No. C15-1701-01

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

October Term 2014

BRIEF FOR RESPONDENT

TEAM 26

BRIEF FOR RESPONDENT

<u>QUESTIONS PRESENTED</u>

I. Did the Fourteenth Circuit correctly deny Petitioner's claim for a foreign tax credit for its payment of the Arrakis Foreign Tax where the tax does not allow for full deduction of expenses like the U.S. income tax; and where it is imposed in addition to, and not a substitute for, the general Arrakis income tax?

II. Did the Fourteenth Circuit correctly deny Petitioner's claim for a foreign tax credit for its payment of an "income tax" levied by the Inter-Sietch Fremen Independence Leauge, a non-state entity, with no defined role in the Arrakisian Constitution, and whose authority to impose the levy was not challenged by Petitioner before the Sietch Council?

TABLE OF CONTENTS

TABLE OF CONTENTS

<u>TABLE OF AUTHORITIES</u>

Federal Statutes

Other Authorities

U.S. Constitutional Provisions

U.S. Supreme Court Cases

Federal Regulations

U.S. Courts of Appeals Cases

U.S. District Court Cases

OPINIONS BELOW

The Internal Revenue Service ("IRS") conducted an audit of Petitioner's 2012 United States Tax return and denied two claims for Foreign Tax Credits. R. at 16-17. After failed negotiations with the IRS, Petitioner paid the full tax and filed suit for review and refund in the United States District Court for the Central District of New Tejas. R. at 17. The district court denied the refund and Petitioner timely appealed. R at 2, 17.

The Court of Appeals for the Fourteenth Circuit affirmed the district court in an unpublished decision reproduced at pages 2-21 of the Transcript of the Record. Petitioner appealed and The Supreme Court of the United States granted review for the October 2014 term.

STATUTORY PROVISIONS

Two primary statutes govern this case along with the associated United States Treasury regulations interpreting the statutes. The full text of Taxes of foreign countries and of possessions of United States, 26 U.S.C. § 901 (2013); Credit for taxes in lieu of income, etc., taxes, 26 U.S.C. § 903 (2005); Income, war profits, or excess profits tax paid or accrued, 26 C.F.R. § 1.901–2 (2013); and Dual capacity taxpayers, 26 C.F.R. 1.901–2A (2013) are reproduced in the Appendix.

JURISDICTIONAL STATEMENT

This Court has jurisdiction to hear appeals from final decisions of the Court of Appeals under 28 U.S.C. § 1254(1).

STANDARD OF REVIEW

This Court reviews questions of law *De Novo*, and reviews findings of fact for clear error. *C.I.R. v. Duberstein,* 363 U.S. 278, 291, 80 S. Ct. 1190, 1200, 4 L. Ed. 2d 1218 (1960).

STATUTES INVOLVED

The relevant portions of 26 U.S.C. § 901 ("§901"), 26 U.S.C. § 903 ("§ 903"), and Treasury Regulation § 1901.2, 1.901.2A, and § 901 of the Internal Revenue Code are reproduced in the appendix to this brief.

STATEMENT OF THE CASE

The Facts

This case concerns a claim for a tax refund. Harkonnen Oil Company ("Harkonnen"), a Delaware corporation based in New Tejas, claimed Foreign Tax Credits on their 2012 U.S. income tax return for levies paid to two foreign states while operating abroad. The Internal Revenue Service, the Central District Court of New Tejas, and the United States Court of Appeals for the Fourteenth Circuit each reviewed and found the payments did not qualify for Foreign Tax Credits. Harkonnen continues to appeal to this Court.

THE CALADAN OIL FIELD LEASE WITH ARRAKIS

In 2007, Harkonnen identified an extensive oil and natural gas field sitting under 231,000 square miles of the Republic of Arrakis ("Arrakis"). R. at 1-2. After conducting studies of this Caladan Oil Field ("Caladan"), Harkonnen entered into lease negotiations with the Arrakis President and lifetime ruler, Jules Corrino ("President Corrino"), to profitability extract, produce, and sell the nearly 150 billion oil and naturals gas units contained under the Caladan field. R. at 3-4.

The record reveals two important economic facts central to the negotiations: (1) President Corrino's family owned all mineral rights in Arrakis and Harkonnen was concerned he would attempt to exact prohibitively-high royalties for the lease;

and (2) under historical religious precedent going back hundreds of years, foreign entities operating in the country were not required to pay income taxes to Arrakis. R. at 3-4. In fact, the Holy Royal Court of Arrakis, responsible for all tax disputes, had recently reaffirmed that precedent. R. at 4.

In March 2008, just over a month after negotiations began, President Corrino announced a change to the long-standing tax doctrine and instituted the "Republic of Arrakis Foreign Value Tax". R. at 5. He declared all foreign entities that operated machinery on Arrakis territory were subject to a tax based on their gross earnings generated in Arrakis. R. at 5. Missing from the declaration of this value tax was the specific tax percentage rate, which was deferred to a future date. R. at 5. Under his plan, the Central Bank of Arrakis would collect and deposit all funds generated by foreign entities subject to the new tax, calculate the appropriate taxes to remit directly to the Arrakis Treasury, and release the remaining funds to the foreign entity. R. at 5.

Negotiations for the lease continued until June 30, 2008, when President Corrino announced the Republic of Arrakis Foreign Value Tax would be renamed the "Republic of Arrakis Foreign Tax" ("Foreign Tax") and set a rate of forty-five percent. R. at 7. That very same day, Arrakis granted Harkonnen an exclusive lease to develop the entire 231,000 square-mile Caladan Oil Field in exchange for a one-time bonus payment of fifty-five million dollars and a fifteen percent royalty. R. at 5. Harkonnen also agreed to pay the Arrakis Foreign Tax. R. at 5. Drilling and production began soon after and by November 2009, Harkonnen started production in a new portion of the Caladan field in Arrakis known as the Sietch Dunes. R. at 7-8.

SIETCH STATE INDEPENDENCE AND THE SIETCH LEASE

Four months later, on March 20, 2010, the native population of the Sietch Dunes region formed a political organization and declared independence from Arrakis. R. at 8. The Arrakis military moved to quell the uprising. R. at 8.. A bloody battle waged for three weeks and resulted in thousands of casualties for both sides before representatives of both groups and Harkonnen Oil engaged in peace talks. R. at 8. The talks produced a ceasefire that led to the Sietch Dunes Peace Treaty. R. at 8. This treaty designated the Sietch Dunes region as an Important Province of Arrakis now called the Sietch State. R. at 8.

One treaty provision included amending the Constitution of Arrakis to create the cabinet position of Vice-President to be appointed by the Sietch State. R. at 8-9. This Vice-President had the power to, among other things, levy a single tax within the Sietch State, and appoint a judicial body known as the "Sietch Council." R. at 9. Pursuant to its authority under the Constitution, the Sietch State signed a lease with Harkonnen to explore and produce oil in the Sietch Dunes in exchange for a bonus and royalty payment. R. at 10. The Sietch State also levies a ten percent tax on all income generated within the Sietch State (regardless of citizenship) minus applicable deductions. R. at 10. Harkonnen agreed to pay this levy, separate and apart from the Arrakis Foreign Tax. R. at 10. Following the peace settlement, the United States designated the Sietch State a "Quasi-Autonomous Region" and established formal diplomatic relations complete with a temporary consulate office in the Arrakis capital. R. at 10-11.

The Inter-Sietch Fremen Independence League and the IFIL Lease

Just eight months later, on the last day of 2009, the newly formed Sietch State suffered its own insurrection when a group known as the Inter-Sietch Fremen Independence League ("IFIL") launched a rebellion in the Sietch State. R. at 11. IFIL is a splinter group that diverged from the terrorist organization Bene Gesserit sometime in the year 2005. R. at 11 IFIL had operated from various bases in the region surrounding Arrakis and had the backing and financial support of Al Dhanab and Anbus, two countries that share a border with Arrakis. R. at 12.

Since the rebellion, IFIL has been formally recognized by just four foreign countries in the region as an independent state of the Sietch Dunes. R. at 12-13. Arrakis and the Sietch State denied the legitimacy of IFIL's claim to the Sietch State but did not respond with military or police forces. R. at 13. Soon IFIL took over an area in the Sietch State known as the Badlands and later forcefully took control of a small Harkonnen drilling station known as Unit #12 located in Onn, the historical seat of the Sietch Empire Throne. R. at 13. IFIL's "Leader Elect", Jessica Moiham demanded Harkonnen pay a tribute to IFIL for Unit #12 production. R. at 13. In response, Harkonnen met with Moiham and signed a lease agreeing to pay IFIL a five hundred and fifty thousand dollar bonus payment and a five percent royalty ("IFIL Lease").

