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No. 12-43

IN THE
Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF OF ANNE ALSTOTT, MARVIN CHIRLESTEIN, MIHIR DESAI, MICHAEL GRAETZ, DANIEL HALPERIN, MITCHELL KANE, LAWRENCE LOKKEN, ROBERT PERONI AND ALVIN WARREN, AS *AMICI CURIAE* IN SUPPORT OF RESPONDENT

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INTEREST OF THE *AMICI CURIAE*

Amici are law professors who teach and have written books and numerous articles on taxation, including U.S. international taxation. Amici's interest is in the proper application of the U.S. tax laws.[1] Brief descriptions follow:

Anne L. Alstott is the Bierman Professor in Taxation at the Yale Law School.

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[1] Pursuant to Rule 37.6, *amici* state that no counsel for a party authored this brief in whole or in part, and no person or entity, other than *amici* and their counsel, made a monetary contribution to the preparation or submission of the brief. As reflected in a letter filed with the Clerk, the Solicitor General has consented to the filing of this brief; petitioners have consented generally to the filing of amicus briefs in this case.

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SUMMARY OF ARGUMENT

In 1997 the newly elected Labour government of the United Kingdom enacted a Windfall Tax applicable to a relatively small group of privatized regulated utilities that years earlier had been sold to the public at a fixed price (£2.40 a share for the regulated electric companies). For the initial four or five years following privatization, the previous Conservative government had also fixed the prices that these monopolies could charge their customers.

The Windfall Tax was designed to redress both undervaluation at privatization (which for petitioners occurred in 1990) and subsequent lax regulation that permitted the utilities to charge unduly high prices during the initial period after privatization. The tax imposed is 23% of the difference between a recomputed share value (based on a fixed price-earnings multiple of earnings) and the lower value at which the shares were actually issued to the public at privatization (the "flotation value").

Based on a specific mathematical reformulation of the tax, which more than doubles its rate and ignores or obscures important variables, petitioner claims that the UK levy is an "income or excess profits tax" eligible for dollar-for-dollar reimbursement by U.S. taxpayers under the foreign tax credit of § 901 of the Internal Revenue Code. But since the value of an income-producing asset necessarily depends on its earnings, a tax on value can be restated mathematically as if it were an income tax. The idiosyncratic algebraic reformulation on which petitioner rests its entire case is only one of several equivalent mathematical reformulations, a number of which lead to the opposite conclusion that the UK tax at issue here is not a creditable income tax. Petitioner would, in effect, have this Court extend the foreign tax credit well beyond its statutory scope of income and excess profits taxes to a whole host of taxes on value and perhaps even to consumption taxes, none of which have ever been creditable.

Precisely because petitioner's reformulation would open the door to claims of foreign tax credits for foreign levies based on value, not income, if this Court accepts petitioner's argument, it would provide a road map to foreign governments, encouraging them to shift the costs of privatization to U.S. taxpayers by initially undervaluing public assets and companies sold to private interests and subsequently imposing a retroactive levy to compensate for the previous undervaluation.

Under petitioner's approach, U.S. taxpayers would reimburse a U.S. parent company dollar-for-dollar for such retroactive payments made by its foreign subsidiaries. The UK tax at issue here is not an income or excess profits tax, and no foreign tax credit should be allowed for it under § 901.

ARGUMENT

I. THE FOREIGN TAX CREDIT SHOULD NOT BE CONSTRUED EXPANSIVELY TO APPLY TO THIS LEVY

This Court has long and unanimously insisted that income tax deductions are a matter of "legislative grace" and are to be strictly construed. *E.g.*, *Indopco, Inc.* v. *Comm'r*, 503 U.S. 79, 84 (1992); *Interstate Transit Lines* v. *Comm'r*, 319 U.S. 590, 593 (1943). Deductions are allowed only "as there is clear provision therefor." *Indopco Inc.*, 503 U.S. at 84 (quoting *New Colonial Ice* v. *Helvering*, 292 U.S. 435, 440 (1934) and *Deputy* v. *Dupont*, 308 U.S. 488, 493 (1940)).

This rule of strict construction applies *a fortiori* to tax credits. The tax savings from an income tax deduction depends on the taxpayer's income tax rate, so a deduction would save a corporation, such as the petitioner here, at most 35% of the amount deducted. 26 U.S.C. §11. In contrast, a tax credit, such as the foreign tax credit allowed by § 901 of the Internal Revenue Code, at issue here, is a dollar-for-dollar offset against U.S. tax. 26 U.S.C.§ 901.

When enacted in 1918, the foreign tax credit was an extraordinarily generous measure virtually unprecedented elsewhere. The economist Edwin Seligman remarked: "The United States is making a present of the revenue to other countries." Edwin R.A. Seligman, *Double Taxation and International Fiscal Cooperation* 135 (1928), quoted in Michael J. Graetz and Michael M. O'Hear, *The "Original Intent" of U.S. International Income Taxation*, 46 Duke L.J. 1021, 1045-46 (1997).

The Third Circuit below was surely right to emphasize that the foreign tax credit is a "privilege extended by legislative grace" that should be "strictly construed." Pet. App. 7.

If this Court were to extend the foreign tax credit to this unique UK levy it would shift the burden of this levy away from the UK utilities' shareholders—where it was intended and carefully calibrated by the UK government to fall—to U.S. taxpayers.

