NO. C15-1701-1

IN THE

SUPREME COURT OF THE UNITED STATES

ROYAL HARKONNEN OIL COMPANY,

PETITIONER,

v.

UNITED STATES,

RESPONDENT.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE FOURTEENTH CIRCUIT

BRIEF FOR RESPONDENT

ORAL ARGUMENT REQUESTED

Team 25

Counsel for Respondent

Dated: November 24, 2014

STATEMENT OF THE ISSUES

I. Whether Harkonnen Oil's tax payments to the Republic of Arrakis in exchange for the exclusive right to develop the Caladan Oil Field are creditable under 26 U.S.C. § 901 or 26 U.S.C. § 903, even though Harkonnen Oil would have been obligated to the pay the tax had it operated at a loss in tax year 2011.

II. Whether the Internal Revenue Service properly denied foreign tax credits for the tax payments Harkonnen Oil made to the nomadic organization known as the Inter–Sietch Fremen Independence League after already granting a foreign tax credit to Harkonnen Oil for tax payments it made to the Sietch State based on the same stream of income.

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STATEMENT OF JURISDICTION

This Court has jurisdiction pursuant to 28 U.S.C. § 1254(1) (2014). The District Court entered judgment in favor of Respondent following a trial. The Court of Appeals for the Fourteenth Circuit affirmed the District Court's order. Petitioner thereafter filed for writ of certiorari, granted by this Court during the October 2014 term.

STANDARD OF REVIEW

Review of a district court's factual findings is under the clearly erroneous standard. *Mollison v. United States*, 481 F.3d 119, 122 (2d Cir. 2007). However, the legal conclusions based upon those facts, including interpretations of the Internal Revenue Code and corresponding Treasury Regulations, are reviewed de novo. *Wilkerson v. United States*, 67 F.3d 112, 115 (5th Cir. 1995); *Boeing Co. v. United States*, 258 F.3d 958, 963 (9th Cir. 2001).

STATEMENT OF THE CASE

This is a case involving the proper interpretation and application of two sections of the Internal Revenue Code as well as the corresponding Treasury Regulations. Petitioner filed suit against the United States in the Central District Court of New Tejas alleging it is entitled to foreign tax credits for payments it made to the Republic of Arrakis ("Arrakis") and the Inter–Sietch Fremen Independence League ("IFIL"). R. at ¶ 40. Following a trial, the District Court entered judgment in favor of the United States as to both tax payments, holding neither of them to be creditable. *Id.*

Upon further review, the Court of Appeals for the Fourteenth Circuit affirmed the holding of the District Court on October 1, 2014, and held that (1) the Republic of Arrakis Foreign Tax is not a creditable foreign tax, and (2) the Internal Revenue Service ("IRS") properly denied Petitioner's claimed foreign tax credit for all tax payments it made to IFIL. R. at ¶ 44.

This Court granted certiorari to determine whether (1) Petitioner's payment of taxes to the Republic of Arrakis is creditable under 26 U.S.C. § 901 or 26 U.S.C. § 903 and (2) whether the IRS properly denied Petitioner's claimed foreign tax credit for all payments to IFIL. R. at 1.

STATEMENT OF THE FACTS

After conducting a feasibility study in 2007 to determine the profitability of developing the Caladan Oil Field, Harkonnen Oil concluded that profits would be possible if new technologies and recovery techniques were utilized and any royalty payments were kept low. R. at ¶¶ 1, 2. The amount of royalty payments were of particular concern to Harkonnen Oil because the President of the Republic of Arrakis, Jules Corrino, and his family own all of the mineral rights in Arrakis. R. at ¶ 2. On February, 5, 2008, Vladimir Harkonnen, the CEO of Harkonnen Oil, began negotiations with President Corrino for the exclusive right to develop the Caladan Oil Field. R. at ¶ 3. Negotiations lasted several months and focused largely on the various royalty payments demanded by President Corrino. *Id.* At the time negotiations began, non–citizens could not be taxed under Arrakis law. R. at n.6.

On March 10, 2008, President Corrino enacted a new tax entitled "The Republic of Arrakis Foreign Value Tax" but delayed designation of a tax percentage until an unspecified date. R. at ¶ 5. On April 26, 2008, Mr. Harkonnen flew to the Sietch Dunes region of Arrakis for a vacation and afterward organized a face–to–face meeting with President Corrino on April 29, 2008. R. at ¶ 11. On June 30, 2008, President Corrino applied a forty–five percent tax rate to the tax on foreign entities, renamed it the "Republic of Arrakis Foreign Tax," and agreed to an oil and gas lease with Harkonnen Oil for the development of the entire Caladan Oil Field. R. at ¶ 13.

Almost two years later, on March 20, 2010, an organization called the "Independent People of Sietch" ("IPS") declared independence from Arrakis. R. at ¶ 15. In response, Arrakis mobilized its military to the Sietch Dunes in order to suppress the uprising. *Id.* On April 9, 2010, Mr. Harkonnen, the U.S. Ambassador to Arrakis, President Corrino, and Paul Atreides (the newly–appointed leader of the IPS) met at a conference known as the Arrakeen Peace Summit. R. at ¶ 16. President Corrino personally guaranteed the safety of all parties at the meeting. *Id.* Three days later, the parties announced a truce known as the Sietch Dunes Peace Treaty. R. at ¶¶ 16, 17. Pursuant to this Treaty, the Sietch Dunes Region was designated an Important Province of Arrakis and was provided with the right to appoint the Arrakis Vice–President. R. at ¶ 17. The powers and requirements for the Vice–President were enacted into the Arrakis Constitution by formal amendment, effective April 13, 2010. R. at ¶ 18. Under this amendment, the Sietch State was given the power to create and enforce laws only as to (1) policing the

State and (2) collecting the State tribute for Arrakis. *Id.* The Sietch State was given the power to decree and levy a single tax in accordance with these limitations. *Id.* On April 15, 2010, Paul Atreides was elected Vice President. R. at ¶ 19. As his first official act, Vice–President Atreides declared a single, ten percent tax on all income generated within the Sietch State. R. at ¶ 20. At all relevant times, Harkonnen Oil paid this tax, and its request for a foreign tax credit as to such payments was granted by the IRS. R. at ¶¶ 20, 39. The Sietch State paid all sums collected pursuant to this tax as tribute to Arrakis. R. at ¶ 20.

On December 31, 2010, a group called the Inter–Sietch Fremen Independence League ("IFIL") launched a rebellion within the Sietch State under the leadership of Jessica Mohiam. R. at ¶ 24. Ms. Mohiam received funding from two of Arrakis' bordering countries, Al Dhanab and Anbus, whose royal families control six of the seven electoral votes for IFIL's leadership. R. at ¶¶ 26, 27. Both Arrakis and the Sietch State denied the legitimacy of IFIL. R. at ¶ 29. On March 20, 2011, IFIL forcefully took control of a small drilling station operated by Harkonnen Oil and identified as Unit #12. R. at ¶ 30. Ms. Mohiam demanded Harkonnen Oil pay tribute to IFIL for the right to continue drilling at Unit #12. *Id.* On March 22, 2011, Mr. Harkonnen met with Ms. Mohiam at Unit #12, where they signed a handwritten oil and gas lease under which Harkonnen Oil would pay a bonus and royalty to IFIL. R. at ¶ 31. Ms. Mohiam then further demanded a tax payment of two percent of the receipts of Unit #12, minus deductions. *Id.* Mr. Harkonnen protested this additional payment and left the negotiation. *Id.* That afternoon, Mr.

Harkonnen called and spoke with President Corrino regarding IFIL's demands. *Id.* President Corrino advised Mr. Harkonnen to take this matter up with the Holy Royal Court of Arrakis. *Id.*

On March 23, 2011, Mr. Harkonnen petitioned the Holy Royal Court of Arrakis for two determinations: (1) the status of IFIL and (2) its ability to levy taxes. R. at ¶ 32. The following day, the Holy Royal Court declared, "Arrakis recognizes IFIL as a part of Sietch" but stated nothing about IFIL's ability to levy a tax. *Id.* One day later, Harkonnen Oil paid the two percent payment to IFIL without further inquiry into the matter. R. at ¶ 33. These funds were not paid as tribute to Arrakis but rather were deposited into a Swiss bank account set up for IFIL by the heir to the throne of Anbus, Prince Dalamak. *Id.* Twenty percent of the funds were then paid to the monarchies of Al Dhanab and Anbus. *Id.*

On May 16, 2011, Mr. Harkonnen met with President Corrino, Vice–President Atreides, and Ms. Mohiam (then Leader Elect of IFIL) at the First Annual Caladan Oil Field Conference. R. at ¶ 35. Following the conference, President Corrino lowered the Republic of Arrakis Foreign Tax to thirty–three percent and issued Proclamation 102, which allowed foreign corporations, for the first time, to take tax deductions. R. at ¶¶ 35, 36. However, foreign corporations were only entitled to take up to ninety–five percent of the deductions available to Arrakis citizens. R. at ¶ 36.

