No. C15-1701-1

IN THE

Supreme Court of the United States

ROYAL HARKONNEN OIL COMPANY,

Petitioner,

v.

UNITED STATES,

Respondent.

On Petition for a Writ of Certiorari to
The United States Court of Appeals
for the Fourteenth Circuit

BRIEF FOR RESPONDENT

Team 46

Attorneys for Respondent

QUESTIONS PRESENTED

I. Whether Harkonnen's payments under the "Republic of Arrakis Foreign Tax" constitute an income tax for which a foreign tax credit is allowed under 26 U.S.C. § 901 where the predominant value recouped under the levy was based on the company's gross receipts without allowing for deduction of significant costs, was paid in exchange for the right to drill oil, and was not a substitute for the generally applicable income tax.

II. Whether Harkonnen's payments to IFIL, a nomadic group of political dissidents, constitute a tax where such a determination would require this Court to recognize IFIL as a foreign country, when the Constitution grants the Executive Branch exclusive authority to do so; where recognizing IFIL as a foreign country subverts the purpose of Section 901; and where Harkonnen received a specific economic benefit in exchange for non-compulsory payment.

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The opinion of the United States District Court for the Central District of New Tejas is unreported. The opinion of the United States Court of Appeals for the Fourteenth Circuit is also unreported, but 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. This Court granted a petition for a writ of certiorari. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (2012).

STATUTORY PROVISIONS INVOLVED

This case involves the interpretation of Section 901 of the Internal Revenue Code. Section 901 allows domestic taxpayers to offset their U.S. tax liability by allowing a dollar-for-dollar credit for "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) (2012). *See* Appendix "A." This case also involves interpretation of Section 903 of the Internal Revenue Code, which places taxes "paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country" within Section 901's scope. 26 U.S.C. § 903 (2012). *See* Appendix "B."

STATEMENT OF THE CASE

In 2011, the Royal Harkonnen Oil Company ("Harkonnen") made payments to the Republic of Arrakis ("Arrakis") and a band of political dissidents, who called themselves the Inter-Sietch Fremen Independence League ("IFIL"), in connection with Harkonnen's oil-mining operations in Arrakis. R. at 16. Harkonnen sought foreign tax credit for those payments on its U.S. Tax Returns for the 2011 tax year.

R. at 16. After the Internal Revenue Service (the "Service") denied credit, Harkonnen paid its taxes and filed the instant lawsuit seeking a refund. R. at 17.

The Regulatory Backdrop. Section 901 of the Internal Revenue Code allows U.S. citizens and corporations to claim credit against their U.S. income tax liability for "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country." § 901(b)(1). The foreign tax credit is designed to reduce the burden of double taxation on U.S. taxpayers who earn income abroad. *Burnet v. Chicago Portrait Co.*, 285 U.S. 1, 9 (1932).

In 1983, the Secretary of Treasury issued final regulations that set out three basic requirements for a foreign government's levy to be credited against U.S. tax liabilities. *See* Treas. Reg. § 1.901-2 (2014). First, the levy must constitute a tax. Treas. Reg. § 1.901-2(a)(1)(i). Second, the levy must be paid or accrued to a foreign country. Treas. Reg. § 1.901-2(a)(1). Finally, the predominant character of the levy must be that of an income tax in the U.S. sense. Treas. Reg. § 1.901-2(a)(1)(ii).

A levy constitutes a tax if it "requires a compulsory payment pursuant to the authority of a foreign country to levy taxes." Treas. Reg. § 1.901-2(a)(2)(i). A foreign levy is not pursuant to a foreign country's authority to levy taxes, and thus is not a tax, if the payer receives a specific economic benefit—including "a concession to extract government-owned petroleum"—in exchange for payment. *Id.*; Treas. Reg. § 1.901-2(a)(2)(ii)(B). The regulations define "foreign country" as "any foreign state . . . and any political subdivision of any foreign state . . . ." Treas. Reg. § 1.901-2(g)(2).

The regulations further explain that a tax's predominant character is that of an income tax in the U.S. sense if it is likely to reach net gain in the normal circumstances in which it applies. Treas. Reg. § 1.901-2(a)(3)(i). A tax is likely to reach net gain only if it satisfies three tests: the realization test, the gross receipts test, and the net income test. Treas. Reg. § 1.901-2(b)(1). The realization test is satisfied if the tax is imposed upon or after 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). The gross receipts test is satisfied if the foreign tax is imposed on the basis of gross receipts or an equivalent that is computed under a method likely to produce an amount that is not greater than the fair market value. Treas. Reg. § 1.901-2(b)(3). The net income test is satisfied if the tax's base is computed by reducing gross receipts to permit recovery of significant costs and expenses attributable, under reasonable principles, to such gross receipts. Treas. Reg. § 1.901-2(b)(4).

The Royal Harkonnen Oil Company. Harkonnen is a U.S. corporation in the business of extracting oil and natural gas deposits. R. at 2. In order to expand its global production, Harkonnen began exploring the feasibility of mining oil and natural gas in an area marred by political unrest and ruled by a de facto monarch—the Republic of Arrakis. R. at 2–3. Harkonnen thought Arrakis' Caladan Oil Field could be a promising opportunity, but was concerned about negotiating oil and gas leases with Jules Corrino, who inherited the role of President of Arrakis. R. at 3. Corrino's family claimed all mineral rights in Arrakis since their rise to power after the "Bloody Ten Year War." R. at 3. Harkonnen was primarily concerned that Corrino would demand a high royalty in exchange for the right to develop the Caladan Oil Field. R. at 3. Ultimately, Harkonnen decided to forego development of smaller oil fields in other countries, and entered into negotiations with Arrakis for the exclusive right to develop the Caladan Oil Field. R. at 3. Consistent with Harkonnen's concerns, the negotiations—which spanned several months—focused largely on President Corrino's demands for various royalty payments. R. at 4.

The Republic of Arrakis. Arrakis is an oil-rich country comprised primarily of two distinct religious bloodlines: the Eternal Arrakis Empire and the Sietch Empire. R. at 3. These two groups have historically engaged in military conflict, punctuated by unstable periods of peace. R. at 3. Arrakis codified the historical and religious distinctions of these groups in its tax laws by setting the applicable rate for each citizen according to whether the citizen would have been a subject of the historical Arrakis or Sietch throne. R. at 4. The Arrakis tax code treats those with Sietch ties as inferior, subjecting them to a five-percent higher applicable tax rate than that of citizens with ties to the Arrakis throne. R. at 4. All Arrakisian citizens may mitigate their tax burdens through application of several robust deductions, which match the available deductions in the Internal Revenue Code. R. at 4. Until 2008, foreign corporations and individuals were not subject to taxation in Arrakis. R. at 4.

The Republic of Arrakis Foreign Tax. On March 10, 2008, after months of negotiating an oil and gas lease with Harkonnen, President Corrino unilaterally drafted and signed into law the "Republic of Arrakis Foreign Value Tax." R. at 5. That levy applied to any entity operating machinery in Arrakis, and was calculated by multiplying the entity's gross receipts generated during the current calendar year by a tax percentage. R. at 5. Consistent with historical Arrakis tax custom, the levy did not allow foreign corporations or individuals any deductions. R. at 4. Corrino did not set an applicable rate until June 30, 2008—the same day he entered into a leasehold with Harkonnen for development of the Caladan Oil Field. R. at 7. Corrino renamed the levy the "Republic of Arrakis Foreign Tax" (the "Arrakis levy"). R. at 7.

Harkonnen Develops the Caladan Oil Field. After several months of negotiation and face-to-face meetings with Corrino, Harkonnen entered into a lease to develop the entire 231,000 square-mile Caladan Oil Field. R. at 7. In exchange for the right to extract crude oil, Harkonnen agreed to pay a one-time bonus of fifty-five million dollars, along with a fifteen percent royalty. R. at 7. Harkonnen also agreed to pay the newly-minted forty-five percent Arrakis levy. R at 7. Harkonnen produced its first barrels of crude oil in January of 2009, and continued development throughout the remainder of 2009, including those portions of the oil field located beneath the Sietch Dunes region of Arrakis. R. at 7–8.