II. THIS ONE-TIME RETROACTIVE LEVY IS NOT IN SUBSTANCE AN INCOME TAX

We agree with petitioner, the Third Circuit, the Fifth Circuit, and the Government that the label of a foreign tax does not determine whether it is eligible for the foreign tax credit. Pet. Br. 4; Pet. App. 8-15; *Entergy Corp.* v. *Comm'r*, 683 F.3d 233, 236 (5th Cir. 2012), petition for cert. pending, No. 12-272 (Filed Sept, 4, 2012); Res. Br. 15. We also agree with petitioner that ignoring the substance of a foreign tax in determining whether it is eligible for the foreign tax credit would be in sharp tension with this Court's opinion in *Biddle* v. *Commissioner*, 302 U.S. 573, 579 (1938). But petitioner's insistence that the Court should ignore the design, wording, structure, history, and purpose of the UK statute at issue here and rely instead simply on its own particular mathematical rewriting of the UK statute is wrong.

Petitioner insists that the UK's imposition of this tax on value, rather than on income or excess profits, is "presentational" or "political," wholly a matter of "form" without any substantive consequences. Pet. Br. 13, 27. But petitioner's repeated insistence that the Third Circuit was "wholly formalistic" Pet. Br. 17, 44, or "hyper-formalistic", Pet. Br. 47, misreads the opinion below. Instead, as we describe in Section III below, what is formalistic is petitioner's insistence that its particular mathematical restatement of the tax is the only way to understand its substance. The language, scope, and structure of the UK Windfall Tax at issue here reflects the UK government's specific concerns with the combination of undervaluation at privatization and overly generous regulation of prices to consumers during the "initial

period" following privatization.

The Windfall Tax at issue here is a one-time retroactive levy imposed by the UK Labour government on a small group of recently privatized regulated utilities to redress a combination of the prior Conservative government's undervaluation of these utilities at the time of their privatization ("flotation") and lax, unduly generous price regulation in the four or five years immediately following the privatization. Pet. App. 24-29; 37-38 (Budget Speech of Chancellor of the Exchequer Gordon Brown: "In determining the details of the tax, I believe I have struck a fair balance between recognizing the position of the utilities today and their undervaluation and under-regulation at the time of privatization."); 38 (Her Majesty's Treasury, Explanatory Notes: Summer Finance Bill 1997: "[T]he companies were sold too cheaply and regulation in the relevant periods was too lax."); 40 (Remarks of the Paymaster General Geoffrey Robinson in the Parliamentary Debate of UK Windfall Tax: "Those companies were sold too cheaply so the taxpayer got a bad deal. Their initial regulation in the period immediately following privatization was too lax, so the customer got a bad deal."). Thus, this levy was limited to undervalued privatized utilities that had been subject to the lax regulation. Pet. App. 129-131.[2] The rate of tax was

[2] The UK statute, enacted by Parliament in July 1997, just two months after the Labour Party took power, provides that "[e]very company which, on 2nd July 1997, was benefitting from a windfall from the flotation of an undertaking whose privatization involved the imposition of economic regulation

set at 23% of the "windfall." Pet. App. at 130 (Pt. I, para. 1(2)).

The "windfall" to be taxed is defined as the difference between two values: (a) "the value in profit-making terms of the disposal made on the occasion of the company's flotation" minus (b) "the value which for privatisation purposes was put on that disposal." Pet. App. 138-139 (Sch. 1, ¶1). The profit-making value is determined by multiplying the average annual book profits for the company's initial period by the applicable price-to-earnings (P/E) ratio. Pet. App. 139 (Sch. 1, ¶2). A company's "initial period" is either the first four years after flotation or the period between flotation and the end of the regulated utility's last financial year that ended before April 1, 1997. Pet. App. 145-146 (Sch. 1, ¶6 (1) and (2)).

The applicable P/E ratio is set by statute at nine. Pet. App. 139 (Sch. 1, ¶2(3)). That figure represents the lowest average P/E ratio, during the relevant period, of the 32 companies subject to the tax. Pet. App. 4; J.A. 129, 135, 147-148, 153.

The second of the two values—the flotation value—is determined by multiplying the highest price per share at which shares in the company were offered during the flotation (at privatization) by the number of shares offered. Pet. App. 139-140 (Sch. 1, ¶3).

The statute, therefore, taxes at a 23% rate the

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shall be charged with a tax (to be known as the 'windfall tax') on the amount of that windfall." Pt. App. 129 (Pt. I, para. 1(1)).

difference between the value for which each company was actually sold (£2.40 per share for each of the 12 regulated privatized electric companies. J.A. 24-25, 364.) and a higher value for which it might have been sold, considering the prices its regulators allowed it to charge. The UK government, based on advice from its consultants at Arthur Andersen, rejected alternative taxes on gross receipts, profits, excess profits, assets, or excess shareholder returns. Pet. App. 32-33; J.A. 505-510.

No one doubts, and the petitioners seem to concede, that if the UK had used actual market values following privatization, that the UK Windfall Tax would be a tax on value, not eligible for the foreign tax credit. Pet. Br. 42. However, the UK government had good reasons for instead using a fixed P/E ratio (which ratios are commonly used to value stocks, J.A. 520-528). First, a statutorily fixed P/E ratio allowed Inland Revenue to avoid valuation disputes. J.A. 575. Even with publicly traded stocks, given the daily volatility in prices, market prices might well have produced controversies. In addition, the UK government estimated that using market values would produce three times the revenue it wanted (£17 billion rather than £5 billion), J.A. 180, and it was concerned that a tax of that size might adversely affect employment and share values within the privatized regulated industries, consequences that were avoided by the actual tax levied.[3] J.A. 127, ¶195 and 279. (Petitioner's expert

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[3] Given its penchant for mathematical equivalencies treating tax rates as variable without regard to the statute, petitioner could respond that a tax on market value differences might have been levied at a 7 2/3% rate rather than 23%, but such a

Chris Wales said: "[o]n the basis of its final scale, [this levy] was well within the means of all the companies affected").