Harkonnen objected to an additional IFIL demand of a two percent income tax on Unit #12 production and protested to President Corrino. R. at 13-14. President Corrino counseled Harkonnen that tax dispute authority rested with the

Holy Royal Court of Arrakis so Harkonnen petitioned the court for a determination of IFIL authority to levy this additional tax. R. at 14. On March 24, 2011, the court declared, "Arrakis recognizes IFIL as a part of Sietch." R. at 14. Harkonnen subsequently paid the income tax to IFIL. R. at 14.

On April 15, 2011, Moiham lost a bid to become the Vice President of the Sietch State. R. at 14. On April 16, 2011 the President of the United States issued Executive Order 14012 declaring "IFIL a sovereign friend of the United States, whom we would like to establish trade relations with." R. at 14. Executive Order 14012 also stated, "the United States would always continue to help individuals around the world obtain freedom." R. at 14.

THE CALADAN OIL CONFERENCE

On May 16, 2011, representatives of Harkonnen, Arrakis, the Sietch State, and IFIL met for the First Annual Caladan Oil Field Conference where they discussed forecast and technology matters related to Caladan Oil Field production. R. at 15. They also discussed a permanent territorial settlement for IFIL, but failed to come to any conclusions. R. at 15. Following the conference, the leaders formally announced their tax levies. R. at 15. The Sietch State reaffirmed a ten percent tax minus deductions; IFIL confirmed a continued rate for Unit #12 of two percent minus deductions, for a total of twelve percent within the Sietch Dunes region. R. at 15. President Corrino declared the Arrakis Foreign Tax would be reduced from forty five to thirty three percent, a decrease of twelve percent. R. at 15.

At this time, President Corrino also issued Proclamation 102 that now allowed foreign corporations to take all tax deductions available to Arrakis citizens, but capped the total deduction amount allowed at ninety five percent of the dollar value of an Arrakis citizen in accordance with Arrakis religious doctrine. R. at 15.

HARKONNEN'S 2012 TAX RETURN

Harkonnen filed its 2012 United States income tax return claiming Foreign Tax Credits for the payments to Arrakis, the Sietch State, and IFIL. R. at 16. Prior to 2012, Harkonnen had taken all Arrakis expenses as deductions and not credits. R. at 16. After an audit, the IRS deemed the payment to Arrakis was an unqualified foreign tax credit because it failed to reach net income. R. at 17. Likewise, the tax payment to IFIL was determined to be an unqualified foreign tax credit because IFIL was not a proper taxing authority; the tax violated the Sietch Dunes Peace Treaty's limitation of a single tax within the Sietch State; and

Harkonnen failed to exhaust its remedies to challenge the IFIL tax under Sietch State domestic law. R. at 17.

The Procedural Summary

Following the IRS audit and denial of the Arrakis and IFIL Foreign Tax Credits, Harkonnen paid the tax and demanded a refund. R. at 17. Harkonnen filed suit in the Central District Court of New Tejas, which ruled for the United States. R. at 17.

Harkonnen appealed to the Fourteenth Circuit, which affirmed the decision of the district court. R. at 19. The court determined that 26 U.S.C. §§ 901 and 903 was the governing law. R. at 17. First, as to the Arrakis payments, the court found the tax was not a creditable foreign tax because, (1) the renamed Foreign Value Tax was not an income tax in the U.S. sense, (2) the tax did not credibly reach net income as required by the statute, and (3) Proclamation 102's cap on foreign corporation deductions failed to allow for "significant cost recoveries" as required by treasury regulations governing § 901. R. at 17. In addition, the court held the Arrakis tax was not a tax "in-lieu of" an otherwise applicable income tax under §

903, but rather a “withholding tax” under that statute due to the Central Bank of Arrakis’ practice of holding the taxed funds prior to remittance. R. at 18.

As to the IFIL tax on Unit #12, the court also found it did not qualify under §§ 901 or 903. R. at 19. The court reasoned, (1) IFIL was not a valid taxing authority, (2) the tax was an impermissible second tax that violated the Arrakis Constitution that allowed for only a single tax within the Sietch State, and (3) Harkonnen failed to exhaust all remedies available under the foreign law to challenge the IFIL tax. R. at 19..

Harkonnen appealed and this Court subsequently granted certiorari. R. at 1.

SUMMARY OF THE ARGUMENT

This Court must affirm the Fourteenth Circuit. On its face, this is a tax interpretation case, but one with broad policy implications. Congress created the Foreign Tax Credit statutes, § 901 and § 903, to provide relief from double taxation when corporations do business abroad and are taxed on income by foreign nations. IRS regulations interpret these statutes and provide strict rules for their use. In 2011 U.S. taxpayers claimed over 100 billion in Foreign Tax credits. [1]It is the responsibility of the taxpayer claiming the credit to establish that a foreign tax is an income tax in the U.S. sense under §901 or a tax "in lieu" of a U.S. income tax under §903. But Harkonnen's claim must fail for three reasons.

First, the IRS, the district court and the Fourteenth Circuit correctly determined the Republic of Arrakis Foreign Tax is not an income tax in the U.S. sense and does not qualify for a foreign tax credit under § 901. Specifically, the Foreign Tax does not sufficiently reach net income because it artificially caps normal business expenses under Arrakis religious doctrine. In addition, the Foreign Tax does not meet the criteria of § 903 since it is not an Arrakis substitute income tax. As a "dual capacity taxpayer" receiving an exclusive benefit from Arrakis, Harkonnen has a heightened duty to prove the foreign levy is legitimately an income tax and not a premium paid for the Caladan Oil Lease.

Second, the IRS, the district court and the Fourteenth Circuit also correctly determined that payment to IFIL does not qualify for a foreign tax credit under §

[1] http://www.irs.gov/uac/SOI-Tax-Stats-Corporate-Foreign-Tax-Credit-Table-1

901. IFIL is not a "foreign country" within the meaning of § 901 and the guiding regulations. Furthermore, the IFIL levy is not a tax under § 901 because it was not levied pursuant to a valid taxing authority, it was paid in exchange for a "specific economic benefit," and it was not compulsory. Harkonnen also failed to exhaust all Arrakis remedies to challenge the IFIL levy.

Third, allowing the credit would upset the balance that Congress and the Secretary of the Treasury have struck between the competing policy interests that § 901 is designed to serve. In seeking reversal, Petitioner invites this Court to ignore the plain requirements of § 901 and judicially expand its reach. This action threatens the stability of current tax treaties and disadvantages corporations that adhere to § 901 requirements. Harkonnen can still claim the payments as deductions from income. The power to make any additional changes to policy rightly rests with the elected Congress.

<u>Argument</u>

The United States taxes its citizens and domestic corporations on their worldwide income regardless of where that income is earned. U.S. Const. amend. XVI. Thus, a potential for double taxation exists when a domestic corporation earns income abroad and a foreign nation taxes that same income. As far back as 1918, Congress sought to remedy this situation by creating the Foreign Tax Credit [2]– a dollar-for dollar credit against U.S. tax liability for income taxes paid to a foreign nation. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 7 (1932) ("[T]he primary design of the provision was to mitigate the evil of double taxation.").

But double taxation is not so daunting that its mere specter should stampede the Treasury into subsidizing every rogue state and splinter cell that labels its predations as taxes. Nor was the credit ever intended to reimburse corporations for any manner of normal fees, royalties, or tributes extracted by foreign governments. Instead, the Foreign Tax Credit is "a privilege extended by legislative grace" that

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[2] Section 131(a)(1) of the Internal Revenue Code of 1939 and 26 U.S.C.A. § 131(a)(1) preceded the current § 901 with the definition of "income tax" unchanged.

should be strictly construed in accordance with the statutes. *Inland Steel Co. v. United States*, 677 F.2d 72, 79 (Ct. Cl. 1982).

When the IRS and both lower courts applied that strict construction for Harkonnen Oil's 2012 tax return, they all came to the same conclusion: Harkonnen claimed unqualified Foreign Tax Credits. Specifically, the Arrakis Foreign Tax and payments to IFIL do not satisfy the clear requirements of § 901 or § 903. R. at 2, 16. Consequently, they cannot be the basis for a Foreign Tax Credit. As a "dual capacity" taxpayer under Treasury guidelines interpreting the statutes, Harkonnen bears the burden of demonstrating any payments to Arrakis and IFIL are qualified levies that satisfy the statutes. 26 C.F.R. § 1.901-2A. But this Court should reject Harkonnen's arguments and deny the refund for three reasons.

