargeable Gains Act 1992, c.12, § 179. (Br29 n.4) His own expert, Baker, disavowed this point and, moreover, a Section 179 tax is creditable. (JA49)

The remaining components are the 23% tax rate and the "applicable price-to-earnings ratio," fixed at 9 for all companies.

Oösthuizen testified that "profits" were "the only real moving part" and "the only variable" in the Tax calculation, as evidenced by SWEB's restatement of its profits and 51.7% reduction of its Tax. (JA1301, 1304) Robinson testified that the design of the Tax provided "a flexible mechanism that could be seen to hit the excess profits," the driver of the Tax. (JA1117) Myers testified that the designers of the Tax "settled on a formula in which the chief moving part was not value but profits." (JA1045) Wales testified: "Profits were the only factor in the calculation that were movable and it was impossible for a company with no profits in the relevant period to have a Windfall Tax liability." (JA951)

In *Entergy*, the Commissioner's principal witness, Baker, who also testified as one of his two witnesses in *PPL*, testified to the following facts:

> If a company had no net profits during its four year initial period, the company would have no Tax.
>
> Once 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.
>
> If a company had no net profits during its four year initial period, but its stock price tripled during that period, it would have no Tax.
>
> If a company had average annual profits during its initial period, multiplied by nine, in excess of its flotation value, but its share price fell during that period, it would have a Tax.

Transcript at 219-222, No. 25132-06 (T.C. Apr. 8, 2008). Baker's testimony demonstrates that Companies Act profits are the only real variable in the Tax.[20]

The Commissioner's other expert, Peter Ashton,[21] testified that the "P/E ratio" in the Tax calculation represented a "market value multiples method for computing the equity value of a company." (JA685) He did *not* testify that the so-called "P/E ratio" had *any* correlation to a real value of the Windfall Tax companies, nor could he. The companies operated in different industries and markets, ranging from telecommunications, to gas distribution, to air and rail transportation, to electricity generation or distribution, to sewer and water, to nuclear power. All were set at 9 with no distinction for individual characteristics, industry, or time of privatization.

PPL's experts refuted Ashton's conclusions. Osborne, as a valuation expert, testified: "Even on a hindsight basis, no valuer could properly assess a value for a UK regulated company on the basis of a multiple applied to average earnings during a single price control period." (JA911)

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[20] In his *Entergy* Reply Brief, the Commissioner cited Baker's testimony that if two companies had the same profits, but different flotation values, they would not have paid the same amount of Tax. Appellant's Reply Brief at 11, No. 10-60988 (5th Cir. May 31, 2011). This is obvious. Flotation value was the benchmark for determining the "excess profits," functioning like invested capital in other creditable excess profits taxes. (JA906-07)

[21] The Commissioner incorrectly states that Ashton is an "accounting expert." (Br26) He was not offered, and is not qualified, as an accounting expert. (JA1516)

Myers analyzed the P/E ratios for the RECs and WASCs and concluded (1) that a ratio of "9" was "arbitrary and inaccurate," (2) that actual P/E ratios "varied widely," and (3) that the actual ratios were all below 9. (JA1068) He explained, this ratio "is not an accurate P/E multiple" and "cannot measure the economic value that the companies could, would, or should have had." (JA1055) He observed that *all* the RECs and WASCs had P/E ratios lower than 9. (JA1054-55)

Selecting a higher "P/E ratio" permitted the tax rate to drop, thus improving the optics of the Tax. It is apparent that the "P/E ratio" of 9 was selected so that a tax rate (23%) lower than the standard corporation income tax rate (33%) could be used. (JA948) In other words, the higher the tax rate, the lower the "P/E ratio;" the lower the tax rate, the higher the "P/E ratio."[22]

The use of a "P/E ratio" in the Windfall Tax statute was completely arbitrary and presentational. The "P/E ratio" of 9 was selected, much the same way as the tax rate percentage, to establish the Tax yield. Wales testified that the tax rate and multiple were open items at the November 1996 presentation. (JA1193) That presentation shows a range of multiples that might be used and the corresponding

[22] In the November 1996 presentation, Andersen used a 33% tax rate and multiples of 5 to 8 to calculate the Tax yield. They did not use a multiple of 9. (JA754-59)

Tax yield. (JA754-759) The "P/E ratio" was not a real P/E. It was simply a factor to be applied against flotation value to flex a tax yield.[23]

6. The Commissioner has turned his back on his prior litigation positions on design, history, and purpose.

No court has taken the position that the Regulation precludes a court from considering evidence of design, history, and purpose under the Regulation. Prior to this litigation, the Commissioner argued in *Texasgulf* and *Exxon*, both post-Regulation cases, that this evidence must be considered.

In *Texasgulf*, the Second Circuit considered the creditability of the same tax at issue in *Inland Steel*, decided in favor of the Commissioner before the Regulation was promulgated. The Commissioner argued that the Regulation incorporated all aspects of the *Inland Steel* decision, including its result, and required consideration *only* of the tax's text, history, and intent. Brief for the Appellant at 18, 25, No. 97-4202, 1998 WL 34077628 (2d Cir. May 4, 1998); *see Addendum* at 70. The Commissioner disavowed use of quantitative evidence. Contrary to his position here, the Commissioner repeated throughout his reply brief in *Texasgulf* that evidence of history and purpose must be considered:

> While Texasgulf dismisses as irrelevant, under the 1983 regulations, the purpose of the processing allowance . . ., we submit that in

[23] The Commissioner states that SWEB's "taxable amount" exceeded its total initial period profits by almost £90 million. (Br16-17) This is unsurprising: average annual profits were multiplied by 9 in the Tax calculation.

> attempting to determine whether a foreign tax is a creditable income tax it is entirely appropriate for the court to consider that purpose.

Reply Brief for the Appellant at 7, No. 97-4202, 1998 WL 34263508 (2d Cir. June 18, 1998); *see Addendum* at 71. Consistent with PPL's position, the Second Circuit held that the taxpayer's quantitative evidence may be just as appropriate as the Commissioner's qualitatative evidence. 172 F.3d at 216. The Second Circuit did not confine its analysis to the text of the statute. *Id.* The Second Circuit ultimately found the taxpayer's quantitative evidence more persuasive. *Id.* at 217.

PPL presented the same type of qualitative evidence that the Commissioner offered in *Texasgulf*. Consistent with the Second Circuit's preference in *Texasgulf*, PPL also presented quantitative evidence.[24] Contrary to his position in *Texasgulf*, the Commissioner argues here that evidence of history and purpose is irrelevant.

In *Exxon*, the Commissioner argued against the taxpayer's quantitative evidence. He relied instead on evidence of design, intent, and purpose: "The regulations embody the analysis of *Inland Steel*, which focuses on the function of the foreign tax, and its history and purpose, to decide whether it is imposed on net gain." Brief for Respondent at 36-37, Nos. 23331-95, 16692-97 (T.C. July 1, 1998); *see* IRS Action on Decision, AOD-2001-04, 2001 WL 931605 (July 30,

[24] The financial and economic testimony offered by Myers and the company-by-company analysis offered by Ballamy are the same type of evidence offered by the taxpayer in *Texasgulf*.

2001) (design and purpose evidence must be considered with quantitative evidence). The Tax Court considered the Commissioner's history and purpose evidence, but found other evidence of "purpose, administration, and structure" and the taxpayer's quantitative evidence more compelling. *Exxon*, 113 T.C. at 356-60.

These cases were tried and decided after the Commissioner issued his Regulation. His position in those cases cannot be squared with his position here.

7. PPL's algebraic expression of the Windfall Tax is not a "hypothetical rewrite," but a logical method for determining predominant character.

The Commissioner argues that the algebraic expression of the Windfall Tax relied upon by the Tax Court constitutes an impermissible "rewriting" of the statute and extrinsic evidence. (Br41-47) To the contrary, that expression was derived directly from the terms of the Windfall Tax statute. It is not "extrinsic," and it is not "hypothetical." The Commissioner stipulated that it is mathematically equivalent. (JA41) Contrary to the Commissioner's assertion (Br43-44), the expression does not factor out his "P/E ratio." The 11.1% rate of return in the expression is the reciprocal of the "P/E ratio." (JA1051)

8. The Commissioner's reliance on plain language case law to interpret a U.K. tax statute is misplaced.

The Commissioner relies on the "plain language" standard applied by U.S. courts when interpreting a U.S. statute. (Br47-51) The Commissioner attempts to apply U.S. statutory construction principles to a U.K. statute. That is not the way foreign tax credits have been evaluated under § 901 and the Regulation. Whether a U.S. court, examining a U.S. statute, or a U.K. court, examining a U.K. statute, would examine the legislative history of the statute is besides the point. The issue is whether a U.S. court is permitted to examine evidence beyond the text of the U.K. tax statute for purposes of determining the predominant character of the U.K. tax. The courts have traditionally considered relevant evidence beyond the text of the foreign tax statute. Nothing in the Regulation, nor in the case law, suggests this is error.

Federal Rule of Civil Procedure 44.1 and Tax Court Rule 146 provide that a U.S. court, in determining foreign law, is entitled to consider all relevant evidence, including testimony, and "may seek the aid of expert witnesses and consider material that would not be admissible at trial." *HFGL Ltd. v. Alex Lyon & Son Sales Managers and Auctioneers, Inc.*, 264 F.R.D. 146, 148 (D.N.J. 2009); *see Grupo Protexa,* 20 F.3d at 1239. Courts have applied these same rules in determining foreign tax creditability. *See Riggs Nat'l*, 163 F.3d at 1368; *Bank of America*, 459 F.2d at 515 n.5.

Among the Commissioner's major complaints is that the Tax Court considered the testimony of Robinson, Osborne, and Wales. (Br47-52) These complaints are hollow. Courts, in determining the creditability of a foreign tax, have traditionally considered similar testimony, including testimony of government officials and experts. *See Inland Steel*, 677 F.2d at 83-84 (speech of Comptroller and Mine Assessor); *Exxon*, 113 T.C. at 357 (expert testimony and statement of member of U.K. House of Lords); *Phillips*, 104 T.C. at 302-08 (expert testimony).

Federal Rule 44.1 and Tax Court Rule 146 expressly permit testimony, no matter the form, in determining foreign law. *See Exxon Corp. v. Commissioner*, T.C. Memo. 1992-92 (admitting expert testimony, affidavits, and letters of government officials), *aff'd sub. nom. Texaco, Inc. v. Commissioner*, 98 F.3d 825 (5th Cir. 1996). The Tax Court, in that case, expressly rejected the Commissioner's argument that testimony and other evidence cannot be considered unless the primary source of the foreign law is ambiguous. The Tax Court correctly observed: "There is no ambiguity requirement in [Rule 146], and we see no reason to limit the expansive scope of its language and that of its counterpart in the Federal Rules in order to read one in." T.C. Memo. 1992-92. Those provisions are not limited to admissibility of evidence. There would be little reason for Rule 44.1 and Rule 146 to exist if, as the Commissioner contends, a court is restricted exclusively to a text-bound analysis.

