NO. C15-1701-1

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM 2014

ROYAL HARKONNEN OIL COMPANY,

Petitioner,

v.

UNITED STATES,

Respondents.

On Writ of Certiorari to the

United States Supreme Court

BRIEF FOR RESPONDENT

TEAM 32

Counsel for Respondent

QUESTIONS PRESENTED

I. Is Harkonnen Oil's payment of taxes to the Republic of Arrakis a creditable foreign tax credit under 26 U.S.C. § 901 or 26 U.S.C. § 903?

II. Did the IRS properly deny Harkonnen Oil's claimed foreign tax credit for all tax payments to Inter-Sietch Fremen Independence League?

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The opinion of the United States District Court for the Central District of New Tejas is unreported. The unreported opinion of the United States Court of Appeals for the Fourteenth Circuit appears in the record at pages 2–21.

STATEMENT OF JURISDICTION

The United States Court of Appeals for the Fourteenth Circuit entered judgment on October 1, 2014. R. at 2. The petition for a writ of certiorari was granted. R. at 1. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254.

STATUTORY PROVISIONS INVOLVED

This case involves interpretation and application of 26 U.S.C. § 901 and 26 U.S.C. § 903. Appendix A contains the full text of 26 U.S.C. § 901. Appendix B contains the full text of 26 U.S.C. § 903.

STATEMENT OF THE CASE

Caladan Oil Field. On March 6, 2007, Royal Harkonnen Oil Company ("Harkonnen Oil") considered whether to develop oil and gas interests in the Caladan Oil Field, a large area spanning approximately 231,000 square miles and resting within the northern and eastern boundaries of the Republic of Arrakis. R. at 2-3. To make the determination, Harkonnen Oil conducted seismic and feasibility studies of the field. R. at 2. After several months and upon completing the study, Harkonnen Oil concluded that the reserves could be profitably extracted by utilizing new technologies and recovery techniques. R. at 3.

A Harkonnen Oil internal document, labeled "CEO Summary: Caladan Oil Field," reached a different conclusion. R. at 3. The document addressed concerns relating to potential negotiations for the exclusive rights to develop on the Caladan Oil Field between Harkonnen Oil and Jules Corrino ("President Corrino"), the president of the Republic of Arrakis. R. at 3. Particularly, Harkonnen Oil feared President Corrino would demand a high royalty payment for any production. R. at 3. By adding a high royalty payment into the potential costs, Harkonnen Oil ultimately concluded that mineral extraction in the Caladan Oil Field would be unprofitable. R. at 3.

On February 5, 2008, Vladimir Harkonnen, Harkonnen Oil's CEO, met with President Corrino and other delegates from Arrakis to negotiate an oil and gas lease covering the entire Caladan Oil Field. R. at 3-4. Negotiations took place for a period of several months and as the internal document foresaw, the negotiations focused largely on various royalty payments President Corrino demanded. R. at 4.

Republic of Arrakis Foreign Value Tax. While negotiations between Harkonnen Oil and Arrakis were still underway, President Corrino drafted and signed into law the Republic of Arrakis Foreign Value Tax. R. at 5. The new tax was put into effect by President Corrino to modernize Arrakis's current tax code and to comport with new international treaties and obligations. R. at 5. Prior to implementing the new tax, the Arrakis Tax Code only subjected Arrakis citizens to the tax code, and rejected taxation of income earned by foreign individuals or entities residing or doing business in Arrakis. R. at 4.

The Republic of Arrakis Foreign Value Tax applied to all foreign entities that operate machinery on Arrakis sovereign territory. R. at 5. The tax deferred designation of the exact tax percentage rate to June 30, 2008 when President Corrino applied a forty-five percent rate to the tax. R. at 5, 7.

The tax indicated a process by which Arrakis could ensure proper enforcement of the tax levy. R. at 5. The Republic of Arrakis Foreign Value Tax tasked the Central Bank of Arrakis with calculating the taxes, and mandated that all monies earned in Arrakis be deposited into the Central Bank of Arrakis prior to disbursement to the foreign entity. R. at 5.

Sietch Dunes Uprising. On April 12, 2008, an uprising began in the northern region of Arrakis, known as the Sietch Dunes. R. at 5. The dissidents of the uprising declared independence of the Sietch Dunes area from Arrakis and called for a restoration of an independent Sietch Throne. R. at 5-6. The Sietch Dunes region the dissidents declared independent was within a 62,000 square mile portion of the Caladan Oil Field. R. at 6. Arrakis mobilized its military into the region to silence the uprising. R. at 5. To ensure atrocities were not committed by Arrakis in the Sietch Dunes, the U. S. State Department declared it would monitor the situation based on human rights concerns. R. at 6-7.

After nearly a month of fighting between Arrakis and the dissidents, resulting in substantially more casualties for the dissidents than Arrakis, Arrakis withdrew its military from the Sietch Dunes. R. at 6-7. Simultaneously, the U.S. State Department reiterated its human rights concerns about Arrakisian military activities. R. at 7. As a result, the United Nations launched an investigation regarding the military activities on May 12, 2008. R. at 7.

Harkonnen Oil and Arrakis Lease. On June 30, 2008, Arrakis and Harkonnen Oil finally signed a lease to develop the entire 231,000 square miles of the Caladan Oil Field. R. at 7. The lease contained provisions for a one-time bonus payment of fifty-five million dollars and a royalty of fifteen percent. R. at 7. Harkonnen Oil agreed to pay the tax enacted on March 10, 2008—which President Corrino renamed the Republic of Arrakis Foreign Tax on that same day. R. at 7. On January 15, 2009, Harkonnen Oil produced the first barrels of crude oil under the lease. R. at 7. Within ten months from the first barrels being produced, Harkonnen Oil's daily production equaled 858,000 barrels of oil per day. R. at 7.

Second Sietch Dunes Uprising. On March 20, 2010, another uprising began in the same Sietch Dunes region as the first. R. at 8. A group calling themselves the Independent People of Sietch ("IPS") declared independence from Arrakis and additionally declared IPS to be the controlling political regime of an independent Sietch Dunes. R. at 8. Despite international opposition, Arrakis mobilized its military in the Sietch Dunes region again to suppress the uprising. R. at 8. The United Nations condemned Arrakis's actions, and the U.S. State Department withdrew its embassy from the capital and largest city of Arrakis, Arrakeen. R. at 8. The U.S. State Department declared Arrakis a "Dangerous State." R. at 8.

After weeks of fighting resulting in approximately thirty-five IPS casualties, Mr. Harkonnen and the United States Ambassador to Arrakis met with President

Corrino and Paul Atreides, the newly appointed leader of the IPS, at a conference to discuss a possible truce between the forces. R. at 8. On April 9, 2010, the conference, referred to as the Arakeen Peace Summit, ensued and President Corrino declared a ceasefire. R. at 8. After the three-day summit, the parties announced a truce, known as the Sietch Dunes Peace Treaty. R. at 8.

The Treaty set forth the terms of the truce between the entities which included: Arrakis declaring the Sietch Dunes would become the Sietch State and be designated an Important Province of Arrakis; the Sietch State having the sole power to appoint the Vice President of Arrakis who would serve in the cabinet of the President; the Sietch State agreed to send monetary tribute to the Republic of Arrakis; the Sietch State agreed to never seek independence form Arrakis again; andlastly, IPS would become a recognized political party of the Sietch State. R. at 8-9.