First, the Arrakis Foreign Tax is not a creditable tax under § 901. It does not operate as an income tax in the U.S. sense because it fails to reach net income. This is because Arrakis religious law arbitrarily limits Harkonnen from deducting otherwise available expenses from gross income. Neither is the Foreign tax one "in-lieu of" an otherwise applicable tax under § 903 because it does not substitute for a generally applicable income tax within the congressional purpose of § 903.

Second, the tax payment to IFIL on Unit #12 production is not a creditable tax because IFIL is not a "foreign country" within the meaning of § 901. Additionally, the IFIL levy itself is not a "tax" for purposes of § 901 because it violates the Arrakis Constitution. Moreover, Harkonnen failed to exhaust all local remedies to challenge this tax.

Third, granting a refund for the credit without fully satisfying the statute would upset the balance that Congress and the Secretary of the Treasury have struck between the competing policy interests that § 901 is designed to serve. That upset could invite an untold number of claims by other corporations seeking to amend past tax returns for their share of the credit bonanza.[3] Courts would be mired in litigation testing all types of exotic foreign payments against the watered-down statute. Instead, this Court should interpret the Foreign Tax Credit

[3] While taxpayers generally have three years after filing to amend a tax return and seek a refund, special rules for refunds involving foreign tax credits extend that time to ten years. (26 U.S.C. § 6511(d)(3)(A)).

regulations in accordance with their plain text and judicial precedent and deny the refund. Yet Harkonnen does not leave empty-handed. Under the current tax code, they still may be able to deduct the payments as expenses from gross income. But the power to fashion any new exemptions to aid corporate profit appropriately rests with an elected congress.

I. THE FOURTEENTH CIRCUIT PROPERLY FOUND THE ARRAKIS FOREIGN TAX FAILS TO FULLY SATISFY THE REQUIREMENTS OF § 901 AND § 903. ADDITIONALLY, HARKONNEN HAS NOT MET ITS BURDEN AS A "DUAL CAPACITY TAXPAYER" IN SHOWING THE ARRAKIS FOREIGN TAX IS SOLELY A TAX ON INCOME.

The regulations governing the Foreign Tax Credit are lengthy and technical, to be sure. But common sense demands such protection so this valuable policy tool is used wisely, and only as Congress intended – to eliminate the burden of double taxation of income.

So for the Arrakis Foreign Tax to merit a full dollar-for-dollar credit against U.S. income tax liability, it must substantially mirror the nature and function of a U.S. income tax. But as the Fourteenth Circuit held, it fails to meet the minimum requirements of §§ 901 or 903. Moreover, Harkonnen benefits from a special relationship with Arrakis that carries with it a correspondingly higher burden of proof in the tax code. This burden also has not been met.

A. THE ARRAKIS FOREIGN TAX IS NOT A CREDITABLE TAX UNDER § 901.

This Court recently reiterated that Treasury Regulation 26 C.F.R. § 1.901-2 is the governing law in a Foreign Tax Credit analysis. *PPL Corp. v. C.I.R.*, 133 S. Ct. 1897, 1901 (2013). To determine if a foreign levy is a creditable tax, this regulation asks if the "predominant character of that tax is that of an income tax in the U.S. sense." 26 C.F.R. § 1.901-2. Put another way, does the tax operate like the U.S. income tax so the taxpayer is actually penalized by paying an income tax once to the foreign nation and then a second time to the United States?

For the answer to be "yes", the tax must be "likely to reach net gain in the normal circumstances in which it applies." *Id.* Since the U.S. only taxes income on net gain, this common-sense requirement insures that a taxpayer does not pay an inflated income tax to a foreign nation then turn around a seek a Foreign Tax Credit for this payment that is greater than the taxpayer would have received under U.S. tax law.

Naturally, a foreign nation's accounting and tax procedures may be quite different from the U.S. Therefore, the regulations further explain that a foreign tax likely meets the "net gain" standard "*if and only if* the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements.") 26 C.F.R. § 1.901-2 (emphasis added). In applying this three-part test, the IRS did not find the Arrakis Foreign Tax failed the "realization" or "gross receipts" requirements. R. at 16-17.

However, it is impossible for the Arrakis Foreign Tax to reach real net gain since Arrakis forbids Harkonnen from deducting all their costs associated with producing income. R. at 15. Presidential Proclamation 102 declares foreign corporations may only deduct costs of producing income at ninety-five percent of the tax deductions allowed to the average Arrakis citizen. *Id.* This is based on Arrakis religious beliefs that a foreign entity cannot have the same benefits as an Arrakis citizen. *Id.*

Even though this current religious edict disallows just five percent of expenses, there is no valid basis in § 901 or the treasury regulations for meeting the "net income" test if deductions are arbitrarily capped. Instead, the "net income" requirement is met when "[r]ecovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts" are deducted. 26 C.F.R. § 1.901-2. While the language of the regulation allows for functional differences in a foreign sovereign's approach to deductions, the text does not allow for artificially limiting expenses. *Id.*

For example, the regulations allow for timing differences between U.S. and foreign tax procedures such as the amount of years to capitalize a cost or if the foreign nation uses a different tax year. Similarly, the regulations permit reasonable differences in the nature of what types of expenses are deductible. As long as the foreign levy permits recovery of the significant expenses or uses "a method that is likely to produce an amount that approximates, *or is greater than*, recovery of such significant costs and expenses. § 1.901–2 (emphasis added).

Wholly different is Proclamation 102's religiously imposed ceiling on expenses. R. at 15. This is not merely a procedural difference in expense type or timing. Rather, Harkonnen will never be able to recover its significant costs and expenses above this artificial limit. Consequently, unlike the U.S. income tax, the Arrakis Foreign Tax burdens an amount greater than net income. Then, by claiming a Foreign Tax Credit on their U.S. income taxes, the Arrakis treasury (controlled by President Corrino and his family) is advantaged at the expense of the U.S. Treasury.

This Court's recent analysis of the "net income" test of § 901 in *PPL* is instructive. 133 S. Ct. at 1902. There, a U.S. corporation that owned twenty five percent of a private United Kingdom electricity supplier sought a foreign tax credit for a "windfall tax" imposed by the British government. *Id.* at 1901. The IRS had disallowed the credit because it seemed to be a tax on the value of the company before and after privatization, as opposed to a tax on income. *Id.* at 1903.

As a threshold issue, this Court did not find the name of the U.K. tax to be determinative to its creditability. *Id.* at 1902. Likewise, although the lower court found the original name, "Republic of Arrakis Foreign Value Tax", to be a disqualification, the United States does not argue that this fact affects creditability. R. at 17. It is the function of the tax, not the name given it by a foreign government that is determinative. 133 S.Ct. at 1902; *See Biddle v. Comm'r of Internal Revenue*, 302 U.S. 573, 578-79 (1938) (holding nothing in the statute suggests a "shifting standard" should apply by way of foreign characterizations).

In the complex tax formula at issue in *PPL*, this Court reasoned that, although the "windfall tax" was calculated as the difference between two values, the formula used the *actual* profits earned. *Id.* at 1905. The actual profits were the realized net income of the company (gross receipts minus expenses) and formed the basis for a "classic excess profits tax" and not a true tax on overall company value. *Id.* at 1905. Therefore, because the "windfall tax" formula had taken into account actual net income, it was eligible for a foreign tax credit under § 901. 133 S.Ct. at 1907 (holding the windfall tax was based on "true net income"); *Entergy Corp. & Affiliated Subsidiaries v. C.I.R.*, 683 F.3d 233, 236 (5th Cir. 2012) *cert. denied sub nom. C.I.R. v. Entergy Corp.*, 133 S. Ct. 2759, 186 L. Ed. 2d 191 (2013) (holding the windfall tax appropriately reached net income by subtracting operating expenses from gross income).

In contrast, the Arrakis Foreign Tax did not reach true net income because it did not allow for a significant portion of Harkonnen's operating expenses to be recovered. This Court cautioned in *PPL* that substance should prevail over form, and in doing so, found the "windfall tax" creditable. 133 S.Ct. at 1899. For the same reason, the substance of the Arrakis Foreign Tax does not reach true net gain because of the artificial religious restrictions of its form.