The UK levy here was designed as a tax on the difference in *values*—rather than incomes or excess profits—to comply with European Community law and avoid Parliamentary delay or defeat. Had the UK enacted an actual tax on profits or used market values, this would have necessitated variable rates to replicate the incidence of the levy in its final form.[4] Such variability would have rendered the levy a "hybrid" tax bill in Parliament, with accompanying legislative roadblocks, and might also have offended nondiscrimination requirements in the European Union. By imposing a tax based upon formulaic differences in valuations and by basing the tax on a fixed "initial period," which for all affected companies ended prior to enactment (either for a four-year period, or, if less, the period between the date of privatization and the company's latest financial reporting year ending before April 1, 1997) the UK government was able to avoid the legislative difficulties of a hybrid tax bill. J.A. 172-173; 331-333. And structuring the tax in this uniform manner also

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low rate may not have been viewed as fulfilling the government's promises, and may well have had collateral consequences. Consider, for example, §199 of the Internal Revenue Code, which is a deduction for 9% of qualifying manufacturing income, rather than a three percentage point reduction in the 35% tax rate because the deduction has financial accounting advantages to the eligible companies. 26 U.S.C. §199.

[4] This is made clear in the next section, which demonstrates the variable rates of the levy when stated in terms of a profits base.

eliminated the prospect of challenges to the tax in in the European Court of Justice or the European Court of Human Rights as violating the nondiscrimination requirements of European Community Treaties. J.A. 509-510. See Ruth Mason, *Flunking the E.C.J.'s Tax Discrimination Test*, 46 Colum. J. Transnat'l. L. 72 (2007); Michael J. Graetz and Alvin C. Warren, *Income Tax Discrimination and the Political and Economic Integration of Europe*, 115 Yale L.J. 1186 (2006).

By taxing these companies based on the differences in values as prescribed in the UK statute, rather than based on market values, the UK government was able to redress the two specific problems it had identified: undervaluation at privatization and lax regulation during the initial period following privatization. Comprehending the latter problem requires a brief explanation of the absence of standard utility regulation by the UK government for the initial period following privatization.

Monopolistic utilities are typically regulated by setting prices based on a rate of return on their invested capital. In this traditional regulatory model, the allowable rate of return is set by the utility regulator.[5]

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[5] In *Bluefield Waterworks & Improvement Co.* v. *Public Service Comm'n*, 262 U.S. 679 (1923), this Court held that the Constitution requires that the rate of return established by a utility regulator must allow rates that are sufficient to yield a reasonable rate of return, which it defined as equal "to that generally being made at the same time and in the same general part of the country on investments in other business

The Tax Court, accepting petitioner's mathematical reformulation, described the tax here as, in the majority of cases, reaching book profits during the initial period that on average exceeded about 11.1% of the companies' total privatization value. Pet. App. 64-65, 83.[6] To reach this result, both excessive regulatory prices and an undervaluation at privatization are necessary. If the aggregate share price at flotations had been higher, the amount of "windfall tax" would have been lower. Likewise, if the prices allowed by the regulator had been lower, the amount of tax would have been lower. Thus, even under the Tax Court's and petitioner's view, the substantive effect of the UK statute was to rectify undervaluation and lax regulation by the prior government by retroactively imposing rate of return ratemaking on those companies, albeit allowing a very generous rate of return on its original flotation value. (We discuss the appropriate tax treatment of a retrospective price adjustment infra at Section VII.)

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undertakings which are attended by corresponding risks and uncertainties," but the company has "no constitutional right to such profits as are realized or anticipated in highly profitable enterprises or speculative ventures." 262 U.S. at 692-693. See also *Fed. Power Comm'n* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) (reaffirming that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks").

[6] Achieving such a uniform rate of return for most of the regulated utilities would have not been possible without using a statutory fixed P/E ratio.

III. MATHEMATICAL REFORMULATIONS OF THE WINDFALL TAX DO NOT RESOLVE THE ISSUE HERE

Petitioners insist that rather than reflecting a substantive purpose and effect, such as we have just described, the structure of the statute is solely a matter of "politics," "presentation," "labels," or "form." And petitioner repeatedly accuses both the Third Circuit and the Commissioner of Internal Revenue of "hyper-formalism." Pet. Br. 13, 20, 23, 27, 34, 44. Eligibility for the foreign tax credit here, petitioner repeatedly insists, should turn on its mathematical recasting of the UK statute as a 51.75% tax on "excess profits." *E.g.*, Pet. Br. 1, 9-10, 20. The Tax Court accepted this argument. Pet. App. 82-84. But petitioner's insistence on its particular idiosyncratic mathematical rewriting of the UK statute's tax base and rate, along with its complete rejection of the clear attempt of Parliament to enact a levy to reach undervaluation and unduly high regulatory prices to consumers, fails to transform this levy into a creditable tax. Any tax on value, when value depends on earnings, can be restated by algebra to look like a different rate of tax on earnings. Moreover, a variety of other mathematical reformulations, which show the UK levy is not creditable, are readily produced. Petitioner's extreme focus on its mathematical reformulation, to the exclusion of the language, scope, and structure of the UK statute obscures rather than elucidates the substance of the levy.

As petitioner's brief indicates, in order for its particular mathematical gymnastics to hold, it must treat the fraction 9/4 as fixed and unchanging.

Petitioner uses this number as an arbitrary multiplier in its mathematical reformulation. But, along with the statutory tax rate of 23%, the statute's P/E ratio of nine was consciously chosen by the UK government to accomplish its legislative purposes. Uncontradicted testimony in the Tax Court proceeding describes this P/E multiple of nine as based on the lowest P/E ratio during the relevant period by the privatized utilities, *i.e.* that for water utilities. J.A. 129 ¶4, 135 ¶11, 147, 153. Using a higher P/E multiple, say ten or eleven, would have increased the amount of tax due. (In petitioner's reformulation, this would show up as a higher tax rate.) The government's expert testified that nine was a reasonable approximation of the P/E ratio for regional electric utilities. J.A. at 523.