After President Corrino amended the Arrakis Constitution to create the post of the Vice President, Paul Atreides was declared Vice President of the Sietch State. R. at 9. The vote was hurried and procedurally questionable because the overwhelming majority of votes came from the IPS political party, only those individuals able to prove a connection to the Sietch bloodlines were eligible to vote, and the votes of those individuals not able to do so were voided. R. at 9-10. United States, Russian, and French Officials investigated allegations of voter fraud after receiving reports from voters within the Sietch State. R. at 10. Ultimately, the United States, Russian, and French Officials concluded that the Sietch State Vice-

Presidential election results were questionable, but recommended no sanctions. R. at 10.

Harkonnen Oil and the Sietch State. On April 16, 2010, Vice President Atreides decreed a single tax as his first official act in his new designation. R. at 10. The decree required ten percent of all income generated in the Sietch State, less any deductions under the Arrakis Tax Code, to be turned over to the Chief Accountant of the Sietch State. R. at 10. All taxes collected by the Sietch State were to be paid as tribute to Arrakis. R. at 10. The decree impacted no payments owed by Harkonnen Oil to Arrakis under the Republic of Arrakis Foreign Tax. R. at 10.

On April 21, 2010, Harkonnen Oil and Vice President Atreides, as head of the Sietch State, executed the Sietch Lease for oil and gas rights over the Sietch Dunes regions. R. at 10. The Sietch Lease included a one-time bonus payment of five million dollars and an annual royalty of five percent. R. at 10. On July 6, 2010, besides lifting the "Dangerous State" designation for Arrakis, the U.S. State Department declared the Sietch State a "Quasi-Autonomous Region" and agreed to establish diplomatic ties with the Sietch State. R. at 10. Until a permanent location could be finalized within the U.S. embassy in Arakeen, a temporary one-room consulate was set in the embassy for the Sietch State. R. at 10-11. Additionally, the U.S. Treasury Department declared that it would accept transactions from the Sietch State. R. at 11.

Harkonnen Oil and the Inter-Sietch Fremen Independence League. On December 31, 2010, yet another rebellion was launched. R. at 11. This uprising was led by a group called the Inter-Sietch Fremen Independence League ("IFIL") and demanded the resignation of Vice-President Atreides. R. at 11. IFIL declared their leader, Jessica Mohiam ("Mohiam"), as the rightful heir of the historic Sietch Throne and the only legitimate Vice President. R. at 11. Mohiam has been associated with the Bene Gesserit, a U.S. State Department and U.S. Treasury declared terrorist organization that operates in the countries surrounding Arrakis, from her birth. R. at 11. This was due to her mother being the founder of the terrorist organization. R. at 11. When she reached eighteen years old in 2005, Mohiam rebelled against her mother and the Bene Gesserit. R. at 11. The U.S. State Department has further classified IFIL as an independent splinter of the Bene Gesserit. R. at 11.

Mohiam lived outside the bounds of Bene Gesserit and within the country of Salusa Secundus, one of the northern neighbors of Arrakis. R. at 12. In December of 2007, Mohiam sought and received support from two countries that share a border with Arrakis and Salusa Secundus, Al Dhanab and Anbus. R. at 12. Mohiam promised to promote economic development in Al Dhanab and Anbus and to oppose the Bene Gesserit in exchange for financial backing from the monarchies in both countries. R. at 12. From 2008 to the present, IFIL has operated throughout the region and moved from place to place. R. at 12.

On January 2, 2011, Al Dhanab and Anbus recognized IFIL as a legitimate foreign government and as an independent state of the Sietch Dunes region. R. at 12. Al Dhanab and Anbus both petitioned to the United States and the United Nations for recognition of IFIL. R. at 12. The United States and the United Nations both agreed to look into the matter for determination, while France and Russia immediately recognized the legitimacy of IFIL as a state within the Sietch Dunes region. R. at 13.

In March of 2011, IFIL forcefully acquired control of a region of the Sietch State known as the "Badlands." R. at 13. Other than denying IFIL's legitimacy, Arrakis and the Sietch State did not act in response. R. at 13. Expanding beyond the Badlands, on March 20, 2011, IFIL forcefully took control of more territory—this time, a small drilling station identified as Unit #12 operated by Harkonnen Oil. R. at 13. Unit #12 is located near a collection of ruins which dates back to the Sietch Empire and is identified on maps as "Onn." R. at 13. "Onn" is historically the seat of the Sietch Empire throne. R. at 13. Upon forcefully expanding control over Unit #12, Mohiam released a recorded statement that claimed Harkonnen Oil was slant drilling the Badlands and until it rectified its insolence and paid tribute, IFIL would continue to control oil production from Unit #12. R. at 13.

A couple days after Mohiam's statement about Harkonnen Oil, Mr. Harkonnen flew to Unit #12 to meet with Mohiam. R. at 13. A partial agreement was reached between the parties and ultimately resulted in the signing of a handwritten oil and gas lease. R. at 13. Harkonnen Oil was to pay a bonus of five hundred and fifty thousand dollars and a five percent royalty to IFIL. Mohiam declared that Unit #12 would have its income taxed at two percent—calculating such tax by taking the receipts generated by Unit #12 and allowing for all deductions authorized by the Sietch State, then multiplying that by two percent. R. at 13. Mr. Harkonnen protested this tax demand and subsequently got in contact with President Corrino to inquire how to handle IFIL's tax request. R. at 14. President Corrino stated that all legal tax disputes in Arrakis were handled by the Holy Royal Court of Arrakis. R. at 14.

From there, Mr. Harkonnen petitioned to the Holy Court of Arrakis for a status determination of IFIL and its ability to levy a tax. R. at 14. The Holy Court responded by claiming that "Arrakis recognizes IFIL as a part of the Sietch." R. at 14. Following the Holy Court's declaration, Harkonnen Oil paid IFIL the agreed upon bonus and royalty by one check, and paid the tax on another check. R. at 14. Mohiam paid twenty percent of the funds IFIL received from Harkonnen Oil to the monarchies of Al Dhanab and Anbus. R. at 14.

On April 15, 2011, the Sietch State held its second election for the Vice-President position. R. at 14. Paul Atreides and Jessica Mohiam finished in a virtual tie, though one day following the results, President Corrino declared Paul Atreides the winner. R. at 14. The United States supervised the election and after President Corrino's appoint of Paul Atreides over Jessica Mohiam for the position, declared the election over, but did not certify the results. R. at 14. Following the election, the President of the United States issued Executive Order 14012. R. at 14. The Executive Order declared "IFIL a sovereign friend of the United States, whom we would like to establish trade relations with," but then went on to state that "the United States would always continue to help individuals around the world obtain freedom." R. at 14.

Caladan Oil Field Conference. In Mid-May of 2011, the First Annual Caladan Oil Field Conference was held. R. at 15. Mr. Harkonnen, President Corrino, Vice President Atreides, and Jessica Mohiam gathered for the conference and engaged in private meetings, presentations regarding new technologies, listened and conducted reports on production and forecasting, and enjoyed a lavish banquet. R. at 15. Following the three-day conference, the following events took place regarding all entities involved in the conference:

- President Corrino lowered the Republic of Arrakis Foreign Tax to thirty-three percent;
- Vice-President Altreides declared that the new tax rate to be paid by foreign companies operating on portions of the Caladan field within the Sietch State would remain at ten percent of all monies generated within the Sietch State less applicable deductions;
- Mohiam declared that IFIL's tax of Unit #12 would remain the same and that all payments required for "slant" drilling had been satisfied by Harkonnen Oil; and
- Arrakis and the Sietch State agreed to consider establishing a permanent principal location for IFIL within the Sietch Dunes region, as no location had yet been agreed upon.