Even where the courts have encountered other purposeful foreign limits on expense deduction, they still required a substitute deduction so the foreign tax still reached net gain. In *Exxon Corp. v. Commissioner,* the Tax Court considered the creditability of a U.K. petroleum revenue tax. 113 T.C. 338 (1999). Due to regulations designed to limit corporate tax avoidance, the foreign authority did not allow a deduction for Exxon's interest expenses in calculating net income. *Id.* The court nevertheless found the petroleum tax did meet the "net income" test under § 901 because it substituted another form of deduction that approximated the same amount as the interest expense. 113 T.C. 338; *Texasgulf, Inc. & Subsidiaries v. C.I.R.*, 172 F.3d 209, 216 (2d Cir. 1999) (finding the Ontario Mining Tax to be eligible for foreign tax credits because a processing allowance effectively compensated for the non-deductibility of interest expense and thus reached an approximate net gain); *See also Seatrain Lines, Inc. v. C.I.R.*, 46 B.T.A. 1076, 1080 (1942) (holding a three percent Cuban tax on foreign shippers was an income tax eligible for a foreign tax credit because it had been reduced from six percent to approximate a deduction for normal operating expenses).

Again in contrast, the Republic of Arrakis Foreign Tax provides for no such offsetting deduction to approximate recovery of the expenses denied by

Proclamation 102. It makes no difference to § 901 that the Proclamation's restrictions were made for religious reasons. Tax regulations should be read to incorporate principles of domestic tax law unless a clear congressional command to the contrary can be determined. *Biddle*, 302 U.S. at 578.

Moreover, the record below reflects an inconsistency of Arrakis tax policy interpretation between the Arrakis Holy Royal Court and Presidential Proclamation 102. In *Lord Remington v. Republic of Arrakis*, the Holy Royal Court upheld the long-standing religious doctrine that foreign entities were not entitled to the level of protection of Arrakis citizens, and therefore, could not be taxed. R. at 4. Although Proclamation 102 was blessed and approved by the religious head of Arrakis, it is unclear if that determination takes precedence over decisions by the Holy Royal Court. R. at 16. If Proclamation 102 is struck down or modified by the Holy Royal Court, Harkonnen's payment to Arrakis is less likely to reach net income, making it further ineligible for a Foreign Tax Credit.

B. THE ARRAKIS FOREIGN TAX IS NOT A TAX "IN-LIEU" OF AN OTHERWISE APPLICABLE INCOME TAX UNDER § 903.

When Congress extended the Foreign Tax Credit act in 1942, it added § 903 to provide that a foreign levy could still qualify as an income tax if it was "a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States." 26 U.S.C. § 903.

The legislative history of this statute hints at two congressional reasons for its creation: (1) the Senate Finance Committee determined some foreign countries provided for taxation on an arbitrary basis instead of on income, and (2) some foreign nations were taxing U.S. companies on gross receipts due to "administrative difficulties" in determining their operating expenses. S. REP. No. 1631, 77th Cong., 2d Sess. 131-32 (1942).

As an initial matter, nothing in the language of the Arrakis Foreign Tax pronouncements indicate it was intended as a tax in-lieu of an income tax for purposes of § 903. In fact, the Republic of Arrakis has taxed its own citizens on income going back hundreds of years. R. at 4. Under the current code's operation, citizens of the Arrakis hereditary bloodline pay an income tax rate five percent lower than citizens born from the Sietch Throne bloodline. R. at 4. All Arrakis citizens are allowed to take deductions from income that are identical to those allowed under U.S. tax law. R. at 4.

These facts negate any inference that the Arrakis tax system is one contemplated by the congressional purpose of § 903. The Arrakis Foreign Tax cannot be a substitute income tax because Arrakis has had an income tax in place for hundreds of years. Neither has Harkonnen demonstrated that Arrakis had "administrative difficulties" in determining the applicable Foreign Tax deductions. Indeed, Arrakis already administers tax deductions for its citizens identical to those in the U.S. Moreover, Proclamation 102 requires Harkonnen to deduct ninety five percent of the deductions available to an Arrakis citizen.

Courts that have considered claims for foreign tax credits under § 903 have consistently looked to whether the tax imposed was on gross receipts as a substitution for a generally applicable income tax. *Nw. Mut. Fire Ass'n v. C.I.R.*, 181 F.2d 133, 134 (9th Cir. 1950) (finding an insurance premium tax was in the nature of gross income as a substitute for an income tax); *United States v. Waterman S.S. Corp.*, 330 F.2d 128, 131 (5th Cir. 1964) *aff'd,* 381 U.S. 252, 85 S. Ct. 1389, 14 L. Ed. 2d 370 (1965) (finding a Philippine occupation tax was a tax in-lieu of an income tax).

C. HARKONNEN HAS NOT CARRIED ITS BURDEN AS A "DUAL CAPACITY TAXPAYER" TO DEMONSTRATE THE ARRAKIS FOREIGN TAX WAS SOLELY A TAX ON INCOME.

Harkonnen qualifies as a "dual capacity taxpayer" under the IRS regulations governing § 901. The regulations define "dual capacity taxpayer" as one that is subject to a foreign levy while also receiving a "specific economic benefit" or a benefit that is not substantially available on the same terms to others subject to the levy. 26 C.F.R. § 1.901-2 ("Thus, a concession to extract government-owned petroleum is a specific economic benefit").

The relevance of this designation is important because it assumes the possibility that the foreign government taxes, not just income from business operations, but also the value of the bestowed economic benefit. Accordingly, when Arrakis granted Harkonnen exclusive rights to develop the Caladan Oil Field, Harkonnen became a "dual capacity taxpayer" with the burden of subtracting any payment based on the value of the lease from the taxes strictly on income.

This status places a heightened burden on the "dual capacity taxpayer" claiming foreign tax credit under § 901 or § 903. 26 C.F.R. § 1.901-2A(b)(1). If the foreign levy does not apply equally to the taxpayer receiving the special economic benefit and other persons, the taxpayer must establish what portion of the levy is really a tax (as opposed to a foreign tax that operates as a royalty or fee). *Id.*

Here, Harkonnen has not established that the Foreign Tax applies the same to them as to other taxpayers, either in general or to other foreign corporations that do not operate machinery in Arrakis (like a bank or investment firm). Consequently, to prevail on the claimed credit, Harkonnen must make a further showing that no portion of the Foreign Tax rate of thirty three percent operates as a fee or royalty for the special economic benefit of the exclusive Caladan Oil Lease. Harkonnen has not made this showing.

On the contrary, the facts in the record make the opposite inference. First, the levy was originally called the Foreign Value Tax and applied to gross receipts – a textbook excise tax; the tax name was only changed on the day the exclusive Caladan lease was signed. Second, President Corrino reduced the tax rate by twelve percentage points immediately after the Caladan Oil Field Conference which saw the Sietch State and IFIL formally levy their own taxes totaling twelve percent. Finally, the Foreign Tax requires all funds be deposited in the Central Bank of Arrakis for administration instead of allowing Harkonnen to calculate its gross receipts and deductions and submit the appropriate tax to the treasury. This transaction structure is more consistent with a tribute than a tax.

II. THE CREDIT CLAIMED FOR MONIES PAID BY PETIONER TO IFIL SHOULD NOT BE ALLOWED BECAUSE THAT LEVY WAS NOT A TAX, WAS NOT COMPULSORY UNDER ARRIKISIAN LAW, AND BECAUSE ALLOWING THE CREDIT IS CONTRARY TO THE POLICY AND INTENT OF THE STATUTE.

Petitioner next attempts to obtain a credit for monies paid to IFIL, a non-state entity, with historical ties to the terrorist organization Bene Gesserit, which recently seized control of a swathe of Arrakisian territory. This Court should deny the credit for five reasons. First, IFIL is not a state under international, or U.S. law. Second, IFIL has no legal authority to levy a tax. Third, Even if IFIL had such authority, the levy at issue is not a tax for purposes of § 901 because it runs afoul of the "special economic benefit" rule. Fourth, even if the levy did not run afoul of the special economic benefit rule, the levy is not a tax because it is not compulsory. Finally, this Court should deny the credit because doing so will serve the intent of § 901 and further the policy ends that § 901 was enacted to promote.