A. Petitioner's Reformulation is Not Mathematically Equivalent Because It Writes Crucial Variables Out of the Formula.

The Government's brief demonstrates in detail how the petitioner's mathematical reformulation ignores flotation value as a variable and shows that if that variable were taken into account, the UK levy would fail the "realization" requirement of the regulations under § 901, 26. C.F.R. §1.901-2(b)(2)(i)(A). Res. Br. 24-25, 34-36. As the Government points out, if flotation value were high enough, even if a company made substantial profits, it would owe no tax. Res. Br. 12, 24 (demonstrating that consequence for British Energy plc).

For petitioner's mathematical reformulation to

hold, one must also ignore that windfall tax liability depends upon how many days a company operated during the "initial period." As petitioner agrees, the statutory windfall tax formula is given by

$$Tax=0.23*\left[\left\{\frac{365}{D}*9*P\right\}-FV\right]$$

"P" denotes total realized profits earned after privatization in the "initial period" of unduly generous regulation, "FV" denotes the firm's flotation value, and "D" denotes the number of days the company operated as a private company during the initial tax period. Pet. Br. at 8-9.

Petitioner reaches its mathematical reformulation by replacing the "D" variable in the denominator with 1,461, the number of days in four years. That substitution produces the fixed multiple of 4/9 in petitioner's rewrite of the statute after further algebraic manipulation. While four years is the initial period for most of the regulated utilities subject to the tax, the number of days in fact varies, and, under petitioner's mathematical rewriting of the statute, this would produce variations in tax rates among the companies from 51.64% to 239.10% as shown in the following table:

Company	Initial Period (in days)	Stipulated Tax Rate Equivalent	Citation in J.A.
27 Windfall Tax Companies Including PPL	1,461 (4 years)	51.71%	J.A. at 37 ¶ 158.
Powergen plc	1,463 (4 years)	51.64%	J.A. at 38-39 ¶¶ 162-63.
National Power plc	1,456 (4 years)	51.89%	J.A. at 39-40 ¶¶ 164-65.
Northern Ireland Electricity plc	1,380 (less than 4 years)	54.75%	J.A. at 40 ¶¶ 166-67.
Railtrack Group plc	316 (less than 4 years)	239.10%	J.A. at 40-41 ¶¶ 168-69.
British Energy plc	*No windfall tax liability.*		J.A. at 33 ¶ 146.

So, petitioner's insistence that the only moving part of the tax is profits is not correct. Petitioner's reformulation should not be relied upon to determine

the predominant character of this UK levy because it ignores variations in flotation value and obscures the fact that tax liability—for all firms—depends on the number of days the firm operated during the tax period. Treasury regulations under § 901 are clear: With exceptions not relevant here, "a tax either is or is not an income tax in its entirety for *all* persons subject to the tax." 26 C.F.R. §1.901-2(a)(1) (emphasis added).[7]

Because the windfall tax was retroactive, the UK government knew when they designed this levy that 16% of the firms subject to it (5 out of 32) would have a different value for the "days in operation" variable than others. It could have chosen to tax each firm on the profits it earned during the tax period, regardless of the number of days it took for the firm to earn that profit. Instead, the government made liability depend explicitly on the number of days a firm operated during the taxable period. This choice—to scale profits by days in operation—belies the windfall tax's predominant character being that of a tax on income.

Even using the petitioner's mathematical version of the tax, a tax of 239.10%, which under its own calculations would apply to Railtrack Group plc, is not an income tax or a tax on net gain as required by 26 C.F.R. §1.901-2 (a)(3)(i). Petitioner simply treats

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[7] In holding for the petitioner, the Tax Court wrote this requirement out of the regulations on the ground that the Commissioner failed to insist upon it in a prior Tax Court proceeding involving a different tax and different taxpayers. Pet. App. 57, n15; 82, n33. (citing *Exxon Corp.* v. *Commissioner,* 113 T.C. 338 (1999).

Railtrack as some "outlier," whose tax rate is irrelevant. Pet. Br. 38, n.3.

B. Many Non-Creditable Taxes Can Be Reformulated to Depend on Income Because of the Close Relationship Between the Value of an Asset and the Income it Produces.

The foreign tax credit is available only for income taxes and excess profits taxes and does not apply to taxes on value or a retroactive adjustment in regulatory pricing. 26 U.S.C. § 901. Mathematical rejiggering, however, can virtually always be deployed to convert a tax on value or a corrective to excessive pricing into a different rate tax on profits.

Indeed, any tax on the value of an income-producing asset can typically be recast as a tax on profits since the value of income-producing assets derives from their income. The value of any income-producing asset is the present discounted value of all future income. The value of equity in a corporation is determined by future profits, the appropriate discount rate, and the growth rate of those profits. In the case of an infinitely lived company producing stable profits, today's value may be represented by this equation:

Value = Profits ÷ Discount Rate[8]

[8] For simplicity of exposition, the formula in the text ignores the growth rate of profits. Including the growth rate, one would rewrite the equation as follows: Value = Profits × (1 + Growth Rate) / (Discount Rate – Growth Rate). For example, assume that a company is expected to provide profits of $100

A shorthand way to convert profits into value is provided by the P/E ratio. For example, a P/E ratio of nine means that a company with $1 of profits is worth $9 today. So,

Value = Profits x (P/E Ratio)

Alternatively, profits may be understood as the difference between revenues and costs. Revenues are the product of prices charged and quantities sold, and in industries such as the regulated utilities at issue here, costs are mostly fixed costs. Accordingly, value may also be represented as:

Value = (Prices Charged x Quantities Sold – Fixed Costs) x (P/E Ratio)

This simple relationship demonstrates the inevitable connections between profits, value, and prices in a high fixed-cost industry. Increases in prices to customers will result directly in more profits, and higher profits will result directly in a higher value via the P/E ratio. Accordingly, reinterpreting a tax on value mathematically as a tax on profits is not difficult, but neither is it helpful, given the universality of these relationships. Concerns about excessive prices will often become manifest as excess profits.