R. at 15. Additionally and following the conference, President Corrino issued Proclamation 102, which stated that foreign corporations could take all tax deductions available to Arrakis citizens. R. at 15. Still, the deductions claimed by a foreign corporations would be capped at ninety-five percent of the dollar value of the Arrakisian citizen. R. at 15. This was due to the religious laws and practices of Arrakis. R. at 15. According to these practices, a foreign corporation cannot share the same benefits as a true believer. R. at 15-16.

Present Tax Dispute. Prior to the tax year 2011, Harkonnen Oil took its expenses from its Arrakis operations as a deduction, not a credit. R. at 16. However, on March 15, 2012, Harkonnen Oil filed its Form 1120 United States Tax Return for the year 2011, then timely filed Form 1118 claiming foreign tax credits for its tax payment to the Republic of Arrakis, the Sietch State, and IFIL. R. at 16.

Due to irregularities, the Internal Revenue Service ("IRS") flagged Harkonnen Oil's 2012 tax returns and performed an audit. R. at 16. Afterwards, the IRS determined that the claimed foreign tax credit sought for the tax payment to Arrakis was an unqualified foreign tax credit because the foreign tax failed to sufficiently reach net income. R. at 16-17. The IRS concluded the tax payments to the Sietch State were credible foreign tax credits. R. at 17. Lastly, the IRS determined the tax payments to IFIL were unqualified foreign tax credits because IFIL was not a proper taxing authority. R. at 17. In addition, the IRS stated Harkonnen Oil's payment to IFIL violated the Sietch Dunes Peace Treaty' limitation of a single tax within the Sietch State and further, that Harkonnen Oil failed to exhaust all of its remedies to challenge a foreign tax under Sietch's domestic law. R. at 17.

Harkonnen Oil and the IRS attempted to negotiate but did not agree, and Harkonnen Oil paid the full tax but later demanded a refund. R. at 17. Harkonnen

Oil then sued in the Central District Court of New Tejas and after a lengthy trial, the District Court Judge ruled in favor of the IRS. R. at 17.

SUMMARY OF THE ARGUMENT

This case concerns Harkonnen Oil's foreign tax payments to the Republic of Arrakis and to IFIL and whether each payment qualifies as a foreign tax credit under 26 U.S.C. § 901 and 26 U.S.C. § 903. This Court should affirm the Fourteenth Circuit Court of Appeals' holding in favor of the United States regarding both foreign tax payments.

I.

For a foreign levy to qualify as a foreign tax credit, the tax must be similar or akin to a United States income tax. A foreign levy is similar to an income tax in the U.S. sense if the tax reaches the taxpayer's net gains. One requirement to meet this net gain test is that the tax must reach the net income of the taxpayer. Here, the tax imposed by Arrakis does not reach Harkonnen Oil's net income because the tax does not allow the Harkonnen Oil the ability to deduct significant costs and expenses attributable to its gross receipts. Furthermore, the cap on deductions Harkonnen Oil may claim fails to satisfy the net income requirement because significant cost recoveries must be able to be deducted from receipts. Additionally, the payments to Arrakis are not "in lieu of income tax payments," as forth within section 903, because according to the authority, payments made under production share agreements regarding petroleum corporations are, in substance, a royalty payment in its entirety, and thus, not eligible for the foreign tax credit under sections 901 and 903.

II.

Claiming the foreign tax credit within 26 U.S.C. § 901 requires the taxing entity be a valid taxing entity. Additionally, the taxpayer must have made a compulsory payment. A payment is noncompulsory is the taxpayer fails to exhaust available remedies to reduce the foreign tax burden.

Here, the Fourteenth Circuit Court of Appeals correctly held Harkonnen Oil's tax payments to IFIL were non-creditable foreign tax credits because IFIL is not a valid taxing entity. Though, the United States has not severed diplomatic relations with IFIL, no relations between the entities have ensued and IFIL falls outside the scope of a valid taxing entity as set forth in 26 U.S.C. § 901. The tax imposed by IFIL violated the Arrakis' Constitution because the Sietch State is the only permitted taxing authority within the region, therefore, IFIL's tax operates as an impermissible second tax.

Lastly, Harkonnen Oil failed to exhaust all of its available remedies to reduce its tax burden to IFIL. Harkonnen Oil solely petitioned to the Holy Royal Court of Arrakis in seeking a determination regarding IFIL's ability to levy a tax. While this act shows some diligence, it is not enough, as Harkonnen Oil was statutorily required to put forth good faith and exhaust its available remedies before paying the tax, and later claiming the foreign tax credit.

ARGUMENT

This Court should review the Fourteenth Court of Appeals' ruling Harkonnen Oil's payment of taxes to the Republic of Arrakis and IFIL were not credible foreign taxes under 26 U.S.C. § 901 or 26 U.S.C. § 903 is a legal ruling reviewed *de novo*. *See, e.g., Riggs Nat'l Corp. & Subsidiaries v. Comm'n*, 163 F.3d 1363 (D.C. Cir. 1999).

Section 901 of the Internal Revenue Code (IRC) allows a domestic corporation to claim a credit against its United States income tax liability for "any income, war profits, and excess taxes paid or accrued during the taxable year to any foreign country…" 26 U.S.C § 901(a) and (b)(1). The purpose of the foreign tax credit is simple—to eliminate double taxation of foreign source income paid to United States taxpayers. *Burnet v. Chicago*, 285 U.S. 1, 7 (1932); *Texasgulf, Inc. and Subsidiaries v. C.I.R.*, 172 F.3d 209, 214 (2d Cir. 1999). In practice, the effects of claiming the credit operate much like the domestic taxpayer making a down payment on its U.S. tax liability with respect to the foreign revenue generated. *See* Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders, ¶ 15.21[1][a] (2014).

Though the guidance within section 901 is not all inclusive regarding foreign tax credits, the following general rules can be deduced from referencing the statute and applicable authority on the subject: (1) only foreign "income taxes" can be credited[1] (or taxes paid in lieu of an income tax, as stated within § 903); (2) only the foreign tax alone, excluding interest or penalties, is creditable; and (3) the taxpayer

[1] The following non-exhaustive list illustrates those taxes which would not qualify as an "income tax," and thus not be eligible as a valid foreign tax credit: property taxes, excise taxes, value-added taxes, sales taxes, succession or transfer taxes, payroll taxes, under or license fees, custom levies, and the like. *See* Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 15.21[1][a] (2014); *see also* 26 U.S.C § 901(f), (i), and (j).

not only bears the economic burden of the tax, but also the legal liability. *Id.*; *see also Biddle v. Comm'n of Internal Revenue*, 302 U.S. 573, 581 (1938).