A. The IFIL Levy Was Not a Tax Paid to a Foreign Country Because IFIL is Not a Foreign Country For Purposes of § 901.

The Court should uphold the decision below and disallow the credit claimed by Petitioner because IFIL is neither a state, nor a subdivision thereof. In a tax refund case, such as the instant case, the IRS is entitled to a strong presumption that its findings are correct. *Texasgulf, Inc. v. United States*, 17 Cl. Ct. 275, 288 (1989). See also *Welch v. Helvering*, 290 U.S. 111, 115, 54 S.Ct. 8, 9, 78 L.Ed. 212 (1933); *Young & Rubicam, Inc. v. United States*, 410 F.2d 1233, 1244, 187 Ct.Cl. 635, 655, (1969); *Jupiter Corp. v. United States*, 2 Cl.Ct. 58, 61 (1983). The facts appearing in the record do not overcome this presumption.

26 U.S.C. § 901(b)(1) allows domestic corporations like the Petitioner to claim a foreign tax credit for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." The term "foreign country" is defined, for purposes of §901, in Treasury Regulations §1.901-2(g)(2) as "any foreign state…and any political subdivision of any foreign state." 26 C.F.R. § 1.901-2(g)(2). Neither §901, nor §1.901-2 define foreign state, but the Restatement (Third) of International Relations Law provides that "[u]nder international law, a state is 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." Restatement (Third) of Foreign Relations Law § 201 (1987).

IFIL does not have a defined territory, or a permanent population. Rather, IFIL is a transient splinter of Bene Gesserit, a terrorist organization that operates in the countries surrounding Arrakis. R. at 11. IFIL moves from place to place throughout the region as its military fortunes dictate. Although presently, IFIL controls the Badlands and the area around Onn, R. at 13, this occupation's permanent status has not been recognized by Arrakis or the Sietch State. R. at 15. Although both Arrakis and the Sietch State have agreed to "consider" a permanent principal location for IFIL, neither that location, nor IFIL's territorial extent, nor even IFIL's role within Arrakis' constitutional structure has been recognized or defined. R. at 15. IFIL's population is similarly indeterminate. Although IFIL controls the Badlands and the deserted ruins of Onn, it claims to represent all members of the Sietch bloodline, even those residing states neighboring Arrakis. R. at 12. The territorially ambiguous and trans-national nature of IFIL precludes it from qualifying as a foreign state.

IFIL also fails to qualify as a foreign state because, for purposes of U.S. law, and specifically, §901, it does not conduct formal relations with other states. It is true that IFIL has been recognized and funded by Al Dhanab and Anbus, R. at 12-13, has also been recognized by Russia and France, R. at 12-13, and has participated in oil and gas talks with the Sietch State and Arrakis. R. at 15. These facts appearing in the record are, however, insufficient to overcome the presumption that the IRS has correctly determined that IFIL does not conduct formal relations with other states. For purposes of this case, this Court must determine whether the IFIL levy is a tax based, not on international law, but "principles of U.S. law." 26 C.F.R. § 1.901-2(a)(2). Under U.S. law, "[d]iplomatic relations are established by receiving and sending ambassadors or other public ministers." *Americans United for Separation of Church & State v. Reagan*, 786 F.2d 194, 202 (3d Cir. 1986).

Americans United dealt with the issue of the United States' formal relations with the Vatican, *id,* and the history behind it is instructive here for how a non-state entity becomes a state for purposes of U.S. law. For over a thousand years, the Vatican had exercised sovereign authority over territories on the Italian peninsula. Bureau of European & Eurasian Affairs, Dep't of State, Background Note: Holy See (March 2012), available at http://www.state.gov/outofdate/bgn/holysee/197875.htm.

During that time, the Vatican engaged in formal relations with numerous other states. *Id.* See also *Ponce v. Roman Catholic Apostolic Church*, 210 U.S. 296, 318, 28 S. Ct. 737, 745, 52 L. Ed. 1068 (1908) (Noting treaty between the Vatican and Spain.) Nonetheless, U.S. Courts did not treat the Vatican as a State until the executive branch of the United States government officially established diplomatic relations with the Vatican in 1983. See *O'Bryan v. Holy See*, 556 F.3d 361, 372 (6th Cir. 2009). (Collecting cases). When it announced formal relations with the Vatican, the State department explained that relations were to be conducted "“at the level of an embassy.” Dep’t of State, 1 Cum. Digest of U.S. Practice in Int’l Law, 1981–1988, at 894 (1993). This was significant because the exchange of ambassadors “upgrad[ed] that relationship so that our relationship with the Holy See, the government of a sovereign city-state, will conform to the relationship we have with other countries.” Dep’t of State, Daily Press Briefing, at 8 (Jan. 10, 1984). Thus, it is the exchange of ambassadors or similar officials between nations that constitutes formal relations for purposes of U.S. law.

In the instant case, IFIL has exchanged no ambassador or similar official with the United States or, so far as the record reflects, with any other nation. It is true that in Executive order 14012 the President referred to IFIL as a “sovereign friend," R. at 14, but that ambiguous salutation fall far short of the textual and institutional commitment to formal relations by which the executive branch recognizes the legitimacy of States. In the case of the Holy See, the State department exchanged ambassadors with the Vatican and explicitly referred to it as a "government of a sovereign city-state." ." Dep't of State, Daily Press Briefing, *supra*, at 8.. "Sovereign friend" is not nearly so clear, and could be reasonably interpreted as being used merely to pressure the Sietch State and Arrakis to deal fairly with IFIL and avoid the atrocities that are characteristic of war in that part of the world. This inference is bolstered by the order's declaration that "the United States would always continue to help individuals around the world obtain freedom." R. at 14. Tellingly, the order also expresses a desire to "establish *trade* relations" with IFIL. R. at 14. (Emphasis added) If the President had meant formal diplomatic relations, he could easily have said so, or, better still, he could have appointed an ambassador, or, at least, a consul to IFIL, as was done with the Sietch State. R. at 10. Given these facts, IFIL simply does not conduct formal relations within the meaning of U.S. law, it has no defined territory, and no permanent population and is, thus, not a foreign state.

Neither is IFIL a subdivision of a foreign state. Notwithstanding the Holy Royal Court of Arrakis' declaration that "Arrakis recognizes IFIL as a part of Sietch," R. at 14, the Sietch State itself has denied the legitimacy of IFIL's pretentions to state authority. R. at 12-13. The Arrakisian Constitution grants the Sietch State authority to police the state and collect taxes. As part of Sietch, IFIL's taxing authority can only come from the Sietch State, and the Sietch State has withheld that authority. R. at 14. Therefore IFIL is not a foreign country within the meaning of § 901, and its levies are not taxes.

B. THE IFIL LEVY IS NOT A TAX BECAUSE IT WAS LEVIED IN VIOLATION OF THE REPUBLIC OF ARRAKIS CONSTITUTION.

Even if IFIL were a foreign country, IFIL lacks the legal authority to levy a tax under the Arrakisian constitution. As discussed above, Petitioner may claim a foreign tax credit for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." 26 U.S.C. § 901(b)(1). Treasury Regulation § 1.901-2(a)(2)(i) defines a tax as a "compulsory payment pursuant to the authority of a foreign country to levy taxes." Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto. *Id.*

Under principles of U.S. law, in order to levy a tax, an entity must possess constitutional authority to do so. See *Nat'l Fed'n of Indep. Bus. v. Sebelius*, 132 S. Ct. 2566, 183 L. Ed. 2d 450 (2012) (holding that a tax levied on individuals failing to carry health insurance was levied pursuant to Congress' valid taxing authority under the Constitution). In *Sebelius*, this Court pointed to Article 1 § 8 of the United states Constitution as the source of Congress' authority for levying a tax on individuals that did not carry health insurance. *Id.* at 2579. This article provides that "congress may lay and collect taxes." U.S. Const., Art. I, § 8, cl. 1.

In the instant case, there is a different but analogous provision in the Arrikisian Constitution. That provision vests in the Sietch state "the power to decree and levy a single tax." R. at 9. The Arrakisian Constitution further provides that this power will be exercised by the Vice President of Arrakis. R. at 9. To the extent that IFIL has any official status within Arrakis, The Holy Royal Court of Arrakis has declared that IFIL "is a part of Sietch." R. at 14. Thus, is IFIL were a foreign country, it would have that status as a subdivision of the Sietch state, which in turn is a subdivision of Arrakis.

In light of these facts, IFIL's supposed authority to levy a tax on Petitioner fails in two respects. First, the levy would violate the "single tax" provision of the Arrakisian Constitution. The Sietch state has the authority to levy only one tax, and already does so, a 10 percent tax of all income generated within the Sietch State which Petitioner has already taken a credit for. R. at 10. The IFIL levy represents a second, and therefore, illegal tax levied by a subdivision of the Sietch State. The second constitutional problem with the IFIL levy is that the Arrakisian constitution places the authority to levy the single tax with the Vice President. Notwithstanding the dispute over the validity of the most recent Sietch elections, the leader-elect of IFIL is not the Vice president of Arrakis and thus cannot levy a tax under the Arrakisian constitution. Accordingly, the levy is not a payment required pursuant to the valid taxing authority of a foreign country, and thus, is not a tax.