That Osborne and Wales are participant-experts does not disqualify them from rendering expert opinions under the Federal Rules of Evidence. Indeed, it enhances and adds credibility to their expertise. Federal Rule of Evidence 703 provides that an expert may base his opinion on facts "perceived by or made known to the expert at or before the hearing." The Advisory Committee's Note to Fed. R. Evid. 703 further confirms that "firsthand observation" is one source of expertise.

Osborne and Wales were not mere staff members, and their proposals were not mere "back-room discussions" and "drafting-table ideas," as the Commissioner asserts. (Br51-52) The Commissioner stipulated: "The tax that the Andersen team devised essentially became the Windfall Tax that Parliament enacted in July 1997." (JA105) Robinson was the Labour Paymaster General and responsible Minister for the Tax. (JA106) In light of the authorities above, it was proper for the Tax Court to consider their testimony.

The Commissioner complains that Robinson's fact testimony and Osborne's and Wales' expert testimony are presented in litigation. (Br48-51) Courts, however, routinely permit admission and consideration of this type of evidence under Federal Rule 44.1 and Tax Court Rule 146. Moreover, this testimony does not stand on its own. Blair, Brown, and Robinson each called the Tax a tax on excess profits in contemporaneous public statements, both in Parliament and in public. If the Tax was not a tax on excess profits, it is difficult to believe that these senior Government Ministers and Members of Parliament would call it an excess profits tax. (JA944) None called it a tax on value.[25]

E. If the Windfall Tax is creditable, a remand of the rescission issue is not required.

The Tax Court did not decide the rescission issue. If the Tax is creditable, SWEB would not have a dividend and a remand would not be required.

[25] The Commissioner relies on the statements of Conservative MP Nick Gibb. (Br27) The Commissioner quotes Gibb's comments on the way the Tax statute "is drafted." (JA528) In other comments, not quoted by the Commissioner, Gibb said the Tax would be "levied on the regional electricity companies on the basis of profits." (JA482) He also stated: "No independent, arm's-length third party would put such a value on a company. . . ." (JA483) In the same debate, Gibb's Conservative colleague, Damian Green, referring to the so-called "P/E ratio," stated that, "it is simplicity to the point of idiocy to try to create a single applicable PE ratio for several companies across a wide range of sectors in different industries. At best, it must be very rough and, as it turns out, it is a completely arbitrary calculation." (JA490)

CONCLUSION

PPL's evidence is powerful and unrebutted. The Tax Court considered this evidence and concluded that the Windfall Tax was a creditable excess profits tax. The Commissioner asks this Court, as it did the Tax Court, to do an extraordinary thing, to confine its examination to the ambiguous face of the foreign statute and to ignore all the evidence of history, design, purpose, operation, and reach of the Tax. The Commissioner asks too much.

The judgment of the Tax Court should be affirmed.

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Respectfully submitted,

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I, Richard E. May, hereby certify on the 9th day of June, 2011, a true and correct copy of the foregoing brief was hand-served on counsel for Respondent-Appellant and counsel for amicus curiae, American Electric Power Company, Inc.:

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Dated: June 9, 2011

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Dated: June 9, 2011

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ADDENDUM

I.R.C. § 901

Sec. 901. Taxes of foreign countries and possessions of United States

(a) Allowance of credit

If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).

(b) Amount allowed

Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) Citizens and domestic corporations

In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States * * *.

* * *

TREAS. REG. § 1.901-2

Sec. 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 * * *) 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. * * *

* * *

(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 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 * * *

* * *

(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 * * *

* * *

(4) Net income —

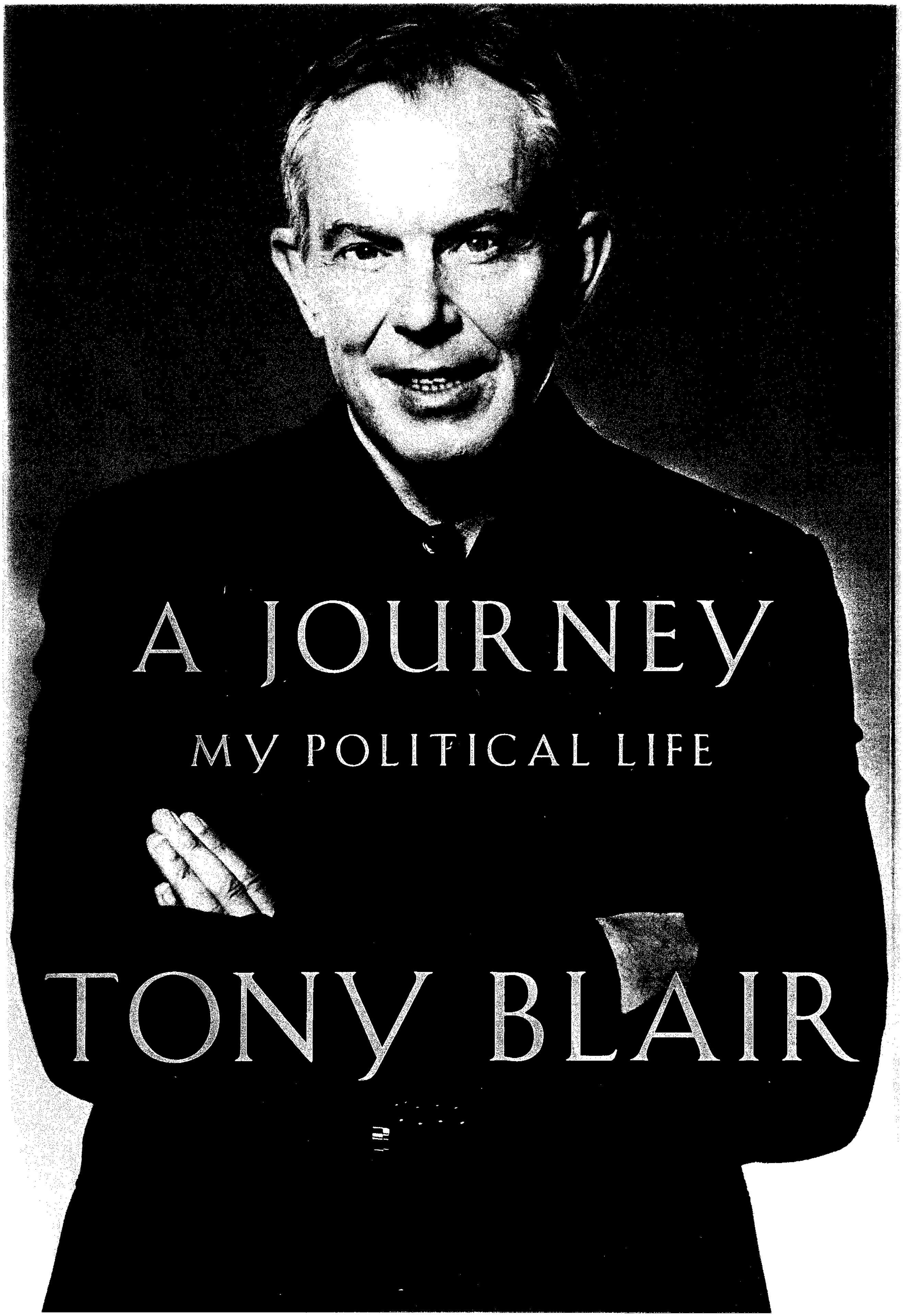
(i) In general. A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts * * * to permit —

(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. * * * 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. * * *

Tony Blair Political Autobiography


A JOURNEY
MY POLITICAL LIFE
TONY BLAIR

TONY BLAIR

A JOURNEY

My Political Life

ALFRED A. KNOPF
NEW YORK · TORONTO · 2010

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For example, are you in favour of a tough approach on law and order or not? Do you support the war in Afghanistan fully or not? Are you for reform or status quo in public services? Do we need less, more or the same amount of public spending? Are you in favour of tax cuts, and if so, for whom? Big state, smaller state, different state?

Politicians, in one way rightly mistrusting the crudity of such simple positioning, don't like this, because once defined you are limited, and their instinct is to keep all options open. The holy grail is to have everyone onside; and I'm not saying I didn't pursue it fairly vigorously and, at points, more successfully than most.

However, you have to be able to answer those questions plainly and clearly. There can be qualifications and "get-outs," but the answers must remain comprehensible, because they define you. They add up to a political, not merely personal, character. This requires thought, detailed analysis and intellectual rigour. Politics is a far more intellectual business than is often realised. You may think: Well, if it's simplicity that's required, you don't need a whole lot of detail. Wrong. The simplicity is not born of superficial analysis. It is simple precisely because it is the product of being worked through.

It was here in the long period of Opposition, when every day, week and month had to be filled with something new or diverting, that the work I had done with Gordon and a range of other policy thinkers paid off. We had burrowed down; we had devilled; we had iterated and reiterated in order to get to grips with the governing principles in each area. So we needed more investment in public services. Fine. But how to pay for it? Growth? Tax rises? Are we against tax cuts or in favour of some? And how does that impact on spending? Is it investment first, then tax cuts? Or can you do both, maybe redistributing? If redistribution, of what sort? On the higher rate, or in other more covert ways?

I can't tell you how many times we went back and forth on these issues, so that by 1994, when we became more busy and the relationship more tense, we were already orientated. The pathfinder was already switched on: growth was key; investment not tax cuts; redistribute, but carefully and not touching income tax; keep the middle class onside, but where growth and some redistribution allowed, focus on the poorest; then, in time, you could balance tax cuts and spending.

Likewise on welfare. Throughout 1995 and 1996, we toyed with a jobs programme. In the end, we came up with the "New Deal" for the unemployed. The phrase was Gordon's, borrowed from Franklin D.

Roosevelt's economic programmes in the 1930s. He always liked that sort of thing. We chose a windfall tax on the privatised utilities as the means of paying for it (being often in a monopoly position, the utilities had ended up with bumper profits). Gordon pushed for the tax, but I was a little reluctant, fearful of alienating business opinion. In early January 1997, I had a set-to with him about it, mainly because his adviser Ed Balls had gone over the top in briefing it. In the end, we settled on a compromise which was less than he wanted, but still a hefty sum.

However, the real crunch came in the programme itself, where Gordon and I were on the same page precisely: along with the job opportunities for the unemployed, we insisted on a responsibility on the part of the unemployed person to take them—i.e. modern, not old-fashioned welfare. This was very controversial ground with a lot of the party. There was a huge outcry from union leaders and others (including Robin Cook) accusing us of introducing a type of workfare, though Robin's comments were in Shadow Cabinet and aimed at Gordon (with whom he had a long-standing feud that had begun deep in the history of 1970s Scottish politics). We stuck to our guns and saw the rebellion off.

But here's the point: each decision—to have a tax, to put it on the utilities, to use it for a new type of jobs programme—was born of a set of thoroughly worked-out positions on tax, on business, on welfare. Our thinking had been painstakingly orientated so that when we came to the policy, it was not only clear but also coherent. The position on welfare didn't contradict the business position. It could have done—we might have raised general corporation tax and funded a new type of jobs programme, but that would have been anti-business. We might have had a windfall tax on utilities and had an old-fashioned, traditional jobs programme, but that would have contradicted our message on welfare, namely that it was about a partnership between state and individual, not a handout. Instead, we chose carefully so that the policy was in balance and consistent with the overall New Labour position and message. In this way, it had broad appeal. Competitive business resented the utility windfall profits from privatisation, while people wanted action on unemployment but thought unemployed people also had a duty to help themselves.