Determining whether a foreign income tax qualifies as a foreign tax credit is a perplexing task given the substantial changes to the foreign tax credit provisions over the years. Still, guidance on the issue is explained in depth within the treasury regulations. *See* Treas. Reg. § 1.901-2. The regulations' guidance as to whether a foreign income tax is credible is predicated on the overarching principle that the foreign tax must be comparable to an "income tax," in the U.S. sense. *Inland Steel Co. v. United States*, 677 F.2d 72, 79 (Ct. Cl. 1982); *see generally* Treas. Regs. §§ 1.901-2(a)(2)(ii) and 1.901-2A. From this, it is necessary to determine the proper definition of an "income tax." Looking again to the regulations, a two-part test is set out to determine this: "a foreign levy is an income tax if and only if (1) [i]t is a tax; and (2) [t]he predominant character of that tax is that of an income tax in the U.S. sense." Treas. Reg. § 1.901-2(a)(1).

Going one step further into the analysis and regarding the first part of the two-fold inquiry, the regulations state a foreign levy is a tax if it requires compulsory payment by the foreign country's taxing authority. Treas. Reg. § 1.901-2(a)(2). A foreign tax will not withstand this first prong if, in levying the tax, the foreign country extends some specific economic benefit to the taxpayer besides imposing the tax. Treas. Reg. § 1.901-2(a)(2)(ii)(B).

Regarding the second step in the analysis, the predominant character of the foreign tax will be deemed as equivalent to that of the U.S. income tax if "the foreign tax is likely to reach net gain in the normal circumstances in which it applies." Treas. Reg. § 1.901-2(a)(3)(i). This part of the inquiry is often referred to as the net gain test and may be satisfied by meeting each of the three requirements set forth within the regulations. A foreign tax is likely to reach the net gain in the normal circumstances in which it applies if and only if the tax, as judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements. Treas. Reg. § 1.901-2(b)(1).

The realization requirement is satisfied if the foreign tax "is imposed [u]pon or subsequent to the occurrence of events … that would result in the realization of income under the income tax provisions of the Internal Revenue Code." Treas. Reg. § 1.901-2(b)(2)(i)(A). Put more simply, the foreign tax law which sets the standard for the foreign tax levy must comport with U.S. tax law regarding the "realization" requirement. The gross receipts requirement has been met if the foreign tax is levied on the basis of gross receipts or an equivalent "computed under a method that is likely to produce an amount that is not greater that [the] fair market value." Treas. Reg. § 1.901-2(b)(3)(i). Lastly, the net income requirement is satisfied if "the base of the tax is computed by reducing gross receipts … to permit … [r]ecovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts." Treas. Reg. § 1.901-2(b)(4).

I. THE TAX PAID TO THE REPUBLIC OF ARRAKIS IS NOT A VALID FOREIGN TAX CREDIT BECAUSE IT IS NOT THE SUBSTANTIAL EQUIVALENT OF AN INCOME TAX, IN THE UNITED STATES SENSE.

To qualify as an income tax in the U.S. sense, the foreign levy must be likely to reach the taxpayer's net gains. Based upon previously discussed guidance and precedent, it is clear this assessment is based on the satisfaction of the three tests enumerated within the treasury regulations. The Fourteenth Circuit Court of Appeals' reasoning for denying the credit for the tax payment to Arrakis was based upon the tax not satisfying the net income test. R. at 17. Furthermore, the Fourteenth Circuit Court of Appeals held, in the alternative, that the tax payments to Arrakis were not "in lieu of" an otherwise applicable income tax, as authorized by 26 U.S.C. § 903, and thus, were not eligible foreign tax credits. R. at 18. The lower court's disposition was correct in each conclusion.

A. The Republic of Arrakis Foreign Tax is Not a Creditable Foreign Tax Credit Because the Tax Does Not Reach Harkonnen Oil's Net Income.

A credible foreign tax must be the substantial equivalent of an income tax as that term is understood in the United States. *Inland Steel Co. v. United States,* 677 F.2d 72 (Ct. Ct. 1982). To qualify as an income tax in the United States sense, the foreign country must have made an attempt always to reach some net gain in the normal circumstances in which the tax applies. *Bank of Am. Nat'l Trust & Sav. Ass'n v. United States*, 198 Ct. Cl. 263, 281 (1972).

To satisfy the net gain test, each of the three above enumerated requirements must be met. The requirement at issue under these facts is the net income requirement. This requirement states that, to credibly reach the net gains of the taxpayer, the foreign tax must allow the taxpayer to deduct the significant costs and expenses attributable to the gross receipts. Treas. Reg. § 1.901-2(b)(4)(i)(A). This requirement is easily reconciled with the basic concept that the income tax seeks to impose a levy on net gains or profits and has been inherent in our system of taxation for nearly sixty years. *Bank of Am. Nat'l Trust & Sav. Ass'n. v. United States*, 61 T.C. 752, 760 (1974).

The foreign levy paid to Arrakis by Harkonnen Oil is not credible under the United States tax code because the tax fails to satisfy the net income requirement. When passed into law on March 10, 2008, the "Republic of Arrakis Foreign Value Tax" was put in place to apply solely to foreign entities operating machinery on sovereign territory within Arrakis. R. at 5. The tax is determined by calculating a corporation's gross receipts based on operations and multiplying the amount by the set tax percentage. R. at 5. By its sheer definition, the tax does not allow gross receipts to be reduced by costs and expenses before it is imposed on the receipts. R. at 5.

The Republic of Arrakis Foreign Tax levy may be compared to the special bank levies, which were held to be non-creditable foreign tax credits in the *Bank of America* case. 198 Ct. Cl. at 270. The levy—claimed to be a foreign tax credit by the bank—did not qualify for the credit because no provision was made to account for the costs or expenses of producing the income. *Id*. at 281. As this Court analogized in *Inland Steel*, "[t]he tax would fall on banks that were successful as well as those that were unsuccessful. Failure to consider operating expenses normal to an active business indicated the governments involved had not designed the taxes to 'nip' net profit." *Inland Steel,* 677 at 1363 (discussing *Bank of America,* 198 Ct. Cl. 263, 281).

Much like the levy in the *Bank of America* case, the Republic of Arrakis Foreign Tax makes no provision to account for the costs and expenses incurred by foreign entities operating machinery within Arrakis, or the foreign entities subject to the Arrakis tax. R. at 5. Because the Arrakis tax fails to consider Harkonnen Oil's operating expenses, the tax does not reach Harkonnen Oil's net gains and cannot satisfy the requisites to qualify as a foreign tax credit.

B. The Arrakis' Cap on Foreign Corporation's Tax Deductions Fails to Satisfy the Statutorily Mandated "Significant Cost Recovery" Requirement.

The net income requirement calls for recovery of significant costs and expenses either: (1) attributable, under reasonable principles, to the corporation's gross receipts; or (2) under a method 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)(B). The only cost or expense the Arrakis tax allows recovery of is by way of the deduction which President Corrino allowed corporations to claim as of May 2011. R. at 15. Though the deduction allows corporations to utilize all deductions the United States Tax Code authorizes, Arrakis imposes a cap on deductions for corporations and thus, does not allow significant costs and expenses to be recovered. The tax payments to Arrakis by Harkonnen Oil are not valid foreign tax credits.

Though President Corrino issued Proclamation 102 in May of 2011 declaring foreign corporations could take all tax deductions available to Arrakis citizens, the tax is still outside a creditable foreign tax credit. R. at 15. Before issuing this Proclamation, foreign corporations could take no deductions in calculating taxes due to Arrakis. R. at 4. The Proclamation issued does not allow a foreign corporation to claim the full deduction an Arrakisian citizen, or United States corporation, could, but instead caps the foreign corporation's deduction to ninety-five percent of the dollar value of an Arrakisian citizen. R. at 15.