C. THE IFIL LEVY WAS NOT A TAX BECAUSE PETITIONER DERIVED A SPECIAL ECONOMIC BENEFIT IN EXCHANGE FOR THE MONIES LEVIED.

Even if IFIL were a foreign country, and even if it had valid authority to levy a tax, the IFIL levy is still not a tax because it violates § 1.901-2's prohibition of credits for taxes collected in exchange for special economic benefits. §1.901-2(a)(2) states that:

Notwithstanding any assertion of a foreign country to the contrary, 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 (as defined in paragraph (a)(2)(ii)(B) of this section) from the foreign country in exchange for payment pursuant to the levy.

§ 1.901-2(a)(2)(ii)(B) defines a special economic benefit as:

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.

Specifically, § 1.901-2(a)(2)(ii)(B) goes on to provide that "An economic benefit includes…a right to use, acquire or extract resources that a foreign country owns or controls (within the meaning of paragraph (a)(2)(ii)(D) of this section)." And, helpfully, provides an example of a special economic benefit that is particularly germane to this case: "Thus, a *concession to extract government-owned petroleum* is a specific economic benefit, but the right to travel or to ship freight on a government-owned airline is not, because the latter, but not the former, is made generally available on substantially the same terms." 26 C.F.R. § 1.901-2 (a)(2)(ii)(B). (Emphasis added).

A further illustration of this regulation's operation is afforded by *Texasgulf*, 17Cl. Ct. 275. In *Texasgulf,* the Plaintiff claimed a foreign tax credit for its payment of a Canadian mining tax. *Id.* Although the levy at issue in that case was levied in exchangefor the right to extract resources, the United States Claims Court nonetheless found thatthe levy was a tax, because Canada did not own or control the resources being extracted. *Id*. at 285.

As an initial matter, the regulation's application to this case clearly indicates that the IFIL levy was paid in exchange for a specific economic benefit. On March

22 2011, Petitioner's Chief Executive Officer was forced to agree to pay a substantial royalty and bonus fee, in addition to a "2% income tax," the levy at issue here. R. at 13. These payments were demanded in exchange for the resumption of petroleum extraction at Unit 12. R. at 13. Extraction rights for government controlled petroleum is one of the specific examples given by § 1.901-2(a)(2)(ii)(B) of a specific economic benefit. "A foreign country controls property that it does not own if the country exhibits substantial indicia of ownership with respect to the property." 26 C.F.R. § 1.901-2(a)(2)(ii)(D). In the instant case, the fact that IFIL was able to demand and get an oil and gas lease, and shut down Unit 12 untill such time as petitioner agreed to pay it, shows that IFIL owned or at least controlled the resources of Unit 12. Accordingly, Petitioner has received a specific economic benefit in return for paying the IFIL levy and the levy is not a tax.

It should be noted, that while 26 C.F.R. § 1.901-2A, does offer a possible exception to the rule stated above, Petitioner cannot avail itself of that exception. § 1.901-2(a)(2)(ii)(a) provides that taxpayers who pay a levy, part of which is paid in exchange for a specific economic benefit, and part of which is generally applicable to all persons in the foreign country, are classified as "dual capacity taxpayers" and are subject to special rules provided in another regulation, § 1.901-2A.

To paraphrase the relevant part of those rules, if a dual capacity taxpayer pays levied monies, the part of the levy that is equally applicable to persons who do not receive the specific economic benefit is counted as a separate levy that is not considered to be paid in exchange for the economic benefit, and is, thus, a tax. 26 C.F.R. § 1.901-2A(a)(1). So, for example, if, in exchange for an oil and gas lease, a company is required to pay both royalties, and a generally applicable corporate income tax, then the royalty payment is made in exchange for a specific economic benefit, and thus, is not a tax, while the corporate income tax payment, because it is generally applicable, is not made in exchange for a specific economic benefit and is a tax. 26 C.F.R. § 1.901-2A(a)(2). (Examples 1 and 2.)

At first glance, this would seem to describe the instant case, but actually, this exception is inapplicable here. In return for the right to operate unit 12, Petitioner must pay IFIL both a royalty and an "income tax." The royalty is expressly paid in exchange for the right to extract oil and gas, and so is clearly not a tax. The "income tax" however, is also not a tax, because it is not generally applicable to persons other than the Petitioner who do not receive the specific economic benefit. IFIL's leader-elect has stated that "Unit #12 would have its income taxed." R. at 13. In other words IFIL has not imposed this levy on corporations doing business in its territory, but rather has imposed this tax specifically on unit 12. Accordingly, the levy cannot apply to any person other than Petitioner, and so falls outside the exception offered by § 1.901-2A.

D. THE IFIL LEVY WAS NOT COMPULSORY BECAUSE PETITIONER'S INTERPRETATION OF ARRAKISIAN LAW WAS NOT REASONABLE, AND BECAUSE PETITIONER FAILED TO RELY ON COMPETENT AUTHORITY AND FAILED TO EXHAUST ITS REASONABLE REMEDIES.

Even if IFIL were a foreign country, and had valid taxing authority, and the IFIL levy was not paid in exchange for a specific economic benefit, the levy is still not a tax because it is not compulsory. A payment is non-compulsory for the purposes of § 901 whenever it "exceeds the amount of liability under foreign law for tax." 26 C.F.R. § 1.901-2(e)(5)(i). A payment exceeds the amount of liability under foreign law unless "the amount paid is 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. *Id.*

Interpreting this regulation, the United States Court of Federal Claims explained that: The preceding definition… contains three elements: 1) The taxpayer's determination that the payment does not exceed the amount of liability under foreign law must be based on an interpretation of foreign law; 2) the interpretation must be reasonable; and 3) the taxpayer must exhaust 'all effective and practical remedies.' *Int'l Bus. Machines Corp. v. United States*, 38 Fed. Cl. 661, 669 (1997).

Thus, unless Petitioner shows that it was liable for the amount of the IFIL levy under a reasonable interpretation of Arrakisian law, and that it exhausted its reasonable remedies, its payment to IFIL exceeds its liability and so is not compulsory.

Petitioner cannot make either showing. First, as discussed above in section B, Petitioner's interpretation of Arrakisian law was incorrect. Additionally, that interpretation was also unreasonable on its face because it contradicted the plain language of the Arrakisian constitution. However, even though Petitioner's interpretation was, by itself, unreasonable, § 1.901(e)(5)(i) generally provides a safe harbor to taxpayers that "rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts." § 1.901(e)(5)(i) also limits the taxpayer's duty to exhaust its remedies to those remedies which are "effective and practical." Unfortunately for Petitioner, it cannot take shelter within either of these harbors because it did not show that it relied on a competent foreign tax advisor, did not show that it disclosed the relevant facts to the advisor that Petitioner did consult, and did not make any attempt to pursue its most obvious remedy.

The operation of the foreign tax advisor safe harbor is illustrated in *Procter & Gamble Co. v. United States*. No. 1:08-CV-00608, 2010 WL 2925099, (S.D. Ohio July 6, 2010). In *Procter & Gamble*, the court faced a dispute over the validity of foreign tax credits claimed by the plaintiff for taxes paid to Japan and to South Korea. *Id*. at 3. In determining its liability for Korean taxes, the Plaintiff in that case consulted a "well-known Korean law firm." *Id*. at 3. With respect to its Japanese taxes, by contrast, the Plaintiff did not show that it sought advice from a comparable Japanese tax advisor. *Id*. at 8-9. As a result, the court determined that "[g]iven that the [Korean] law firm confirmed the legality of the Korean claims, these claims may be deemed compulsory payments." *Id*. at 10. The court then disallowed the credits claimed for the Japanese tax payments, in part, because the Plaintiff had not shown that it based its interpretation of Japanese law on the advice of Japanese counsel. *Id*. at 10.

Another example of the foreign tax advisor safe harbor appears in *Schering Corp. v. Commissioner of Internal Revenue*. 69 T.C. 579, 600 (1978). In *Schering*, the Petitioner in that case sought to claim a foreign tax credit of a Swiss withholding tax. The Petitioner in that case sought the advice of Swiss counsel, which confirmed the legality of the tax. *Id.* at 590. The *Schering* court then found that this reliance on Swiss counsel justified the Petitioner's interpretation of Swiss law. *Id.* at 591-592.