Prior to tax year 2011, Harkonnen Oil took its expenses from its Arrakis operations as a deduction and not as a credit on its U.S. tax returns. R. at ¶ 38. On

March 15, 2012, Harkonnen Oil filed its Form 1120 U.S. Tax Return for the year 2011, claiming foreign tax credits for its tax payments to Arrakis, the Sietch State, and IFIL. *Id.* The IRS flagged Harkonnen Oil's 2012 tax returns for irregularities and proceeded to perform an audit. R. at ¶ 39. The IRS subsequently denied a foreign tax credit for Harkonnen Oil's tax payments to Arrakis and IFIL but granted a foreign tax credit for the tax payments to the Sietch State. *Id.* After its negotiation attempts with the IRS failed, Harkonnen Oil paid the full tax and demanded a refund. R. at ¶ 40. Harkonnen Oil thereafter filed suit in the Central District Court of New Tejas, which ruled in favor of the United States on both foreign tax credit denials. *Id.* The Court of Appeals for the Fourteenth Circuit affirmed, holding neither tax payment to be creditable. R. at ¶ 44.

SUMMARY OF THE ARGUMENT

The Court of Appeals for the Fourteenth Circuit correctly held that Harkonnen Oil's payment of the Republic of Arrakis Foreign Tax is not eligible for a foreign tax credit under the Internal Revenue Code. In particular, Harkonnen Oil's tax payment to Arrakis is not creditable under 26 U.S.C. § 901 because (1) it is a payment in exchange for specific economic benefits—both direct and indirect—and is, therefore not a "tax," and (2) the predominant character of the levy is not that of an income tax in the U.S. sense. The tax payments to Arrakis are also not creditable under 26 U.S.C. § 903 because the levy is not "in lieu of" an otherwise generally imposed income tax.

The IRS also properly denied Harkonnen Oil's claimed foreign tax credit for all tax payments it made to IFIL. Specifically, the levy imposed by IFIL is not a "tax" for purposes of the Internal Revenue Code's foreign tax credit provisions because it is not a compulsory payment pursuant to IFIL's authority to levy taxes. Rather, the amount paid by Harkonnen Oil exceeded its liability under foreign tax law because it unreasonably interpreted the applicable foreign law in a way that increased its foreign tax liability and also because it failed to exhaust all effective and practical remedies to lower its foreign tax burden. The IFIL levy is also not pursuant to IFIL's authority to levy taxes because it is a payment in exchange for a specific economic benefit. In the alternative, even if the IFIL levy is held to constitute a "tax" and be otherwise creditable, no tax imposed by IFIL may be credited under the Internal Revenue Code because: (1) IFIL is not a valid taxing authority, and (2) the United States does not conduct diplomatic relations with IFIL. Accordingly, this Court should affirm the judgment of the Court of Appeals for the Fourteenth Circuit and hold that Harkonnen Oil's tax payments to the Republic of Arrakis and IFIL are not creditable under the foreign tax credit provisions of the Internal Revenue Code.

ARGUMENT

I. Harkonnen Oil cannot receive a foreign tax credit for its payment of the Republic of Arrakis Foreign Tax under either 26 U.S.C. § 901 or 26 U.S.C. § 903.

The Court of Appeals for the Fourteenth Circuit properly held that Harkonnen Oil's payment of the Republic of Arrakis Foreign Tax is not creditable under the foreign tax credit provisions of the Internal Revenue Code. The Internal

Revenue Service ("IRS") requires U.S. citizens and domestic corporations to report both income earned within the United States and abroad. *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 135 (1989). Similar to other countries' tax systems, this requirement potentially subjects a taxpayer to multiple taxations because foreign countries often tax income earned within their borders as well. *Id.* In order to eliminate this potential conflict, the Internal Revenue Code allows U.S. citizens and domestic entities to claim a credit or take a deduction on their domestic tax liability for taxes paid abroad on a given stream of income. *Burnet v. Chi. Portrait Co.*, 285 U.S. 1, 12 (1932). The purpose of this credit is to "mitigate the evil of double taxation" on income earned abroad. *Id.* at 7. However, the foreign tax credit is "a privilege extended by legislative grace," and, therefore, sections 901 and 903 are to be "strictly construed" by the courts. *Texasgulf, Inc. & Subsidiaries v. C.I.R.*, 172 F.3d 209, 214 (2d Cir. 1999) (quoting *Inland Steel Co. v. United States*, 230 Ct.Cl 314, 325 (1982)). Applying these provisions to Harkonnen Oil's payment of the Republic of Arrakis Foreign Tax, the IRS, the Central District Court of New Tejas, and the Fourteenth Court of Appeals were correct in concluding Harkonnen Oil is not entitled to a foreign tax credit.

A. Harkonnen Oil's payment of taxes to the Republic of Arrakis is not eligible for a foreign tax credit under 26 U.S.C. § 901.

The Court of Appeals for the Fourteenth Circuit correctly held that Harkonnen Oil's payment of the Republic of Arrakis Foreign Tax is not creditable under section 901 of the Internal Revenue Code. Under section 901, United States citizens and domestic corporations are permitted to claim a tax credit against their

U.S. income taxes for "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." 26 U.S.C. § 901(b)(1) (2014). However, not all such foreign taxes are creditable; rather, "foreign tax creditability depends on whether the tax, if enacted in the U.S., would be an income, war profits, or excess profits tax." *PPL Corp. v. C.I.R.*, 133 S.Ct. 1897, 1902 (2013). The record reflects no indication that the Republic of Arrakis Foreign Tax qualifies as a war profits or excess profits tax. Therefore, the relevant question presented for purposes of section 901 is whether the levy would qualify as an income tax under U.S. principles. A foreign levy is an income tax for purposes of section 901 if, and only if, (1) it is a tax and (2) the predominant character of that tax is that of an income tax in the U.S. sense. Treas. Reg. § 1.901–2(a)(1) (2013). Because the Republic of Arrakis Foreign Tax satisfies neither of these two independent requirements, it is not creditable under section 901.

a. The Republic of Arrakis Foreign Tax is a payment in exchange for specific economic benefits—both direct and indirect—and is, therefore, not a tax.

A foreign levy is only considered a "tax" for purposes of section 901 if it requires a compulsory payment pursuant to a foreign country's authority to levy taxes. Treas. Reg. § 1.901–2 (a)(2)(i). In determining whether a foreign levy indeed requires a compulsory payment pursuant to a foreign country's authority to levy taxes, a court is to consider principles of U.S. law and not principles of the law of the foreign country. *Id.* Under U.S. principles, a levy is not pursuant to a foreign country's authority to levy taxes, and consequently is not a tax, to the extent that a person subject to the foreign levy "receives (or will receive), *directly or indirectly*, a specific economic benefit . . . from the foreign country in exchange for payment pursuant to the levy." *Id.* (emphasis added). Because the Republic of Arrakis Foreign Tax paid by Harkonnen Oil is a payment in exchange for both direct and indirect specific economic benefits, it is not a levy pursuant to the Republic of Arrakis' authority to levy taxes and is, therefore, not a tax.

i. The levy paid by Harkonnen Oil to the Republic of Arrakis constitutes a payment in exchange for a *direct* specific economic benefit.

The Republic of Arrakis Foreign Tax is not a tax under U.S. principles because Harkonnen Oil received a direct specific economic benefit in exchange for payment of the levy: the exclusive right to develop the Caladan Oil Field. The definition of "specific economic benefit" for purposes of sections 901 and 903 is:

> 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, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general.

Treas. Reg. § 1.901–2(a)(2)(ii)(B). In other words, if a person subject to a levy "receives an economic benefit that, in general, is not being received by persons upon which the charge is not being imposed," then the levy is not a "tax" as that term is generally understood in the United States. *Phillips Petroleum Co. v. C.I.R.*, 104 T.C. 256 (1995); *see also Exxon Corp. v. C.I.R.*, 113 T.C. 338 (1999). For example, regulation 1.901–2 provides that "a concession to extract government–owned petroleum is a specific economic benefit" because it is not a right "made generally available on substantially the same terms." Treas. Reg. § 1.901–2(a)(2)(ii)(B). The regulation further emphasizes that an economic benefit includes "a right to use, acquire or extract resources . . . that a foreign country owns or controls." *Id.*

Per the Arrakis Lease, Harkonnen Oil received the exclusive right to develop the Caladan Oil Field. This is precisely the type of economic benefit envisioned by the drafters of regulation 1.901–2 in that it is "a right to use, acquire or extract resources." *Id.* Moreover, because this is an exclusive right, it necessarily follows that no other entity or individual, whether subject to the levy or not, received the same, or a substantially similar, benefit. Indeed, the entire 231,000 square miles of the Caladan Oil Field are included within the Arrakis Lease. R. at ¶ 13. Therefore, Harkonnen Oil clearly received an economic benefit from the Republic of Arrakis.

Moreover, this economic benefit was received by Harkonnen Oil specifically in exchange for its payment of the Republic of Arrakis Foreign Tax. Indeed the tax was created specifically for Harkonnen Oil and after negotiations had stalled over President Corrino's demands of "various royalty payments." R. at ¶ 3. Prior to negotiations between President Corrino and Harkonnen Oil, it was *against Arrakis law* for foreign citizens and entities to be taxed because they were not entitled to protection beyond the Arrakis Foreign Protection Act. R. at n.6. Yet just one month after such negotiations began, President Corrino drafted and signed into law the new tax—notably, with no specified percentage. R. at ¶ 5. Subsequently, on June 30, 2008, President Corrino announced that a forty–five percent tax rate would be applied to the tax. R. at ¶ 13. This was the same day that the Arrakis lease was signed. *Id.* Thus, no other foreign entity or individual had ever been subject to this tax prior to Harkonnen Oil. Rather, the tax was a way for Harkonnen Oil and President Corrino to compromise in negotiation: President Corrino would get his "various royalty payments," while Harkonnen Oil would count on receiving a foreign tax credit for a portion of such royalties. R. at ¶ 3. In other words, this tax was imposed as a mere *additional* charge upon Harkonnen Oil in exchange for the exclusive right to extract oil and is, therefore, a specific economic benefit. *See Exxon Corp. v. C.I.R.*, 113 T.C. No. 24 (1999).