The treasury regulations offer significant guidance in determining whether a foreign tax allows recovery of significant costs and expenses. Specifically, the regulations state that “a tax on gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax).” Treas. Reg. § 1.901-2(b)(4)(i)(B).

Applying this guidance to the facts, it is easy to imagine a situation where the Republic of Arrakis Foreign Tax would force a corporation operating within Arrakis to incur a loss from being capped at the deductions, or costs and expenses, it may claim, and therefore have to make a tax payment to Arrakis therefrom. The treasury regulations are clear in stating the business subject to the tax must be “almost certain [to] never incur a loss.” *Id.* Because this is not the case regarding the Republic of Arrakis Foreign Tax, it does not satisfy the significant cost recovery requirement as mandated by the statute and treasure regulations.

The Republic of Arrakis Foreign Tax is not a creditable foreign tax credit under section 901, primarily because the tax does not reach Harkonnen Oil’s net gain. The tax payments do not reach Harkonnen Oil’s net income and further, do not satisfy the significant cost recovery requirement. Harkonnen Oil’s tax payments to Arrakis are invalid foreign tax credits and the Fourteenth Circuit Court of Appeals was correct in its equivalent finding. R. at 17.

C. Alternatively, the Republic of Arrakis Foreign Tax is Not "In Lieu Of" an Otherwise Applicable Income Tax.

The Republic of Arrakis Foreign Tax is not "in lieu of" an otherwise applicable tax as stated within 26 U.S.C § 903 and therefore cannot afford Harkonnen Oil the relief of utilizing the payment as a foreign tax credit. To qualify as a tax in lieu of a foreign income tax under section 903, the tax must be a substitute for, and not in addition to, an income tax otherwise generally imposed, but may not be dependent upon the availability of a credit for the tax against the taxpayer's U.S. federal income tax liability. Treas. Reg. § 1.903-1(b). A foreign levy satisfies the substitution requirement only if it operates in substitution for, rather than in addition to, and income tax. *Id*. A foreign tax qualifies as an in lieu of tax if it is a tax, it meets the substitution requirements, and it is not a soak-up tax. Treas. Reg. §§ 1.903-1(a), 1.903-1(b)(2).

The only form of payment which may be contested as an in lieu of tax is the one-time bonus payment of fifty-five million dollars and a royalty of fifteen percent of Harkonnen Oil's receipts to be paid to Arrakis. R. at 7. Though the opposition may try to claim these payments to Arrakis an in lieu of tax, the Revenue Service has spoken on this issue and declared that the share of production received by a foreign government under a production share agreement regarding petroleum corporations is, in substance, a royalty in its entirety, and thus, not eligible for the foreign tax credit under sections 901 and 903. Rev. Rul. 76-1591.

From this explicit guidance, the payments Harkonnen Oil made to Arrakis regarding the lease and development to take place on Caladan Oil Field were not in lieu of a foreign income tax. Instead, and under the Revenue Ruling, the payments were merely royalty payments in its entirety and therefore fall outside the scope of section 903.

II. THE TAX PAID TO IFIL IS NOT A VALID FOREIGN TAX CREDIT BECAUSE IFIL IS NOT A VALID TAXING AGENCY AND THE IFIL TAX VIOLATES THE ARRAKIS CONSTITUTION IN IMPOSING AN IMPERMISSIBLE SECOND TAX.

As a preliminary matter, though the Fourteenth Circuit Court of Appeals was correct in concluding the Arrakis tax is not a credible foreign tax, its reasoning was incorrect in one minute respect. R. at 17. The fact that the tax was initially labeled as a "value tax" is of no significance regarding whether the foreign levy shares the predominant character with an income tax in the U.S. sense. R. at 5. "The label and form of [a] foreign tax is not determinative." *Inland Steel Co v. United States*, 677 F.2d 72 (Ct. Cl. 1982). *See Entergy Corp. v. Comm'r*, 683 F.3d 233, 236 (5th Cir. 2012) (holding the label of a foreign tax does not determine whether it is eligible for the foreign tax credit); *PPL Corp. v. Comm'r*, 665 F.3d 60, 65 (3d Cir. 2011) (same)). The original name of the tax, the "Republic of Arrakis foreign Value Tax," is not relevant with regards to whether the tax is a credible foreign tax. R. at 5.

The Fourteenth Circuit Court of Appeals correctly held that the IRS properly denied Harkonnen Oil's claimed foreign tax credits for all tax payments to IFIL. R. at 18. In rendering this conclusion, the court based its holding on two independent grounds. R. at 18. First, IFIL is not a valid taxable agency the foreign tax credit does not apply. R. at 18. Second, because the tax violated the Arrakis Constitution, which only permits the Sietch State to have territorial taxing authority over a single tax within the state, the tax by IFIL acts as an impermissible second tax. R. at 18. Each independent ground adequately satisfies the notion that the tax payments to IFIL were not creditable foreign tax credits.

A. IFIL is Not a Valid Taxable Entity

Section 901(j) of Internal Revenue Code denies a foreign tax credit for income taxes paid to any country falling within a class of disapproved countries. 26 U.S.C. § 901(j). Denial of the credit includes taxes paid to countries with which the United States has no diplomatic relations or has severed diplomatic relations, countries identified by the Secretary of State as having repeatedly provided support for acts of international terrorism, and countries with governments the United States does not recognize. *Id*. § 901(j)(2)(A).

The Fourteenth Circuit Court of Appeals alluded to Executive Order 14012 issued by the President of the United States, and the ruling by the Holy Royal Court of Arrakis in stating that on the surface, it may seem IFIL is a valid taxing entity. R. at 18. Nonetheless, the lower court correctly held these two facts do not establish the validity of IFIL as a taxing entity. R. at 18. This is solely due to the language in section 901(j) regarding a denial of the foreign tax credit in certain foreign countries. R. at 14. Within Executive Order 14012, the President declared "IFIL [to be] a sovereign friend of the United States, whom we would like to establish trade relations with." R. at 14. Then, the Executive Order sets forth blanket coverage language, which seemingly applies to many countries or entities, which stated, "the United

States would always continue to help individuals around the world obtain freedom." R. at 14.

The language within the Executive Order places IFIL into the category of a country "which the United States has not severed diplomatic relations but does not conduct such relations…" 26 U.S.C. § 901(j)(2)(A)(iii). While the United States, via the President's Executive Order, may have expressed a desire to establish trade relations with IFIL, nothing in the record demonstrates that such relations ever occurred. Without ever conducting relations with the United States, IFIL falls into the third subsection of the statute and therefore, is of the countries the legislature intended to be denied coverage within the foreign tax credit. 26 U.S.C § 901(j)(1)-(4).

The Holy Royal Court of Arrakis declaring Arrakis' recognition of IFIL as a part of the Sietch bears no significance. As section 901(j) unequivocally sets forth, recognition of the entity must be determined by the United States—nowhere in the statute is there a provision for another foreign country's recognition of the at issue country's status relevant in this analysis. Thus, Judge Layton of the Fourteenth Circuit Court of Appeals erred in relying so heavily on the Holy Court's disposition in concluding IFIL was a valid taxing entity. R. at 21.