I was obsessed by the thought that this Labour government had to be different; had to be able to govern for a lengthy term, as Tory governments seemed habitually capable of doing. In order to achieve this, there was no room for compromise on essentials. That is emphatically not to say we didn't compromise. We did. In 1995, I came out for a publicly owned railway system. I never had much faith in this particular privatisation of the Tories and felt it would lead to a hugely complex and possibly uncompetitive system; but on the other hand, I wasn't going to waste money renationalising it. On the NHS and schools we also compromised, sometimes more than I liked. However, when it came to those issues fundamental to New Labour—to its rationale, its heart, its political soul, if you will—there was no compromise at all. Often this was posed less in terms of what we would do than in what we wouldn't. But that was natural for Opposition; and in any event, it created the right political space for those things I was determined to move forward on, if and when prime minister.

So: no return to the old union laws; no renationalisation of the privatised utilities; no raising of the top rate of tax; no unilateralism; no abolition of grammar schools. And there were certain clear pointers to future policy: a tough line on antisocial behaviour; investment and reform in public services; pro-Europe and pro-U.S.; opportunity and responsibility together in welfare; encouragement for small- and medium-sized enterprises and even-handedness between business and labour (employees might have additional individual rights, but not collective ones).

At every stage of this (and the decisions came pretty fast and furious), I was reconciled to fighting, and to leaving if I lost. The party had to know I was not bluffing. If they didn't want New Labour, they could get someone else. The country had to know that if I was going to be their prime minister, I would be "of the party" but also removed from it.

At times—and this was a muted criticism from GB also—it seemed as if I was deliberately provoking the party. Genuinely I wasn't; but I was not going to defer. I was going to speak the same language to party and country. In so doing, I was going to encourage the sensible and modernising people in the party to step up and step out. Party leaders have a symbiotic impact on their activists. There is a subtle cloning process that goes on which, in turn, gives more strength to the leader.

Speeches I gave back then were different in content to the speeches in the early part of the twenty-first century, to be sure, but in tone they remained the same. Our understanding of what it meant to modernise changed with the experience of governing, but the will and determination to modernise never wavered. Of course, the other point to under-

Government's Opening Brief in *Texasgulf*

For Opinion See 172 F.3d 209

United States Court of Appeals,
Second Circuit.
TEXASGULF, INC., and Subsidiaries as successor in interest to Texasgulf, Inc. and Subsidiaries, Petitioner -- Appellee,
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent -- Appellant.
No. 97-4202.
May 4, 1998.

On Appeal from the Decision of the United States Tax Court

Brief for the Appellant

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***1** PRELIMINARY STATEMENT

The decision appealed from was rendered by Judge John O. Colvin of the United States a Tax Court. The Tax Court's opinion is officially reported at 107 T.C 51 (1996). (I-A. 6.)[FN1]

FN1. "I-A." and "II-A." references are to the first and second volumes of the joint record appendix. "SA." references are to the separately bound record appendix that has been submitted under seal.

STATEMENT OF SUBJECT MATTER AND APPELLATE JURISDICTION

On March 29, 1989, pursuant to I.R.C. § 6212,[FN2] the Commissioner of Internal Revenue ***2** sent to Texasgulf, Inc. (referred to hereafter as Texasgulf or taxpayer) a statutory notice of deficiency redetermining its federal income tax liabilities for the years 1978, 1979, 1980 and 1981. (I-A. 7-8.)[FN3] On June 29, 1989, taxpayer filed a petition for redetermination in the Tax Court (I-A. 2.) That petition was timely, pursuant to § 6213(a) of the Code. The Tax Court had jurisdiction to consider the case pursuant to §§ 6213, 6214 and 7442 of the Code. On March 27, 1997, the Tax Court entered its decision that finally disposed of all claims of the parties. (I-A. 38.) On June 18, 1997, within the 90-day period provided by § 7483 of the Code, the Commissioner filed her notice of appeal to this Court. (I-A. 5.) Inasmuch as the taxpayer had its principal place of business in Connecticut at the time it filed its petition in the Tax Court, this Court has jurisdiction to hear this appeal pursuant to § 7482(a) of the Code.

FN2. Unless otherwise indicated, all statutory references are to the Internal Revenue Code (26 U.S.C.) ("I.R.C." or "the Code") as amended and in effect during the years in issue. In 1986, the 1954 Code was re-designated as the Internal Revenue Code of 1986.

FN3. The parties later agreed that only the years 1978 through 1980 would be litigated. (A. 196.)

STATEMENT OF THE ISSUE

Whether the Tax Court erroneously interpreted Treasury Regulation §1.901-2 in holding that the Ontario Mining Tax is an income tax that qualifies for the foreign tax credit provided by § 901(b)(1) of the Code.

STATEMENT OF THE CASE

The facts were partially stipulated in the Tax Court (I-A. 40, 61, 63), and they may be summarized as follows.

***3** Texasgulf, Inc. is a Delaware corporation, which had its principal place of business in Stamford, Connecticut, at the time it filed the petition in the Tax Court. It is the corporate parent of Texasgulf, Canada (also a Delaware corporation), which discovered the Kidd Creek mineral resource near Timmins, Ontario in 1964. The The Kidd Creek Mine was a source of lead, copper, zinc and silver. The extraction of ore from Kidd Creek was subject to the Ontario Mining Tax (OMT), and for the years in issue in this case, 1978, 1979 and 1980, Texasgulf Canada paid OMT in the aggregate amount of approximately $32 million (Canadian). (I-A. 8-9.) Texasgulf claimed foreign tax credits on its consolidated U.S. income tax returns for these OMT payments. Inasmuch as Texasgulf could not utilize the full credit for 1978, the unused credit for that year was carried over to 1979, pursuant to § 904(c) of the Code.

The Tax Court's opinion summarizes the relevant provisons of the OMT at I-A. 11-16. They are also reproduced in Joint Exhibit 68-BN at I-A. 118-183. Briefly stated, during the years 1974 to 1980, the OMT was administered by the Ontario Ministry of Natural Resources. (There is both a Canadian federal income tax, administered by the Canadian Department of National Revenue, and an Ontario provincial income tax, administered by the Ontario Ministry of Revenue.) The OMT applies to every mine in the Province of Ontario to the extent that the miner's "profit" (as defined for OMT purposes) exceeds a statutory exemption. That exemption was $100,000 (Canadian) in 1978; in 1979 it was raised to $250,000. (I-A. 12-13.) The tax is graduated, with rates (for the years 1974 through 1978) ranging from 15 percent on the first $1 million of taxable profit to 40 percent on amounts in excess of $40 million. (Amendments in 1978 lowered the maximum rate to 30 percent on profits in excess of $20 million.) (Ex. 68-BN, I-A. 140.)

***4** "Profit" for OMT purposes is framed as follows (OMT § 3) (I-A. 120-121):
The profit for a taxation year is the difference between,
(a) where the mineral substances raised, taken or gained from the mine are sold as such, the amount of the gross receipts from the output during the taxation year;
(b) where the mineral substances or a part thereof are not sold as such, the amount of the actual market value at the pit's mouth of the mineral substances raised, taken or gained from the mine that are fed into a treatment plant at any mill, smelter or refinery and the product thereof is sold in the taxation year: or
(c) if there is no means of ascertaining the actual market value at the pit's mouth of the mineral substances referred to in clause *b,* the amount at which the mine assessor appraises the value of such mineral substances, provided that the mine assessor in appraising such value shall deduct,
(i) the processing costs incurred as prescribed or determined by the regulations, and
(ii) an allowance for profit in respect of processing at a rate or rates prescribed by the regulations or determined by the mine assessor,
from the proceeds of the processed mineral substances sold during the taxation year, and the following expenses, payments, allowances and deductions....

Sections 3(d) through (n) of the OMT (I-A. 121) allow deductions for specific expenditures, *viz.,* scientific research conducted in Canada and relating to mining in Ontario, mine-related salaries, operating expenses, depreciation and certain development costs. Deductions are specifically *disallowed* in § 4 of the OMT for investment interest, "depreciation in the value of the mine, mining land or mining property by reason of exhaustion or partial exhaustion of the ore or mineral," *i.e.,* cost depletion, royalties paid for production of a mine on privately owned land, and (except as authorized in § 3), plant and equipment costs.

There are three ways to calculate the amount from which deductions and allowances are ***5** subtracted to compute "profit" for OMT purposes. OMT §§ 3(3)(a), (b) and (c). (I-A. 120-121.) If the miner sells ore without processing it, gross revenues are the total receipts from selling the unprocessed ore. If the miner processes ore prior to sale, it subtracts deductions and allowances from the market value of the mined mineral at the pit's mouth. Finally, there is a third method of calculating the tax, and which is the one used by most miners subject to the tax, which applies in situations where the miner does not know the market value of the ore at the pit's mouth. Under this method, which is called the "appraisal" method, deductions and allowances are subtracted from the value of the ore at the pit's mouth as appraised by the Mine Assessor on the basis of financial statements and data included on an OMT return.

Critical to the operation of the appraisal method, which was that used by Texasgulf, is the "processing allowance" referred to as "an allowance for profit in respect of processing" in OMT § 3(c)(2). This allowance, which first appeared in the OMT statute in 1974 (having previously been permitted administratively by regulations that had the effect of law), was intended, at least in part, to provide incentives to mine operators to invest in downstream processing plant and equipment and to construct such facilities in Canada, particularly in northern Ontario. (I-A. 49, ¶ 26.) The processing allowance is not available to two groups of miners. The first, as noted above, is miners that do not process the mineral before sale. The second group is miners who process ore but who have no profits or who operate at a loss. (II-A. 299-300.) The processing allowance is computed on the basis of a sliding scale percentage of the asset cost of various processing assets situated in Canada. OMT, § 5(1). For example, for the years in issue here, the allowance is eight percent of the asset cost of a concentrator, if the miner does not also operate a smelter, but rises to 16 percent if the miner has a concentrator and a smelter (but not a refinery), ***6** and to 20 percent if the miner has a processer, smelter and a refinery. (The allowance is 30 percent if the processing equipment is in Northern Ontario.) If the miner also operates a semifabricating plant in Northern Ontario, the allowance rises to 35 percent of capital cost. (I-A. 133-134.)

The processing allowance is subject to a statutory minimum and maximum amount. OMT, § 5(5). For the years in issue, the minimum processing allowance was 15% of combined profits, and the maximum was 65% of combined profits. (I-A. 134.) Most miners subject to the tax claimed the full 65% processing allowance. (I-A. 15.)

Most miners began their OMT calculation of OMT profit with net income from mining and processing as reported on financial statements, and then adjusted this income by adding expenses which were not deducted (investment interest, cost depletion and royalties) and subtracting income not related to Ontario mining and processing. The miners then deducted the processing allowance. (I-A. 15.)

The evidence adduced at trial showed that like most miners in Ontario that were subject to the OMT, Texasgulf's processing allowances exceeded its non-deductible expenses during the over-all period 1968 through 1980. (I-A. 16-17.) For the years 1968 through 1980, Texasgulf's total processing allowances exceeded total nondeductible expenditures by approximately C$128 million, although in seven of those years (1969-1973, and 1977-1978) the processing allowances did not exceed nondeductible expenses. (I-A. 17.)

