No. 12-43

In The
Supreme Court of the United States

PPL CORPORATION AND SUBSIDIARIES,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

On Petition For Writ Of Certiorari To The United States Court Of Appeals For The Third Circuit

BRIEF FOR SOUTHEASTERN LEGAL FOUNDATION, CATO INSTITUTE, AND GOLDWATER INSTITUTE AS *AMICI CURIAE* IN SUPPORT OF THE PETITION FOR WRIT OF CERTIORARI

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August 10, 2012

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QUESTION PRESENTED

Whether, contrary to decades of case law, it is correct to look only at the terminology or formula used in a foreign tax statute and not to consider the purpose and economic substance of the foreign government's tax assessment in determining whether, under U.S. law, an American taxpayer who pays the foreign tax may claim the traditional statutory right against double taxation found in section 901 of the Internal Revenue Code.

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INTEREST OF *AMICI CURIAE*[1]

Southeastern Legal Foundation ("SLF") is a not-for-profit national constitutional public interest law firm and policy center that promotes the public interest in the proper construction and enforcement of the laws and Constitution of the United States in the courts of law and through public discourse. SLF advocates constitutional individual liberties, limited government, and the free enterprise system in its litigation cases and *amicus* participation in state and federal courts.

While SLF is by no means a single-issue organization, about half of the litigation matters and policy debates in which SLF has participated since its founding in 1976 have involved the vindication of private property rights. SLF has represented parties and submitted *amicus* briefs before this Court in numerous cases presenting governmental threats to the property rights of individuals and businesses, including through overreaching use of eminent domain powers and excessive and imbalanced regulation. SLF prides itself on defending ordinary citizens and small business owners in local communities throughout America who find their freedom and their

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[1] All parties received timely notice of the intent to file this brief and have consented to its filing in letters on file with the Clerk of the Court. No counsel for a party has authored this brief in whole or in part, and no person other than *amici* and their counsel has made a monetary contribution to the preparation or submission of this brief. *See* Sup. Ct. R. 37.2(a), 37.6.

property under challenge from arbitrary and unreasonable bureaucratic power.

The Cato Institute ("Cato") was established in 1977 as a nonpartisan public policy research foundation dedicated to the principles of individual liberty, free markets, and limited government. Cato's Center for Constitutional Studies was established in 1989 to help restore the constitutional limits on government that are the foundation of freedom. Toward those ends, Cato publishes books and studies, conducts conferences and forums, and publishes the annual *Cato Supreme Court Review*. Cato participates from time to time as an *amicus* in important cases implicating fundamental liberties, free markets, and judicial checks on arbitrary government action.

The Goldwater Institute ("Goldwater") is a nonprofit educational foundation that was established in 1988. Through litigation, research papers, editorials, policy briefings, and forums, Goldwater advances non-partisan public policies founded upon the principles of limited government, economic freedom, and individual responsibility. Goldwater participates in court cases and frequently files *amicus* briefs through its Scharf-Norton Center for Constitutional Litigation.

Amici file this brief because the legal position taken below by the Commissioner of Internal Revenue—which has precipitated directly conflicting decisions from two courts of appeals—raises basic issues of agency power that transcend the interests of

any particular taxpayer or class of taxpayers. This case concerns the limits of the power of a federal agency to apply a statute originally focused on economic substance in a manner that utterly ignores the true nature of the underlying transaction. *Amici* urge the Court to take up this case, not only to resolve the clear circuit split, but also to rein in the Commissioner's discretion to act against the property interests of individuals and businesses through an overly formalistic reading of the law that only serves the convenience and institutional self-interests of the tax collector.

SUMMARY OF ARGUMENT

The Court should grant certiorari to resolve the uncertainty created for taxpayers by the direct conflict between the Courts of Appeals for the Third and Fifth Circuits concerning the correctness of the Commissioner's effort to apply the allowance of credit for foreign "excess profits taxes" found in section 901(b)(1) of the Internal Revenue Code, 26 U.S.C. § 901(b)(1). There are compelling reasons to reject the judgment of the Third Circuit in favor of the Fifth Circuit's substance-focused approach, which is fully consistent with the historical understanding of section 901 approved long ago by this Court and in previous lower court decisions.