IFIL is not a valid taxing entity under section 901(j) of the Internal Revenue Code. Though the Executive Order issued by the President may have expressed a desire to conduct relations with IFIL, no relations ever occurred. The Holy Royal Court of Arrakis' ruling IFIL was a part of the Sietch State bears no significance in the determination, as the only recognition that the statute is concerned with is that of the United States. For these reasons, the Fourteenth Circuit Court of Appeals was correct in holding tax payments to IFIL were non-creditable foreign tax credits because IFIL is not a valid taxing entity.

B. The IFIL Tax Violates the Arrakis Constiution by Imposing an Impermissible Second Tax.

On April 12, 2010, President Corrino drafted an amendment to the Arrakis Constitution in response to the Sietch Dunes Peace Treaty reached by the parties involved. R. at 8-9. The amendment went into effect on the following day and in sum, created the post of the Vice President of Arrakis, and listed the powers and requirements of the post. R. at 9. The relevant portion of the amendment for the purposes of this discussion stated that the Vice President has the power to "[d]ecree and levy a single tax and have the power to amend the tax with the approval of the sitting President of Arrakis." R. at 9. Accordingly, Vice President Arteides decreed a single tax under this provision. R. at 10. Once this tax was enacted, no additional taxes were authorized by the Arrakis Constitution. R. at 5, 9-10. After Jessica Mohiam, for IFIL, took control of Unit #12, she imposed an income tax over Harkonnen Oil's receipts. R. at 13. Though the single tax had been put into place by Vice President Arteides within the Sietch State, and Unit #12 was within this controlling region, Mohiam still insisted on imposition of the tax. R. at 13.

Though Harkonnen Oil initially challenged IFIL's authority to impose this tax, and eventually sought a ruling, the underlying matter still exists in that IFIL had no authority to impose a second tax over the Sietch State region, yet did so anyways. The tax acted as an impermissible second tax over income already being taxed by the

Sietch State. R. at 10. The Fourteenth Circuit Court of Appeals correctly found IFIL violated the Arrakis Constitution in implementing an impermissible second tax on Harkonnen Oil.

III. HARKONNEN OIL FAILED TO EXHAUST ALL OF ITS REMEDIES TO REDUCE THE TAX BURDEN TO IFIL.

Besides the tax payments to IFIL being non-creditable foreign tax credits, Harkonnen Oil did not exhaust all effective and practical remedies to reduce its tax liability for the foreign tax. The treasury regulations set forth guidance for taxpayers who may be subject to noncompulsory tax payments, as is the case with Harkonen Oil and the tax demanded by Jessica Mohiam, for IFIL. Treas. Reg. § 1.901-2(e)(5)(i).

As a preliminary matter, it is of course necessary that the tax payment rendered be compulsory. 26 U.S.C. § 901. The regulations state that an amount paid is not a compulsory payment, and thus not an amount of tax paid, if the taxpayer fails to exhaust all effective and practical remedies, including invocation of competent authority procedures available under applicable tax treaties, to reduce the taxpayer's tax liability. Treas. Reg. § 1.901-2(e)(5)(i).

Under these facts, the only remedy Mr. Harkonnen sought for Harkonnen Oil to reduce tax liability imposed by IFIL was by petitioning to the Holy Royal Court of Arrakis. R. at 14. The Holy Royal Court determined that "Arrakis recognizes IFIL as a part of the Sietch," and as such, Harkonnen Oil paid the tax. R. at 14. While petitioning to the Holy Royal Court shows some recourse for Harkonnen Oil, the remedy sought is not enough. According to the regulations, "a taxpayer may generally rely on advice obtained in good faith from competent foreign tax advisors to whom the taxpayer has disclosed relevant facts." Treas. Reg. § 1.901-2(e)(5)(i). While Harkonnen Oil would have relied in good faith on a determination from "competent foreign tax advisors," the facts of this case do not place the Holy Royal Court into that category. Harkonnen Oil had no reason not to seek the advice and consultation of the United States in concluding IFIL was a valid taxing entity. This conclusion is furthered by the fact that the U.S. State Department was heavily engaged in the occurrences that took place in the Arrakis region between 2008 though 2012.

Harkonnen Oil failed to exhaust all its available remedies to reduce the tax burden it was subject to from IFIL. No impediments stood in the way of Harkonnen Oil seeking the United States' and/or the Sietch Council's determination of IFIL's status as a valid taxing entity. Such a determination, or attempt to receive a determination, would have satisfied Harkonnen Oil's requirement to exhaust reasonable all remedies in making a compulsory tax payment.

CONCLUSION

The United States respectfully requests this Court affirm the judgment of the United States Court of Appeals for the Fourteenth Circuit because the foreign levies paid to Arrakis and IFIL were not creditable foreign tax credits. The appellate court correctly held the Republic of Arrakis Foreign Tax as an invalid foreign tax credit because the tax payment to Arrakis did not reach Harkonnen Oil's net income, or net gains. The appellate court correctly held that IFIL was not a proper taxing entity and that Harkonnen Oil failed to exhaust remedies in mitigating the tax imposed by IFIL.

Respectfully submitted,

/s/ Team #32

Team #32

Counsel for Respondents

APPENDIX A

26 U.S.C.A. § 901

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

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

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

> (1) Citizens and domestic corporations.--In the case of a citizen of the United States and of a domestic corporation, the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or to any possession of the United States; and
>
> (2) Resident of the United States or Puerto Rico.--In the case of a resident of the United States and in the case of an individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any possession of the United States; and
>
> (3) Alien resident of the United States or Puerto Rico.--In the case of an alien resident of the United States and in the case of an alien individual who is a bona fide resident of Puerto Rico during the entire taxable year, the amount of any such taxes paid or accrued during the taxable year to any foreign country; and
>
> (4) Nonresident alien individuals and foreign corporations.--In the case of any nonresident alien individual not described in section 876 and in the case of any foreign corporation, the amount determined pursuant to section 906; and
>
> (5) Partnerships and estates.--In the case of any person described in paragraph (1), (2), (3), or (4), who is a member of a partnership or a beneficiary of an estate or trust, the amount of his proportionate share of the taxes (described in such paragraph) of the partnership or the estate or trust paid or accrued during the taxable year to a foreign country or to any possession of the United States, as the case may be. Under rules or regulations prescribed by the Secretary, in the case of any foreign trust of which the settlor or another person would be treated

as owner of any portion of the trust under subpart E but for section 672(f), the allocable amount of any income, war profits, and excess profits taxes imposed by any foreign country or possession of the United States on the settlor or such other person in respect of trust income.

(c) Similar credit required for certain alien residents.--Whenever the President finds that--

(1) a foreign country, in imposing income, war profits, and excess profits taxes, does not allow to citizens of the United States residing in such foreign country a credit for any such taxes paid or accrued to the United States or any foreign country, as the case may be, similar to the credit allowed under subsection (b)(3),

(2) such foreign country, when requested by the United States to do so, has not acted to provide such a similar credit to citizens of the United States residing in such foreign country, and

(3) it is in the public interest to allow the credit under subsection (b)(3) to citizens or subjects of such foreign country only if it allows such a similar credit to citizens of the United States residing in such foreign country,

the President shall proclaim that, for taxable years beginning while the proclamation remains in effect, the credit under subsection (b)(3) shall be allowed to citizens or subjects of such foreign country only if such foreign country, in imposing income, war profits, and excess profits taxes, allows to citizens of the United States residing in such foreign country such a similar credit.