Under Treasury Regulation 1.901–2, the minerals within the Caladan Oil Field must also be owned or controlled by Arrakis in order for this specific economic benefit to render the tax not creditable. Admittedly, the minerals within the Caladan Oil Field are not owned by the Republic of Arrakis; instead, they are wholly owned by the royal family of President Corrino. R. at ¶ 2. However, even though the Republic of Arrakis does not *own* the minerals within the Caladan Oil Field, it certainly *controls* the minerals within the meaning of regulation 1.901–2. A foreign government controls property it does not own if it "exhibits substantial indicia of ownership with respect to the property." Treas. Reg. § 1.901–2(a)(2)(ii)(D). This standard is met in this instance. In particular, the Arrakis Lease, which gave Harkonnen Oil the right to develop the entire Caladan Oil Field, was signed by the Republic of Arrakis rather than the true owners of the mineral rights—the Arrakis royal family. R. at ¶ 13. Pursuant to this lease, Harkonnen Oil promised to pay, and did pay, a one–time bonus payment of $55,000,000 and a royalty payment of fifteen percent. R. at ¶ 13. However, these payments were owed and paid to the only other party to the transaction, the Republic of Arrakis, and not to the royal family. *See id.* Thus, despite not owning the minerals within the Caladan Oil Field, the Republic of Arrakis nevertheless exhibited "substantial indicia of ownership" over, and therefore controlled, the minerals by (1) signing a lease for the exclusive right to develop the minerals and (2) collecting the bonus and royalty payments owed for such development. Treas. Reg. § 1.901–2(a)(2)(ii)(D). As such, a direct specific economic benefit was received by Harkonnen Oil in the form of the exclusive right to develop government–controlled resources. Accordingly, the Republic of Arrakis Foreign Tax is not pursuant to Arrakis' authority to levy taxes and, therefore, is also not a tax under regulation 1.901–2(a)(2)(i).

ii. The levy paid by Harkonnen Oil to the Republic of Arrakis is also not a tax because it constitutes a payment in exchange for an *indirect* specific economic benefit.

A specific economic benefit may be received by a taxpayer either directly from the foreign government or indirectly through a related third party. Treas. Reg. § 1.901–2(a)(2)(i). In either situation, the result is the same: the levy is deemed not to be pursuant to the foreign country's authority to levy taxes and is, therefore, not a tax. *Id.* An indirect specific economic benefit is received by a person subject to a foreign levy where "another person receives a specific economic benefit and that other person owns or controls, directly or indirectly, the first person"—that is, the taxpayer. Treas. Reg. §1.901–2(a)(2)(ii)(E)(1). In this regard, Harkonnen Oil has received an indirect specific economic benefit because Vladimir Harkonnen, the

CEO of Harkonnen Oil, is a related third party who has received a specific economic benefit from Arrakis and has control over the taxpayer.[1]

As CEO, Mr. Harkonnen has direct control over the business decisions and direction of Harkonnen Oil. In particular, he has the power to negotiate and enter into contracts on behalf of the company. R. at ¶¶ 3, 11, 31. In fact, Mr. Harkonnen negotiated both the Arrakis Lease and the IFIL Lease, and he withdrew from preliminary negotiations with IFIL at his sole discretion. *Id.* He further had the authority to bind the company to the informal, handwritten IFIL lease with Jessica Mohiam after just a half day of negotiation, at most. *See* R. at ¶ 31 ("That afternoon, Mr. Harkonnen telephoned President Corrino and asked how he should handle IFIL's tax request."). Mr. Harkonnen clearly has the authority to determine Harkonnen Oil's business decisions. As such, he has direct control over the company, and any specific economic benefit received by Mr. Harkonnen is also deemed an indirect specific economic benefit to Harkonnen Oil. *See* Treas. Reg. § 1.901–2(a)(2)(ii)(E)(1).

Since Harkonnen Oil became subject to the Republic of Arrakis Foreign Tax, Mr. Harkonnen received many economic benefits from Arrakis—particularly in the form of services. *See* Treas. Reg. § 1.901–2(a)(2)(ii)(B) (stating "[an] economic benefit includes . . . a service" not made available on substantially the same terms to others). More specifically, Mr. Harkonnen received personal services from both Arrakis and President Corrino not made available on substantially the same terms

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[1] The Record is silent as to whether Mr. Harkonnen also owns Harkonnen Oil.

to *anyone* else, much less other individuals subject to the levy or to the general population of Arrakis. For example, on April 9, 2012, Mr. Harkonnen participated in the extremely sensitive political meeting known as the Arrakeen Peace Summit. This meeting was called to negotiate peace terms between Arrakis and the Independent People of Sietch ("IPS") after Arrakis mobilized its military into the Sietch Dunes in order to suppress an IPS uprising. The only other participants were all important officials of interested governments: the U.S. Ambassador to Arrakis, President Corrino, and Paul Atreides (the then–newly appointed leader of the IPS). R. at ¶ 16. Mr. Harkonnen's individual safety was even "personally guaranteed" by President Corrino. *Id.*

On May 16, 2011, Mr. Harkonnen met in private with President Corrino and Paul Atreides (then Vice–President of Sietch State), along with the Leader Elect of IFIL, Jessica Mohiam, at the First Annual Caladan Oil Field Conference. R. at ¶ 35. Again, Mr. Harkonnen was the only non–political figure at a high profile meeting. This three–day conference included "private meetings, presentations of new technologies . . . and a lavish banquet." *Id.* At the close of this banquet, the Republic of Arrakis Foreign Tax was suddenly lowered to a rate of thirty–three percent. *Id.*

Additionally, President Corrino made himself available to Mr. Harkonnen at seemingly a moment's notice. For example, after he became concerned with the prospect of Arrakis' actions being deemed human rights violations by the U.S. State Department, Mr. Harkonnen contacted President Corrino directly via email and requested clarification of the situation. R. at ¶ 10. In response, President Corrino indeed provided a clarification and further attempted to calm Mr. Harkonnen, instructing him that "there was no need to worry." R. at ¶ 10. Few individuals in this world can "request clarification" from a foreign president based on mere personal concern of a violent uprising within the foreign country and receive a direct, personal message in return. Furthermore, on April 26, 2008, Mr. Harkonnen went on a "previously planned" vacation to the Sietch Dunes and afterward arranged a face–to–face meeting with President Corrino on April 29, 2008. R. at ¶ 11. Again, few people can arrange for a personal meeting with a foreign president, fewer still who provide only a one– to two–day notice. Moreover, on March 22, 2011, rather than call an attorney or a tax specialist, Mr. Harkonnen called President Corrino for advice on how he should handle IFIL's tax request. R. at ¶31. President Corrino personally advised him to go through the Holy Royal Court of Arrakis for a formal determination. *Id.*

In his role as CEO of Harkonnen Oil, it is clear that Mr. Harkonnen directly controlled the company in its business decisions and direction. In particular, he negotiated and entered into the lease agreements with Arrakis and IFIL on behalf of Harkonnen Oil and withdrew from the IFIL negotiations at his own discretion. R. at ¶ 3, 11, 31. Moreover, after the Arrakis Lease was signed and Harkonnen Oil began paying the Republic of Arrakis Foreign Tax, Mr. Harkonnen began receiving the types of services and accommodations typically reserved only for foreign heads of state. Specifically, Mr. Harkonnen was invited to partake in multiple high–profile meetings involving international affairs and even had his individual safety personally guaranteed by President Corrino. R. at ¶ 16, 35. Mr. Harkonnen was further given the utmost priority and attention from President Corrino and indeed took advantage of this by setting up a short notice, face–to–face meeting, by requesting clarification on a political uprising, and by asking for personal advice on tax issues. R. at ¶ 10, 11, 31. These services were not made available on substantially the same terms to *anyone*, much less to the other foreign entities or individuals subject to the tax, if any, or to the general public of Arrakis. As such, Mr. Harkonnen received direct specific economic benefits from Arrakis which also constitute indirect specific economic benefits to Harkonnen Oil. Accordingly, the Republic of Arrakis Foreign Tax is not pursuant to Arrakis' authority to levy taxes and is thus not a tax. *See* Treas. Reg. § 1.901–2(a)(2)(i) (providing that "a foreign levy is not pursuant to a foreign country's authority to levy taxes, and thus is not a tax, to the extent a person subject to the levy receives (or will receive), directly or indirectly, a specific economic benefit . . . .").

b. The predominant character of the Republic of Arrakis Foreign Tax is not that of an income tax in the U.S. sense.