The more important point is, as we have seen, that this UK tax was fashioned to target the

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next year, that profits will grow at 2% forever, and that the appropriate discount rate is 10%. In this case, value would be $1,275 ($1,275=$100×(1.02)/(0.08)). In this example, 12.75 is the P/E ratio that results from the growth rate and discount rate assumed.

combination of unduly high regulatory prices and undervaluation at privatization. It is hardly surprising that British politicians often used the shorthand of excess profits to refer to the situation that developed. The legislative record demonstrates clearly that the target of the tax was unduly high prices during the initial period and undervaluation at flotation – and that excess profits were merely a consequence of these underlying mistakes.

Accepting mathematical translation of taxes on value (such as property taxes, wealth taxes, or estate taxes) into taxes on income would expand the scope of the foreign tax credit far beyond the annual income and wartime excess profits taxes which § 901 was designed to reach. Such a translation is almost always possible whenever the tax paid is highly correlated with the income from the relevant assets and is inevitable when one is imposing the tax retroactively as here. The Government's brief details the numerous ways in which values for purposes of the federal estate tax and state and local property taxes depend on a multiple of earnings. Res. Br. 16-20.

Like wealth taxes, non-creditable taxes on consumption are also closely related to taxes on income. Since consumption and income are often correlated, accepting mathematical reformulations of the sort used by petitioner here might also potentially extend the foreign tax credit to a variety of consumption taxes. This is, of course, exactly what at least some amici for petitioner intend. Brief for Amici Curiae Roseanne Altshuler, et.al. at 19-20, citing Charles E. McLure, Jr. and George R. Zodrow,

The Economic Case for Foreign Tax Credits for Cash Flow Taxes, 51 Nat. Tax J. 1 (1998). See also Alvin C. Warren, *How Much Capital Income Taxed Under an Income Tax is Exempt Under a Cash-Flow Tax?* 52 Tax L. Rev. 1 (1996).

C. Equally Valid Mathematical Reformulations Show That This UK Levy is Not Creditable.

The Third Circuit was unwilling to accept petitioner's insistence that it treat the UK tax rate as a variable (rather than the 23% specified in the statute) and the court engaged in its own mathematical reformulation of the UK tax, even while tentatively accepting petitioner's use of 9/4 as a multiplier. Pet. App. 11. The Third Circuit uses the following equation to describe the tax:

$$\text{Tax}=23\%\text{x}[2.25\text{xP}]$$

Ibid. Based on this formulation, which surely is just as reasonable as petitioner's preferred equation, the Third Circuit held that the UK tax violates the gross receipts requirement of 26 C.F.R. §1.901-2(b)(3)(B). Pet. App. 12-13. Respondent's brief elaborates on this point and also explains other reasons why the UK tax fails to meet the specific requirements of Treasury's regulations. Res. Br. 33-42. We do not repeat those arguments here, but instead explain why such mathematical gyrations are inapt to resolve the applicability of the foreign tax credit and why petitioner's claim that the UK tax should be viewed as an "excess profits tax" under 26 U.S.C. § 901 is error.

A third mathematical equivalence, as apt as any other—given that the tax is a one-time retroactive tax—would be to restate the tax as a tax of 207% of average annual excess profits earned during the initial period. To reach this equivalence, start from the statutory windfall tax formula and accept (for the sake of argument) petitioner's assumption that the "D" variable equals four. One then obtains:

$$\text{Tax}=0.23*\left[\left\{\frac{P}{4}*9\right\}-FV\right]$$

Pet. Br. 9. Algebra then allows one to rewrite this as:

$$\text{Tax}=2.07*\left[\frac{P}{4}-\frac{FV}{9}\right]$$

This reformulation suggests that the UK government imposed a windfall levy on the excess of average annual profits (during a four-year initial period) over "normal" annual profits (calculated using the statutory P/E ratio of nine).

Such a tax, even though it reaches the same result as petitioner's algebra, is not creditable under § 901. Like the Third Circuit's formulation, this formulation clearly runs afoul of the net gain requirement of the regulations. 26 C.F.R. 1.901-2. A tax that reaches more than 100% of a profits base does not reach net gain. Such a tax is not an income or excess profits tax in the U.S. sense. The Third Circuit recognized precisely this point when it observed that a tax cannot reach net gain if it taxes more than 100% of profits. Pet. App. 8-13. Despite petitioner's insistence on its algebraic recharacterization, no one idiosyncratic

mathematical rendition of this unique tax can claim to reveal its true substance.

Petitioner repeatedly insists that its mathematical reformulation makes this an "easy" or "straightforward" case. Pet. Br. 12, 20, 21, 37. But, in fact, the inevitable relationships between value and income, prices and profits, along with the many equally relative alternative mathematical formulations of the British levy at issue here, are confounded by petitioner's insistence on its particular algebraic reformulation.