The Sietch State. Political tensions in Arrakis finally reached a boiling point on March 20, 2010, when a group identifying themselves as the "Independent People of Sietch" declared independence from Arrakis. R. at 8. Arrakis immediately mobilized its military to suppress the would-be uprisings. R. at 8. After weeks of fighting and several thousand casualties, Corrino met with the leader of the Independent People of Sietch, Paul Atreides, to declare a truce. R. at. 8. The truce, known as the "Sietch Dunes Peace Treaty," established the Independent People of Sietch as an independent political party of Arrakis, designated the Sietch State as a province of Arrakis, and granted the Sietch State an appointment on President Corrino's cabinet. R. at 8.

Corrino then amended the Arrakis Constitution to recognize the Sietch State as a political subdivision of Arrakis. R. at 9. That amendment created the post of Vice-President. R. at 9. Among the limited powers granted to the Vice-President under the amendment was the power to "[d]ecree and levy a single tax and to have the power to amend the tax with approval of the sitting President of Arrakis." R. at 9. Paul Atreides was voted in as Vice-President on April 15, 2010, and immediately utilized his taxing authority to pass an income tax applicable to income generated in the Sietch State.[1] R. at 9–10.

The Inter-Sietch Fremen Independence League. IFIL is a group of political dissidents, who, for years, has not been tied to any one location, but instead moved throughout the region surrounding Arrakis. R. at 12. Since 2007, IFIL received funding from Arrakis' neighboring countries, Al Dhanab and Anbus. R. at 12. IFIL is governed by a single leader, chosen through seven electoral votes. R. at 12. The Al Dhanab and Anbus royal families each hold three votes, and the sole remaining vote is determined by a majority election among those pledging membership to IFIL. R. at. 12. A person must attain five of seven electoral votes to be elected. R. at 12.

IFIL Invades Arrakis. On December 31, 2010, in an effort to eject Paul Atreides as Vice-President, IFIL swept into Arrakis and launched a rebellion in the Sietch State. R. at 11. IFIL's goal was to replace Atreides with Jessica Mohiam, the leader of IFIL and daughter of a founding member of the Bene Gesserit terrorist group. R.

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[1] Harkonnen paid taxes pursuant to the Sietch State income tax. R. at 10. The Internal Revenue Service granted Harkonnen foreign tax credit on its 2011 tax returns for its payments under the Sietch State income tax. R. at 17. The Sietch State tax payments are not at issue in the instant appeal.

at 11. By March of 2011, IFIL took forceful control of the Badlands region of the Sietch State. R. at 13. On March 20, 2011, IFIL pushed beyond the Badlands and captured one of Harkonnen's drilling stations, Unit #12. R. at 13. Upon taking control of the oil well, Mohiam issued a statement proclaiming, "Harkonnen Oil is slant drilling the Badlands and until they rectify their insolence and pay tribute, IFIL will control oil production from Unit #12." R. at 13.

Two days after IFIL seized Unit #12, Harkonnen sent its president to Arrakis to meet with Mohiam. R. at 13. The meeting resulted in a lease, under which Harkonnen agreed to pay a one-time $550,000 bonus and a five-percent royalty. R. at 13. Mohiam further declared a levy against two-percent of Harkonnen's income generated by Unit #12. R. at 13. IFIL calculated this two-percent profit interest by taking the receipts generated by Unit #12, less deductions[2] for costs and the like, and multiplying by two percent (the "IFIL levy"). R. at. 13.

Harkonnen initially disputed payment of this two-percent fee. R. at 14. It petitioned the Holy Royal Court of Arrakis (the "Holy Royal Court"), which handles all tax disputes in Arrakis, for determination of IFIL's authority to require payment of the levy. R. at 14. The Holy Royal Court declared only that "Arrakis recognizes IFIL as a part of Sietch." R. at 14. Harkonnen accepted this declaration as a sufficient answer to its petition and did not inquire further regarding whether IFIL held any

[2] The deductions IFIL allowed are the same deductions allowed to foreign corporations in the Sietch State, which uses the same deductions as Arrakis, but allows foreign corporations to claim them. R. at 10, 13. Because the deductions allowed under the Arrakis Tax Code match those in the Internal Revenue Code, the deductions allowed by IFIL mirror the deductions allowed corporations in the United States.

taxing authority under the Arrakis Constitution. R. at 14. The next day Harkonnen sent two checks to IFIL—one for its royalty and bonus payments, the other for the two-percent income payment. R. at 14. IFIL deposited both checks into its Swiss bank account and ultimately paid twenty percent of those funds to the Al Dhanab and Anbus monarchies. R. at 14.

World Perceptions of IFIL. Although IFIL's leader claims to oppose the Bene Gesserit, the U.S. State Department nevertheless classified IFIL as a splinter group of that terrorist organization. R. at 11. Al Dhanab and Anbus, who hold pecuniary and voting interests in IFIL, recognize IFIL as a legitimate foreign government and independent state of the Sietch Dunes region of Arrakis. R. at 12. Russia and France recognize IFIL's legitimacy as a state within the Sietch Dunes region. R. at 13. Notwithstanding the State Department's classification, the President of the United States issued Executive Order 14012, stating that the U.S. "would like to establish trade relations" with IFIL, which the order described as a "friendly sovereign." R. at 14. Finally, the Holy Royal Court, under its decision in the Harkonnen dispute, recognized IFIL as part of Sietch. R. at 14.

Corrino Amends the Republic of Arrakis Foreign Tax. On May 16, 2011, President Corrino met with the Harkonnen's president, Arrakis Vice-President Paul Atreides, and IFIL leader Jessica Mohiam. R. at 15. The meeting's discussions focused on oil production in the Caladan Oil Field. R. at 15. After the meeting, Corrino amended the Arrakis levy, lowering the applicable rate to thirty-three percent. R. at 15. Through a separate proclamation, Corrino also modified the levy by allowing foreign corporations to claim all deductions available to Arrakisian citizens. R. at 15.

Those deductions, however, were capped at ninety-five percent of the dollar value allowed to Arrakisian citizens. R. at 15.

Harkonnen's 2011 Tax Returns. On March 15, 2012, Harkonnen filed its U.S. Tax Return for the 2011 tax year. R. at 16. As a "calendar year" company, the applicable dates for Harkonnen's tax returns were January 1, 2011, through December 31, 2011. R. at. 16. Harkonnen sought foreign tax credit for its payments to Arrakis and IFIL. R. at 16. Those payments were calculated as follows:

The Arrakis Levy	
January 1 – May 15, 2011: *Gross receipts x 45%*	May 16 – December 31, 2011: *(Gross receipts – (deductions x 95%)) x 33%*
The IFIL Levy	
March 22 – December 31, 2011: *(Gross receipts – deductions) x 2%*	

The Service audited Harkonnen's returns and determined that the company's payments to IFIL and Arrakis were not eligible for foreign tax credit. R. at 16–17. Harkonnen then paid the entire sum of its U.S. tax liabilities. R. at 17.

The Underlying Tax Suit. After demanding a refund, Harkonnen filed this suit in the United States District Court for the Central District of Tejas, claiming that it was entitled to foreign tax credit for its payments to IFIL and Arrakis. R. at 17. After trial, the district court ruled that Harkonnen was not entitled to foreign tax credit. R. at 17.

Harkonnen then appealed the district court's ruling. The United States Court of Appeals for the Fourteenth Circuit affirmed the district court. R. at 17–19.

SUMMARY OF THE ARGUMENT

The Fourteenth Circuit properly denied Harkonnen's request for foreign tax credit for its payments to both Arrakis and IFIL.

I.

Harkonnen's payments to Arrakis do not qualify for credit under Section 901 of the Internal Revenue Code because the Arrakis levy is not a tax, income tax, or "in lieu" tax. Although the Arrakis levy was computed using two different formulae, the levy must be analyzed as single levy because each calculation references the same base—gross receipts.

The Arrakis levy does not constitute a tax because Harkonnen received a specific economic benefit in exchange for its payment. The regulations consider the right to extract government-owned oil a specific economic benefit. Persons who receive such a benefit are called "dual capacity taxpayers." The regulations create a presumption that a dual capacity taxpayer's payment of a foreign levy was made in exchange for the specific economic benefit, and thus was not a payment of tax. Based on all of the relevant facts and circumstances in the record, Harkonnen failed to rebut this presumption.

Further, the regulations allow credit only for foreign levies that have the predominant character of an income tax as understood in the U.S. Of primary concern is whether the foreign levy reaches the taxpayer's net income. The relevant inquiry is the levy's economic effect. A foreign levy reaches net income only if it allows deductions for significant costs and expenditures. Considered as a whole, the Arrakis levy fails to reach net income because, over the course of the year, the predominant amount paid under the Arrakis levy was attributable to a calculation that did not allow any deductions.