The second requirement for a foreign levy to be a creditable income tax under section 901 is that its predominant character be that of an income tax in the U.S. sense. Treas. Reg. § 1.901–2(a)(1). This requirement is satisfied: (1) if the foreign tax is likely to reach net gain in the normal circumstances in which it applies and (2) only to the extent that liability for the tax is not dependent on the availability of a credit for the tax against income tax liability to another country. Treas. Reg. § 1.901–2(a)(3). Admittedly, the second element appears to be satisfied in this instance because neither the Sietch State tax nor the IFIL tax impacted Harkonnen Oil's payment of the Republic of Arrakis Foreign Tax. R. at ¶¶ 20, 31. However, as held by the Court of Appeals for the Fourteenth Circuit, the Republic of Arrakis Foreign Tax does not reach net gain in the normal circumstances in which it applies. R. at ¶ 41. Thus, even if the Court holds the levy to be a "tax," the Republic of Arrakis Foreign Tax is nevertheless not creditable under section 901 because its predominant character is not that of an income tax in the U.S. sense. *See PPL Corp.*, 133 S.Ct. at 1901 (stating "the 'predominant character' of a tax, or the normal manner in which a tax applies, is controlling").

The Treasury Regulations provide that a foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax satisfies each of three requirements: (1) realization, (2) gross receipts, and (3) net income. Treas. Reg. 1.901–2(b)(1). While the first two of these requirements are not in dispute here, the Republic of Arrakis Foreign Tax nevertheless fails to satisfy the third requirement—the net income prong. A foreign tax satisfies this requirement if 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. Treas. Reg. 1.901–2(b)(4)(i). In other words, in determining the net income requirement, it is important "to determine the expenses of which the foreign tax takes account in order to see whether taxation of net gain is the ultimate objective or effect of that tax." *Inland Steel*, 230 Ct.Cl. at 326.

In *Inland Steel*, a company involved in an iron ore mining operation sought to credit a mining tax similar to the tax in the case at hand over a two–year period. *Id.* at 324. In one year, the payment was based solely on sales of unprocessed iron ore. *Id.* In the next, it was based solely on the proceeds of sales of unprocessed ore and processed pellets. *Id.* For both years, specific expenses and allowances were deductible from the proceeds attributable to the extraction activity. *Id.* These deductions included transportation costs, working expenses (including office overhead) directly connected with the mining operation, depreciation of mining plant, and certain exploration and development costs incurred. *Id.* at 328. However, several other categories of mine operating expenses were excluded from the list of allowable deductions. *Id.* at 329. In particular, the company incurred approximately $30.8 million in preproduction exploration and development expenses, of which only $7.3 million were eligible for deduction; the company's interest expenses of almost $2 million per year were not considered in calculating the taxable profit; and the company's calculation of taxable profits also did not include an allowance for the physical depletion of its mineral resource. *Id.*

In determining whether the mining tax was creditable, the United States Court of Claims concluded that, notwithstanding its nominal objective to reach a defined net profit, the tax 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 applied. *Id.* at 329–30. Specifically, as an active mining operator, the company incurred significant expenses in the operation of its business, and its net profit was naturally dependent on "the relationship of its expenses, operating and general, to its income from that business operation." *Id.* at 334. But because of the mining tax's large–scale omission of significant costs of the mining business, the court found that net gain of the company's business was not sure, or even very likely, to be reached by the tax:

> It is as if a very large chunk of the outlays of that business had been shaved off, and only a fraction left, out of which 'net gain' is to be found. The exclusions are far too widespread and important to permit the conclusion that some net gain is sure to be reached.

Id. at 335. Rather, the taxes paid "seem[ed] to be taxes on the privilege to conduct mining operations in Ontario," and the court thus held the taxes to not be creditable. *Id.* at 338; *see also Bank of America Nat'l Trust & Sav. Ass'n v. United States*, 198 Ct. Cl 263 (1972) (foreign taxes held not creditable because no provision was made to reach the net gain realized after an accounting for costs normally incident to the banking business); *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894 (3d Cir. 1955) (tax on the income from an active asbestos quarry that restricted allowable deductions to costs incurred in mining operations only, with no deductions for expenses incident to the general conduct of the business, held not creditable).

In this instance, the Republic of Arrakis Foreign Tax does not allow for a recovery of significant costs and expenses, but rather it is "more in the nature of a tax on the privilege of doing business" in Arrakis' Caladan Oil Field. *Allstate Ins. Co. v. United States*, 190 Ct.Cl. 19, 28–29 (1969). The tax cannot be said to reach the concept of net gain in the U.S. sense because it would have been imposed on Harkonnen Oil even if its business had operated at a loss. *See Inland Steel*, 230 Ct.Cl at 336. Indeed for at least four and one–half months of the tax year at issue, 2011, the tax payments were calculated without any deductions. Given that Harkonnen Oil is a foreign company conducting business operations in Arrakis, the deductions offered by the Arrakis Tax Code were not originally applicable to it as a matter of religious law. R. at ¶ 4. It was not until after the three–day First Annual Caladan Oil Field Conference on May 16, 2011, that President Corrino issued Proclamation 102, which, for the first time, allowed Harkonnen Oil to take deductions under the Arrakis Tax Code.[2] R. at ¶¶ 35, 36. Because the Record is silent as to the exact date of the issuance of Proclamation 102 and as to the date it took effect, it will be assumed, *arguendo*, that it took the earliest possible effect: May 19, 2011—exactly three days after the conference began. However, even assuming that Proclamation 102 took instantaneous effect on that date, it necessarily follows that the Republic of Arrakis Foreign Tax did not take into account *any* of the costs and expenses of Harkonnen Oil for the first five and one–half months of the tax year at issue. Moreover, even after that Proclamation 102 took effect, Harkonnen Oil could only claim ninety–five percent of the deductions available to Arrakis citizens. R. at ¶ 36.

These excluded deductions "are far too widespread and important to permit the conclusion that some net gain is sure to be reached." *Inland Steel*, 230 Ct.Cl at

[2] Respondent has conceded that these deductions match available deductions under the United States Tax Code. R. at n.7.

335. For over four and one–half months of the tax year at issue, the tax was based solely on gross receipts. But "a tax is creditable only if it applies to realized gross receipts *reduced by significant costs and expenses attributable to such gross receipts*. A tax based solely on gross receipts . . . [is] noncreditable because it . . . fail[s] the Treasury Regulation's *net income* requirement." *PPL Corp.*, 133 S.Ct. at 1906 (emphasis in original). Moreover, for the remainder of the year, Harkonnen Oil still could not claim the full amount of deductions an Arrakis citizen would have otherwise been eligible for under the Arrakis Tax Code. Because of these significant excluded deductions, and because "[c]reditability is an all or nothing proposition," the Republic of Arrakis Foreign Tax cannot be said to satisfy the net income requirement. *Id.* at 1901. As such, the predominant character of the tax is not that of an income tax in the U.S. sense, and the tax is therefore not creditable. Treas. Reg. § 1.901–2(a)(1).

B. Harkonnen Oil's payment of taxes to the Republic of Arrakis is not creditable under 26 U.S.C. § 903 because the Republic of Arrakis Foreign Tax is not "in lieu of" an otherwise generally imposed income tax.

Although a foreign levy may not be creditable under section 901, it may nevertheless qualify as a creditable tax if it meets the "in–lieu–of" tax requirements of section 903. A levy is creditable as an in–lieu–of tax if it is a tax within the general rule of Treasury Regulation 1.901–2(a)(2) and if the substitution requirement is satisfied. Treas. Reg. 1.903–1(a) (2013). In other words, in order for a foreign levy to be creditable under section 903, it must (1) still qualify as a "tax" as that term is understood for purposes of section 901 and (2) also operate as a tax imposed in substitution for an income tax otherwise generally imposed. Treas. Reg. 1.903–1(b)(1). Thus, to the extent the Court holds the Republic of Arrakis Foreign Tax to not constitute a tax within the meaning of section 901, it is also not creditable under section 903 as a matter of law. *See supra* Part I.A.a. Alternatively, even if the Court holds the levy to constitute a tax, the Republic of Arrakis Foreign Tax is nevertheless not creditable under section 903 because it is not "in lieu of" an income tax otherwise generally imposed.

Assuming the Court indeed holds the Republic of Arrakis Foreign Tax to constitute a "tax", the determinative question for purposes of section 903 "is whether it can fairly be said that [the Republic of Arrakis Foreign Tax also] constituted a substitute for a generally levied income tax *which otherwise would have been imposed* upon [Harkonnen Oil] by [Arrakis]." *United States v. Occidental Life Ins. Co. of Cal.*, 385 F.2d 1, 10 (9th Cir. 1967) (emphasis added). However, there is no such other, generally imposed income tax to which Harkonnen Oil would have been subject to had the Republic of Arrakis Foreign Tax not been imposed upon it. While Arrakis does impose a general income tax on all its citizens, that income tax would not have otherwise been applicable to Harkonnen Oil. In *Lord Remmington v. Republic of Arrakis*, the Holy Royal Court "recently ruled on this issue . . . and stated that foreign citizens and entities . . . could not be taxed." R. at n.6. Thus, setting aside the newly–created Republic of Arrakis Foreign Tax, Harkonnen Oil would not have been subject to, as a matter of Arrakis law, any other tax imposed by the Arrakis government.