Section 901(a) of the Code (*infra,* pg. ia) allows the foreign tax credit, which permits a U.S. taxpayer to offset the foreign tax directly against its U.S. tax liability. Section 901(b)(1) of the Code (*infra,* pg. ia) provides that the amount allowed as a credit to a domestic corporation is ***7** "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States." Implementing that provision are Treasury Regulations, promulgated in 1983 as T.D. 7918, 1983-2 C.B. 113 (*infra,* pg. ia). Under these regulations, "...A foreign levy is a creditable tax only if it is a tax and its predominant character is that of an income tax in the U.S. sense."[FN4] Under § 1.901-2(a)(1) of the regulations (*infra,* pg. ia), in order for the foreign tax to be creditable, its "predominant character" must be that of an income tax in the U.S. sense. Further, that regulation provides that (except to the extent otherwise provided in other provisions irrelevant here), "a tax either is or is not an income tax, in its entirety, for all persons subject to the tax."

FN4. Taxpayers are given an election, in Section 1.901-2(h) of the regulations, to have them apply to any prior open years. Texasgulf made such an election. (I-A.43, ¶ 11.)

Apart from other criteria, a foreign tax has the predominant character of an income tax in the U.S. sense only if it is likely to reach net gain in the normal circumstances in which it applies. See regulation § 1.901-2(a)(3)(i), *infra,* pg. iia. Section 1.901-2(b)(1) (*infra,* pg. iia) spells out how that determination is to be made. A tax is likely to reach net gain under normal circumstances 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." it was conceded below that the OMT satisfied the realization and gross receipts requirements for the tax years here in issue. The controversy was with respect to the net income requirement set forth in § 1.901-2(b)(4) of the regulations.

Under § 1.901-2(b)(4)(i) (*infra,* pg. iia), the net income requirement is met if, "judged on the basis of its predominant character," the tax base is computed by reducing gross receipts to ***8** 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." The regulation goes on to provide that "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."

The Commissioner maintained that the OMT did not meet the net income test because it disallowed deductions for significant costs and expenses, *viz.,* interest, cost depletion and royalties with respect to extraction from private land, and that the "processing allowance" granted in the OMT did not compensate for these disallowed expenses. As noted above, the processing allowance is based on a percentage of the cost of processing assets situated in Canada, and is subject to the limitations that it may not be less than 15% nor more than 65% of a miner's combined profit from mining and processing. The allowance is therefore available only where there are profits (although interest, cost depletion and royalties are items that may exist without regard to profitability). Also, based on the Hallett analysis of the Parson's survey of OMT returns (SA. 132), the Commissioner argued that since in a substantial number of the 213 OMT returns covered by the Parsons survey the processing allowance was less than the disallowed deductions, the OMT failed as a creditable income tax under the language of the regulations providing that the tax "either is, or is not an income tax, in its entirety, for all persons subject to the tax." (I-A. 29.) It was Texasgulf's position that the disallowed expenses were not ***9** significant, but that even if they were, the processing allowance more than made up for them, based on aggregate industry data. To that end, it relied on a study (the Parsons report) (I-A. 66), which examined 213 OMT returns, and a report by Mr. Rachamalla, the Ontario Mine Assessor. (I-A. 94.) Their testimony was generally to the effect that for the vast majority of OMT taxpayers, the processing allowance exceeded the disallowed deductions for interest, depletion and non-Crown royalties. It was conceded by the Commissioner that the Parsons report included a representative cross-section of OMT taxpayers. The Tax Court did not consider Rachamalla's report or testimony in reaching its decision. (I-A. 26.) The Parsons study, which represented about 80 percent of the total OMTpaid between 1968 and 1980, showed that, overall, processing allowances exceeded nonrecoverable expenses by slightly more than three to one, a conclusion the Commissioner did not dispute. (I-A. 26-29.)

The Tax Court agreed with Texasgulf, concluding, on the basis of its industry data, that the processing allowance exceeded the disallowed deductions both in the aggregate and for the "vast majority" of OMT taxpayers, and that it was "likely to approximate or exceed the nonrecoverable expenses for the years in issue." (I-A. 30.) It rejected the Commissioner's argument that there were so many OMT returns (both taxable and nontaxable) for which the processing allowance did not make up for disallowed deductions that the OMT failed the "flush language" test of Section 1.901-2(a)(1) that the tax must be an income tax, in its entirety, for all persons subject to it. The 1983 regulations, the court held, substituted a new set of "quantitative" standards for creditability, and that Texasgulf's aggregate data was an appropriate means to meet those standards. (I-A. 31, 33-34.)

The Tax Court entered its decision in accordance with the opinion, and this appeal by the ***10** Commissioner followed.[FN5]

> FN5. Texasgulf also is litigating its entitlement to foreign tax credits in the Court of Federal Claims for the years 1968, 1969 and 1970; the years 1971 through 1977 are pending administratively before the IRS. In an opinion issued in 1989, Judge Horn granted the Government's motion for partial summary judgment andheld that the tax was not creditable. In April, 1992, however, Judge Horn partially vacated her decision, and held that while the disallowed expenses under the OMT were significant, there was a question of material fact as to whether the processing allowance provided in the OMT effectively compensated for the loss of these deductions. That issue has been tried and is on submission.

SUMMARY OF ARGUMENT

Under Section 901 of the Code, in order to qualify for the foreign tax credit, the foreign levy must be an income tax in the U.S. sense of the term. The Treasury Regulations implementing Section 901 provide that a foreign tax is creditable only if its "predominant character" is that of an income tax in the U.S. sense. And a foreign tax has the predominant character of an income tax in the U.S. sense only if it is likely to reach net gain in the normal circumstances in which it applies. We maintain that the OMT, while concededly a "tax," is not an income tax that is "likely" to reach net gain in the normal circumstances in which it applies, and that its "predominant character," as determined by its text, its function and and its purpose, is far closer to a property or severance tax than it is to a U.S. income tax.

The regulations implementing Section 901 make it clear that a foreign tax is likely to reach net gain in normal circumstances if, judged on the basis of its predominant character, it satisfies three tests: realization, gross receipts and net income. There was no dispute in this case that for the years in issue the realization and gross receipts tests were met by the OMT; the controversy was with respect to the net income requirement. Under the regulations, that test will be met if, based on the "predominant character" of the tax, the tax base is computed by reducing gross receipts to reflect recovery of significant costs and expenses attributable to such receipts, or if recovery of such costs and expenses is computed under a method that is likely to produce an amount that approximates or exceeds recovery of such expenses. Recognizing that a foreign tax does not have to be a perfect mirror image of the Internal Revenue Code in order to be creditable, the regulations provide that a foreign tax that does not permit recovery of significant costs or expenses, but that provides allowances that effectively compensate for such recovery, is treated as permitting recovery.

Under the OMT, investment interest, cost depletion and royalties on privately owned land are not deductible. We maintain that these deductions, which would be allowed to U.S. taxpayers in determining their taxable income, are significant. But the OMT grants a "processing allowance" to miners who also process ore in Canada, and Texasgulf maintains that this processing allowance more than makes up for the lost deductions. The processing allowance is based on a percentage of the cost of the processing assets, and it is subject to a statutory floor (15 percent of combined mining/processing profits) and and ceiling (65 percent of combined profit). The processing allowance is intended, at least in part, to serve as an incentive to miners to process their ore in Canada in general and in Northern Ontario in particular.

It is Texasgulf's position that, based on its aggregate industry data showing that for the years 1968 through 1980, the processing allowances exceeded the disallowed deductions for most OMT taxpayers, the net income requirement was satisfied and the "predominant character" of the OMT was that of an income tax in the U.S. sense. We maintain that the processing allowance bears no relationship to the disallowed expenses and costs, and that the result of Texasgulf's industry survey is essentially coincidental. The processing allowance would not be available in years in which there were no profits, while nondeductible expenses (particularly interest) might well increase. And non-processing miners do not receive a processing allowance at all. The actual operation of the processing allowance is not to reach net taxable income in the U.S., but rather is to bring the tax base for miner/processers in line with the tax base (which is mining profit of pit's mouth value) for miners who do not process their ore.

Further, the Tax Court stated that the Commissioner's evidence was to the effect that that if all the 213 OMT returns (145 of which reflected liability for the tax) that were surveyed by Texasguif's expert were considered, without regard to whether or not they showed an actual OMT liability, the nonrecoverable expenses exceeded the processing allowance in sixty cases. (I-A. 27-29.)[FN6] Indeed, according to Texasgulf's expert, nonrecoverable expenses exceeded the processing allowance in nineteen of the 145 returns reporting OMT liability. (I-A. 27.) This is certainly sufficient to dictate the conclusion, under the "flush language" of § 1.901-2(a)(1), that the OMT is not an income tax for a significant segment of those taxpayers subject to it, and that it therefore is not a creditable income tax for anyone.

FN6. The source of the Tax Court's figure of sixty returns is unclear. Hallett's report (SA 149) identified 83 returns in which the disallowed deductions exceeded the processing allowance.

The Tax Court's decision incorrectly rejected these arguments, and is at odds with the most important precedent in the area, the Court of Claims decision in *Inland Steel Co. v. United States,* 677 F.2d 72 (1982). In that case, the Court of Claims held that the OMT, as it applied in 1964 and 1965, was not eligible for the foreign tax credit. The preamble to the current regulations, which govern in this case, explicitly states that the regulations adopt the criterion for creditability set forth in *Inland Steel.* Contrary to the Tax Court's holding, there is nothing in these regulations to suggest that they were adopting a new, "quantitative" test for creditability, pursuant to which industry data would become determinative of the creditability of the foreign tax.

The decision of the Tax Court is erroneous and it should be reversed.

ARGUMENT

THE TAX COURT ERRED IN HOLDING THAT THE OMT IS A FOREIGN INCOME TAX THAT QUALIFIED FOR THE FOREIGN TAX CREDIT

Standard of Review

Decisions of the Tax Court are reviewed in the same manner and to the same extent as decisions by the district courts in civil actions tried to the court, *i.e.,* the Tax Court's findings of fact are reviewed under the clearly erroneous standard, while its legal conclusions are reviewed *de novo.* See Internal Revenue Code, § 7482(a)(1); *Friedman v. Commissioner,* 53 F.3d 523, 528 (2dCir. 1995). In this case, the Tax Court's holding that the OMT is a creditable income tax within the meaning of § 901(b)(1) of the Internal Revenue Code and Treasury Regulation 1.901-2 involves the interpretation of a statute and an agency regulation that is fully reviewable by this Court as a question of law.