Most fundamentally, this case presents an important opportunity for the Court to ensure that

taxpayers will not lose their right to avoid double taxation through a contrivance of administrative Newspeak. The application of section 901 espoused by the Commissioner and approved by the Third Circuit takes a venerable principle of the tax code that has long been held to require an examination of the true underlying purpose and operation of a foreign tax and converts it into a mechanical review that refuses to look beyond the superficial language of the foreign law.

It is telling that here the Commissioner has invoked this myopic approach to section 901 to deny the taxpayer a foreign tax credit and coincidentally to advance the revenue-raising objectives of the Internal Revenue Service ("IRS"). Not surprisingly, in cases where the IRS believes the literal terms of a foreign tax provision tend to disguise its true character, the Commissioner has not hesitated to present extensive evidence of the tax's underlying purpose and economic substance as a basis to deny the taxpayer a credit under section 901. The self-serving nature of the Commissioner's current position is a ringing alarm that calls out for this Court's review.

ARGUMENT

THE COURT SHOULD GRANT REVIEW TO SETTLE THE CIRCUIT SPLIT AND SAVE AMERICANS FROM AN ADMINISTRATIVE OVERREACH THAT BREAKS FAITH WITH THE HISTORICAL UNDERSTANDING OF THE LAW AT ISSUE.

A. This Case Presents an Intolerable Conflict Between the Hyper-Formalism of the Third Circuit and the More Traditional Substance-Based Approach of the Fifth Circuit.

The Commissioner's argument for denying taxpayers a section 901 credit for payment of the United Kingdom's Windfall Tax has spawned a direct conflict between the Third Circuit's opinion below and the Fifth Circuit. *Compare* Pet. App. 15 ("we hold that the [U.K.] windfall tax is not creditable") *with Entergy Corp. v. Comm'r*, 683 F.3d 233, 239 (5th Cir. 2012) ("We . . . disagree with the Third Circuit's conclusion and hold that the Windfall Tax is a creditable foreign income tax. . . .").

The court below accepted the Commissioner's position that the Windfall Tax should not be treated as a tax on net income for purposes of Treasury Regulation 1.901-2 (the IRS rule interpreting section 901), because, according to the U.K. statute's taxing formula, the law's 23-percent tax rate is levied against the difference between the historical purchase price paid for the businesses in question (called the "flotation value") and a calculated "profit-making

value," rather than against a simpler measure of net income. *See* Pet. App. 8-15. At the Commissioner's urging, the court refused to look beyond the literal terms of the statute to the substance and purpose of the tax, which was clearly intended to, and did, capture only that subset of net income (about 52 percent of actual profits earned above a prescribed rate of return during a four-year period) that the British Parliament determined represented "excess profits" for the businesses. *See id.*

The Fifth Circuit followed a very different path. Rejecting the Commissioner's claim that the court "should rely exclusively, or even chiefly, on the text of the Windfall Tax," 683 F.3d at 236, Chief Judge Jones stressed the reasoning in the historical line of cases applying section 901. Those cases teach that "[t]he label and form of the foreign tax is not determinative," *Inland Steel Co. v. United States*, 677 F.2d 72, 80 (Ct. Cl. 1982); whether or not the foreign levy "is labeled a gross income or a net income tax" or uses some other "form" or "name," "[t]he important thing is whether the other country is attempting to reach *some net gain*," *Bank of Am. Nat. Trust & Sav. Ass'n v. United States*, 459 F.2d 513, 519 (Ct. Cl. 1972) (emphasis added). *See* 683 F.3d at 236.[2] Applying this

[2] This Court's longstanding interpretation of section 901 reflects the same view. In *Biddle v. Comm'r*, 302 U.S. 573 (1938), the Court held that a taxpayer who was a shareholder in a British corporation was not entitled to a credit for a British income tax assessed on the taxpayer's proportionate share of the taxes paid by the corporation on its own profits. *Id.* at 575,

(Continued on following page)

traditional analysis, the Fifth Circuit held that it was proper to allow a credit for payment of the U.K. Windfall Tax. *Id.* at 238.