IV. THE PREDOMINANT CHARACTER OF THE UK WINDFALL TAX IS NOT AN INCOME OR EXCESS PROFITS TAX AS REQUIRED BY 26 U.S.C. 901

To be creditable under § 901, a tax must have the "predominant character" of "an income tax" in the U.S. sense. 26 C.F.R. §1.901-2(a)(1)(ii). As this Court has clearly stated: "The phrase 'income taxes paid,' as used in our own revenue laws, has…a well-understood meaning to be derived from an examination of the statutes which provide for the laying and collection of income taxes. It is that meaning, which must be attributed to it as used in section 131 [the unchanged statutory predecessor to §901]." *Biddle,* 302 U.S. at 579. The Government details why the UK levy fails to meet the specific requirements of the regulations under §901. Res. Br. 33-42. Here, we show the UK Windfall Tax to be a unique levy without any precedent in U.S. income or

excess profits tax law, instead departing from that meaning in several crucial respects.

A. The UK Windfall Tax is a One-time Retroactive Levy; Income and Excess Profits Taxes are Imposed Annually and Are Prospective.

The U.S. corporate income tax has been imposed based on annual income each year since 1909; the individual income tax annually since 1913. Wartime excess profits taxes were also always levied annually during the period when they were in force. To the contrary, the UK Windfall Tax is a one-time retroactive levy based on differences in values designed to remedy the combination of undervaluation at privatization and steep prices during the period immediately following privatization.

The UK levy was imposed to remedy undervaluation and regulatory pricing shortcomings by a government that was no longer in office when the tax was enacted. It is totally retroactive in effect. U.S. income taxes are imposed prospectively and changes are generally made effective only for the period subsequent to the announcement of a prospective change in law or following enactment.[9]

[9] It is rather common for U.S. income tax amendments to take effect on the date of announcement of congressional consideration or beginning with the year of enactment. Claims that such effective dates—a far cry from this UK statute, which reaches back many years—violate the Due Process Clause of

U.S. excess profits taxes, which petitioner urges are comparable to this UK levy have all been prospective. The Excess Profits Tax of 1917, enacted on March 3, 1917, made clear that "the first taxable year shall be the year ending December thirty-first, nineteen hundred and seventeen." Excess Profits Tax of 1917, ch. 159 §200, 39 Stat. 1000, 1000 (repealed 1921). Subsequent amendments later in 1917 and 1918 significantly changed how "normal" levels of return were calculated, but did not impose the excess profits tax retroactively. See Roy G. Blakey and Gladys C. Blakey, *The Revenue Act of 1918*, 9 Am. Econ. Rev. 213, 226-31 (1919); Roy G. Blakey, *The War Revenue Act of 1917*, 7 Am. Econ. Rev. 791, 795-97 (1917). The Excess Profit Tax in the National Industrial Recovery Act of 1933 did not operate retroactively. The statute makes clear that the excess profit tax should be imposed only in the year following the first year in which a simultaneously enacted corporate excise tax was also imposed. Ch. 90, §216, 48 Stat. 195, 208 (repealed 1945). The Excess Profit Tax of the Second Revenue Act of 1940 did not operate retroactively. Enacted in October of 1940, the excess profits tax was imposed on excess income determined with respect to "each tax year beginning after December 31, 1939." Ch. 757, §710, 54 Stat. 974, 975 (repealed 1945). Nor did the Excess Profits Tax of 1950 operate retroactively. It was enacted in January 1951 and imposed on excess profits earned in taxable years "ending after June 30, 1950…and beginning before July 1, 1953." Ch. 1119, §430, 64 Stat. 1137. In sharp contrast, the

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the Fifth Amendment have been rejected. See *U.S.* v. *Darusmont*, 449 U.S. 292 (1981).

UK tax as issue here is a one-time purely retroactive levy. (Petitioner's expert testified that the UK government rejected an excess profits tax that would operate on a prospective basis, even though, excess profits taxes "generally are prospective" and that "a typical excess profits tax is forward looking." J.A. 561, 564.)

B. The UK Tax is Based on Average Book Profits Over an "Initial Period," Not Annual Income.

This court long ago recognized that an income tax in the U.S. sense is, and always has been, imposed based on an annual accounting period. *Burnet* v. *Sandford & Brooks Co.*, 282 U.S. 359, 364 (1931) ("All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period, either the calendar year or, at the option of the taxpayer the particular fiscal year which he may adopt.") Surely the requirement of "net gain" in the "normal circumstances of its operations in which it applies" under 26 C.F.R. §1.901-2(a)(3)(i) of the regulations implies the crucial income tax role of an annual accounting period; otherwise, it would not be describing a tax "with the predominant character of an income tax." This point is so clear that it was not essential for Treasury to restate it explicitly in the regulations. In contrast, the UK windfall tax was imposed one-time only on the shortfall in flotation values.

Even petitioner's mathematical restatement of the tax treats the base of the tax as a levy applicable to profits over a four-year period. The UK levy, however, applies only where a company (or a demerged successor) was in existence on 2nd July 1997. Pet. App. 130. For most of the UK companies (including Petitioner), the "initial period" ended long before 2nd July 1997. Pet. App. 141-43. (Schedule 1 (5&6)). Thus, if a company were to have been liquidated, say in 1995, the UK levy would have no effect at all on the profits of that historic entity. And, for companies that have demerged, the Windfall Tax liability is allocated based on the "respective market capitalisations of the companies at the time of the demerger." J.A. 130 ¶8. That treatment cannot be squared with the way an income tax actually applying over the initial period would operate. Likewise, for companies that were only partially privatized, only a proportion of the company's privatization price and subsequent value as normally calculated are taken into account. J.A. 129-130 ¶7.

As we described in Section III, petitioner's mathematical expression can be rewritten in the mathematically equivalent form: $Tax = 2.07 \times (P/4 - FV/9)$; under this formulation, the levy is a one-period 207% profits tax on the excess of average annual profits (during a four year testing window) over "normal" annual profits (calculated with the statutory P/E ratio of nine). Like the Third Circuit's alternative formulation, this formulation clearly violates the net gain requirement, because it reaches more than 100% of a profits base. Pet. App. 13.