Harkonnen Oil will likely rely upon Example 1 of Treasury Regulation 1.903–1(b)(3) in an attempt to prove the creditability of the Republic of Arrakis Foreign Tax under section 903. However, that example is readily distinguishable from the case at hand. In Example 1, a country imposes a general income tax from which nonresidents are exempted. Treas. Reg. § 1.903–1(b), Ex. (1). Such nonresidents are instead subject to a gross income tax on income from the country that is "not attributable to a trade or business carried on in [the country]." *Id.* The example concludes that this nonresident tax on gross income satisfies the substitution requirement of section 903. *Id.* This example is distinguishable upon two grounds: (1) the Republic of Arrakis Foreign Tax *is* attributable to a trade or business carried on within Arrakis, namely the development of the Caladan Oil Field, and (2) there is no Arrakis income tax that would otherwise be imposed on Harkonnen Oil or any other foreign entity. This latter differentiation is particularly important because, in Example 1, foreign entities are *exempted* from the resident income tax specifically so that they may be taxed pursuant to a separate foreign income tax. But here, the Holy Royal Court of Arrakis has mandated, as a matter of law, that the general income tax imposed upon Arrakis citizens may not be imposed upon foreign entities or individuals. In other words, the foreign income tax in Example 1 operates in lieu of the domestic income tax, but the Republic of Arrakis Foreign Tax does not. Instead, it has been imposed upon Harkonnen Oil specifically because no alternative tax scheme would otherwise be applicable to it. As such, it cannot be said that the Republic of Arrakis Foreign Tax operates as a substitute for a generally levied income tax that "otherwise would have been imposed upon [Harkonnen Oil] by [Arrakis]." *Occidental*, 385 F.2d at 10.

The *Occidental* case is particularly instructive on this differentiation. There, the taxpayer was a stock life insurance company seeking a foreign tax credit for premium taxes it paid to the Province of Quebec. *Id.* at 1. Over this same period, the Province of Quebec also imposed a general, seven–percent income tax pursuant to the Quebec Corporation Tax Act. *Id.* at 3. The parties conceded that this seven–percent levy was an income tax that would have been creditable under section 901. *Id.* at 11. However, a subdivision of this Act specifically exempted any company from the tax which was instead specially taxed under the premiums tax at issue. *Id.* Thus, the court found that "under the clear, unambiguous terms of the Quebec statutes, [the insurance company] was not subject to the income tax *only because it was required to pay the premiums tax.*" *Id.* (emphasis added). Accordingly, the Ninth Circuit Court of Appeals held that it was manifest that the Quebec premiums tax operated in lieu of an income tax "otherwise generally imposed." *Id.* at 12.

In this instance, however, Harkonnen Oil was not exempt from the Arrakis income tax "only because" it was required to pay the Republic of Arrakis Foreign Tax. *Id.* at 11. On the contrary, the domestic Arrakis income tax was held by the Holy Royal Court to be entirely inapplicable to foreign entities and individuals as a matter of law because they are not entitled to the same protections under the Arrakis Tax Code. R. at n.6. Therefore, no tax would have otherwise been imposed upon Harkonnen Oil by Arrakis, and the Republic of Arrakis Foreign Tax is thus not a substitute for an "otherwise generally imposed" income tax. Accordingly, Harkonnen Oil did not meet its burden of bringing itself within the statutory provision upon which it relies, and the Republic of Arrakis Foreign Tax is not creditable under section 903. *See Keasbey*, 133 F.2d at 898 (stating the taxpayer bears the burden of proof in bringing itself within the foreign tax credit provisions).

II. The IRS properly denied Harkonnen Oil's claimed foreign tax credit for all tax payments it made to IFIL.

The Court of Appeals for the Fourteenth Circuit correctly held that Harkonnen Oil's tax payments to IFIL are not creditable under the Internal Revenue Code. The foreign tax credit is a privilege provided by legislative grace; therefore, it is the taxpayer's burden to bring itself within the statutory language and show itself entitled to a foreign tax credit. *See Inland Steel*, 230 Ct.Cl at 325. In this regard, Harkonnen Oil has failed to meet its burden. In particular, the IFIL levy does not constitute a "tax" for purposes of the Code's foreign tax credit provisions because it is not a compulsory payment pursuant to IFIL's authority to levy taxes. More specifically, Harkonnen Oil's tax payments exceeded the company's liability under applicable foreign tax law and further were paid in exchange for specific economic benefits. Additionally, even if the IFIL levy qualified as a tax and was otherwise creditable, no tax imposed by IFIL may be eligible for a foreign tax credit because it does not constitute a "foreign country" for purposes of the Code, and also because the United States does not conduct diplomatic relations with it. As such, the IRS, the Central District Court of New Tejas, and the Fourteenth Court of

Appeals all correctly concluded that Harkonnen Oil is not entitled to a foreign tax credit for its payments to IFIL.

A. The levy imposed by IFIL is not a compulsory payment pursuant to its authority to levy taxes and is thus not a tax for purposes of the Internal Revenue Code's foreign tax credit provisions.

In order for a foreign levy to be a creditable income tax under sections 901 and 903 of the Internal Revenue Code, it must first qualify as a "tax." *See* Treas. Reg. §§ 901–2(a)(1), 903–1(a). A foreign levy is considered a tax if it requires "a compulsory payment pursuant to the authority of a foreign country to levy taxes." Treas. Reg. § 901–2(a)(2)(i). However, an amount paid to a foreign country is not a compulsory payment, and consequently not a payment of a tax, to the extent that it (1) exceeds the amount of liability under foreign tax law or (2) is a payment in exchange for a specific economic benefit. Treas. Reg. §§ 901–2(a)(2), 901–2(e)(5). The burden lies with Harkonnen Oil, as the taxpayer, to demonstrate that the tax payments to IFIL are compulsory. John P. Dombrowski, *Foreign Tax Credits: The Recent Decision in Procter & Gamble v. United States Allows Procedure to Override the Statutory Intent*, 44 U. TOL. L. REV. 405, 417 (2013) [hereinafter *Foreign Tax Credits: The Recent Decision*] ("The burden lies with the taxpayer to determine if a payment is compulsory, as defined by the regulation."). Because the tax payments made by Harkonnen Oil to IFIL exceeded its liability under foreign tax law and because the IFIL levy is a payment in exchange for a specific economic benefit, the IFIL levy does not constitute a compulsory payment pursuant to IFIL's authority to levy taxes. Accordingly, the IFIL levy is not a tax under section 901–2(a)(2) and, therefore, is not a creditable income tax under either section 901 or section 903.

a. The amount paid by Harkonnen Oil to IFIL exceeded the amount of liability under foreign tax law.

The Treasury Regulations provide that an amount paid to a foreign country is not a compulsory payment, and is thus not an amount of tax paid, to the extent that it exceeds the amount of liability under foreign tax law. Treas. Reg. § 1.901–2(e)(5). An amount paid does not exceed the amount of liability under foreign tax law if (1) the amount is determined by the taxpayer in a manner consistent with a reasonable interpretation and application of the foreign law and (2) the taxpayer exhausts all effective and practical remedies to reduce, over time, the taxpayer's liability for foreign tax. *Id.* However, in this instance the IFIL levy constitutes an impermissible second Sietch State tax in express violation of the Arrakis Constitution. R. at ¶ 18. Thus, the amount Harkonnen Oil paid to IFIL could not have been reasonably interpreted to be a legally imposed tax payment. Moreover, Harkonnen Oil misconstrued the opinion of the Holy Royal Court of Arrakis and did not seek a determination from the Sietch Council, thereby failing to satisfy the requirement that it exhaust all effective and practical remedies to lower its foreign tax burden. Accordingly, the amount paid by Harkonnen Oil to IFIL exceeded the amount of liability under foreign tax law and is therefore not a payment of a tax. R. at ¶ 43.

i. Harkonnen Oil unreasonably interpreted the applicable foreign law in such a way that increased its foreign tax liability.

The Fourteenth Court of Appeals correctly held that the amount paid to IFIL by Harkonnen Oil exceeded its liability under foreign tax law because the IFIL levy is an express violation of the Arrakis Constitution. R. at ¶ 43. The first requirement for an amount paid to not exceed the amount of liability under foreign tax law is that it be "determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law . . . in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax." Treas. Reg. § 1.901–2(e)(5)(i). An interpretation or application of foreign law is unreasonable if there is actual or constructive notice, including a published court decision, to the taxpayer that its interpretation or application is likely to be erroneous. *Id.* Under the applicable foreign law, the Sietch State—of which IFIL has been deemed to be "a part" by the Holy Royal Court of Arrakis—has the constitutional power to decree and levy a single tax to be paid as tribute to Arrakis. R. at ¶¶ 18.4, 32. But by agreeing to pay the IFIL levy, Harkonnen Oil nevertheless subjected itself to a second Sietch State tax that was imposed in express violation of the Arrakis Constitution and was further not paid as tribute to Arrakis. R. at ¶ 18. As such, Harkonnen Oil unreasonably interpreted the applicable foreign law in a way that would increase, rather than limit, its liability over time, and its payments are therefore not creditable.