Finally, the levy is not an "in lieu" tax under Section 903. A foreign levy qualifies as an "in lieu" tax only if it acts as a substitute for a generally applicable income tax. Because Harkonnen, as a foreign entity, would face no tax liability in Arrakis absent the Arrakis levy, the Arrakis levy is not an "in lieu" tax. The Fourteenth Circuit therefore properly denied foreign tax credit to Harkonnen for its payments under the Arrakis levy.

II.

The IFIL levy also does not qualify for foreign tax credit under Section 901 of the Internal Revenue Code. As an initial matter, Harkonnen's claim would require this Court to recognize the legitimacy of IFIL as a foreign country. That claim presents a political question that is reserved solely for the Executive Branch. Hence, this Court does not have jurisdiction over Harkonnen's claim, and should leave the Service's initial ruling in place.

Even if Harkonnen's claim is justiciable, Harkonnen is not entitled to credit because IFIL is not a foreign country. Section 901 allows foreign tax credit only for payments made to a foreign country. Because this Court has found the term "foreign country" ambiguous, this Court must construe the term in a manner that effectuates Section 901's purpose. Any construction that includes IFIL runs contrary to Section 901's inherent limitations.

Lastly, even were this Court to find that IFIL is a foreign country, its levy does not constitute a tax because payment of the levy was not compulsory, and Harkonnen received a specific economic benefit in exchange for payment. IFIL controls the oil that it allowed Harkonnen to extract using Unit #12. As with the Arrakis levy, the right to extract IFIL-controlled oil makes Harkonnen a dual capacity taxpayer. Harkonnen cannot rebut the presumption that its payment to IFIL constituted a royalty rather than a tax. Additionally, payment of the IFIL levy was not compulsory because Harkonnen failed to exhaust all practical and effective remedies to eliminate its obligation to pay the levy. The Fourteenth Circuit therefore correctly denied foreign tax credit to Harkonnen for its payments to IFIL.

ARGUMENT

Harkonnen challenges the lower court's denial of foreign tax credit for both the Arrakis and IFIL levies. Whether each levy merits foreign tax credit turns on application of Section 901 of the Internal Revenue Code. Both issues concern purely legal questions concerning the scope of that federal statutory provision and the corresponding Treasury Regulations.

A district court's findings of fact are reviewed under the clearly erroneous standard; legal conclusions, however, are reviewed *de novo*. *Intertan, Inc. v. Comm'r*, 117 F. App'x 348, 349 (5th Cir. 2004). As to legal conclusions that were based on findings of fact—such as those resulting in the trial court's ultimate determination of tax liability—the proper standard of review is *de novo*. *American Elec. Power Co., Inc. v. U.S.*, 326 F.3d 737, 741–42 (6th Cir. 2003) (citing *Frank Lyon Co. v. United States*, 435 U.S. 561, 581 (1978)).

The Fourteenth Circuit properly held that Harkonnen's payments to both Arrakis and IFIL are not eligible for foreign tax credit under Section 901. Because the Arrakis levy is neither a tax nor an income tax, and IFIL is neither a foreign country nor was its levy a tax, this Court should affirm the judgment below.

I. HARKONNEN'S PAYMENTS TO ARRAKIS ARE NOT TAXES FOR WHICH CREDIT IS ALLOWED UNDER 26 U.S.C. § 901.

The Service properly denied foreign tax credit to Harkonnen for its payments to Arrakis because the Arrakis levy was neither a "tax" nor an "income tax" within the meaning of 26 U.S.C. § 901. Section 901 of the Internal Revenue Code allows domestic corporations to claim credit against their income tax liability in the U.S. for "any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country. . . ." § 901(b)(1). Taxes "paid in lieu of a tax on income, war profits, and excess profits otherwise generally imposed by any foreign country" are also creditable under Section 901. § 903.

The foreign tax credit provisions exist primarily to mitigate the burden of double taxation that exists for domestic corporations operating abroad, which arises as a result of the corporation being taxed in both the U.S. and the foreign country. *See Burnet*, 285 U.S. at 9. A secondary objective of the foreign tax credit is to encourage—or at least not discourage—American foreign trade. *See Phillips Petroleum Co. v. Comm'r*, 104 T.C. 256, 284 (1995) (citing H.R. Rept. 767, 65th Cong. 2d Sess. (1918)). Despite these objectives, the foreign tax credit operates as "an exemption from tax," and therefore "the credit provisions of Section 901 are to be strictly construed." *Exxon Corp. v. Comm'r*, 113 T.C. 338, 350 (1999).

The dollar-for-dollar credit allowed under Section 901 offsets a U.S. taxpayer's domestic income tax liability only if the foreign levy meets the requirements set forth in Treasury Regulations 1.901–3. The Arrakis levy fails to satisfy the criteria set forth in the regulations and is therefore not a creditable tax for three principal reasons: (1) it is not a tax; (2) it is not a tax on net income; and (3) it is not a tax in lieu of a generally applicable income tax.

A. The Arrakis Levy, Although Calculated With Two Varying Formulae, Constitutes a Single Levy Because Each Calculation References The Same Base.

As a threshold matter, this Court must first determine whether the Arrakis levy—as applied January 1 through May 15, 2011, and May 16 through December 31, 2011—constitutes a single levy. Payments pursuant to a foreign levy "must be combined or separated before judging whether the payments have the 'predominate character' of an income tax." Joel D. Kuntz & Robert J. Peroni, *U.S. International Taxation* § B4.03, at 2(a) (2014). As with other considerations under Section 901, this inquiry "depends on U.S. principles." Treas. Reg. § 1.901-2(d)(1). Consequently, it does not matter "whether foreign law imposes the levy or levies in a single or separate statutes." *Id.*

Where a foreign country computes its levy using two different formulae, and each is "computed by reference to a separate base," the levy is treated as two separate levies; each one must be analyzed individually under Section 901. *Id.* The regulations illustrate that a levy against different elements of taxpayer's income is a levy against separate bases. Specifically, Example 3 of the regulations explains that a levy against mining income would constitute a separate base from a levy against manufacturing income. Treas. Reg. § 1.901-2(d)(3), Ex. 3. The regulations thus treat a foreign levy as a single levy where it utilizes two distinct formulae, and each is computed by reference to the *same* base. *See* Treas. Reg. § 1.901-2(d)(1). "Levies are not separate merely because different rates apply to different taxpayers." *Id.* So, for example, a foreign levy that taxes the gross receipts of small businesses at one rate, and the gross receipts of large businesses at another rate would constitute a single levy because each taxes the same base.

The Arrakis levy constitutes a single levy because each of the levy's formulae is calculated by reference to gross receipts. The first portion of the levy was computed by taking the gross receipts generated by Harkonnen's operations occurring in Arrakis and multiplying that amount by forty-five percent ("Formula 1"). R. at 7. Formula 1 did not provide for any deductions to mitigate Harkonnen's costs and expenses because Arrakis historically allowed deductions only for those with Arrakis or Sietch heritage. R. at 4–5. The second portion of the levy calculated Harkonnen's liability by multiplying gross receipts times thirty-three percent, with a capped allowance of cost deductions ("Formula 2"). R. at 15. Thus, the levy's structure over the 2011 calendar year was as follows:

The "Republic of Arrakis Foreign Tax" Levy	
Formula 1	**Formula 2**
January 1 – May 15, 2011: *Gross receipts x 45%*	May 16 – December 31, 2011: *(Gross receipts – (deductions x 95%)) x 33%*

Notwithstanding the fact that Formula 2 incorporated a limited scheme of deductions, the Arrakis levy constitutes a single levy. That is because deductions are not an element of income under the regulations. Instead, the regulations treat different *forms* of income as different elements of income. *See e.g.*, Treas. Reg. § 1.901-2(d)(3) (explaining that income from mining, manufacturing, technical services, other services, and investments, are different bases because they are different forms of income). Because Formula 1 and 2 are both calculated by reference to the same element of Harkonnen's income—gross receipts—the Arrakis levy constitutes a single levy.

The regulations support this treatment of the Arrakis levy. Examples 3, 4, and 5 of Treasury Regulation 1.901-2(d)(1) reflect the following understanding of the separate levy rules:

- Where a foreign levy taxes the same base (e.g., gross receipts), applying different rates to different persons, but allowing the same deductions for those persons, the foreign levy constitutes a single levy.
- Where a foreign levy taxes different bases (e.g., manufacturing v. mining), and allows different deductions based on those income streams, the foreign levy constitutes separate levies.
- Where a foreign levy taxes different bases, but allows the same deductions across those income streams, the foreign levy constitutes a single levy.