Certainly, if unresolved, the conflict between the opposing approaches taken by the Fifth Circuit in *Entergy Corp.* and the Third Circuit in this case will leave American taxpayers in an untenable quandary. Taxpayers in Texas, for example, will continue to be guided by the traditional inquiry that looks through the terminology of the foreign tax law to its actual substantive effect, whereas the availability of the credit for taxpayers in Pennsylvania and New Jersey will be determined by the language used in the foreign country's statute. That situation is unfair and intolerable, and this Court should grant review to put an end to it.

B. The Commissioner's Self-Serving Position Is a Stark Departure from the Language and Traditional Interpretation of Section 901.

First enacted in 1918 and substantially unchanged in 94 years, section 901 permits U.S. citizens

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580-82. These amounts, although denominated "income" in the U.K., were not actually received by the shareholder as dividends and would not be considered taxable income under the U.S. tax code, and thus the taxpayer would not face double taxation in the absence of a credit. *See id.* at 581-82. Importantly, the Court reasoned that the availability of a credit under section 901 is not determined "by reference to foreign characterizations and classifications of tax legislation." *Id.* at 579.

and businesses a credit for "the amount of any income, war profits, and excess profits taxes paid" to a foreign country. 26 U.S.C. § 901(b)(1). The credit allowance was designed "to mitigate the evil of double taxation." *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932).

One would think there is little room for doubt that the British Windfall Tax is an "excess profits tax" within the plain meaning and traditional understanding of section 901. It was enacted in 1997 by the British Labour Government for the express purpose of taxing what Parliament figured were "excess" or "windfall" profits earned by businesses that had been privatized by the earlier Conservative Government, and it creates the very real threat of double taxation for U.S. owners of the affected businesses. *See* Pet. 5-9.

Yet the Commissioner today would deny this tax credit and ignore the substantive effect of the Windfall Tax simply because the U.K. statute, in setting out the formula for calculating the tax, uses the term "profit-making value" instead of the magic words "net income" and "gross receipts"—in other words, because it expresses the tax rate as a percentage of an imputed value (albeit one calculated on the basis of actual profits), rather than directly as a percentage of net income. The Commissioner maintains that taxpayers may not probe behind the language of the statute and the Tax Court may not consider evidence of the statute's purpose and substantive effect, *see* Pet. App.

8, even though such evidence has commonly been presented in prior cases under section 901.[3]

How did we get here? How could the Commissioner so thoroughly jettison the "Oldspeak" of section 901, as traditionally understood, in favor of this Orwellian Newspeak?[4]

The first step in this transformation was Treasury Regulation 1.901-2, promulgated in 1983 and loosely based on the case law that had developed under section 901. Regulation 1.901-2 conflates the three types of taxes listed in section 901 ("income, war profits, and excess profits taxes") into a single concept of "income tax," which it then defines as a foreign tax "[t]he predominant character of" which "is that of an income tax in the U.S. sense." Treas. Reg. § 1.901-2(a)(1)(ii); Pet. App. 109. The rule further specifies that the

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[3] *See Inland Steel*, 677 F.2d at 82 (exploring "History and Purpose" of foreign tax); *see also Texasgulf, Inc. v. Comm'r*, 172 F.3d 209, 211-14 (2d Cir. 1999) ("Essential to the resolution of this appeal is an understanding of the nature and operation of the [foreign tax] during the relevant taxable years.") (discussing trial evidence, including expert testimony, on "the industry-wide operation" of the tax). The rules of procedure for both the Tax Court and the district courts make it clear that in determining a foreign law, the court "may consider any relevant material or source, including testimony, whether or not submitted by a party or otherwise admissible." Tax Ct. R. 146; *see* Fed. R. Civ. P. 44.1 (same).