In the instant case, Petitioner has not shown a similar reliance. Nowhere does the record reveal any consultations between Petitioner and Arrakisian counsel, or any kind of Arrakisian tax professional. The only consultation that the record does show is a single phone conversation between Petitioner's CEO and the President of Arrakis. R. at 14. The record does not show that Petitioner disclosed any of the relevant facts during that conversation, and reveals no tax advice offered by the President. Instead the President merely referred Petitioner to the Holy Royal Court of Arrakis. R. at 14. Even if the President had offered tax advice, the record does not reveal that the President is an Arrakisian attorney, or tax professional. Instead the record states that the President is a hereditary ruler. R. at 3. The Holy Royal Court of Arrakis also did nothing to buttress Petitioner's interpretation of Arrakisian law, confining itself to the observation that "Arrakis recognizes IFIL as a part of Sietch." R. at 14. This paucity of supporting facts prevents petitioner from overcoming the presumption that the IRS's determination of this issue is correct.

Another reason that the *Procter & Gamble* court disallowed the Plaintiff's Japanese tax credits was that the Plaintiff had failed to exhaust its remedies under Japanese law. No. 1:08-CV-00608, 2010 WL 2925099 at 10. In *Procter & Gamble*, the Plaintiff was charged both Japanese and South Korean taxes on a single stream of income. The court considered the question of whether the Plaintiff had properly sought credits from Japan for the taxes that it paid to South Korea. *Id.* The court considered testimony to the effect that the Plaintiff no steps to obtain relief from Japanese tax authorities for its Korean tax payments. *Id.* at 7-8. The court concluded that the Japanese payment was non-compulsory because the Plaintiff had not exhausted its remedies under Japanese law. *Id.* at 8. The court also concluded that Plaintiff was not entitled to avail itself of the provision in § 1.901(e)(5)(i) that limits the remedy requirement to those remedies which are reasonable because the Plaintiff failed to introduce any evidence of its likelihood of success along the Japanese avenues of recovery. *Id*. at 8.

Petitioner in the instant case confronts the identical pair of hurdles faced by the Plaintiff in *Procter & Gamble*. First, as in *Procter & Gamble*, the Petitioner, so far as the record reveals, has made no effort to challenge the IFIL levy before the relevant court. As the Holy Royal Court pointed out to Petitioner, IFIL is a part of Sietch. The Arrakisian constitution vests all judicial functions within the Sietch State in the Sietch Council. Therefore, Petitioner could have sought relief from the Sietch Counsel for the IFIL levy. Having failed to do so, Petitioner has failed to exhaust its remedies.

Second, Petitioner cannot claim that petitioning the Sietch Counsel would be unreasonable, impractical, or ineffective because as in *Procter & Gamble*, Petitioner has introduced no evidence whatsoever of the difficulty of pursuing relief from the Sietch Council, or of its likelihood of success in obtaining that relief. Respondent notes that if anything, the record suggests a high likelihood of success for Petitioner. This is because the Sietch Council is appointed by Vice President Atreides, R. at 9, who also happens to be IFIL's bitter political rival. R. at 14. Further, as a matter of common sense, Respondent also notes that Petitioner has chosen to litigate this case all the way to the United States Supreme Court. There is nothing in the record to indicate that an appeal to the Sietch Council would be any more onerous than the instant litigation.

Petitioner has not exhausted his reasonable remedies under Arrakisian law. Therefore, the IFIL levy is not compulsory. Being non-compulsory, the levy is not a tax for purposes of § 901. Since the levy is not a tax, Petitioner cannot claim a foreign tax credit for it.

III. DENYING PETITIONER FOREIGN TAX CREDITS FOR THE ARRAKIS FOREIGN TAX AND THE IFIL LEVY WILL ADVANCE THE POLICY GOALS OF § 901 BECAUSE IT WILL AVOID DOUBLE TAXATION WITHOUT UNNECESSARILY SUBSIDIZING FOREIGN ENTITIES.

§ 901's foreign tax credits, and the regulations promulgated by the Treasury to implement them, represent a compromise between competing policy considerations. John P. Dombrowski, *Foreign Tax Credits: The Recent Decision in Proctor & Gamble v. United States Allows Procedure to Override the Statutory Intent*, 44 U. Tol. L. Rev. 405 (2013). One the one hand, these rules seek to relieve U.S. taxpayers of the burden of double taxation of income earned overseas, and by doing so, to promote international trade. On the other hand, limitations are imposed to ensure that the Treasury is not required to subsidize foreign governments. This latter end is pursued by § 1.901-2's requirement that the levy being credited actually is a tax, and that taxpayers are incentivized to take reasonable steps to limit their foreign tax liability. Affirming the Fourteenth Circuit balances these policy considerations in two ways.

First, this Court would be upholding the integrity of §§ 901 and 903 of the tax code. The Foreign Tax Credit is a valuable tool, but not one to be given away. Numerous other corporations and individuals earning income abroad comply with the regulations every year. Many operate in countries with negotiated tax treaties that define exactly what foreign levies satisfy § 901. Reversing and granting this refund would give an unfair advantage to companies doing business in Arrakis and undermine existing treaties.

Second, since IFIL is not a state and not a valid taxing authority, there is no danger of double taxation here. The IFIL levy is not a tax, but rather a fee paid by Harkonnen in exchange for the right to extract oil and gas. Accordingly, denying the refund will not threaten international trade, because Harkonnen is already incentivized to trade with IFIL by the opportunity to extract oil and gas from Unit 12. In view of the very low rate at which the levy on Unit 12's production is calculated, it is highly unlikely that the IFIL levy will negatively impact international trade to any significant degree. What denying the credit will do, however, is preserve the Treasury from bearing the costs of Petitioner's business dealings with renegade elements in a highly volatile part of the world.

<u>CONCLUSION</u>

This Court should hold Petitioner is not entitled to Foreign Tax Credits on its 2012 U.S. income tax return for payment of the Arrakis Foreign Tax and the IFIL Levy. The requested refund should be denied.

For the foregoing reasons, the United States respectfully requests this Court affirm the judgment of the United States Court of Appeals for the Fourteenth Circuit.

<u>**STATUTORY APPENDIX**</u>

U.S. Const. art. I § 8 cl. 1. Taxing Power

The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States;

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28 U.S.C. § 1331(2006) Federal Question Jurisdiction

The district courts shall have original jurisdiction of all civil actions arising under the Constitution, laws, or treaties of the United States.

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26 U.S.C. § 901 (2013) (excerpted) Taxes of foreign countries and of possessions of United States

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

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

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

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26 U.S.C. § 903 (2005) Credit for taxes in lieu of income

For purposes of this part and of sections 164(a) and 275(a), the term "income, war profits, and excess profits taxes" shall include a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.

26 C.F.R. § 1.901–2 (2013) (excerpted) Income, war profits, or excess profits tax paid or accrued.

(a) Definition of income, war profits, or excess profits tax--(1) In general. Section 901 allows a credit for the amount of income, war profits or excess profits tax (referred to as "income tax" for purposes of this section and §§ 1.901–2A and 1.903–1) paid to any foreign country. Whether a foreign levy is an income tax is determined independently for each separate foreign levy. A foreign levy is an income tax if and only if--

i) It is a tax; and

(ii) The predominant character of that tax is that of an income tax in the U.S. sense.

Except to the extent otherwise provided in paragraphs (a)(3)(ii) and (c) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Paragraphs (a), (b) and (c) of this section define an income tax for purposes of section 901. Paragraph (d) of this section contains rules describing what constitutes a separate foreign levy. Paragraph (e) of this section contains rules for determining the amount of tax paid by a person. Paragraph (f) of this section contains rules for determining by whom foreign tax is paid. Paragraph (g) of this section contains definitions of the terms “paid by,” “foreign country,” and “foreign levy.” Paragraph (h) of this section states the effective date of this section.