1. *Introduction*

In order to avoid or minimize double taxation, the Internal Revenue Code permits a foreign tax credit for foreign income taxes. See *Biddle v. Commissioner,* 302 U.S. 573 (1938); *Bank of America Nat'l. Trust & Savings Assn, v. Commissioner,* 61 T.C. 752, 760 (1974). ***14** Consistent with that statute, the Treasury Regulations require that to be eligible for the U.S. foreign tax credit, the foreign tax must be imposed on net income in the U.S. sense. In an effort to meet this test, Texasgulf introduced extensive industry data in the Tax Court relating to the question whether the "processing allowance" granted processing miners under the OMT equalled or exceeded deductions that were disallowed under that tax in the years 1968 through 1980. Inasmuch as this evidence indicated that for this period the allowances exceeded disallowed deductions for the large majority of OMT taxpayers, Texasgulf maintains that it satisfied the net income standard of the regulations, and that the "predominant character" of the OMT is that of an income tax in the U.S. sense for the tax years 1978 through 1980. It is our position that Texasgulf's industry data, even if it is representative and accurate, is simply irrelevant to the proper interpretation of the statute and the regulations, which require that to be creditable the foreign tax must be an income tax, and this means it must be a tax on net income in the U.S. sense. We maintain that the "predominant character" of the OMT, and its creditability for U.S. tax purposes, is a question that must be analyzed in terms of how that law is written and how it functions, in order to see if it is an income tax in the U.S. sense of the term. As we argue below, and as the Court of Claims held in *Inland Steel Co. v. United States,* 677 F.2d 72 (1982), the OMT is a hybrid tax that is more accurately characterized as a property or severance tax than an income tax in the U.S. sense. Indeed, it is premised on a tax base of "profit" that is essentially pit's mouth value, or something that approximates it, and the processing allowance serves to make that approximation for integrated miner/processers who cannot ascertain the actual market value of the mineral at the pit's mouth. Accordingly, we submit, it is not creditable as an "income tax" as § 901(b)(1) of the Code requires. Further, the pertinent inquiry into the foreign ***15** tax's similarity (or dissimilarity) to a U.S. income tax cannot be transformed into one of fact and resolved on the basis of expert testimony comparing, for particular years, the dollar impact of the processing allowance with disallowed deductions for a group of Ontario miners subject to the tax.

It was stipulated that the processing allowance was intended by the provincial government, at least in part, to provide an incentive to mine operators to invest in processing plant and equipment in Canada, and particularly in northern Ontario. (I-A. 49.) But in terms of its function, the processing allowance, which appears to have no analog in financial accounting, serves to "back out" processing income from the tax base, which is mining revenue or, in OMT parlance, "pit's mouth value."[FN7] Put in slightly different terms, the OMT is based on a concept of "profit" from ore extraction, not "profit" from downstream processing. The processing allowance plainly was not meant to, and does not, take the place of disallowed expenses, other than by coincidence.

> FN7. See, in this regard, Parsons, *Canadian Mining Taxation* 2d ed. 1990 (Butterworths, Toronto and Vancouver), where the author (one of Texasgulf's experts), discussing the Quebec mining tax, notes (pp. 121-122) [emphasis supplied]:
> The Quebec mining duties are essentially similar to those mining taxes that are imposed by most other resource-based provinces; they constitute a tax on profits derived from mining operations, payable by the operator of a mine in Quebec. *Mining duties, in theory, are intended to be imposed on the "pit's mouth value of the ore, less direct mining expenses.* In practice, the general approach is to determine a mining company's total income from mining and processing operations and to deduct a processing allowance to arrive at the income which in theory is attributable to the extraction of the ore.

2. *The Inland Steel decision and its adoption by the 1983 Treasury Regulations*

In *Inland Steel Co. v. United States,* 677 F.2d 72 (1982), the then-Court of Claims held ***16** that the OMT, as it applied in the years 1964 and 1965, was not eligible for the foreign tax credit provided by § 901(b)(1) of the Internal Revenue Code. In so holding, the court followed its earlier decision in *Bank of America Nat'l Trust & Sav. Ass'n. v. United States,* 459 F.2d 513 (Ct.Cl. 1972), and ruled that to be creditable the foreign tax must "be the substantial equivalent of an income tax as that term is understood in the United States" (677 F.2d at 79), and that to meet this test "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 went on to note that the OMT's concept of "net profit" was "an artificial concept utilized to satisfy the requirement of Canada's tax system," and pointed out in this regard the OMT's "severe limitations on deductions." 677 F.2d at 83. The court rejected Inland's argument that the disallowed deductions for interest, cost depletion and royalty payments were irrelevant to the inquiry, and opined that (677 F.2d at 85): "The exclusions [from deductibility] are far too widespread and important to permit the conclusion that some net gain is sure to be reached." Finally, the court was concerned that a miner's unsold inventory of gold and gypsum could be subject to the tax, which would pemit the tax to be imposed on unrealized income, "a generally impermissible result for an income tax in the United States sense." 677 F.2d at 87.

Although several important features of the OMT have been amended since the mid-1960's, much of the Court of Claims's opinion remains highly significant and its reasoning is strongly persuasive, inasmuch as the 1983 regulations explicitly adopt its analysis. That analysis is based on the text and operation of the foreign tax, with the ultimate objective to decide if it reaches net income as the concept exists in U.S. tax law.

In this vein, the Court of Claims discussed in considerable detail (677 F.2d at 81-82) the ***17** operation of the OMT. It noted that it is administered by ministries concerned with mining and natural resources, rather than by the federal and provincial tax departments, and it analyzed the computation of OMT profit, particularly from the perspective of the allowed and disallowed deductions. The court then turned to the history and purpose of the OMT, and found that it is "a formulary tax that nominally and structurally is designed to reach a particular type of net profit derived from a statutorily circumscribed business activity--the extractive phase of a mining operation."

Based on this analysis, the Court of Claims characterized the OMT as "a hybrid type of tax, with both income tax and property tax features," 677 F.2d at 82, and concluded that "The historical development of the OMT, and its present position in the Canadian tax structure, support the conclusion that the OMT is a tax on the privilege of mining in Ontario." *Ibid.* Central to this conclusion was the court's observation that "Notwithstanding its nominal objective to reach 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." *Ibid.*

Of particular significance was the Court of Claims's emphasis on the point that (677 F2d at 85):
the large-scale omission from the OMT of significant costs of the mining business, it cannot be said that the net gain of that business is sure, or very likely, to be reached by the tax. For instance, the non-deductibility of land expenses, rent, and private royalties-- all or a large part of each of which mirror important costs of mining production--remove from the consideration of the OMT crucial expenses that are normally incurred in the mining business, significant expenses which may well offset any gain the company could make from mining. The same is true of other exploration, development, and preproduction costs.

***18** Against this background, the preamble to the 1983 regulations is important (1983-2C.B. at 114):
...A foreign levy is a creditable tax only if it is a tax and its predominant character is that of an income tax in the U.S. sense.

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.C.. 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.

At no point do the preamble to the new regulations, or the regulations themselves, indicate that a new or "quantitative" approach was being taken. To the contrary, the analysis of *Inland Steel* was being followed, and that analysis, as discussed in detail above, focusses on the function of the foreign tax (which essentially turns on its text), and its history and purpose, in order to decide whether it is imposed on net gain which would be recognized as such in this country.[FN8]

FN8. The OMT has been amended numerous times over the years, and the tax, as it pertains to the years in issue, is not identical to that involved in *Inland Steel.* The OMT was amended six times between 1970 and 1980, and it was substantially modified in 1974, including changes to the deduction provisions and the processing allowance. And it is important to note that in the Court of Federal Claims case involving Texasgulf's claim to foreign tax credits for the OMT in the years 1968 through 1970, the Government is maintaining that the OMT did not meet either the gross receipts or realization tests of the 1983 regulations, neither of which was challenged in the instant case. Indeed, the parties in the Court of Federal Claims case have submitted briefs to Judge Horn on the issue of the collateral estoppel effect of the Tax Court's decision here, and it is our position that based on the significant differences in the OMT, as well as the different evidence in the record before the Court of Federal Claims, collateral estoppel would not apply against the Government in the event the Tax Court decision stands. As of this writing, Judge Horn has not ruled on the matter.

***19** If the OMT, as it stood in 1978 through 1980, is properly subjected to this functional analysis, we submit that it no more qualifies for the foreign tax credit under the 1983 regulations than did its predecessors prior to the promulgation of the regulations. It was, and remains for the years in issue, an excise or severance tax on mineral extraction for which mining profit or pit's mouth value, not net income in the U.S. sense, is the tax base.

As the Tax Court noted (I-A. 21), there is no dispute here that the OMT is a tax (as opposed to a royalty, for example) within the meaning of regulation § 1.901-2(a)(2)(i). The dispute is whether it is an income tax within the scope of § 901(b)(1) of the Code and the regulations. More particularly, the parties disagree as to the "predominant character" of the OMT under regulation § 1.901-2(a)(3), which provides that "The predominant character of a foreign tax is that of an income tax in the U.S. sense if, 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...." This formulation is based on Judge Davis's opinion for the Court of Claims in *Bank of America v. United States,* 459 F.2d at 517-523, and was reaffirmed in *Inland Steel.*[FN9] . And the regulation goes on, in § 1.901-2(b)(1), to provide that "A foreign tax is likely to reach net gain in ***20** 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."

FN9. In *Bank of America,* the court expressed the view that (459 F.2d at 523) "...the term 'income tax' in Sec. 901(b) 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 sure to reach some net gain because costs or expenses will not be so high as to offset the net pro??

It was not disputed in the Tax Court that, for the years involved here, the OMT meets the realization and gross receipts requirements of the regulations. (I-A. 22.)[FN10] The controversy was with respect to whether it satisfied the net income requirement of § 1.901-2(b)(4). Under that regulation, the net income requirement is met 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 (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."

FN10. The realization requirement was obvously inserted in the 1983 regulations to meet the concerns expressed by the court in *Inland Steel* that the OMT could reach the value of unsold inventory. With respect to the gross receipts requirement, the Commissioner's concession here may have been improvident. In U.S. tax law, "gross receipts" means the receipts of the person liable for the tax; a mine operator in this country would not be liable for income tax on receipts that belonged to someone else. Under the OMT, the operator is named as a party required to pay the tax, even if it is entitled to only a portion of the mine's proceeds. (OMT §§ 1(g), 2(2), 3(1), I-A. 119.)

The regulation, recognizing that the foreign tax need not be cast in precisely the same terms as the U.S. Internal Revenue Code in order to be creditable, goes on to provide that "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." The question, then, ***21** narrows to whether the processing allowance "effectively compensates" for the nondeductible expenses. And we submit that, except as a matter of happenstance, it does not, for the processing allowance, keyed as that allowance is to an arbitrary percentage of the cost of processing assets situated in Canada, bears no more than an accidental relationship to the disallowed deductions.

There can be no doubt that the OMT prohibits the deduction of interest, non-Crown royalties and cost depletion. And it is similarly not open to serious challenge that those expenses are "significant." As the Court of Claims made clear in *Inland Steel,* those expenses are significant, and there is nothing to contradict that conclusion in the record in the instant case. The Parsons Report (I-A. 66) does not discuss the significance of the disallowed deductions, but as the Tax Court's opinion itself makes clear, Texasgulf itself had over $21.5 million in interest deductions disallowed in calculating its 1978 OMT, and in 1980 it had over $10.7 million of royalty expenses disallowed in calculating its OMT liability. (I-A. 17.) It would be difficult to characterize these disallowed deductions as insignificant.[FN11]

FN11. Hallett, the Commissioner's expert, was of the view that the nonrecoverable expenses were "materially significant." (SA.150.)