Treas. Reg. § 1.901-2(d)(3). It follows that where, as here, a foreign levy applies two formulae to the same base, the foreign levy constitutes a single levy despite the fact that one formula allows for deductions that the other does not.

Indeed, this reading of the regulations is consistent with the policy of the foreign tax credit. By treating levies like the Arrakis levy as a single levy, multinational corporations will typically receive more foreign tax credit for their development abroad. A constrained reading of the separate levy rules on the other hand "requires fragmenting foreign tax systems . . . and results in the crediting of significantly fewer taxes." Glenn E. Coven, *International Comity and the Foreign Tax Credit: Crediting Nonconforming Taxes*, 4 Fla. Tax Rev. 83, 106 (1999). Two significant limitations still buffer the foreign tax credit from abuse: the regulations' predominant character test and the rules under Section 904 of the Internal Revenue Code (as explained more fully below, the Arrakis levy fails the predominant character test). *See* 26 U.S.C. § 904; Treas. Reg. § 1.901-2(a)(1)(ii); *see also* Rev. Rul. 64-620, 1964-2 C.B. 187. Assuming that a foreign levy meets these requirements, an increase in foreign tax credit will encourage international development, which will in turn increase comity between the U.S. and foreign countries that rely on American corporations to fuel their economies. Because the Arrakis levy constitutes a single levy, this Court must analyze the levy as a whole to determine whether it constitutes a tax, an income tax, or an "in lieu" tax.

B. The Arrakis Levy is Not a Tax Because Harkonnen Received a Specific Economic Benefit in Exchange For Voluntary Payment.

Harkonnen's payments under the Arrakis levy do not constitute taxes under the applicable regulations and are therefore not creditable under Section 901. "A foreign levy is [a creditable income tax] if and only if . . . [i]t is a tax." Treas. Reg. § 1.901-2(a)(1)(i). Whether the foreign levy constitutes a tax for purposes of Section 901 is ultimately "determined by principles of U.S. law and not by principles of law of the foreign country." *Id.*; *see also Biddle v. Comm'r*, 302 U.S. 573, 579 (1938).

Under U.S. law, a foreign levy is not a tax if "the payors of the levies receive specific economic benefits in exchange for payment of the levies." *Exxon*, 113 T.C. at 350; Treas. Reg. § 1.901-2(a)(2). The regulations refer to persons who are subject to a foreign country's levy and who also receive a specific economic benefit from that country as "dual capacity taxpayer[s]." Treas. Reg. § 1.901-2(a)(2)(ii)(A). Dual capacity taxpayers are subject to special regulations, and may claim credit under Section 901 only by proving that their payments to the foreign country were *not* made in exchange for the specific economic benefit received. *See* Treas. Reg. § 1.901-2A. Harkonnen is a dual capacity taxpayer. Further, because Harkonnen's payments to Arrakis under the levy are akin to a royalty interest exchanged for a specific economic benefit, Harkonnen is not entitled to foreign tax credit.

1. Harkonnen's exclusive right to develop the Caladan Oil Field constitutes a specific economic benefit, making Harkonnen a dual capacity taxpayer.

Harkonnen is considered a dual capacity taxpayer because it received a specific economic benefit from Arrakis. The regulations define the term specific 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." Treas. Reg. § 1.901-2(a)(2)(ii)(B). Expressly included within this definition is "the right to use, acquire, or extract resources that a foreign country owns or controls." *Phillips*, 104 T.C. at 286. In contrast, the "term does not include the right or privilege merely to engage in business generally." *Id.*

Harkonnen received a specific economic benefit under its oil and gas lease with Arrakis—the right to extract and exploit oil and gas resources owned by the governing autocracy of Arrakis. R. at 3; *see also* Treas. Reg. § 1.901-2(a)(2)(ii)(B) (explaining that "a concession to extract government-owned petroleum is a specific economic benefit"). Because the plain terms of the regulations dictate that such an arrangement constitutes a specific economic benefit, Harkonnen is a dual capacity taxpayer and is subject to Treasury Regulation 1.901-2A.

2. Harkonnen cannot rebut the strong presumption that its payments under the Arrakis levy were made in exchange for the right to extract government-owned petroleum.

Under Treasury Regulation 1.901-2A, Harkonnen is not entitled to foreign tax credit for its payments to Arrakis because they were made in exchange for the right to extract oil and natural gas. Dual capacity taxpayers "have the burden to establish the extent, if any, to which foreign levies they pay constitute taxes—as opposed to payments for the specific economic benefits received." *Exxon*, 113 T.C. at 350–51. "A foreign charge imposed on persons that receive a specific economic benefit is presumed to be compensation for a specific economic benefit." *Phillips*, 104 T.C. at 287.

The dual capacity taxpayer may rebut this presumption in two ways. First, if the foreign levy applied both to dual capacity taxpayers and other persons, the dual capacity taxpayer may rebut this presumption by showing that the foreign levy, in practice, applied to the dual capacity taxpayer and other persons in the same manner. Treas. Reg. § 1.901-2A(a)(1). The dual capacity taxpayer must put forward affirmative evidence to make this showing. *Id.* Second, the dual capacity taxpayer may obtain a foreign tax credit if it shows, "based on all the relevant facts and circumstances,"[3] that its payment pursuant to the levy operated as a tax. Treas. Reg. § 1.901-2A(b)(2)(ii).

Harkonnen cannot rebut this presumption for two reasons: (1) no evidence suggests that in practice the Arrakis levy applied in the same manner to Harkonnen and to other persons that would be subject to the levy, and (2) based on the facts and circumstances, the Arrakis levy operated as a royalty interest rather than a tax.

a. Harkonnen cannot show that the Arrakis levy applied, in practice, in the same manner to both Harkonnen and other persons subject to the levy.

Harkonnen cannot satisfy its burden of showing that it was treated the same as other persons subject to the Arrakis levy. There is no evidence of record to show that anyone other than Harkonnen ever paid the Arrakis levy. Hence, there is no affirmative evidence against which to compare Harkonnen's treatment under the levy. *See* Treas. Reg. § 1.901-2A(a)(1). Even so, Harkonnen's negotiations with President Corrino suggest that Harkonnen had greater control over the applicable levy structure than did any other entity. Corrino did not set the initial rate until the day Harkonnen signed its oil and gas lease with Arrakis, three and a half months after Corrino enacted the Arrakis levy. R. at 7. That rate remained in effect until

[3] The regulations also offer taxpayers an alternative means of proving the extent to which a foreign levy was not paid in exchange for a specific economic benefit, called the "safe harbor method." *See* Treas. Reg. § 1.901-2A(c)(2). The "safe harbor method" is only available to taxpayers who affirmatively elect it in their tax returns. *Id.* In the absence of such election, the "facts and circumstances" method acts as the default rule. Because the record is absent of any indication that Harkonnen elected the "safe harbor method," the applicable test for determining creditability is the "facts and circumstances" method.

Harkonnen again met with Corrino, at which point Corrino reduced the rate and for the first time allowed foreign corporations to claim deductions. R. at 15. Harkonnen therefore cannot rebut the presumption that it received differential treatment as a dual capacity taxpayer from other persons subject to the Arrakis levy.

b. Harkonnen cannot show that, under the facts and circumstances of this case, the Arrakis levy functioned as a tax rather than a royalty interest.

Harkonnen also cannot satisfy its burden of proving that the Arrakis levy operated as a tax rather than some other non-creditable payment, such as a royalty. Where a dual capacity taxpayer receives differential treatment from other persons subject to a foreign levy, the dual capacity taxpayer may only receive foreign tax credit if it shows that the foreign levy functioned as a tax "based on all the relevant facts and circumstances." Treas. Reg. § 1.901-2A(b)(2)(ii).

For dual capacity taxpayers who engage in the extraction of government-owned petroleum, this inquiry turns on whether the levy is akin to either a tax or a royalty interest. *See e.g., Exxon*, 113 T.C. at 355 ("the proper focus is whether the [levy] was imposed and paid 'in exchange for' the [right to extract oil]"); *Phillips*, 104 T.C. at 295 ("Our focus here is to distinguish between a royalty interest retained by a government, as the owner of natural resources, and a tax imposed on the net profits generated predominantly from the same government-owned resources."). A royalty refers to a share of the product or profits reserved by an owner for permitting another to use a property. *Kasey v. Comm'r*, 33 T.C. 656, 657–58 (1960); *Sneed v. Comm'r*, 33 B.T.A. 478, 482 (1935). On the other hand, a tax is a revenue-raising levy imposed by a governmental unit, generally imposed by legislative authority for a public purpose.