[4] *See* George Orwell, *Nineteen Eighty-Four* 255 (New American Library ed. 1981) (Appendix: "The Principles of Newspeak") ("When Oldspeak had been once and for all superseded, the last link with the past would have been severed.").

"predominant character" test is satisfied only if the foreign tax "is likely to reach net gain in the normal circumstances," and only if, "judged on the basis of its predominant character," the tax meets three technical requirements: (1) It is imposed upon or after the "realization" of income; (2) it is imposed on the basis of "gross receipts," and (3) the base of the tax constitutes "net income"—"gross receipts" less "significant costs and expenses." Treas. Reg. 1.901-2(b)(2), (3), (4); Pet. App. 114, 120, 122.

One may question why the IRS needed to graft this multi-factor test onto the plain language of section 901, but in practice the regulation has heretofore been applied consistently with the substance-over-form reasoning followed in the courts.

Thus, the Fifth Circuit in *Entergy Corp.* had no problem concluding that the U.K. Windfall Tax satisfies the substantive requirements of Treasury Regulation 1.901-2's "predominant character" test: The tax was based on, and increased in proportion to, a subset of the financial profits (*i.e.*, net income) *actually realized* by the affected businesses during a particular period, which means that it was necessarily levied on gross receipts less operating expenses and could never exceed any appropriate measure of income. *See* 683 F.3d at 238. "The tax rose in direct proportion to additional profits above a fixed (and carefully calculated) floor. That Parliament termed this aggregated but entirely profit-driven figure a 'profit-making value' must not obscure the history and actual effect

of the tax, that is, its predominant character." *Id.* at 236-37.[5]

The problem presented in this case, however, is that the Commissioner's current position severs the last link to any meaningful examination of the foreign tax's "history and actual effect." It abandons all vestiges of the substantive "predominant character" test in favor of a rote, mechanical application of the regulatory sub-factors to the literal language of the foreign statute.

That this position is unfaithful to the old statute is underscored by its self-serving nature. It has the look of a litigating position, adopted out of convenience and selectively applied by the IRS only where it works against the taxpayer and increases the returns to the tax collector. Indeed, there have been many court cases over the decades where the shoe was on the other foot and it was the Commissioner who urged a substantive examination into the nature and effect of the foreign tax to show that the credit should be disallowed. *See, e.g.*, *Biddle v. Comm'r*, 302 U.S. at 579 (noting that the Board of Tax Appeals made

[5] The Fifth Circuit explained that the "gross receipts" requirement in the regulation is designed "to prevent foreign nations from 'soaking up' American tax revenue by levying an income tax on an imputed amount deliberately calculated to reach some amount *greater than the business's actual gross receipts*." 683 F.3d at 237 (emphasis added) (citing Boris I. Bittker & Lawrence Lokken, Federal Taxation of Income, Estates & Gifts ¶ 72.1 (2011)).

findings in the Commissioner's favor "supported . . . by much expert testimony," and mandating, at the urging of the Commissioner, "an examination of the manner in which the British tax is laid and collected . . . and whether it is the substantial equivalent of payment of the [income] tax as those terms are used in our own statute").

The Commissioner's hyper-formalistic application of section 901, as approved by the Third Circuit, threatens taxpayers with the arbitrary denial of their traditional statutory right against "the evil of double taxation." The abrupt break from the historical understanding of section 901 will inevitably subvert the stability and predictability of financial transactions for U.S. individuals and companies with business interests overseas.

In short, the position upheld below represents a dangerous exercise of administrative power, and this case gives the Court an important opportunity to reaffirm the substantive protection originally granted by Congress.

CONCLUSION

For the foregoing reasons, *amici curiae* urge the Court to grant the petition for writ of certiorari.

Respectfully submitted,

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