The Tax Court ducked the issue of the significance of the disallowed deductions, reasoning (I-A. 29), "We need not decide whether nonrecoverable costs are significant because we decide the case by considering whether the processing allowance is likely to exceed nonrecoverable expenses under section 1.901-2(b)(4(i)(B), Income Tax Regs....under [which the question] ...is not whether the nonrecoverable expenses are significant; it is whether the ***22** processing allowance is likely to approximate or exceed them." [Footnote omitted.][FN12] The Tax Court's reasoning was flawed; it focussed simply on a dollar-comparison analysis, using aggregate industry data compiled for a period of relative prosperity for OMT taxpayers and that therefore happened to produce an excess of processing allowances for some miners, rather than on the basic nature of the OMT.

FN12. The Court of Federal Claims has explicitly ruled that the OMT does not permit the deduction of items that are significant costs for the mining industry. See *Texasgulf. Inc. v. United States,* 89-1 USTC ¶ 9385 (1989).

It is Texasgulf's position that it meets the net income requirement of the regulations because the OMT's processing allowance is likely to approximate or exceed nonrecoverable expenses, based on industry-wide data establishing that the processing allowance far exceeded disallowed expenses for a large majority of OMT returns filed and in the aggregate for all returns studied. We maintain that the processing allowance has no constant--or even predictable--relationship to the disallowed expenses that are present without regard to profitability from one year to another, and therefore cannot be said to be "likely" to compensate for those expenses. The allowance therefore does not operate to bring receipts to net taxable income in the U.S. sense of the term. (Not to mention the fact that some miners subject to the OMT are not entitled to a processing allowance at all.)

The Tax Court, viewing the "predominant character" language of the regulation as sanctioning a "quantitative" approach, accepted Texasgulf's argument that industry data could be used to determine the "predominant character" of the OMT by looking to see if most miners received a processing allowance that exceeded their nondeductible costs and expenses. In doing ***23** so, however, the court ignored the primary requirement of both the Code and the regulations, *viz.,* that the foreign tax must operate as an income tax in the U.S. sense in order to be creditable. While the OMT has some aspects of a tax on income, albeit income as defined specifically for purposes of that tax, its administration, its operation and its purpose are obviously far closer to a excise or severance tax than to a tax on net income as our tax law uses the term.

The predominant characteristic of income taxes, federal and state, in the United States is that they are comprehensive taxes on the net income of individuals and corporations, with relatively few individuals or corporations exempt from that tax (cf. I.R.C. §§ 501--528) and relatively few exclusions from taxable income (cf. I.R.C. §§ 101--124). A number of states in this country that may or may not impose comprehensive income taxes impose specialty excise taxes analogous to the OMT. These are generally styled severance taxes in the United States.[FN13] Cf. *e.g., Commonwealth Edison Co. v. Montana,* 453 U.S. 609 (1981), and cases cited therein. And in this vein, it is reasonable to conclude that when the Treasury Regulations speak in terms of a foreign tax's "predominant character," they contemplate a comparison with U.S. tax laws. And a comparison of the OMT with U.S. tax laws compels the conclusion that the OMT is a transactional tax akin to a severance tax, not a tax on net income.

FN13. See, *e.g.,* Montana Code Anno., §§ 15-23-502 ("net proceeds tax" on minerals other than coal and metals); 15-23-701 (coal gross proceeds); 15-23-801 (metal mines gross proceeds); Nevada Rev. Statutes Anno., Ch. 362 (tax on net proceeds of minerals); Oklahoma Statutes Anno., Title 68, § 1001 (gross production tax on asphalt, ores, oil and gas and royalties); Tennessee Code Anno., Title 67, Ch. 7 (severance taxes); Vernon's Texas Codes Anno., Subtitle I (severance taxes), Chs. 201, 202 (gas and oil production taxes); Utah Code Anno., Title 59, Ch. 5, §§ 59-5-101 et. seq. (severance tax on oil, gas and mining); Wyoming Statutes Anno., § 39-6-302 (excise tax on extraction of minerals).

In addition to the numerous state severance taxes applicable to natural resource ***24** exploitation, the Internal Revenue Code, in Subtitle D, Miscellaneous Excise Taxes, included, prior to its repeal in 1997, a tax that presented close parallels to the OMT. It was captioned "Tax on Removal of Hard Mineral Resources From Deep Seabed," and was set forth at §§ 4495--4498. It imposed a tax of 3.75 percent on the "imputed value" of nodules containing listed minerals removed, under permit, from the deep seabed. Section 4497 explained that "imputed value" meant, with respect to any hard mineral resource, twenty percent of the fair market value of any commercially recoverable metals and minerals contained in the nodules removed. As the House Ways and Means Committee Report explained (see RIA United States Tax Reporter -- Excise Taxes, p. 4140): "The 20-percent figure relates to the estimated proportionate share of the costs of the mining process itself in relation to the total costs involved in mining, transporting, processing and marketing the nodules." As the Committee noted, the 3.75 percent tax on "imputed value," in effect, is imposed at the rate of.75 percent of the fair market value of the commercially recoverable metals and minerals. (Ibid.) The analogy to the OMT's processing allowance is striking, and the point to be emphasized is that by the criteria of this country's Internal Revenue Code, the Tax on Removal of Hard Mineral Resources From Deep Seabed is an excise tax, not an income tax.[FN14]

FN14. It bears noting in this regard that both the Province of Ontario and Canada have comprehensive income taxes, although these statutes may contain special rules with respect to allowable deductions, exemptions and allowances in the case of natural resource income (see BNA Tax Management Foreign Income Portfolio No. 955-2nd, pp. A-27 -- A-28; A-68 -- A-73). See, also, Parsons, *Canadian Mining Taxation,* 2d ed. 1990 (Butterworths, Toronto and Vancouver, 1990), pg. 55.

Nothing in the 1983 regulations indicates any narrowing of or departure from the fundamental principle set forth in regulation § 1.901-2(a)(2)(ii), that the predominant character of ***25** the foreign tax must be "that of an income tax in the U.S. sense." Nor is there anything to suggest that the Treasury was prepared to abandon its victory in *Inland Steel* in favor of a test for creditability that would be based on industry-wide data respecting the foreign tax's economic impact on those subject to it.[FN15] If, as in the Seabed tax, Congress acted on the basis of such data, that would be within its prerogative. But that does not establish that such imprecise and sketchy data satisfies the requirement that Congress has established in I.R.C. § 901(b)(1) for creditability, *viz.,* that the foreign tax must be an income tax. Cf. *Biddle v. Commissioner,* 302 U.S. 573 (1938).

FN15. In fact, the IRS's administrative position, stated in Rev. Rul 85-16, 1985-1 C.B. 180, is that "The

Ontario Mining Tax is neither an income tax within the meaning of section 901(b) of the Code nor a tax in lieu of an income tax within the meaning of section 903." The ruling continues, "In *Inland Steel Co. v. United States,* 677 F.2d 72 (Ct.Cl. 1982), the court held that the payments exacted under the Ontario Mining Tax (OMT) do not result from any concept of net gain that would be recognized as the base for an income tax in the United States, but rather, seem to be taxes on the privilege to conduct mining operations in Ontario."

The Tax Court dismissed the significance of the *Inland Steel* decision on the basis that the Court of Claims "did not have industry-wide data to consider, and the Secretary had not yet promulgated regulations using a quantitative approach." (I-A. 33-34.) But the Tax Court completely missed the point that the 1983 regulations did not change the rules from a functional, text-based analysis to a "quantitative" approach in which industry-wide data (assuming it were available) would be determinative of a foreign tax's creditability. Indeed, there is no reason to assume that the Federal Circuit, if it were called upon to resolve the question of the OMT's creditability under the 1983 regulations, would consider industry-wide data relevant, much less controlling.

***26** There is nothing "quantitative" about the "predominant character" test prescribed in the regulations. At no point do the regulations suggest that the predominant character of a foreign tax is a matter to be decided based upon a "quantitative" analysis in which aggregate industry data is dispositive, or even relevant. To the contrary, as the preamble to the regulations makes clear, the focus of the regulations is on the operation of the statute involved, *i.e.,* how do its provisions function, in comparison to the U.S. income tax, and do they end up with a tax on net income in the U.S. sense. This was the approach taken by the Court of Claims in *Inland Steel,* and it was intended to be the focus under the regulations.

In simplest terms, the industry data which that are the support of Texasgulf's case, and the Tax Court's decision, are irrelevant to the determination of a foreign tax's predominant character. The correct analysis is to look to the text of the foreign tax statute, and if there are ambiguities in that text, to its legislative purpose. From that foundation, the court can make a comparison to U.S. tax law, and can then determine whether the tax is an income tax in the U.S. sense. If the OMT is examined in this light, it is apparent that it has few of the characteristics of an income tax in the U.S. sense of the term; its function and its purpose are primarily those of a transactional or excise tax on mining, not a tax on net income in the U.S. sense, even though it is nominally based on a miner's profit from mining.

In this regard it bears repeating that the processing allowance is an arbitrary computation intended to provide an estimate of processing profits. The cost of processing assets may be a reasonable basis on which to estimate processing profits, given an implicit rate of return which varies with the nature, cost and location of the processing plant and equipment. But the allowance bears no relationship to the disallowed costs and expenses of an Ontario miner. As an ***27** incentive to Ontario miners to do their processing in Canada, it is computed on the basis of a percentage of the cost of processing equipment in Canada, which bears no relationship to the amount of interest, non-Crown royalties or depletion a miner incurs in a given year.[FN16] The more advanced the downstream processing equipment is, the higher the processing allowance percentage. Thus, if a miner which extracted ore from Ontario shipped it to the United States for processing, it would be entitled to no processing allowance, and under the Tax Court's "quantitative" analysis, if enough miners did this, the OMT would become a non-creditable tax, even though the OMT remained exactly the same. By the same token, the statutory floor and ceiling on the processing allowance -- 15 and 65 percent of combined profits respectively -- are subject to the vagaries of the company's overall profit and loss picture. And under the Tax Court's approach, although the period 1968 through 1981 appears to have been a relatively profitable one for the Ontario mining industry, an economic downturn might well alter the balance between disallowed expenses and the processing allowance, leading to the conclusion that the OMT might then become noncreditable. Interest expenses, for example, might well increase, while profits (and with them the processing allowances) would go down.

FN16. When Mr. Parsons was asked on cross-examination what the purpose of the processing allowance for the years 1978 through 1980 was, he replied (II-A. 298) "I don't know."