See Phillips, 104 T.C. at 295; *Cox v. Comm'r*, 41 T.C. 161, 164 (1963); *Amtorg Trading Corp. v. Comm'r*, 25 B.T.A. 327, 332–33 (1932), *rev'd on other grounds* 65 F.2d 583 (2d Cir. 1933).

"When the owner of a mineral interest is a government, the distinction between a royalty interest and a tax can only be determined by an examination of the particularities involved in the imposition of the charges." *Phillips*, 104 T.C. at 295. The U.S. Tax Court has considered several factors when determining whether a foreign levy constitutes a tax or a royalty interest for foreign tax credit purposes, including the following: how the levy was enacted; the timing of the levy's enactment as compared to when the specific economic benefit was granted; whether the levy granted additional benefits to the payer; whether any royalties were paid separate from the levy and whether those royalties constitute substantial compensation for the specific economic benefit; how the levy was administered; and how the levy was structured. *See e.g., Exxon*, 113 T.C. at 350–56; *Phillips*, at 293–297.

Considering "all the relevant facts and circumstances," Treas. Reg. § 1.901-2A(b)(2)(ii), Harkonnen cannot rebut the presumption that the levy was a negotiated royalty rather than a compulsory tax. The Tax Court has held that where a taxpayer acquired its specific economic benefit long before a levy was implemented, and the levy grants no new benefits, the levy constitutes a tax. *See Exxon*, 113 T.C. at 356; *Phillips*, 104 T.C. at 290. On the contrary, Harkonnen's rights under the oil and gas lease arose contemporaneously with its obligation to pay the Arrakis levy. R. at 7. Moreover, while a "tax in this country is generally understood . . . to be imposed by legislative authority," Corrino drafted and enacted the Arrakis levy without any formal legislative process. *Phillips*, 104 T.C. at 295. Notably, Harkonnen "agreed" to pay the Arrakis levy upon the consummation of its oil and gas lease with Arrakis. R. at 7. Yet, a "tax is compulsory, an exaction of sovereignty *rather than something derived by agreement*." *Phillips*, 104 T.C. at 295 (emphasis added). This fact, in combination with the fact that Corrino enacted the levy only one month after he entered into negotiations with Harkonnen to develop the Caladan Oil Field, suggests that the levy was exchanged quid pro quo for the right to exploit Arrakis' oil resources. And although Harkonnen agreed to pay a separate royalty, its standard rate of fifteen-percent was not the "high royalty payment" Harkonnen feared. R. at 3.

Finally, while the Arrakis levy was administered like many taxes (through a withholding), its original structure operated like a royalty interest—it did not allow Harkonnen to "give effect to items of income or expense." *Phillips*, 104 T.C. at 296 (stating that a royalty typically does not allow deductions for expenses). Accordingly, Harkonnen cannot rebut the presumption that its payments to Arrakis were made in exchange for a specific economic benefit. The Arrakis levy is not a tax, and Harkonnen is not entitled to foreign tax credit.

C. The Arrakis Levy is Not Creditable Because Its Predominant Character is Not Akin to an Income Tax in the U.S. Sense.

Even if this Court finds that the Arrakis levy qualifies as a tax, the Service properly denied Harkonnen foreign tax credit because the levy's predominant character is not that of an income tax in the U.S. sense, as required under Treasury Regulation 1.901-2(a)(1)(ii). To result in foreign tax credit, a foreign levy must be an "income, war profits, or excess profits tax." § 901(b)(1). The regulations treat a foreign levy as such only if its "predominant character . . . is that of an income tax in the U.S. sense." Treas. Reg. § 1.901-2(a)(1)(ii).

To meet this "predominant character" standard, a foreign tax must be likely to reach net gain under the normal circumstances in which it applies. Treas. Reg. § 1.901-2(a)(3)(i). A tax is likely to reach net gain under normal circumstances if, and only if, it satisfies tripartite criteria known as the net income, realization, and gross receipts tests. Treas. Reg. § 1.901-2(b)(1). A foreign tax either does or does not satisfy each test in its entirety; thus, U.S. law may treat a tax as non-creditable for all persons subject to it even though the tax does, in fact, reach net gain for some taxpayers. Treas. Reg. § 1.901-2(a)(1)(ii).

While the Arrakis levy concededly meets the realization and gross receipt tests, it fails to satisfy the net income test, and is therefore not an income tax in the U.S. sense. A foreign tax meets the net income requirement if, again, examining its predominant character, its base is an amount that reflects the reduction of gross receipts by (1) significant costs, expenses, and capital expenditures that are attributable, under reasonable principles, to such gross receipts or (2) significant costs and expenses calculated under a formulation "that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses." Treas. Reg. § 1.901-2(b)(4)(i)(A)–(B). Recoverable costs and expenses include not only all operating expenses necessary to conduct business, namely those expenses directly related to operations, but also general and administrative expenses incidentally related to the business. *Keasbey & Mattison Co. v. Rohensies*, 33 F.2d 894, 898 (3d Cir. 1943); *see also Phillips*, 104 T.C. at 312–13. In assessing whether the predominate character of a foreign levy satisfies the net income test, the appropriate focus is on the economic substance of the operation of the tax. *PPL Corp. v. Comm'r*, 133 S. Ct. 1897, 1902 (2013).

The first portion of the Arrakis levy—Formula 1—fails the net income test because it is a tax on gross receipts. As a result, and based on the levy's predominant economic and financial effect, the Arrakis levy as a whole fails the net income test, regardless of whether Formula 2 reaches net gain.

1. The first portion of the Arrakis levy fails the net income requirement because it does not allow any deductions for significant costs, expenses, and capital expenditures.

The first portion of the Arrakis levy (Formula 1) fails the net income test because it does not allow for any deductions. Typically, when a foreign levy fails to allow any deductions for significant costs and expenses, the levy fails the net income test. *See Phillips*, 104 T.C. at 312 ("Failure to take into account operating expenses normal to the active conduct of business indicates that the government involved did not design the tax to reach net profit.").

However, in a "rare situation," a tax that applies only to a business' gross receipts may satisfy the net income requirement. Treas. Reg. § 1.901-2(b)(4)(i). That "rare" case exists only where "the tax is almost certain to reach some net gain in the normal circumstances in which it applies because costs and expenses will almost never be so high as to offset gross receipts, and the rate of the tax is such that after the tax is paid persons subject to the tax are almost certain to have net gain." *Id.* Accordingly, in the absence of deductions for significant costs and expenses, a tax on gross receipts can satisfy the net income test "only if [a] business[] subject to the tax

[is] almost certain to never incur a loss (after payment of the tax)." *Id.* Stated somewhat differently, it must be almost certain that the business will generate gross receivables in an amount that exceeds both the costs of generating those receivables and the associated tax liability. An example of such a tax is a tax on gross wages. *See* Treas. Reg. § 1.901-2(b)(4)(iv).

Because Formula 1 of the Arrakis levy disallows *any* deductions, the computation is not geared towards reaching net income. *Cf. Phillips.*, 104 T.C. at 315 (determining that Norwegian taxes reached net income in the U.S. sense when "each [was] computed, without substantial deviation, by reducing a taxpayer's gross receipts with the expenses and capital expenditures attributable thereto").