(2) Tax—

(i) In general. A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. A penalty, fine, interest, or similar obligation is not a tax, nor is a customs duty a tax. Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of law of the foreign country. Therefore, the assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto. Notwithstanding any assertion of a foreign country to the contrary, 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 (as defined in paragraph (a)(2)(ii)(B) of this section) from the foreign country in exchange for payment pursuant to the levy. Rather, to that extent, such levy requires a compulsory payment in exchange for such specific economic benefit. If, applying U.S. principles, a foreign levy requires a compulsory payment pursuant to the authority of a foreign country to levy taxes and also requires a compulsory payment in exchange for a specific economic benefit, the levy is considered to have two distinct elements: A tax and a requirement of compulsory payment in exchange for such specific economic benefit. In such a situation, these two distinct elements of the foreign levy (and the amount paid pursuant to each such element) must be separated. No credit is allowable for a payment pursuant to a foreign levy by a dual capacity taxpayer (as defined in paragraph (a)(2)(ii)(A) of this section) unless the person claiming such credit establishes the amount that is paid pursuant to the distinct element of the foreign levy that is a tax. See paragraph (a)(2)(ii) of this section and § 1.901–2A.

(ii) Dual capacity taxpayers--(A) In general. For purposes of this section and §§ 1.901–2A and 1.903–1, a person who is subject to a levy of a foreign state or of a possession of the United States or of a political subdivision of such a state or possession and who also, directly or indirectly (within the meaning of paragraph (a)(2)(ii)(E) of this section) receives (or will receive) a specific economic benefit from the state or possession or from a political subdivision of such state or possession or from an agency or instrumentality of any of the foregoing is referred to as a “dual capacity taxpayer.” Dual capacity taxpayers are subject to the special rules of § 1.901–2A.

(B) Specific economic benefit. For purposes of this section and §§ 1.901–2A and 1.903–1, the term “specific economic benefit” means 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. Thus, a concession to extract government-owned petroleum is a specific economic benefit, but the right to travel or to ship freight on a government-owned airline is not, because the latter, but not the former, is made generally available on substantially the same terms. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls (within the meaning of paragraph (a)(2)(ii)(D) of this section); or a reduction or discharge of a contractual obligation. It does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.

(C) Pension, unemployment, and disability fund payments. A foreign levy imposed on individuals to finance retirement, old-age, death, survivor, unemployment, illness, or disability benefits, or for some substantially similar purpose, is not a requirement of compulsory payment in exchange for a specific economic benefit, as long as the amounts required to be paid by the individuals subject to the levy are not computed on a basis reflecting the respective ages, life expectancies or similar characteristics of such individuals.

(D) Control of property. A foreign country controls property that it does not own if the country exhibits substantial indicia of ownership with respect to the property, for example, by both regulating the quantity of property that may be extracted and establishing the minimum price at which it may be disposed of.

(E) Indirect receipt of a benefit. A person is considered to receive a specific economic benefit indirectly if another person receives a specific economic benefit and that other person--

(1) Owns or controls, directly or indirectly, the first person or is owned or controlled, directly or indirectly, by the first person or by the same persons that own or control, directly or indirectly, the first person; or

(2) Engages in a transaction with the first person under terms and conditions such that the first person receives, directly or indirectly, all or part of the value of the specific economic benefit.

(3) Predominant character. The predominant character of a foreign tax is that of an income tax in the U.S. sense--

(i) If, within the meaning of paragraph (b)(1) of this section, the foreign tax is likely to reach net gain in the normal circumstances in which it applies,

(ii) But only to the extent that liability for the tax is not dependent, within the meaning of paragraph (c) of this section, by its terms or otherwise, on the availability of a credit for the tax against income tax liability to another country….

e) Amount of income tax that is creditable--(1) In general. Credit is allowed under section 901 for the amount of income tax (within the meaning of paragraph (a)(1) of this section) that is paid to a foreign country by the taxpayer. The amount of income tax paid by the taxpayer is determined separately for each taxpayer…

(5) Noncompulsory amounts--(i) In general. An amount paid is not a compulsory payment, and thus is not an amount of tax paid, to the extent that the amount paid exceeds the amount of liability under foreign law for tax. An amount paid does not exceed the amount of such liability if the amount paid is 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 (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce, over time, the taxpayer's liability for foreign tax (including liability pursuant to a foreign tax audit adjustment). Where foreign tax law includes options or elections whereby a taxpayer's tax liability may be shifted, in whole or part, to a different year or years, the taxpayer's use or failure to use such options or elections does not result in a payment in excess of the taxpayer's liability for foreign tax. 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. In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed the relevant facts. A remedy is effective and practical only if the cost thereof (including the risk of offsetting or additional tax liability) is reasonable in light of the amount at issue and the likelihood of success. A settlement by a taxpayer of two or more issues will be evaluated on an overall basis, not on an issue-by-issue basis, in determining whether an amount is a compulsory amount. A taxpayer is not required to alter its form of doing business, its business conduct, or the form of any business transaction in order to reduce its liability under foreign law for tax.

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26 C.F.R. 1.901-2A (2013) (excerpted) Dual capacity taxpayers.

(a) Application of separate levy rules as applied to dual capacity taxpayers--(1) In general. If the application of a foreign levy (as defined in § 1.901–2(g)(3)) is different, either by the terms of the levy or in practice, for dual capacity taxpayers (as defined in § 1.901–2(a)(2)(ii)(A)) from its application to other persons, then, unless the only such difference is that a lower rate (but the same base) applies to dual capacity taxpayers, such difference is considered to be related to the fact that dual capacity taxpayers receive, directly or indirectly, a specific economic benefit (as defined in § 1.901–2(a)(2)(ii)(B)) from the foreign country and thus to be a difference in kind, and not merely of degree. In such a case, notwithstanding any contrary provision of § 1.901–2(d), the levy as applicable to such dual capacity taxpayers is a separate levy (within the meaning of § 1.901–2(d)) from the levy as applicable to such other persons, regardless of whether such difference is in the base of the levy, in the rate of the levy, or both. In such a case, each of the levy as applied to dual capacity taxpayers and the levy as applied to other persons must be analyzed separately to determine whether it is an income tax within the meaning of § 1.901–2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of § 1.903–1(a). However, if the application of the levy is neither different by its terms nor different in practice for dual capacity taxpayers from its application to other persons, or if the only difference is that a lower rate (but the same base) applies to dual capacity taxpayers, then, in accordance with § 1.901–2(d), such foreign levy as applicable to dual capacity taxpayers and such levy as applicable to other persons together constitute a single levy. In such a case, no amount paid (as defined in § 1.901–2(g)(1)) pursuant to such levy by any such dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit, and such levy, as applicable in the aggregate to such dual capacity taxpayers and to such other persons, is analyzed to determine whether it is an income tax within the meaning of § 1.901–2(a)(1) or a tax in lieu of an income tax within the meaning of § 1.903–1(a). Application of a foreign levy to dual capacity taxpayers will be considered to be different in practice from application of that levy to other persons, even if no such difference is apparent from the terms of the levy, unless it is established that application of that levy to dual capacity taxpayers does not differ in practice from its application to other persons.

(2) Examples. The provisions of paragraph (a)(1) of this section may be illustrated by the following examples:

> **Example 1.** Under a levy of country X called the country X income tax, every corporation that does business in country X is required to pay to country X 40 percent of its income from its business in country X. Income for purposes of the country X income tax is computed by subtracting specified deductions from the corporation's gross income derived from its business in country X. The specified deductions include the corporation's expenses attributable to such gross income and allowances for recovery of the cost of capital expenditures attributable to such gross income, except that under the terms of the country X income tax a corporation engaged in the exploitation of minerals K, L or M in country X is not permitted to recover, currently or in the future, expenditures it incurs in exploring for those minerals. In practice, the only corporations that engage in exploitation of the specified minerals in

country X are dual capacity taxpayers. Thus, the application of the country X income tax to dual capacity taxpayers is different from its application to other corporations. The country X income tax as applied to corporations that engage in the exploitation of minerals K, L or M (dual capacity taxpayers) is, therefore, a separate levy from the country X income tax as applied to other corporations. Accordingly, each of (i) the country X income tax as applied to such dual capacity taxpayers and (ii) the country X income tax as applied to such other persons, must be analyzed separately to determine whether it is an income tax within the meaning of § 1.901–2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of § 1.903–1(a).

Example 2. The facts are the same as in example 1, except that it is demonstrated that corporations that engage in exploitation of the specified minerals in country X and that are subject to the levy include both dual capacity taxpayers and other persons. The country X income tax as applied to all corporations is, therefore, a single levy. Accordingly, no amount paid pursuant to the country X income tax by a dual capacity taxpayer is considered to be paid in exchange for a specific economic benefit; and, if the country X income tax is an income tax within the meaning of § 1.901–2(a)(1) or a tax in lieu of an income tax within the meaning of § 1.903–1(a), it will be so considered in its entirety for all corporations subject to it.