The Tax Court's analysis, then, creates more problems in terms of determining creditability under the regulations than it solves. One might well ask whether the "quantitative" test may be satisfied with financial information derived from tax returns, or will some other data suffice? How is this data to be obtained, particularly in light of tax return information confidentiality laws? How large should the industry sample be? Will more than one-half the ***28** taxpaying population suffice? Suppose the data does not include one taxpayer whose situation is so dominant that it represents more than half the tax revenue? Or, suppose that this dominant taxpayer is included in the over-all data, but its processing allowance is so large that it exceeds both its own disallowed deductions and those of many others in the group? And quite apart from the size of the industry sample, the Tax Court's approach depends upon which years are selected for analysis. If the profit and loss cycles in the industry were short enough, the creditability of the OMT could switch back and forth on a year-to-year basis. The dispute then would shift to what the appropriate time span should be for examination of the industry data blessed by the Tax Court's approach. And that approach is unlikely to help most taxpayers. While the population of Ontario miners is quite small, Parsons testified that compiling industry data "was not an easy task because we could not compel any mine operator in the province to cooperate with us...[and] we were looking at a period that occurred some time ago." (II-A. 254.) There is no doubt that in most foreign tax creditability disputes the taxpaying populations will be much too large to permit the type of studies undertaken by Parsons.

It is clear that the Tax Court's one-dimensional analysis, focussing only on dollar amounts of disallowed expenses vs. processing allowances, not only ignores the general requirement that the foreign tax must be "an income tax in the U.S. sense," but also misconstrues the function and purpose of the OMT's processing allowance. Its purpose, as noted, is to provide an incentive to miner/processers to do their processing in Canada. Its function is to permit the OMT to be levied on mine output by removing (albeit roughly) processing income from the tax base, which thereby becomes the same for non- processing miners and for those who also process the ore. The OMT, therefore, is far closer to an excise tax ***29** rather than it is to a creditable income tax, as the Court of Claims correctly held in *Inland Steel.*

In short, there is no doubt that the OMT does not operate as an income tax with respect to non-processing miners, who receive no processing allowance, or with respect to marginally profitable miners, who may have large non-deductible expenses and small processing allowances. The Tax Court ignored these rather obvious points, as well as the regulation's fundamental requirement that any method for providing an allowance to compensate for disallowed costs and expenses must be "likely to produce an amount that approximates, or is greater than" the disallowed costs and expenses. It would seem self-evident that where two deductions (or a deduction and an allowance) bear no necessary relationship to each other, one cannot be said to be "likely" to approximate or be greater than the other. Such a result is purely a matter of coincidence.

The Tax Court dismissed this argument with the comments that § 1.901-2(b)(4) "requires us to consider whether the processing allowance approximates or exceeds nonrecoverable expenses, not whether there is a nexus between the two" (I-A. 29), and "The regulations do not provide that the processing allowance must bear a predictable relationship to nonrecoverable expenses." (I-A. 37.) But in doing so, the Tax Court lost sight of the first principle of the regulations, as well as the explicit language of § 901(b)(1) of the Code, which mandate that to be creditable the foreign tax must be an income tax in the U.S. sense of the term, and it must be an income tax for all to whom it applies. A processing allowance that takes the place of disallowed deductions that would be allowable under U.S. tax law principles cannot serve to reduce gross income to net taxable income in the U.S. sense unless it bears some rational and predictable relationship to those disallowed deductions. There is nothing whatever to suggest that the term ***30** "predominant character" was intended by the drafters of the regulations to make the question of creditability turn on the vagaries of industry data pertaining to the financial impact of the foreign tax on a subset of taxpayers whose only common characteristic may be that they are subject to the tax.

Finally, the Tax Court's decision is flawed insofar as it rejected the Commissioner's argument, based on the flush language of regulation § 1.901-2(a)(1), that the OMT is not creditable because it is not an income tax for each taxpayer subject to it. (I-A. 35-36.) That regulation provides that "Except to the extent otherwise provided in paragraphs (a)(3)((ii) and (c) of this section [which are inapplicable here], a tax either is or is not an income tax, in its entirety, for all persons subject to the tax."

We do not maintain that regulation § 1.901-2(a)(1) requires that if there is only one taxpayer for whom the foreign tax is not an income tax because its processing allowance does not equal or exceed disallowed deductions, the tax would automatically be non-creditable not only for that taxpayer but also for all others in the taxpaying population whose processing allowances equal or exceed the disallowed deductions. But we do maintain that aggregate industry data, on which Texasgulf based its case (and which became the "quantitative" rationale of the Tax Court's opinion), is a profoundly unreliable basis on which to determine creditability. This is underscored by the situation in the instant case, where there was evidence that a substantial number of OMT returns--sixty (according to the Tax Court's characterization of Hallett's testimony) of the 213 OMT returns covered by Parsons's industry survey, without regard to whether they indicated tax liability or not, reflected processing allowances that did not exceed the disallowed deductions. That evidence reinforces the conclusion that whatever the OMT is, it ***31** is not a creditable income tax in the U.S. sense of the term under the clear mandate of the Code and the Treasury Regulations.

CONCLUSION

For the foregoing reasons, the decision of the Tax Court is incorrect and should be reversed.

STATUTE AND REGULATIONS

INTERNAL REVENUE CODE

SEC. 901. TAXES OF FOREIGN COUNTRIES AND OF POSSESSIONS OF UNITED STATES.

(a) ALLOWANCE OF CREDIT.-If the taxpayer chooses to have the benefits of this subpart, the tax imposed by this chapter shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960. Such choice for any taxable year may be made or changed at any time before the expiration of the period prescribed for making a claim for credit or refund of the tax imposed by this chapter for such taxable year. The credit shall not be allowed against any tax treated as a tax not imposed by this chapter under section 26(b).

(b) AMOUNT ALLOWED.-Subject to the limitation of section 904, the following amounts shall be allowed as the credit under subsection (a):

(1) CITIZENS AND DOMESTIC CORPORATIONS.-In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and

TREASURY REGULATIONS

1.901-2 (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.

1.901-2(a)(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 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.

1.901-2(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.

1.901-2(b)(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 is 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 expense 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 satisfied 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 satisfied 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.

TEXASGULF, INC., and Subsidiaries as successor in interest to Texasgulf, Inc. and Subsidiaries, Petitioner -- Appellee, v. COMMISSIONER OF INTERNAL REVENUE, Respondent -- Appellant.
1998 WL 34077628 (C.A.2) (Appellate Brief)

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Government's Reply Brief in *Texasgulf*

For Opinion See 172 F.3d 209

United States Court of Appeals,
Second Circuit.
TEXASGULF, INC., and Subsidiaries as successor in interest to Texasgulf, Inc. and Subsidiaries, Petitioner - Appellee,
v.
COMMISSIONER OF INTERNAL REVENUE, Respondent - Appellant.
No. 97-4202.
June 18, 1998.

ON APPEAL FROM THE DECISION OF THE UNITED STATES TAX COURT

Reply Brief for the Appellant

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***1** Several points made in Texasgulf's answering brief merit a reply; in all other respects, we stand on our opening brief.

(1) Reduced to its barest essentials, Texasgulfs argument comes down to the proposition that the 1983 regulations changed the nature of the OMT from a non-creditable hybrid tax to a creditable income tax. The proposition does not survive its statement. The regulations may put the prior case law on a different footing insofar as precedential weight is concerned, but they cannot transform the OMT into an income tax.

(2) Texasgulf argues (Br. 33) that the 1983 regulations "altered the inquiry to be conducted by a reviewing court and the range of evidence appropriately introduced to establish that a tax is eligible for credit." Texasgulf then posits that the pre-regulation case law required a structural or textual analysis and comparison of the foreign tax with U.S. income tax principles. ***2** while the regulations establish a new criterion, viz. the foreign tax is to be evaluated on the amount of gain that is taxed. (Br. 34, emphasis in original.)

There is no doubt that the regulations codify the well settled principle that the foreign tax must reach net gain in the normal situation for it to be a creditable income tax. We do not understand Texasgulf to argue to the contrary. But the regulations do not state that the test in this regard is to be "the amount of gain that is taxed," much less that this determination is to be made on the basis of aggregate industry data, with its inherent uncertainties, as opposed to a taxpayer-specific inquiry.

It is equally clear that the regulations provide a degree of flexibility in the analysis of the creditability of a foreign tax in not insisting that to qualify as an income tax in the U.S. sense of the term it must replicate the Internal Revenue Code in every respect. Hence, if the tax is otherwise qualified, the provision in the regulations that a foreign tax may reach net income, and thus qualify for the credit, if it permits the recovery of significant costs and expenses by means of a computation that is likely to approximate or exceed them. See Treas. Reg. 1.901-2(b)(4)(i). But again, the regulations do not refer to the use of aggregate industry data as an acceptable mode of proof of whether the foreign tax's alternative methodology does produce an approximation of (or exceeds) the disallowed deductions. In this regard, Texasgulf's entire case turns on the happenstance of its proof that, for a thirteen year period, the OMT's processing allowance generally exceeded disallowed deductions for a representative group of miners subject to the tax. (Although in that same thirteen-year period, Texasgulf's own disallowed deductions exceeded the processing allowance in seven of the years. (I-A 17).) That is hardly a reliable benchmark for determining whether a particular foreign impost is a creditable income tax.

***3** (3) Texasgulf also claims (Br. 29) that "The Commissioner does not dispute that, as the Tax Court held. Treasury Regulations 'supercede [sic] prior case law to the extent that they provide requirements and definitions not found in prior case law.' (A. 31; sec also Nissho Iwai American Corp. v. Commissioner, 89 T.C. 765, 777 (1987).)" While we agree that the issuance of regulations serves to distinguish earlier, pre-regulation cases, and may (in appropriate circumstances), weaken their status as precedent, we do dispute that the regulations in this case create a new set of rules that renders the pre-existing case law irrelevant.[FN1] Such a conclusion is entirely antithetical to the preamble to the 1983 regulations, quoted at page 18 of our opening brief. And we certainly dispute the implicit conclusion to which Texasgulf's argument leads, viz., that the regulations could alter the character of the OMT to make it creditable.

FN1. In a similar vein, Texual later asserts (Br. 35) that "... it is long settled that later-enacted Treasury Regulations or rule or modify earlier judicial decisions to the extent those decisons are inconsistent," citing Nissho Iwai. But an administrative regulation can neither overrule nor modify earlier judicial decisions; its role is to set forth how the agency will interpret and apply the statute and the cases. The judiciary will then interpret and evaluate the more recent regulation.

Texasgulf's argument on the effect of the regulations (in essence, that they preempt the prior case law and render a virtual nullity) is thus an overstatement, and in fact overstates the Tax Court's decision. Its quotation of the Tax Court's opinion leaves out the word "can" between "Regulations" and "supersede," turning the Tax Court's observation into an unequivocal rule of law. And the cases cited by the Tax Court for the proposition that new regulations can supersede prior case law to the extent that they provide new requirements and definitions do not really support it. In Bowater, lnc. v. Commissioner, 101 T.C. 207, 212 (1993) the parties agreed that a new regulation was applicable to the controversy before the court, and the court characterized ***4** one of its earlier decisions as "distinguishable" because the regulation did not apply in it. See 101 T.C. at 212. Significantly, however, the Tax Court then went on to quote the prior decision and to follow it. In Nissho Iwai American Corp., Commissioner. 89 T.C. 765, 776-777 (1987), the taxpayer argued that a temporary regulation was invalid, and that a line of older cases (the "Mexican railroad car rental" cases) should govern instead. See 89 T.C. at 775. The Tax Court found the temporary regulation was alid, and commented that "We believe that the years have sapped such decisions [the Mexican railroad car rental cases] of whatever vitality they may have had; accordingly We decline to follow the holdings of those cases." [Footnote omitted.] See 89 T.C at 777.