Additionally, the application of Formula 1 to "all foreign entities that operate machinery" in Arrakis does not constitute the "rare" case in which a tax based only on gross receipts satisfies the net income test. R. at 5. Unlike a tax on gross wages, a forty-five percent tax on the gross receivables of a company that operates machinery in many, if not most, circumstances would result in an after-tax loss. Harkonnen's business is illustrative. Subterranean oil drilling and extraction is a tremendous financial undertaking. The U.S. Energy Information Administration estimated that, from 2007 to 2009, the total upstream cost for producing crude oil and natural gas was $16.88 per barrel of oil equivalent.[4] By October 30, 2009, Harkonnen's daily production equaled 858,000 barrels of oil, approximately totaling $14,483,040 in upstream costs per day. R. at 7. In order to not operate at a loss under Formula 1, or

[4] *How much does it cost to produce oil and natural gas?*, U.S. Energy Information Administration (Jan. 2014), http://www.eia.gov/tools/faqs/faq.cfm?id=367&t=6.

just break even, Harkonnen would have to generate $26,332,800 per day in gross receivables. It is not "almost certain" that Harkonnen will generate that level of daily gross receivables, such that its tax liability and costs will be offset. Treas. Reg. § 1.901-2(b)(4)(i). To the extent that the regulations create any exception to the requirement that deductions be allowed for significant costs and expenses, that exception only applies when gross receivables are generated with next to no costs, such as in the case of gross wages. *See e.g.,* Ernest R. Larkins, *International Applications of U.S. Income Tax Law: Inbound and Outbound Transactions* 201 (2004) (stating that Mexico's tax on personal service income of U.S. individuals working as employees in Mexico, which did not allow deductions for related employment expenses, satisfied the net income test because employee expenses are minimal under normal circumstances and thus, the tax is almost certain to reach net gain); Treas. Reg. § 1.901-2(b)(4)(iv), Ex.3 (explaining that a foreign tax imposed at the rate of 40 percent on the amount of gross wages realized by an employee and allowing for no deductions, satisfies the net income requirement because "costs and expenses of employees attributable to wage income are almost always insignificant compared to the gross wages realized;" thus, "such costs and expenses will almost always not be so high as to offset the gross wages and the rate of the tax is such that, under the circumstances, after the tax is paid, the employees subject to the tax are almost certain to have net gain."). Where, as here, the costs and expenses associated with generating the gross receivables are substantial, the exception cannot apply. Because Formula 1 does not allow any deductions for significant costs and expenses, this portion of the Arrakis levy fails the net income test.

2. The Arrakis levy as a whole fails the net income requirement because the predominant amount paid under the levy is non-creditable.

The Arrakis levy's predominant character, when considered as a whole, fails to reach net gain. This is true regardless of whether the latter portion of the Arrakis levy (Formula 2) satisfies the net income test. In determining whether the predominant character of a foreign levy satisfies the net income test, "the crucial inquiry is the tax's economic effect." *PPL*, 133 S. Ct. at 1902; *see Commissioner v. Sw. Exploration Co.*, 350 U.S. 308, 315 (1956) (stating the black-letter principle that "tax law deals in economic realities, not legal abstractions"). Courts must consider the tax's practical operation when determining whether it is creditable for U.S. tax purposes. *See Entergy Corp. and Affiliated Subsidiaries v. Comm'r*, 682 F.3d 233 (5th Cir. 2012); *see also Maryland v. Louisiana*, 451 U.S. 725, 756–57 (1981) (examining a state tax's "actuality of operation" and "practical operation" to determine whether it discriminated against interstate commerce in favor of local interests). Thus, the foreign levy's actual economic and financial effect as applied to a majority of taxpayers controls.

The predominant character of the Arrakis levy fails the net income test because the predominant amount paid under the levy was attributable to the portion of the levy that failed to reach net gain—i.e., the non-creditable portion due under the Formula 1 computation predominates over the amount due under the Formula 2 computation. Although the period during which Formula 2 was in effect (7 ½ months) was longer than the period in which Formula 1 was in effect (4 ½ months), the amount Arrakis collected under the Formula 1 computation, in normal circumstances, is greater than the amount collected under the Formula 2 computation. The following example is illustrative.

Assume that Corporation H generated twenty dollars per month in gross receipts for each month of the year. Looking at various levels of costs, Corporation H's tax liabilities under Formula 1 and 2 would be as follows:

Formula 1: January 1 – May 15 (4 ½ months) *Gross receipts x 45 %*	**Formula 2**: May 16 – December 31 (7 ½ months) *(Gross receipts – (deductions x 95%)) x 33%*
$20/month x 4 ½ months = $90 gross receipts **90 x .45 = $40.50**	$20/month x 7 ½ months = $150 gross receipts Costs: $120, (150 – (120 x .95)) x .33 = $11.88 Costs: $100, (150 – (100 x .95)) x 33% = $18.15 Costs: $80, (150 – (80 x .95)) x 33% = $24.42 Costs: $60, (150 – (60 x .95)) x 33% = $30.69 Costs: $40, (150 – (40 x .95)) x 33% = $36.96 **Costs: $28.70, (150 – (28.70 x .95)) x .33 = $40.50** Costs: $20, (150 – (20 x .95)) x 33% = $43.23 Costs: $10, (150 – (10 x .95)) x 33% = $46.36 Costs: $0, (150 – (0 x .95)) x 33% = $49.50

In this illustration, the only way Corporation H's tax liability to Arrakis for the Formula 1 portion of the levy would be *less* than its liability under the Formula 2 portion is if Corporation H's costs were less than $3.83 per month during Formula 2's effective period ($28.70 total costs over that period). In other words, unless Corporation H is abnormally efficient, and reaps more than 80.8% profits per month (or 80.8 cents on the dollar), then Corporation H will pay more under the Formula 1 portion than under the Formula 2 portion of the Arrakis levy.

As this illustration shows, the "economic reality" is that Formula 1 (a gross receipts tax) represents the predominant character of the levy. *PPL,* 133 S. Ct. at 1910. It is theoretically possible for some companies to operate at an 80.8% profit margin. For those hyper-efficient companies, the predominant amount paid to Arrakis may be attributable to Formula 2. Putting aside those outliers, however, the predominant amount paid by a majority of companies that would be subject to the Arrakis levy is not attributable to net gain. *See PPL*, 133 S. Ct. at 1901 (stating that a tax that fails to operate as an income tax in most instances is not creditable, "even if it may effect a handful of taxpayers differently."). Instead, the predominant amount paid would be attributable to gross receipts. As such, the predominant character of the Arrakis levy is not that of an income tax. It is not creditable under Section 901.

3. Allowing foreign tax credit for the Arrakis levy would create a perverse incentive for foreign governments and unduly burden U.S. taxpayers.

Allowing Harkonnen foreign tax credit for its payments to Arrakis would result in an unprecedented expansion of the foreign tax credit beyond the statutory language of Section 901. This Court has long and unanimously insisted that income tax deductions are a matter of "legislative grace" and are to be strictly construed. *See* *e.g., Indopco, Inc., v. Comm'r*, 503 U.S. 79, 84 (1992); *Interstate Transit Lines v. Comm'r*, 319 U.S. 590, 593 (1943). This rule of strict construction applies with equal force to foreign tax credit. *Exxon*, 113 T.C. at 350.

Contrary to that principle, Harkonnen asks this Court to extend to it foreign tax credit for a levy whose predominant character failed to reach net income. In effect, Harkonnen asks this Court to hold that, by amending the "Republic of Arrakis Foreign Tax" midway through the tax year, Arrakis somehow transmogrified a tax on gross receipts into a tax on net income. That is an unprecedented reading of the scope of income taxes eligible for foreign tax credit under Section 901, which belies the statutory language, the history of the provision, and the policy of the foreign tax credit.

Treating the Arrakis levy as a creditable foreign tax under Section 901 would provide a roadmap for foreign governments to manipulate the Internal Revenue Code. The effect would be to open the door for foreign governments to pass taxes on gross receipts for a portion of the year, and then amend those taxes midway through the year to reach net income.[5] If such a tax were considered creditable, a portion of the costs of generating gross receivables would shift from privately owned companies to

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[5] To the extent that there is any argument that judging predominant character based on amount paid could lead to manipulative practices by foreign governments, that argument is foreclosed by the soak-up tax rule. *See* Treas. Reg. § 1.901-2(c)(1). The soak-up tax rule denies credit to foreign taxes that are dependent upon the availability of foreign tax credit. Take for example a foreign government that algebraically rigged its tax structure to recoup 51% in creditable income taxes and 49% in non-creditable taxes from a U.S. corporation. The soak-up rule would allow U.S. Courts and the Service to look through the form of such a tax to find that it was dependent upon the availability of foreign tax credit, and thereby deny credit.

the U.S. fisc and the American taxpayer. This Court should not construe Section 901 in a manner that requires U.S. taxpayers to reimburse a corporation dollar-for-dollar for its generation of foreign-sourced gross receivables. The Arrakis levy at issue here is not, by its predominant character, an income tax in the U.S. sense and no foreign tax credit should be allowed under Section 901.