The role of average profits in the UK statute creates an additional conflict with the net gain requirement of the regulation. Profits taxes that truly reach net gain always increase as the amount of gain increases. This fundamental principle applies to any income or profits tax: for any range of net gain that incurs positive tax liability, more gain means more tax.

But this will not always happen under the UK levy. Consider a hypothetical firm ("A") with an initial period of 1,000 days that earns profits of $100 million during that time. Suppose further that A's flotation value was $300 million. It is straightforward to calculate A's windfall tax liability (under the statutory formulation), as $6,555,000. *See* Jacob Goldin, *Reconsidering Substance Over Form in PPL*, Tax Notes at 1229, 1231 (Dec. 2012). Now consider a second hypothetical firm ("B") that is identical to A in all but the following respect: B begins operating as a private company one day earlier than A, so that its initial period consists of 1,001 days. Suppose B earns total profits of $100,100,000 during that time (that is, at the same rate as A, but for one day longer). Under the UK levy, B's tax liability is $6,555,000 – exactly the same as A's liability, notwithstanding B's greater amount of profit. *Ibid.* To see an even more striking conflict with the essential principles of income taxation, consider a third hypothetical firm ("C") that operates for 1,001 days in its initial period and earns total profits of $100,005,000 during that time. C's liability would be $6,483,294. The liability would be less than A's, notwithstanding the fact that C has more profit. *Ibid.*

These examples depend on the fact that average profits rather than actual profits determine liability under the UK levy. A firm that operates for half of a year must pay the levy as if it had continued to earn profit at the same rate during a full four-year initial period. An equally profitable firm that operates for the full four-year period owes the same amount of tax as the firm that operated for six months, despite having earned eight times as much total profit. A firm that earns $50,000,000 per year owes the exact same amount whether it operates for one, two, three, or four years, even though it earns radically different amounts of profit in each of these cases. A levy that operates this way cannot meet the requirement that its predominant character be that of an income tax or satisfy regulatory net gain requirements.

And yet, this is the way the UK levy operates. Two of the firms subject to the BWT were privatized for less than one of the four years covered by the tax. In particular, Railtrack Group plc and British Energy plc operated as private companies for 316 and 260 days respectively. Despite having initial periods of less than one year, both companies were taxed according to their average profits. Consequently they paid the same amount of tax as if they had continued to earn profits at the same rate for the entire four-year period.

Moreover, the taxpayer's mathematical reformulation of the UK levy implies that Railtrack Group and British Energy were singled out for staggeringly high tax rates of 239% and 291% respectively. Petitioner offers no reason for the UK government to single out firms with later

privatization dates for such harsh "income tax" treatment. However, as the Third Circuit points out, viewing the levy as a tax on value rather than income, each firm (including Railtrack Group and British Energy) is taxed at the same rate: 23%. Pet. App. 8-14.

C. The UK Government Did Not Regard the Windfall Levy as an Income Tax.

Until it was abolished in 1999, the UK system of corporate-shareholder taxation provided shareholders with income tax credits for corporate taxes paid with respect to amounts of profits distributed by the corporation to its shareholders as dividends. Under the UK system, in order that credits be similar for all shareholders, a minimum "advance corporate tax" ("ACT") was required to be paid when dividends were distributed. This ACT was allowed to reduce or offset regular corporate income taxes imposed on the corporation. See American Law Institute, *Integration of the Individual and Corporate Income Taxes* 661-662 (1993). The UK windfall tax was explicitly prohibited from qualifying as ACT. J.A. 130 ¶9. This makes clear that the UK government did not regard this tax as having the "predominant character of an income tax," even for purposes of its own corporate income tax.

Indeed, the Parliamentary debates over the UK levy reveal that the UK Parliament did not expect the Windfall Tax to be eligible for the foreign tax credit under U.S. law. J.A. 162 (Statement of Nick

Gibb, member of Parliament from Bogor Regis and Littlehampton: "[T]he Windfall Tax is unlikely to be a creditable tax for U.S. double tax relief purposes because it is a tax on capital rather than income...") J.A. 170 ("The Paymaster General may dismiss that issue as a matter for foreign Governments, but it's a direct consequence of the ill-thought out nature of levying this tax…" *Ibid.* Mr. Gibb also pointed out that the UK Chartered Institute of Taxation had suggested that the tax could be made creditable by restructuring the tax. J.A. 170, 176; Res. Br. 46 n4.)

V. THE UK LEVY MAY NOT EVEN QUALIFY AS A TAX UNDER TREAS. REG. §1.901-2(a)(2)(i).

The Treasury regulations draw a sharp distinction between a creditable compulsory payment which is in the nature of a tax and a non-creditable compulsory payment in exchange for a specific economic benefit. 26 C.F.R. §1.901-2(a)(2)(i). The UK levy in substance is a compulsory payment in exchange for a specific economic benefit, as that term is used in the regulations. Consider a simple numerical example which models the crucial features of the UK levy. Assume a flotation of shares at a total value of £900x, premised on predicted income of £100x per year and a nine to one P/E ratio. Further, assume actual realized income of £110x per year, which would generate a valuation of £990x based on a nine to one P/E ratio. Recall that the entire scheme of the UK levy is to recapture some of the benefit realized by privatized monopolies that benefitted from unduly high prices set by the previous government during the initial period.