(d) Treatment of dividends from a DISC or former DISC.--For purposes of this subpart, dividends from a DISC or former DISC (as defined in section 992(a)) shall be treated as dividends from a foreign corporation to the extent such dividends are treated under part I as income from sources without the United States.

(e) Foreign taxes on mineral income.--

(1) Reduction in amount allowed.--Notwithstanding subsection (b), the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country or possession of the United States with respect to foreign mineral income from sources within such country or possession which would (but for this paragraph) be allowed under such subsection shall be reduced by the amount (if any) by which--

(A) the amount of such taxes (or, if smaller, the amount of the tax which would be computed under this chapter with respect to such income determined without the deduction allowed under section 613), exceeds

(B) the amount of the tax computed under this chapter with respect to such income.

(2) Foreign mineral income defined.--For purposes of paragraph (1), the term “foreign mineral income” means income derived from the extraction of minerals from mines, wells, or other natural deposits, the processing of such minerals into their primary products, and the transportation, distribution, or sale of such minerals or primary products. Such term includes, but is not limited to--

(A) dividends received from a foreign corporation in respect of which taxes are deemed paid by the taxpayer under section 902, to the extent such dividends are attributable to foreign mineral income, and

(B) that portion of the taxpayer’s distributive share of the income of partnerships attributable to foreign mineral income.

(f) Certain payments for oil or gas not considered as taxes.--Notwithstanding subsection (b) and sections 902 and 960, the amount of any income, or profits, and excess profits taxes paid or accrued during the taxable year to any foreign country in connection with the purchase and sale of oil or gas extracted in such country is not to be considered as tax for purposes of section 275(a) and this section if--

(1) the taxpayer has no economic interest in the oil or gas to which section 611(a) applies, and

(2) either such purchase or sale is at a price which differs from the fair market value for such oil or gas at the time of such purchase or sale.

(g) Certain taxes paid with respect to distributions from possessions corporations.--

(1) In general.--For purposes of this chapter, any tax of a foreign country or possession of the United States which is paid or accrued with respect to any distribution from a corporation--

(A) to the extent that such distribution is attributable to periods during which such corporation is a possessions corporation, and

(B)(i) if a dividends received deduction is allowable with respect to such distribution under part VIII of subchapter B, or

(ii) to the extent that such distribution is received in connection with a liquidation or other transaction with respect to which gain or loss is not recognized, shall not be treated as income, war profits, or excess profits taxes paid or accrued to a foreign country or possession of the United States, and no deduction shall be allowed under this title with respect to any amount so paid or accrued.

(2) Possessions corporation.--For purposes of paragraph (1), a corporation shall be treated as a possessions corporation for any period during which an election under section 936 applied to such corporation, during which section 931 (as in effect on the day before the date of the enactment of the Tax Reform Act of 1976) applied to such corporation, or during which section 957(c) (as in effect on the day before the date of the enactment of the Tax Reform Act of 1986) applied to such corporation.

[(h) Repealed. Pub.L. 110-172, § 11(g)(9), Dec. 29, 2007, 121 Stat. 2490]

(i) Taxes used to provide subsidies.--Any income, war profits, or excess profits tax shall not be treated as a tax for purposes of this title to the extent--

(1) the amount of such tax is used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person (within the meaning of section 482), or any party to the transaction or to a related transaction, and

(2) such subsidy is determined (directly or indirectly) by reference to the amount of such tax, or the base used to compute the amount of such tax.

(j) Denial of foreign tax credit, etc., with respect to certain foreign countries.--

(1) In general.--Notwithstanding any other provision of this part--

(A) no credit shall be allowed under subsection (a) for any income, war profits, or excess profits taxes paid or accrued (or deemed paid under section 902 or 960) to any country if such taxes are with respect to income attributable to a period during which this subsection applies to such country, and

(B) subsections (a), (b), and (c) of section 904 and sections 902 and 960 shall be applied separately with respect to income attributable to such a period from sources within such country.

(2) Countries to which subsection applies.--

(A) In general.--This subsection shall apply to any foreign country--

(i) the government of which the United States does not recognize, unless such government is otherwise eligible to purchase defense articles or services under the Arms Export Control Act,

(ii) with respect to which the United States has severed diplomatic relations,

(iii) with respect to which the United States has not severed diplomatic relations but does not conduct such relations, or

(iv) which the Secretary of State has, pursuant to section 6(j) of the Export Administration Act of 1979, as amended, designated as a foreign country which repeatedly provides support for acts of international terrorisms.

(B) Period for which subsection applies.--This subsection shall apply to any foreign country described in subparagraph (A) during the period--

(i) beginning on the later of--

(I) January 1, 1987, or

(II) 6 months after such country becomes a country described in subparagraph (A), and

(ii) ending on the date the Secretary of State certifies to the Secretary of the Treasury that such country is no longer described in subparagraph (A).

(3) Taxes allowed as a deduction, etc.--Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(4) Regulations.--The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this subsection, including regulations which treat income paid through 1 or more entities as derived from a foreign country to which this subsection applies if such income was, without regard to such entities, derived from such country.

(5) Waiver of denial.--

(A) In general.--Paragraph (1) shall not apply with respect to taxes paid or accrued to a country if the President--

(i) determines that a waiver of the application of such paragraph is in the national interest of the United States and will expand trade and investment opportunities for United States companies in such country; and

(ii) reports such waiver under subparagraph (B).

(B) Report.--Not less than 30 days before the date on which a waiver is granted under this paragraph, the President shall report to Congress--

(i) the intention to grant such waiver; and

(ii) the reason for the determination under subparagraph (A)(i).

(k) Minimum holding period for certain taxes on dividends.--

(1) Withholding taxes.--

(A) In general.--In no event shall a credit be allowed under subsection (a) for any withholding tax on a dividend with respect to stock in a corporation if--

(i) such stock is held by the recipient of the dividend for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which such share becomes ex-dividend with respect to such dividend, or

(ii) to the extent that the recipient of the dividend is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(B) Withholding tax.--For purposes of this paragraph, the term "withholding tax" includes any tax determined on a gross basis; but does not include any tax which is in the nature of a prepayment of a tax imposed on a net basis.

(2) Deemed paid taxes.--In the case of income, war profits, or excess profits taxes deemed paid under section 853, 902, or 960 through a chain of ownership of stock in 1 or more corporations, no credit shall be allowed under subsection (a) for such taxes if--

(A) any stock of any corporation in such chain (the ownership of which is required to obtain credit under subsection (a) for such taxes) is held for less than the period described in paragraph (1)(A)(i), or

(B) the corporation holding the stock is under an obligation referred to in paragraph (1)(A)(ii).

(3) 45-day rule in the case of certain preference dividends.--In the case of stock having preference in dividends and dividends with respect to such stock which are attributable to a period or periods aggregating in excess of 366 days, paragraph (1)(A)(i) shall be applied--

(A) by substituting "45 days" for "15 days" each place it appears, and

(B) by substituting "91-day period" for "31-day period".

(4) Exception for certain taxes paid by securities dealers.--

(A) In general.--Paragraphs (1) and (2) shall not apply to any qualified tax with respect to any security held in the active conduct in a foreign country of a business as a securities dealer of any person--

(i) who is registered as a securities broker or dealer under section 15(a) of the Securities Exchange Act of 1934,

(ii) who is registered as a Government securities broker or dealer under section 15C(a) of such Act, or

(iii) who is licensed or authorized in such foreign country to conduct securities activities in such country and is subject to bona fide regulation by a securities regulating authority of such country.