D. The Arrakis Levy is Not a Creditable "In Lieu" Tax Because it is Not a Substitute For a Generally Imposed Income Tax.

The Arrakis levy is also not an "in lieu" tax because it fails to fit the mold of the Section 903 and Treasury Regulation 1.903-1. If a tax, standing alone, fails to constitute an income tax in the U.S. sense, it may nevertheless be credited against U.S. tax liabilities under Section 903 if the tax is imposed "in lieu of" an income tax. § 903. In order to qualify as an "in lieu" tax, the regulations require that the tax satisfy the "substitution" test.[6] Treas. Reg. § 1.903-1(b)(1). A foreign tax meets the substitution requirement "if the tax in fact operates as a tax imposed in substitution for, and not in addition to, an income tax or a series of income taxes otherwise generally imposed." *Id.*

This "in lieu" provision was intended to "allow[] the credit for any alien tax imposed instead of an income tax (if the latter was generally levied) for whatever reason the [foreign] country might consider it proper to substitute the 'in lieu' levy in the special case for the ordinary income tax generally imposed." *Metro. Life Ins. Co. v. United States*, 375 F.2d 835, 838 (Ct. Cl. 1967) (citation omitted); *see* Elisabeth A.

[6] An "in lieu" tax must still be a tax within the meaning of Section 901. Treas. Reg. § 1.903-1(a)(1). Thus, if the levy is in fact a royalty, and not a tax, the Arrakis levy is also not an "in lieu" tax.

Owens, *The Foreign Tax Credit* 28 (1961) ("To be allowed as a credit, the 'in lieu' tax must actually replace a tax which would qualify for the credit.") For a tax to be creditable under this provision, the foreign country must first have adopted an income tax that remains applicable to a significant sector of the taxpaying public. It must then have exempted an identifiable segment of the income of a class of taxpayers from that income tax and have imposed a different form of taxation *in place of* that income tax *on those taxpayers. Id.* (stating that the taxpayer must "demonstrate[] that the tax is intended by the foreign government as a substitute for an income tax which would be imposed on the taxpayer if he did not pay the 'in lieu' tax."). In operation, the substitution test asks whether but for the tax for which credit is sought under Section 903, the taxpayer would have been subject to the otherwise applicable general income tax. *See* Treas. Reg. § 1.903-1(b)(1) (stating that where a company agreed to pay a gross receipts tax on one of its income-generating activities in place of the generally-imposed net income tax that would normally apply to that activity, as well as all other income-generating activities, the gross receipts tax was substituted for the net income tax).

The Arrakis levy is not an "in lieu" tax because it did not take the place or function of the tax laws generally imposed in Arrakis. In order for the Arrakis levy to meet the substitution requirement, some other generally-imposed income tax must have applied to Harkonnen. However, under the law of Arrakis, absent some positive statutory action, foreign persons and entities are not subject to taxation in Arrakis. *See Lord Remington v. Republic of Arrakis*, R. at 4. But for the Arrakis levy, Harkonnen would not incur any tax liability in Arrakis. *See* Owens, *supra*, at 74 (noting that "the claimant must also prove that he is exempt from the income tax because he is subject to the tax in issue"). By definition, the Arrakis levy is not a substitute for anything. It is therefore not a creditable "in lieu" tax.

The Arrakis levy is not a tax, income tax, or "in lieu" tax. Therefore, the Fourteenth Circuit properly held that Harkonnen is not entitled to foreign tax credit for its payments to Arrakis.

II. HARKONNEN IS NOT ENTITLED TO FOREIGN TAX CREDIT FOR ITS PAYMENTS TO IFIL UNDER 26 U.S.C. § 901.

Harkonnen's claim that it is entitled to foreign tax credit under Section 901 of the Internal Revenue Code for its payments to IFIL fails for three reasons. First, because Harkonnen seeks judicial determination of a matter that the Constitution commits exclusively to the Executive Branch, Harkonnen's claim is a non-justiciable political question. Second, even if the case is justiciable, Harkonnen is not entitled to foreign tax credit because IFIL is not a foreign country. Finally, assuming for argument's sake that IFIL is a foreign country, Harkonnen is not entitled to foreign tax credit because its payments to IFIL do not constitute a tax. Allowing Harkonnen foreign tax credit for its payments to IFIL would be inconsistent with the inherent limits of the foreign tax credit system.

A. Harkonnen's Claim For Foreign Tax Credit Presents a Non-Justiciable Political Question.

Harkonnen's request for foreign tax credit for its payments to IFIL requires this Court to recognize IFIL as a foreign country. That request presents a non-justiciable political question. The political question doctrine "excludes from judicial review those controversies which revolve around policy choices and value determinations constitutionally committed to the halls of Congress or the confines of the Executive Branch." *Japan Whaling Ass'n v. American Cetacean Soc'y*, 478 U.S. 221, 230 (1986). A controversy "involves a political question . . . where there is a 'textually demonstrable constitutional commitment of the issue to a coordinate political department; or a lack of judicially discoverable and manageable standards for resolving it.'" *Nixon v. United States*, 506 U.S. 224, 228 (1993) (quoting *Baker v. Carr*, 369 U.S. 186, 217 (1962)).

Normally where a controversy turns on interpretation and application of a federal statute there is no political question, even if "the issues have political implications." *INS v. Chadha*, 462 U.S. 919, 943 (1983). "That is not to say, however, that no statute could give rise to a political question." *Zivotofsky v. Clinton*, 132 S. Ct. 1421, 1435 (U.S. 2012) (Sotomayor, J., concurring). A political question persists where, as here, the relief sought would require the court to direct a decision that is the sole constitutional responsibility of another branch.

It is firmly established in our constitutional framework that the sole authority to recognize foreign states and their governments lies with the Executive Branch. *See* U.S. Const. art. II, § 3 (Reception Clause); *see also* Alexander Hamilton, *Pacificus No. 1* (June 29, 1793), *reprinted in* 15 *The Papers of Alexander Hamilton*, 33, 41 (Harold C. Syrett & Jacob E. Cooke, eds., 1969) (noting that the sole authority of recognizing the revolutionary government of France laid with the President); *First Nat'l City Bank v. Banco Nat'l de Cuba*, 406 U.S. 759, 767 (1972) (noting the primacy of the Executive Branch in matters of recognition of foreign governments); *Baker*, 369 U.S. at 212 ("recognition of foreign governments . . . strongly defies judicial treatment").

Where there is no dispute as to the legitimacy of the foreign government, interpretation of the phrase "foreign country" in federal statutes is simply a matter of statutory construction. For example, in *Burnet v. Chicago Portrait Company*, this Court interpreted the phrase "foreign country" to consider whether payments to a *recognized* political subdivision of Australia were eligible for foreign tax credit. *Burnet*, 285 U.S. 1 (1932); *see also Cheung v. United States*, 213 F.3d 82, 89 (2d Cir. 2000) (stating that where the government of Hong Kong had already been recognized as legitimate by the Executive Branch, determination of whether Hong Kong constitutes a foreign country for purposes of the extradition statute is not a political question). However, where the legitimacy of a foreign government is subject to dispute, the determination of whether that body constitutes a foreign country would require this Court to exceed the bounds of Article III's limitation on federal court jurisdiction. *See Zivotofsky*, 132 S. Ct. at 1432 (Sotomayor, J., concurring) (stating that when a court "cannot resolve a dispute in the absence of a yet-unmade policy determination charged to a political branch, resolution of the suit is beyond the judicial role envisioned by Article III.").

Application of Section 901 to Harkonnen's payments to IFIL is inextricably intertwined with the recognition of IFIL as a legitimate foreign state. Despite the President's lesser step of extending a diplomatic olive branch to the IFIL insurgency by way of Executive Order 14012, the Executive Branch has yet to take a firm stance on the status of IFIL as a legitimate government. R. at 14. The President's statement referring to IFIL as a "sovereign friend," on its own, does not imply that IFIL is a legitimate foreign government. R. at 14. Therefore, any ruling by this Court that establishes—or declines to establish—IFIL as a foreign country would deprive the Executive Branch of its exclusive authority to make that determination. Because this case presents a non-justiciable political question, over which federal courts do not have jurisdiction, this Court should leave intact the Service's denial of foreign tax credit to Harkonnen with respect to its payments to IFIL.

B. IFIL is Not a Foreign County Within The Meaning of Section 901.

Even if this case is justiciable, Harkonnen is not entitled to foreign tax credit for its payments to IFIL because IFIL is not a foreign country within the meaning of Section 901. Section 901 allows credit only for taxes "paid to [a] foreign country." Treas. Reg. § 1.901-2(a)(1).