There is no indication that in promulgating the 1983 regulations the Treasury intended to supersede, supplant, replace or administratively overrule the decision of the Court of Claims in Inland Steel Co. v. United States, 677 F.2d 72 (1982). *Quite* the opposite is true; as we noted in our opening brief (pg. 18), the regulations focus on the question whether the foreign tax "is likely to reach net gain in the normal circumstances in which it applies," as the preamble makes clear. And the preamble is equally explicit in stating that "This standard...adopts the criterion for creditability set forth in Inland Steel Company....and Bank of America National Trust and Savings Association...." Surely, if the drafters of the regulations intended to do away with the analysis of the Inland Steel and Bank of America decisions, and meant to replace that approach with a set of what Texasgulf calls (Br. 35) "new, quantitative rules," they would have so stated. They did not.

Indeed, this Court, in American Metal Co. v. Commissioner. 221 F.2d 134 (2d Cir. 1955), cert. denied, 350 U.S. 829 (1955), in analyzing Mexican mining production taxes (which it found ***5** not to he creditable as income taxes), stressed that "the determinative question" is whether the foreign tax is the substantial equivalent of an income tax as that term is understood in our tax law. See 221 F.2d at 137. The Court
cited as authority for this proposition, inter alia, its prior decision in New York & Honduras Rosario Min. Co. v. Commissioner, 168 F.2d 745 (1948), in which a tax on mining enterprises, but measured by net income, was held to he creditable, and Keaseby & Mattison Co. v. Rothensies, 133 F.2d 894 (3d Cir. 1943), cert. denied, 320 U.S. 739 (1943), in which the court held that the four percent tax imposed on annual profits imposed by the Quebec Mining Act was not creditable. All of these decisions were cited by the Court of Claims in Inland Steel.

(4) Texasgulf's assertion that the regulations now require creditability to be determined simply on the basis of the amount of gain that is taxed (Br. 34) would allow coincidence or happenstance to dictate creditability. Put another

way, Texasgulf's position would require the court to ignore the foreign statute (and, it goes without saying, its purpose), and look only to the bottom-line numbers. This is obviously a departure from established principles of tax analysis that finds support neither in law nor in common sense.

There is nothing new in the regulation's requirement that the foreign tax, to be a creditable income tax, must be likely to reach net gain in normal circumstances. That is the teaching of the cases cited in the preamble, as Texasgulf acknowledges (Br. 27). It is certainly true that the regulations then lay out three tests to determine if the foreign tax meets the net gain standard, but even if one accepts Texasgulf's characterization of these tests as "exclusive,"(ibid.). the regulations cannot transform a non-income tax into a creditable income tax.

***6** In implementing the Code's requirement that the foreign tax must be an income tax, the regulation's fundamental premise, articulated even prior to the "likely to reach net gain analysis." is that the predominant character of the foreign tax must be that of an income tax in the U.S. sense. See Treas. Keg. 1.901-2(a)(ii). It is our position, of course, that the predominant character of the OMT is far closer to a transactional excise or severance tax than it is to a general income tax as mat term is used in this country's tax laws. The OMT is imposed on a specific industry, it is not administered by the regular federal and provincial taxing authorities (I-A. 49-50), and it has a self-contained set of definitions and operating rules for determining mining profit as the tax base.

It is also noteworthy in this regard that Texasgulf does not respond to our argument (pp. 23-24 of our opening brief) that the predominant character of the OMT is analogous to the severance taxes on mineral production that exist in many states. Nor docs it acknowledge our point (pp. 23-24 of our opening brief) that the Internal Revenue Code contained (until 1997) a closely analogous tax in §§ 4495-4498, the "Tax on Removal of Hard Mineral Resources from Deep Seabed," which was an excise tax, not an income tax. The "predominant character" of the OMT, we submit, is that of a severance or excise tax.

(5) Texasgulf asserts (Br. 55) that, in essence, the Court of Claims reached the wrong result in Inland Steel because the record before it was "deficient" and "misleading," in that "the only data before the Claims Court in Inland Steel, were demonstrably aberrant when compared to every other Mining Tax taxpayer." This, in turn, is based on Texasgulf's evidence that Caland, the OMT taxpayer in inland Steel, had unusually large royalties and cost depletion when compared to those paid by other OMT taxpayers. (Ibid.) What Texasgulf does not address, ***7** howcvor, is whether the Court of Claims applied the correct tests to resolve the question whether the OMT, as it applied to Calami, was an income tax in the U.S. sense of the word. As the preamble to the regulations makes clear, the drafters of the 1983 regulations were of the view that the court's analysis was correct, and, of equal importance for present purposes, that their regulations were consistent with it.

(6) While Texasgulf dismisses as irrelevent, under the 1983 regulations, the purpose of the processing allowance (Br. 36-37), we submit that in attempting to determine whether a foreign tax is a creditable income tax it is entirely appropriate for the court to consider that purpose. As the Tax Court noted (I-A. 19), a credit against U.S. income tax is, in effect, an exemption from taxation that is dependent upon legislative grace, and it is the taxpayer's burden to establish that it clearly falls within the statute that allows the credit. Here, the statute is § 901(b)(1) of the Code, which requires that to be creditable the foreign tax must be an "income tax." We submit that Texasgulf's proof falls far short of establishing, much less clearly establishing, that the OMT is an income tax.

Texasgulf does not dispute that the processing allowance is intended to stimulate investment in downstream processing plant and equipment in Canada, and to "back out" mining profit from combined mining-cum-processing profit. There is no indication that it is intended to compensate for disallowed deductions. Texasgulf's response is less than convincing when, in an effort to rebut this point, it argues (Br. 43) that "Indeed, the processing allowance is directly related to interest expense, the largest of the nonrecoverable expenses... A taxpayer's processing allowance and interest expense are both linked to the scale of the taxpayer's processing assets which, unlike mining assets, can be financed by debt....Thus, both interest expense and the ***8** processing allowance are likely [to] grow as the taxpayer increases its investment in processing assets." Cut even if there were merit to this speculation with respect to the processing allowance's role as to disallowed interest, it would not answer the loss of cost depletion and non-Crown royalties under the OMT.

Indeed, as a policy matter it is difficult to justify a foreign tax credit for a tax that a miner/processer who operates in the United States could claim only as a deduction as opposed to a federal lax credit. As we noted in our opening brief (pg. 23), a number of states impose severance taxes on natural resource extraction that arc in many respects similar to the OMT. While these taxes may be deductible, either as taxes under § 164 or as business expenses under § 162 of the Code, they are not creditable, dollar-for-dollar, against the taxpayer's U.S. tax liability.

(7) Texasgulf dismisses, as ill founded, our argument that the use of aggregate industry data as evidence of the "predominant character" of a foreign tax creates serious problems for both taxpayers and the Commissioner. (Br. 39.) More particularly, Texasgulf maintains that the Tax Court's decision is unique to the evidence in the instant case, and that different taxpayers, on a different record, might not persuade the court that a foreign tax's predominant character was that of an income tax in the U.S. sense. (Ibid.) This may be true, but there is nothing in the Tax Court's opinion indicating that it should be treated so narrowly and as so fact-specific. To the contrary, the opinion suggests (I-A. 33-35) that particularly in a case where the universe of taxpayers is comparatively limited, as it is with respect to miners subject to the OMT, the court would again accept "representative" industry data as controlling on the question of the creditability of the foreign tax.

***9** In this regard, it is noteworthy that Texasgulf assails the Court of Claims decision in Inland Steel as having been based on "aberrant" evidence, because the OMT taxpayer's disallowed interest and cost depletion expenses in that case were unusually large. (Br. 35.) Texasgulf's argument is the paradigm of the mischief inherent in reliance on industry-wide oata, even if that data is "representative." Such an approach merely shirts the focus of judicial inquiry as to creditability from an analysis of the foreign tax as it applies to the particular taxpayer to the potentially far more difficult questions of the components of the "representative" industry-wide evidentiary database and the time frame that it covers.

(8) Texasgulf urges, as an alternative basis for affirmance, that its disallowed deductions under the OMT are not "significant," construed as a percentage of its gross receipts, and that it therefore docs not matter if the processing allowance is not "likely" to cover (or exceed) these expenses. (Br. 43.) The Tax Court deemed it unnecessary to decide this factual question. Sec 1-A. 34.

We have no quarrel with Texasgulf's position that an appellate court may affirm on the basis of reasons not advanced by the trial court. But we do not believe that this ease is one in which that rule of appellate practice should be applied. As the Tax Court pointed out (I-A. 34-35), the Court of Federal Claims has already ruled that the disallowed deductions of the same taxpayer but for different tax years are significant.[FN2] We submit that it is the Tax Court, as the ***10** finder of fact, that should he the tribunal to make a finding on this point for purposes of this case.

FN2. See Texastuilfv. United States, 17 Cl. Ct. 275, 287-288 (1989):
"Although Inland Steel Co., concerned a determination of whether the Ontario Mining Tax is an income tax in the United States "sense" and was issued prior to the promulgation of Treasury Regulation section 1.901-2, the reasoning and, therefore, holding in Inland Steel Co., contrary to the plaintiff's argument, does apply in the instant case. Since the drafters of Treasury Regulation section 1.901-2 intended to adopt the standard of Inland Steel Co. the use of the word "significant" in section 1.901-2(b)(4)(i)(A) was intended to reflect the holding of that case....The instant case concerns the same Ontario Mining Tax levy and the same disallowed deductions, which include interest, depletion, and royalties. In accordance with Inland Steel Co., this court finds, that the disallowed deductions in the instant action are "significant" and that the Ontario Mining Tax is not likely to reach net gain, as described in subsection (A) of Treasuiy Regulation section 1.901-2(b)(4)(i)."

> As noted in our opening brief (pg. 10, fn. 5), Judge Horn partially vacated her 1989 decision granting summary judgment in favor of the Government, and ruled that there was a triable issue of material fact as to whether the processing allowance effectively compensated for the lost deductions. The issue has been tried and remains on submission.

And there is ample room to challenge Texasgulf's gross receipts argument on its merits, as the Commissioner did in the Tax Court. There is nothing in the regulations dictating that the test for significance of disallowed deductions should be based on a comparison of the deductions with the taxpayer's gross receipts. Gross receipts, which is likely to be the largest possible numerator of a fraction in which disallowed deductions is the denominator, may be a highly unreliable basis for comparison. It is entirely possible that in an industry where gross receipts are high but profit margins are small, a comparison with pre-tax net income will provide a more accurate picture of the deductions' significance. And finally, even if the Tax Court (or this Court) were to agree with Texasgulf that the gross receipts comparison is appropriate in the circumstances of this particular case, there is no sound basis for extending that conclusion to other taxpayers.

***11** CONCLUSION

For the reasons stated herein, and in our opening brief, the decision of the Tax Court is erroneous and should be reversed.

TEXASGULF, INC., and Subsidiaries as successor in interest to Texasgulf, Inc. and Subsidiaries, Petitioner - Appellee, v. COMMISSIONER OF INTERNAL REVENUE, Respondent - Appellant.
1998 WL 34263508 (C.A.2) (Appellate Brief)

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