The applicable foreign law in this instance makes clear that the Sietch State may impose only a single tax. After the Arrakeen Peace Summit, the Sietch Dunes Peace Treaty designated the Sietch State as "an Important Province of Arrakis" and created the position of Arrakis Vice–President to serve in the cabinet of the President. R. at ¶ 17. Following the treaty, the Arrakis Constitution was amended, effective April 13, 2010, to include a list of powers and requirements for the Vice–President position. R. at ¶ 18. In particular, the amendment provides that Sietch State laws may "only" be created and enforced with respect to (1) policing the State and (2) collecting the State tribute for Arrakis. *Id.* The amendment then grants two specific powers to the Vice–President for such purposes: the Vice–President may appoint a judicial council of ten individuals (the "Sietch Council") and may decree and levy a *single* tax, which can then only be amended with the prior approval of the President of Arrakis. *Id.*

Harkonnen Oil was fully aware of the constitutional constraints imposed upon the Sietch State as a province of Arrakis. Indeed, on March 22, 2011, Mr. Harkonnen protested the imposition of a tax by IFIL and ultimately stormed out of the negotiations with Ms. Mohiam specifically because of this news. R. at ¶ 31. Had he believed that IFIL, as a sovereign authority, could rightfully impose such a tax, Mr. Harkonnen would not have protested the tax. To be sure, the Record makes no indication that he protested either the Arrakis tax or the Sietch State tax before agreeing to pay them on behalf of Harkonnen Oil. Moreover, any collections received by the Sietch State, of which IFIL is a part, are constitutionally required to be paid as tribute to Arrakis. R. at ¶ 18.2 (providing that laws may be created and enforced in the Sietch State "only as to" policing the State and collecting the State tribute for Arrakis). But here, Ms. Mohiam instead paid twenty percent of the funds IFIL received from Harkonnen Oil directly to the monarchies of Al Dhanab and Anbus. R. at ¶ 33. Thus, Harkonnen Oil is seeking to receive a foreign tax credit for payments it knows to be unconstitutional under foreign tax law on two separate grounds—namely, that they were imposed as an impermissible second Sietch State tax and further were paid as tribute to two foreign countries rather than to Arrakis. Certainly this is not a reasonable interpretation of Arrakis law.

The unreasonableness of the interpretation adopted by Harkonnen Oil is even more evident considering the immediate action it took following Mr. Harkonnen's protest of the IFIL levy. In particular, Harkonnen Oil thereafter petitioned the Holy Royal Court of Arrakis "for a determination of the status of IFIL and its ability to levy a tax." R. at ¶ 32. However, the Court did not address the latter issue at all but rather merely declared that "Arrakis recognizes IFIL as a part of Sietch." *Id.* Despite receiving no clear answer from the Court, Harkonnen Oil decided to nevertheless pay IFIL the two percent levy on March 25, 2011, the very next day. R. at ¶ 33. But given the Court's declaration, this was an entirely unreasonable interpretation of the law. The Holy Royal Court wholly ignored Harkonnen Oil's request to determine IFIL's ability to levy taxes and instead declared IFIL to be "a part of" the Sietch State. See R. at ¶ 32. It necessarily follows from this decision that IFIL is subject to and restricted by the constitutional limitation of one single tax for all of the Sietch State. Therefore, it was unreasonable for Harkonnen Oil to interpret the Court's decision as a validation of IFIL's authority to levy taxes.

Alternatively, the Court's opinion was, at best, ambiguous. But even assuming so, Harkonnen Oil was still required to reasonably interpret it "in such a way as to reduce, over time, [its] reasonably expected liability." Treas. Reg. § 1.901–2(e)(5)(i). Given this ambiguity, Harkonnen Oil's interpretation is not reasonable because it was put on constructive notice by the Court's opinion that a decision to pay the tax would likely be an erroneous interpretation of the law. *See* Treas. Reg. § 1.901–2(e)(5)(i) ("An interpretation or application of foreign law is not reasonable if there is actual notice or constructive notice (e.g., a published court decision) to the taxpayer that the interpretation or application is likely to be erroneous."). Moreover, Harkonnen Oil neither sought nor relied on the advice of a competent foreign tax advisor in interpreting the Holy Royal Court's opinion before it decided to pay the levy the very next day. *Cf. IBM Corp. v. United States*, 38 Fed.Cl. 661, 673 (1997) (finding the taxpayer's interpretation to be reasonable given its good faith reliance upon the advice of two tax professors). This was certainly not a good faith, reasonable interpretation of foreign law made in such a way to reduce Harkonnen Oil's liability over time. Rather, it was a rash business decision made for the simple purpose of drilling Unit #12 as soon as possible. As a consequence, it is Harkonnen Oil, not the U.S. Treasury, that should be required to shoulder the costs of this voluntary business decision. *P&G Co. v. United States*, No. 1:08–CV–00608, 2010 WL 2925099, at *8 (S.D. Ohio July 6, 2010) (stating that "a system under which the United States Treasury pays out foreign tax credits without first demanding that American companies effectively and practically reduce their foreign tax payments would . . . leav[e] the United States to foot the bill through the credit system").

The foreign tax credit is a privilege extended by legislative grace that allows U.S. citizens and domestic entities to mitigate the evil of double taxation. *Burnet*, 285 U.S. at 12; *Inland Steel*, 230 Ct.Cl at 677. This does not mean, however, that a U.S. citizen or domestic entity can agree to pay any foreign tax and thereafter rely upon the U.S. government to effectively subsidize that tax via a foreign tax credit. *See Foreign Tax Credits: The Recent Decision*, *supra* p. 27, at 417. Therefore, a taxpayer seeking a foreign tax credit is required to reasonably interpret the applicable foreign tax law "in such a way as to reduce, over time, [its] reasonably expected liability." Treas. Reg. § 1.901–2(e)(5)(i). But here, Harkonnen Oil did not bring itself within the provisions of sections 901 or 903. Rather, it chose to interpret an, at best, ambiguous court decision overnight without the advice of a competent foreign tax advisor. As such, Harkonnen Oil unreasonably interpreted Arrakis law in a way that would *increase*, rather than reduce, its liability over time, and the amount paid by it to IFIL thus exceeded its liability under foreign tax law. Accordingly, Harkonnen Oil's payments were not compulsory payments pursuant to IFIL's authority to levy taxes and are, therefore, not creditable.

ii. Harkonnen Oil failed to exhaust all effective and practical remedies to lower its foreign tax burden.

Additionally, the Fourteenth Court of Appeals was correct in holding the amount paid by Harkonnen Oil to IFIL exceeded the company's liability under foreign tax law because it failed to exhaust all effective and practical remedies to lower its foreign tax burden. R. at ¶ 43. The requirement that a taxpayer exhaust its remedies prior to claiming a foreign tax credit is a core component of the

Internal Revenue Code's foreign tax credit scheme. *P&G Co.*, 2010 WL 2925099, at *8. The availability of a tax credit for foreign taxes eliminates or reduces the burdens of double taxation on American corporations and promotes international trade. *Inland Steel*, 230 Ct.Cl at 325. However, "a system under which the U.S. Treasury pays out foreign tax credits without first demanding that American companies effectively and practically reduce their foreign tax payments would create a moral hazard." *P&G Co.*, 2010 WL 2925099 at *8. Taxpayers would have no incentive to challenge the validity of any foreign tax whether or not properly imposed, thereby leaving the United States to foot the bill through the credit system. *Id.* In such a case, double taxation would be avoided, but the U.S. Treasury would effectively be involuntarily subsidizing foreign governments, an outcome the Treasury is disinclined to accept. *See Foreign Tax Credits: The Recent Decision*, *supra* p. 27, at 417. Thus, it is a vital component of the foreign tax credit scheme that U.S. taxpayers exhaust all effective and practical remedies to lower their foreign tax burden over time.

In *P&G Co. v. United States*, an American company, P&G, attempted to claim a foreign tax credit for tax payments it made to two separate governments on the same stream of income and over the same period of time. *P&G Co.*, 2010 WL 2925099 at *4. In particular, one of P&G's affiliates, P&G Northeast Asia ("P&G NEA"), managed its Japanese and Korean operations from a principal office in Japan. *Id.* at *2. It had no physical location of its own in Korea but instead contracted with an independent contractor to manufacture products in Korea. *Id.*

P&G NEA would then sell the finished products into the Korean marketplace through a wholly–owned distributing subsidiary and under trademarks owned by P&G. *Id.* Many of these products were also manufactured using patented technology owned by P&G, which by contrast authorized P&G NEA to use its intellectual property in exchange for a royalty fee. *Id.*

For several years, neither P&G nor P&G NEA paid any taxes to the Korean government because P&G NEA was based in Japan and had no employees in Korea. *Id.* However, in 2006, Korea's National Tax Service audited P&G's business in Korea and determined that a portion of the royalties paid to it by P&G NEA was subject to Korean taxes. *Id.* In response to receiving this surprising news, P&G sought legal advice from its Korean counsel, which was a well–known Korean law firm. *Id.* at *3. The firm reviewed relevant legal authorities, provided its analysis of the legal issues in a memorandum to P&G NEA, and concluded that the taxes were properly assessed by the Korean authorities. *Id.* Further, because the taxes were properly imposed, the memorandum concluded that a challenge to the assessment was unlikely to be successful. *Id.* Relying on this assessment, P&G and P&G NEA determined that there was no reasonable basis to appeal the assessment of the Korean NTS or to invoke the grievance process provided under the applicable U.S.–Korea tax treaty. *Id.*