(B) Qualified tax.--For purposes of subparagraph (A), the term "qualified tax" means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if--

(i) the dividend to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

(C) Regulations.--The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

(5) Certain rules to apply.--For purposes of this subsection, the rules of paragraphs (3) and (4) of section 246(c) shall apply.

(6) Treatment of bona fide sales.--If a person's holding period is reduced by reason of the application of the rules of section 246(c)(4) to any contract for the bona fide sale of stock, the determination of whether such person's holding period meets the requirements of paragraph (2) with respect to taxes deemed paid under section 902 or 960 shall be made as of the date such contract is entered into.

(7) Taxes allowed as deduction, etc.--Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(l) Minimum holding period for withholding taxes on gain and income other than dividends etc.--

(1) In general.--In no event shall a credit be allowed under subsection (a) for any withholding tax (as defined in subsection (k)) on any item of income or gain with respect to any property if--

(A) such property is held by the recipient of the item for 15 days or less during the 31-day period beginning on the date which is 15 days before the date on which the right to receive payment of such item arises, or

(B) to the extent that the recipient of the item is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

This paragraph shall not apply to any dividend to which subsection (k) applies.

(2) Exception for taxes paid by dealers.--

(A) In general.--Paragraph (1) shall not apply to any qualified tax with respect to any property held in the active conduct in a foreign country of a business as a dealer in such property.

(B) Qualified tax.--For purposes of subparagraph (A), the term “qualified tax” means a tax paid to a foreign country (other than the foreign country referred to in subparagraph (A)) if--

(i) the item to which such tax is attributable is subject to taxation on a net basis by the country referred to in subparagraph (A), and

(ii) such country allows a credit against its net basis tax for the full amount of the tax paid to such other foreign country.

(C) Dealer.--For purposes of subparagraph (A), the term “dealer” means-

(i) with respect to a security, any person to whom paragraphs (1) and (2) of subsection (k) would not apply by reason of paragraph (4) thereof, and

(ii) with respect to any other property, any person with respect to whom such property is described in section 1221(a)(1).

(D) Regulations.--The Secretary may prescribe such regulations as may be appropriate to carry out this paragraph, including regulations to prevent the abuse of the exception provided by this paragraph and to treat other taxes as qualified taxes.

(3) Exceptions.--The Secretary may by regulation provide that paragraph (1) shall not apply to property where the Secretary determines that the

application of paragraph (1) to such property is not necessary to carry out the purposes of this subsection.

(4) Certain rules to apply.--Rules similar to the rules of paragraphs (5), (6), and (7) of subsection (k) shall apply for purposes of this subsection.

(5) Determination of holding period.--Holding periods shall be determined for purposes of this subsection without regard to section 1235 or any similar rule.

(m) Denial of foreign tax credit with respect to foreign income not subject to United States taxation by reason of covered asset acquisitions.--

(1) In general.--In the case of a covered asset acquisition, the disqualified portion of any foreign income tax determined with respect to the income or gain attributable to the relevant foreign assets--

(A) shall not be taken into account in determining the credit allowed under subsection (a), and

(B) in the case of a foreign income tax paid by a section 902 corporation (as defined in section 909(d)(5)), shall not be taken into account for purposes of section 902 or 960.

(2) Covered asset acquisition.--For purposes of this section, the term "covered asset acquisition" means--

(A) a qualified stock purchase (as defined in section 338(d)(3)) to which section 338(a) applies,

(B) any transaction which--

(i) is treated as an acquisition of assets for purposes of this chapter, and

(ii) is treated as the acquisition of stock of a corporation (or is disregarded) for purposes of the foreign income taxes of the relevant jurisdiction,

(C) any acquisition of an interest in a partnership which has an election in effect under section 754, and

(D) to the extent provided by the Secretary, any other similar transaction.

(3) Disqualified portion.--For purposes of this section--

(A) In general.--The term “disqualified portion” means, with respect to any covered asset acquisition, for any taxable year, the ratio (expressed as a percentage) of--

(i) the aggregate basis differences (but not below zero) allocable to such taxable year under subparagraph (B) with respect to all relevant foreign assets, divided by

(ii) the income on which the foreign income tax referred to in paragraph (1) is determined (or, if the taxpayer fails to substantiate such income to the satisfaction of the Secretary, such income shall be determined by dividing the amount of such foreign income tax by the highest marginal tax rate applicable to such income in the relevant jurisdiction).

(B) Allocation of basis difference.--For purposes of subparagraph (A)(i)-

(i) In general.--The basis difference with respect to any relevant foreign asset shall be allocated to taxable years using the applicable cost recovery method under this chapter.

(ii) Special rule for disposition of assets.--Except as otherwise provided by the Secretary, in the case of the disposition of any relevant foreign asset--

(I) the basis difference allocated to the taxable year which includes the date of such disposition shall be the excess of the basis difference with respect to such asset over the aggregate basis difference with respect to such asset which has been allocated under clause (i) to all prior taxable years, and

(II) no basis difference with respect to such asset shall be allocated under clause (i) to any taxable year thereafter.

(C) Basis difference.--

(i) In general.--The term “basis difference” means, with respect to any relevant foreign asset, the excess of--

(I) the adjusted basis of such asset immediately after the covered asset acquisition, over

(II) the adjusted basis of such asset immediately before the covered asset acquisition.

(ii) Built-in loss assets.--In the case of a relevant foreign asset with respect to which the amount described in clause (i)(II) exceeds the amount described in clause (i)(I), such excess shall be taken into account under this subsection as a basis difference of a negative amount.

(iii) Special rule for section 338 elections.--In the case of a covered asset acquisition described in paragraph (2)(A), the covered asset acquisition shall be treated for purposes of this subparagraph as occurring at the close of the acquisition date (as defined in section 338(h)(2)).

(4) Relevant foreign assets.--For purposes of this section, the term "relevant foreign asset" means, with respect to any covered asset acquisition, any asset (including any goodwill, going concern value, or other intangible) with respect to such acquisition if income, deduction, gain, or loss attributable to such asset is taken into account in determining the foreign income tax referred to in paragraph (1).

(5) Foreign income tax.--For purposes of this section, the term "foreign income tax" means any income, war profits, or excess profits tax paid or accrued to any foreign country or to any possession of the United States.

(6) Taxes allowed as a deduction, etc.--Sections 275 and 78 shall not apply to any tax which is not allowable as a credit under subsection (a) by reason of this subsection.

(7) Regulations.--The Secretary may issue such regulations or other guidance as is necessary or appropriate to carry out the purposes of this subsection, including to exempt from the application of this subsection certain covered asset acquisitions, and relevant foreign assets with respect to which the basis difference is de minimis.

(n) Cross reference.--

(1) For deductions of income, war profits, and excess profits taxes paid to a foreign country or a possession of the United States, see sections 164 and 275.

(2) For right of each partner to make election under this section, see section 703(b).

(3) For right of estate or trust to the credit for taxes imposed by foreign countries and possessions of the United States under this section, see section 642(a).

(4) For reduction of credit for failure of a United States person to furnish certain information with respect to a foreign corporation or partnership controlled by him, see section 6038.

APPENDIX B

<u>26 U.S.C.A. § 903</u>

§ 903. Credit for taxes in lieu of income, etc., taxes.

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.