Mapping this characteristic onto the simple example we present here, the £10x per year "excess profit" has its genesis in the £10x per year excessive prices the government set for the regulated utility. Over a four-year initial period, the taxpayer in this example realizes £40x of excess profit from the ability to charge those excessive premiums, and the UK government would collect £20.70x.[10]

In substance, then, this arrangement reflects a £20.70x payment to the government for the specific economic benefit of charging a £40x premium over market prices. Although the regulations contain no explicit reference to a government-granted right to charge excessive prices as a "specific economic benefit," such a right is within the ambit of the general definition of that term in the regulations: "an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country." 26 C.F.R. §1.901-2(a)(2)(ii)(B). Further, the regulations list as examples certain analogous items such as "fee[s] or other payment[s]" and monopoly rights such as patents. 26 C.F.R. §1.901-2(a)(2)(ii)(B). Based on this authority alone, the UK levy may be understood as a payment for a specific economic benefit and should thus be non-creditable.[11]

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[10] The £20.70 is computed, as under the UK statute, based on the difference in values: 23% × (£990-900) = £20.70.

[11] The fact that the payment obligation arose after the granting of the economic benefit should not be dispositive. If the levy would be non-creditable if assessed during the initial period we do not see how that defect could be cured simply by delaying

VI. ALLOWING A FOREIGN TAX CREDIT FOR THE UK LEVY AT ISSUE HERE WOULD CREATE PERVERSE INCENTIVES FOR FOREIGN GOVERNMENTS AND UNDULY BURDEN U.S. TAXPAYERS

The opinion of the Tax Court makes clear that the court regards any distinction between taxes on income and taxes "imposed on the difference between two values" as unimportant. Pet. App. 81. Putting aside amounts that are spent for consumption (which would apply only to individuals and are irrelevant for corporations), the Tax Court quotes with approval economic definitions of income that equate income to the change in the market value of assets between two points in time. The Tax Court suggests that a tax based on such differences in value would qualify for the foreign tax credit under its reading of the Treasury regulations. Pet. App. 81 n.31. This is an unprecedented reading of the scope of income taxes eligible for the foreign tax credit under § 901, violates the regulatory realization requirement, and, as we have discussed, creates the potential for an unwarranted extension of the foreign tax credit to a number of taxes based on value, such as property taxes or estate taxes.

In addition to its unprecedented expansion of the foreign tax credit beyond the statutory language of §901 and beyond what that provision's history, case law, or its policy imply, treating a one-time

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the timing of the imposition of the levy, given that it applies only to those parties who received the specific economic benefit.

retroactive tax on differences in value, such as the Windfall Tax at issue here, as eligible for the foreign tax credit would provide a roadmap for foreign governments to shift the costs of acquiring privatized assets away from the owners of these assets to the U.S. fisc and American taxpayers.

In a privatization, the foreign government receives both an upfront payment from a buyer and ongoing payments of corporate tax. These are fundamentally equivalent to the foreign government, with the exception that ongoing income taxes could be creditable to a buyer resident in a foreign tax credit country. Consider a foreign government that low-balls its privatization price, with the shortfall offset by subsequent special taxes. If those taxes are creditable in the U.S., some of the privatization price would be paid by U.S. taxpayers.

This highlights how important it is to understand (a) the unique privatization setting, (b) the relationship between regulatory prices and proceeds at privatization, and (c) the potentially dangerous precedent here. Finding for the petitioner would permit foreign governments to privatize assets with low initial prices and then retroactively adjust those prices through windfall taxes in order to shift the costs to the U.S. treasury. There is no reason to extend 26 U.S.C. §901 to give foreign governments such perverse incentives to levy ex post taxes. Nor is there any reason to give foreign governments an incentive to set regulatory prices to consumers that are excessive in one period and then retrospectively tax the excess value that such prices produce, as a means of shifting the costs of the price premium to

the citizens of our nation simply because it provides a credit for foreign income taxes.

VII. THE PROPER TREATMENT OF THE UK WINDFALL TAX IS EITHER CAPITALIZATION OR A DEDUCTION TO THE EXTENT THAT EXCESS PRICES DURING THE INITIAL PERIOD INCREASED U.S. TAXABLE INCOME

As we have described—and as the record in this case makes clear—the UK Windfall Tax was enacted to address the *combination* of undervaluation when these regulated utilities were originally privatized and excessive prices due to the prior government's lax regulation during the initial period and its eschewing normal rate of return regulation.

Despite the deduction for taxes allowable under 26 U.S.C. §164(a), treating this tax as the equivalent of retroactively increasing the original privatization price could require that the tax be capitalized as an additional cost of acquisition of shares in the UK regulated companies. See, *e.g.*, *Woodward* v. *Comm'r*, 397 U.S. 572, 577-578 (1970) (confirming that all costs of acquisition of shares in a company must be capitalized); *Comm'r* v. *Idaho Power Co.*, 418 U.S. 1, 17-19 (1974) (requiring capitalization of otherwise deductible costs).

In addition to undervaluation when privatized, the UK Windfall Tax also addressed the excessive prices that the prior government allowed the privatized regulated utilities to charge their customers during the "initial period." The U.S.

income tax law addresses situations like this by allowing a deduction whenever a utility collects revenue during an initial period and subsequently is required by the government to disgorge a portion of the revenues from the earlier years. 26 U.S.C. 1341. The taxpayer is permitted to deduct the subsequent payments, but only to the extent that the original revenues served to increase the taxpayers' taxable income in the earlier years (which we cannot assume here because of the UK statute's use of book rather than taxable profits). See *United States* v. *Skelly Oil Co.*, 394 U.S. 678 (1969). Had the UK government turned the revenues from its windfall levy over to the utilities' customers, this would unambiguously be the appropriate treatment of the windfall tax payment here. The fact that the UK government used the proceeds instead to fund a welfare-to-work program J.A. 26 ¶99 should not change this income tax treatment. At most, the payments required under the UK Windfall Tax should be allowed a deduction, not a foreign tax credit under § 901.

CONCLUSION

For the foregoing reasons, the opinion of the Third Circuit below should be affirmed.

Respectfully Submitted.

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