Relying on its legal counsel, P&G ultimately paid taxes on the same income stream to both Japan and Korea for the year 2006. *Id.* at *4. After the I.R.S. denied P&G's double tax credit attempt, a federal district court determined that the

Korean claims could be deemed compulsory payments under Treas. Reg. § 1.901–2 because P&G obtained a confirmation of their legality by a competent law firm. *Id.* at *10. However, the Japanese payments could not be deemed compulsory payments because P&G did not attempt to reduce its tax liability from Japan after Korea laid claim to the *same* source of income. *Id.* As a result, P&G was entitled to a foreign tax credit only in the amount of the tax payments it made to Korea and could not also claim additional credit in the amount of the tax payments made to Japan on the same income. *Id.*

Similarly, Harkonnen Oil is seeking to claim a double foreign tax credit on tax payments it made to two foreign governments over the same source of income. More specifically, the income received by Harkonnen Oil from Unit #12 was taxed by both the Sietch State and IFIL for tax year 2011. However, because Harkonnen Oil has already received a foreign tax credit for the tax payments it made to the Sietch State, it cannot now claim another foreign tax credit for the tax payments it made to IFIL on the same source of income unless it can demonstrate that it exhausted all effective and practical remedies in an attempt to reduce its foreign tax burden. But Harkonnen Oil cannot make such a demonstration because it (1) failed to obtain a determination on IFIL's authority to levy taxes from the Holy Royal Court of Arrakis and (2) made no attempt to petition the Sietch Council for a reduction in its tax liability to the Sietch State after IFIL laid claim to the same source of income. *See id.* at *8 ("[T]he onus is on [the taxpayer] to exhaust all practical and effective remedies, in both countries, before claiming a foreign tax credit").

Furthermore, the fact that, prior to tax year 2011, Harkonnen Oil took its expenses from its Arrakis operation as a deduction rather than a credit is also indicative of its failure to exhaust all effective and practical remedies. R. at ¶ 38. A voluntary tax rule is not necessary to protect the United States when foreign taxes are deducted because a deduction does not allow a taxpayer to recoup fully its foreign tax costs against its U.S. tax liability. Alan Fischl & Michael Harper, *What Exactly is a 'Voluntary Tax'?*, 19 J. INT'L TAX 32, 34 (2008). Since the taxpayer necessarily bears some of the burden of the foreign tax under a deduction, it has an incentive to ensure that its foreign tax liability is as low as possible. *Id.* But here, in its very first year of paying the IFIL levy, Harkonnen Oil suddenly switched to crediting its foreign tax payments so that its failure to seek a determination of the applicable law by a competent authority would not affect its own financial interest but would rather be imposed upon the U.S. Treasury. This is not the purpose of the foreign tax credit. *See Burnet*, 285 U.S. at 12. A taxpayer is not permitted to be indifferent to its potential foreign income tax liability with the mindset that the foreign tax can merely be offset against its U.S. tax liability at a later time. On the contrary, in order to claim the privilege of a foreign tax credit, Harkonnen Oil was first required to do everything practical and effective within its power to lower its foreign tax liability. Treas. Reg. § 1.901–2(e)(5)(i).

Harkonnen Oil will likely rely upon *IBM Corp. v. United States* in an effort to show its compliance with the exhaustion of remedies requirement through its petition to the Holy Royal Court of Arrakis. In *IBM*, the U.S. Court of Federal Claims determined that a domestic entity satisfied the exhaustion of remedies requirement of Treasury Regulation 1.901–2(e)(5)(i) despite not exhausting all available litigation procedures. *IBM v. United States*, 38 Fed.Cl. 661, 681 (1997). On its face, this holding might seem to imply that by petitioning the Holy Royal Court, Harkonnen Oil satisfied this requirement as well. However, a further inquiry into the facts of *IBM* shows that the circumstances of that case are readily distinguishable from those present here. In particular, the court's holding was premised on the fact that the taxpayer, IBM, sought advice from two foreign tax professors, who opined in a joint opinion letter that the arguments available to IBM would be "a near certain loser" in the Italian courts. *Id.* at 673. It was on this basis that the court was hesitant to require IBM to exhaust all available litigation procedures because it likely would not have been practical or effective for it to do so. *Id.* at 673–75. Thus, the court held that the exhaustion requirement was satisfied. *Id.* at 675.

In this instance, however, there is no indication that it would have been impractical or ineffective for Harkonnen Oil to pursue the litigation procedures available to it. Specifically, unlike IBM, Harkonnen Oil never solicited the advice of a competent foreign tax authority. Therefore, it had no reasonable interpretation of the applicable foreign law by a competent authority on which to rely in foregoing the litigation remedies available to it via the Holy Royal Court of Arrakis and the Sietch Council. While the company did petition the Holy Royal Court, the Court did not respond to its request for a determination of IFIL's authority to levy taxes. R. at ¶ 32. In response to this lack of an answer, Harkonnen Oil could have easily appealed the Court's decision or re–petitioned the Court for a determination of IFIL's taxing authority. *See id.* (providing that it took just one day for the Holy Royal Court to respond to Harkonnen Oil's petition). However, it did not. Moreover, as in *P&G*, Harkonnen Oil should have petitioned the Sietch Council for a reduction in its Sietch State tax liability after IFIL laid claim "to the same source of income." *P&G Co.*, 2010 WL 2925099 at *8 ("[T]he onus is on [the taxpayer] to exhaust all practical and effective remedies, *in both countries*, before claiming a foreign tax credit.") (emphasis added). But again, it did not. Having failed to exhaust either of these practical and effective remedies, Harkonnen Oil did not satisfy the exhaustion of remedies requirement of Treasury Regulation 1.901–2(e)(5)(i), and it, therefore, cannot claim a second foreign tax credit on the same stream of income as the Sietch State tax. Rather, Harkonnen Oil, not the U.S. Treasury, should be responsible for such payments because they exceeded the amount of liability under foreign tax law and are thus not compulsory payments pursuant to IFIL's authority to levy taxes. Treas. Reg. § 1.901–2(e)(5).

b. The IFIL levy is a payment in exchange for a specific economic benefit.

In the alternative, the IFIL levy is not a compulsory payment pursuant to IFIL's authority to levy taxes because it is a payment in exchange for a direct specific economic benefit—the right to use Unit #12 to extract resources. Treas. Reg. § 1.901–2(a)(2)(i). Economic benefits that a foreign government does not make available on substantially the same terms to substantially all persons subject to the tax are regarded as specific economic benefits. *Exxon Corp.*, 113 T.C. No. 24 (1999). The Treasury Regulations further specify that a right to use, acquire, or extract resources that a foreign country owns or controls is also a specific economic benefit. Treas. Reg. § 1.901–2(a)(2)(ii)(B). Here, Harkonnen Oil received the right to extract resources from Unit #12 in exchange for payment of the IFIL levy. Although IFIL does not *own* the minerals being extracted from Unit #12, it certainly *controls* them within the meaning of the statute. As such, Harkonnen Oil received the specific economic benefit of a right to extract government–controlled resources, and its payments are therefore not compulsory payment pursuant to IFIL's authority to levy taxes.

The Arrakis royal family owns the minerals within the Caladan Oil Field, not IFIL. R. at ¶ 2. However, even though IFIL does not own the minerals being extracted from Unit #12, it certainly controls them within the meaning of regulation 1.901–2. A foreign government controls property it does not own if it "exhibits substantial indicia of ownership with respect to the property." Treas. Reg. § 1.901–2(a)(2)(ii)(D). This standard is easily satisfied here because IFIL wanted its control over the region to be known. Indeed, the Record reflects that on March 20, 2011, IFIL "forcefully took control" of Unit #12. R. at ¶ 30. Ms. Mohiam also released a recorded statement stating that "IFIL [would] control oil production from Unit #12" until Harkonnen Oil paid tribute to it. *Id.* Thus, despite not owning the minerals extracted from Unit #12, IFIL nevertheless controlled them by exhibiting "substantial indicia of ownership" over the minerals.

Pursuant to the IFIL Lease, the exclusive right to extract such IFIL–controlled resources from Unit #12 was granted to Harkonnen Oil. This is precisely the type of specific economic benefit which was contemplated by the Treasury Regulations in that it is a right to extract government–controlled resources not made available on substantially the same basis to anyone else. Treas. Reg. § 1.901–2(a)(2)(ii)(B). Indeed, this "tax" was not imposed upon anyone other than Harkonnen Oil nor was it imposed for any other purpose than for the right to extract resources specifically from Unit #12. As such, the IFIL levy constitutes a concession to extract government–controlled petroleum and is thus a payment in exchange for a specific economic benefit. Therefore, the tax payments made by Harkonnen Oil to IFIL may not be credited because they were not compulsory payments made pursuant to IFIL's authority to levy taxes. Treas. Reg. § 1.901–2(a)(2)(i).

B. Alternatively, even if the IFIL levy is held to constitute a tax, no tax imposed by IFIL may be credited under the Internal Revenue Code.

Assuming the Court holds the levy imposed by IFIL to constitute a tax, it nevertheless cannot be claimed as a foreign tax credit because no tax imposed by IFIL is creditable. Under sections 901 and 903, certain taxes paid to a "foreign country" may be claimed as a foreign tax credit. However, IFIL does not meet the statutory requirements to qualify as a foreign country, and consequently the foreign tax credit provisions are inapplicable to the IFIL levy. Moreover, taxes imposed by countries with which the United States does not conduct diplomatic relations are also ineligible to be claimed as a foreign tax credit. Therefore, even if the Court finds IFIL to qualify as a foreign country for purposes of the Internal Revenue Code, the IFIL levy is nonetheless not creditable because the U.S. does not conduct diplomatic relations with it. Accordingly, regardless of whether the IFIL levy is otherwise creditable, Harkonnen Oil cannot successfully claim a foreign tax credit for its payments to IFIL.

a. IFIL is neither a foreign state nor a political subdivision of a foreign state and, therefore, is not a valid taxing authority.

The Fourteenth Court of Appeals correctly held that IFIL is not a valid taxing authority because it is not a sovereign political entity within the Sietch State. Under sections 901 and 903, certain taxes paid to a "foreign country" may be claimed as foreign tax credits. Treas. Reg. §§ 1.901–2(a)(1), 1.903–1(a). The term foreign country is defined to mean "any foreign state, any possession of the United States, and any political subdivision of any foreign state or of any possession of the United States." Treas. Reg. § 1.901–2(g)(2). In this regard, IFIL does not qualify as a foreign country because it is neither a "foreign state" nor a "political subdivision" of a foreign state.[3] As such, no tax imposed by IFIL—even if otherwise creditable—may be claimed as a foreign tax credit.

[3] As IFIL has been recognized as a part of the Sietch State, it does not qualify as a possession of the United States or a political subdivision of a possession of the United States. R. at ¶ 32; *see* Treas. Reg. § 1.901–2(g)(2) ("The term 'possession of the United States' includes Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands and American Samoa.").

IFIL does not qualify as a "foreign state" as that term is understood in the United States. The term foreign state on its face indicates "an entity that has a defined territory and population under the control of a government and that engages in foreign relations." *Samantar v. Yousuf*, 560 U.S. 305, 314 (2010); *see also Nat'l Petrochemical Co. of Iran v. M/T Stolt Sheaf*, 860 F.2d 551, 553 (2d Cir. 1988) ("[A] 'state' is generally defined as 'an entity that has a defined territory and a permanent population, under the control of its own government, and that engages in, or has the capacity to engage in, formal relations with other such entities."). But IFIL has neither a defined territory nor a permanent population. Indeed, the Record makes clear that "[f]rom 2008 to the present, IFIL has operated throughout the region, moving from place to place." R. at ¶ 26. Moreover, neither Arrakis nor the Sietch State has yet to agree to a permanent principal location for IFIL within the Sietch Dunes region. R. at ¶ 35. Accordingly, IFIL does not qualify as a foreign country for purposes of the Internal Revenue Code as a foreign state.

Similarly, IFIL does not qualify as a "political subdivision" of a foreign state as that term is understood for purposes of U.S. tax law. Although the term political subdivision is not defined within the Internal Revenue Code, the accompanying Treasury Regulations provide that a political subdivision is "any division of a state or a local government that is a municipal corporation or has been delegated the right to exercise part of the sovereign power of such a unit." Treas. Reg. § 1.103–1(b). Therefore, in determining whether IFIL is a political subdivision, the relevant question is whether it was authorized to exercise power that could properly be characterized as "sovereign." *Tex. Learning Tech. Group v. C.I.R.*, 958 F.2d 122, 124 (5th Cir. 1992). But IFIL received no such authorization from either the Republic of Arrakis or the Sietch State. Indeed, the Arrakis Constitution was amended specifically to limit the Sietch State's taxing authority to only one tax. R. at ¶ 18.4. Furthermore, because IFIL is a part of the Sietch State, it has no authority to levy taxes in addition to the preexisting Sietch State tax for which Harkonnen Oil has already received a foreign tax credit. R. at ¶ 32.

Additionally, IFIL is not the type of established local government contemplated by the statute as a political subdivision—namely, a province, city, or other municipality of a foreign state. *See P&G Co.*, 2010 WL 2925099, at *9 (finding that the Chonan Municipal Government is a political subdivision of South Korea and thus a foreign country within the meaning of Treas. Reg. §1.901–2); Rev. Rul. 74–435, 1974–2 C.B. 204, at *2 (finding that the Canton of Vaud and its communes or municipalities are political subdivisions of Switzerland and thus are also foreign countries within the meaning of section 901); *Texasgulf, Inc. v. United States*, 84 A.F.T.R.2d 99–6642 (Fed. Cl. 1999) (finding that Ontario is a political subdivision of Canada and thus a foreign country under section 901). In particular, IFIL does not answer to the Republic of Arrakis nor to the Sietch State. Rather, six of its seven electoral votes for its entire governing structure, the Leader Elect, rest in the royal families of Al Dhanab and Anbus. R. at ¶ 27. The remaining seventh vote is submitted by a majority election among all individuals pledging membership to IFIL, but because IFIL has no established presence, this seventh vote is also not necessarily controlled by citizens of Arrakis. *Id.* Moreover, IFIL has violated the Arrakis Constitution by levying a second Sietch State tax and also by not pledging the proceeds as tribute to Arrakis. R. at ¶ 18. Instead, IFIL deposits the check in a foreign bank account set up for it by the heir to the throne of Anbus and pays a twenty percent tribute to the monarchies of Al Dhanab and Anbus. R. at ¶ 33. In other words, IFIL is indirectly controlled by two foreign countries and does not operate as a province, city, or municipality of Arrakis or the Sietch State. Thus, it is not a political subdivision of Arrakis. Accordingly, IFIL does not qualify as a foreign country for purposes of the Internal Revenue Code, and the tax payments made to it by Harkonnen Oil are therefore not creditable.

b. The United States does not conduct diplomatic relations with IFIL, and, therefore, no tax payment imposed by it is creditable.

In the alternative, even if IFIL is found to otherwise qualify as a "foreign country," no tax payment imposed by IFIL is creditable because the United States does not conduct diplomatic relations with it. Pursuant to section 901(j), taxes paid or accrued to certain countries are not creditable regardless of whether the taxes otherwise qualify as a foreign tax credit under any other provision of Part III. Income from Sources Without the United States. 26 U.S.C. § 901(j)(1). Thus, where section 901(j) is applicable to a particular country, no tax imposed by it may be credited under either section 901 or section 903, both of which fall under Subpart A. of Part III. *See* INT'L INCOME TAX AND ESTATE PLANNING § 3:31 (2d ed. 2013) ("Income taxes paid [to section 901(j)] countries are ineligible for the credit."). Assuming IFIL is held by this Court to qualify as a foreign country, it also qualifies as a country to which section 901(j) applies because the United States does not conduct diplomatic relations with it. *See* 26 U.S.C. § 901(j)(2)(iii). As such, the Fourteenth Court of Appeals was correct in holding that no tax imposed by IFIL may be claimed as a foreign tax credit.

Recognition of a country is a critical step in establishing diplomatic relations with the United States. *Zivotofsky ex rel. Zivotofsky v. Secretary of State*, 725 F.3d 197, 205 (D.C. Cir. 2013). The Supreme Court has stated that the "refusal to recognize has a unique legal aspect. It signifies this country's unwillingness to acknowledge that the government in question speaks as the sovereign authority for the territory it purports to control." *Banco Nacional de Cuba v. Sabbatino*, 376 U.S. 398, 410 (1964). Political recognition is an exclusive function of the Executive. *Id.* Thus, if the Executive does not recognize a country as a sovereign authority, the country cannot be said to have diplomatic relations with the United States.

The IFIL organization is not recognized as a sovereign government entity by the United States. On January 2, 2011, IFIL was recognized as a legitimate foreign government for the first time by Al Dhanab and Anbus, the two countries which essentially control IFIL through their six out of seven electoral votes for the organization's Leader Elect. R. at ¶¶ 27, 28. Subsequently, these two countries petitioned the United States to recognize IFIL, and the U.S. "agreed to look at the matter for a [later] determination." R. at ¶ 28. At that point in time, there can be no question that the U.S. had not yet recognized IFIL and had no diplomatic relations with it. Therefore, section 901(j) applied to IFIL in January 2011.

On April 16, 2011, the President of the United States issued Executive Order 14012, which Petitioner will likely argue constitutes the establishment of U.S. diplomatic relations with IFIL. R. at ¶ 34. However, the order's language—that the U.S. "would like to establish trade relations with" IFIL—indicates precisely the opposite. It necessarily implies that such relations had yet to be established as of that date. *Id.* Moreover, the underlying message of Executive Order 14012 was to simply convey that the U.S. would be willing "to help [IFIL] obtain freedom." R. at ¶ 34. Again, this language expressly indicates that the Executive had not yet recognized IFIL as a sovereign entity; rather, it was conveying that the U.S. was willing to help IFIL achieve that status and would like to establish trade relations with it. Accordingly, because the Executive has not recognized IFIL as a sovereign entity, the United States does not conduct diplomatic relations with IFIL. Therefore, section 901(j) is applicable to IFIL, and thus no tax payments made to it are creditable under any provision of the Internal Revenue Code.

CONCLUSION

For these reasons, Respondent respectfully requests that this Court affirm the judgment of the U.S. Court of Appeals for the Fourteenth Circuit and hold Harkonnen Oil's tax payments to the Republic of Arrakis and IFIL not creditable under the Internal Revenue Code.

Respectfully submitted,

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Team 25
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