In an early case, this Court considered the meaning of the term "foreign country" as it is used in Section 901, and found that "[t]he word 'country[]' . . . is ambiguous." *Burnet*, 285 U.S. at 5. In *Burnet*, this Court reasoned that "[t]he term 'foreign country' is not a technical or artificial one, and the sense in which it is used in a statute must be determined by reference to the purpose of the legislation." *Id.* Because a primary purpose of the foreign tax credit is "to mitigate the evil of double taxation," the ultimate "criterion was the fact that the tax was imposed by the authority of a foreign country and not the international status of the particular government to which it was paid." *Id.* Hence, this Court held that New South Wales, a recognized political subdivision of Australia, constituted a foreign country within the meaning of Section 901's predecessor. *Id.*

Although this Court found in *Burnet* that "the word 'country' is manifestly used in the sense of government," that construction itself lends no manageable criteria to determine what constitutes a "government" for purposes of Section 901. *Id.* at 7. Nor does the regulations' definition of "foreign country" as "any foreign state" shed light on the issue. Treas. Reg. § 1.901-2(g)(2); *see also Burnet*, 285 U.S. at 16 (explaining that "ambiguous regulations are of little value in resolving statutory ambiguities"). For this reason, the proper inquiry is whether granting tax credit for payments under IFIL's levy serve the purpose of Section 901. *See id.*

To be sure, mitigation of double taxation is one objective of the foreign tax credit. There are, however, several limiting principles to the foreign tax credit's aim of mitigating double taxation. An important limitation to that purpose is reflected by Section 901(j), which denies foreign tax credit for levies of foreign countries who "support . . . acts of international terrorism." 26 U.S.C. § 901(j)(2)(A)(iv). Thus, a countervailing purpose of the foreign tax credit system is to partition the U.S. and its corporations from groups with ties to terrorist activities.

Any definition of the term "foreign country" that includes IFIL would run contrary to the purpose of the Section 901 scheme—particularly Section 901(j). By U.S. standards, IFIL's hostile takeovers of Unit #12 and the Badlands region of Arrakis constitute acts of terrorism. *See e.g.,* 28 C.F.R. § 0.85(l) (defining terrorism as "the unlawful use of force and violence against persons or property to intimidate or coerce a government, the civilian population, or any segment thereof, in furtherance of political or social objectives"); *see also* R. at 13 ("until [Harkonnen] rectif[ies] their insolence and pay[s] tribute, IFIL will control oil production from Unit #12."). Moreover, the Secretary of State classified IFIL as a splinter group of the terrorist organization known as the Bene Gesserit, and IFIL's leader is a bloodrelative of a founder of the Bene Gesserit. R. at 11. Although other countries have taken action to recognize IFIL, this Court may not second guess the State Department's classification of IFIL as a relative of the Bene Gesserit terrorist organization. This Court should not construe Section 901 in a manner that subverts the statutory chasm that Section 901 creates between the U.S. and terror-related organizations. IFIL is not a foreign country within the meaning of Section 901.

C. Harkonnen's Payments to IFIL Are Not Creditable Under Section 901 Because The IFIL Levy Does Not Constitute a Tax.

Even supposing IFIL qualifies as a foreign country under Section 901, Harkonnen's payments under the IFIL levy do not constitute taxes under the applicable regulations and are therefore not creditable under Section 901. U.S. taxpayers may receive foreign tax credit for their payment of a foreign levy only if the foreign levy "is a tax." Treas. Reg. § 1.901-2(a)(1)(i). A foreign levy constitutes a tax "if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes." Treas. Reg. § 1.901-2(a)(2). The regulations further provide that a foreign levy is not a tax to the extent that the person subject to the levy receives a specific economic benefit in exchange for payment of the levy. *Id.*

The regulations thus espouse three distinct requirements that a foreign levy must meet in order to be credited against a domestic tax payer's income tax liability: (1) the payer must not receive a specific economic benefit in exchange for payment; (2) the recipient of the payment must issue the levy pursuant to its lawful taxing authority; and (3) the payment must be compulsory. Harkonnen's payments to IFIL fail each of these requirements.

1. Harkonnen's payments to IFIL are not taxes under Section 901 because Harkonnen received a specific economic benefit in exchange for those payments.

The IFIL levy fails the first and second requirements of the definition of a "tax" under the regulations. "[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 . . . a specific economic benefit . . . from the foreign country in exchange for payment." Treas. Reg. § 1.901-2(a)(2)(i); *see also Exxon*, 113 T.C. at 350. As explained previously, persons who are subject to a foreign country's levy and who also receive a specific economic benefit from that country are called "dual capacity taxpayer[s]," Treas. Reg. § 1.901-2(a)(2)(ii)(A); they are entitled to a foreign tax credit only if they prove that their payments to the foreign country were *not* made in exchange for the specific economic benefit received. *See* Treas. Reg. § 1.901-2A. With respect to the IFIL levy, Harkonnen is a dual capacity taxpayer and is not entitled to foreign tax credit.

a. Harkonnen is a dual capacity taxpayer because its rights under its oil and gas lease with IFIL constitute a specific economic benefit.

In exchange for its payment to IFIL, Harkonnen received a specific economic benefit—the right to extract petroleum using the Unit #12 drilling station. Harkonnen is thus a dual capacity taxpayer. "[A] concession to extract government-owned petroleum is a specific economic benefit." Treas. Reg. § 1.901-2(a)(2)(ii)(B).

The regulations, however, do not require outright ownership of the petroleum in order for an extraction contract to constitute a specific economic benefit. Instead, the foreign country need only *control* the petroleum. *See* Treas. Reg. § 1.901-2(a)(2)(ii) (stating that a specific economic benefit includes "a right to use, acquire or extract resources . . . that a foreign country owns or *controls*"). A foreign country controls subsurface petroleum if it "exhibits substantial indicia of ownership with respect to the property . . . ." Treas. Reg. § 1.901-2(a)(2)(ii)(D).

Harkonnen's oil and gas lease with IFIL constitutes a specific economic benefit. As of March 20, 2011, when IFIL forcefully captured Unit #12, IFIL retained open and notorious control of Unit #12. R. at 13. IFIL's leader issued a proclamation declaring that IFIL would maintain "control" over Unit #12's oil production until Harkonnen "[paid] tribute." R. at 13. IFIL therefore "regulat[ed] the quantity of property that may be extracted" by severing Harkonnen's right and ability to extract oil using Unit #12, until Harkonnen paid IFIL. Treas. Reg. § 1.901-2((a)(2)(ii)(D) (stating that regulation of the amount of a natural resource that may be extracted is an indicia of ownership of the natural resource). Under principles of U.S. law, a person's interest in subsurface oil and gas is typically limited to the right of extraction. *See e.g.*, *NCNB Texas Nat'l Bank, N.A. v. West*, 631 So. 2d 212 (Ala. 1993) (holding that a landowner's right to un-extracted oil in the ground is limited to a right to extract that oil, but is not an outright ownership interest in the oil itself until it has been extracted and reduced to possession); *Feely v. Davis*, 784 P.2d 1066 (Okla. 1989) (same); *Murbarger v. Franklin*, 163 N.E.2d 818 (Ill. 1960) (same). Thus, by exerting physical dominion over the point and means of extraction, IFIL retained control of the oil and gas beneath Unit #12.

As a result, Harkonnen's oil and gas lease with IFIL—to extract and exploit IFIL-controlled petroleum deposits using Unit #12—constitutes a specific economic benefit. Therefore, as a person subjected to IFIL's two-percent levy on Unit #12's income and who is the recipient of a specific economic benefit, Harkonnen is a dual capacity taxpayer.

b. Harkonnen's payments to IFIL are not creditable because those payments constitute additional compensation paid in exchange for the specific economic benefit IFIL granted to Harkonnen.

Under the regulations applicable to dual capacity taxpayers, Harkonnen is not entitled to foreign tax credit. A dual capacity taxpayer's payments to a foreign country are only entitled to credit if the dual capacity taxpayer is able to show that the foreign country's levy was *not* paid in exchange for the specific economic benefit. *Exxon*, 113 T.C. at 350–51. The presumption is that the dual capacity taxpayer received the specific economic benefit in exchange for payment of the levy. *Phillips*, 104 T.C. at 287. The dual capacity taxpayer may rebut this presumption by showing that, "based on all the relevant facts and circumstances," payment pursuant to the levy operated as a tax. [7] Treas. Reg. § 1.901-2A(b)(2)(ii).

Where, as here, the foreign country that imposed the levy also owns or controls the petroleum in which it granted a specific economic benefit, the creditability inquiry turns on whether the levy is akin to a either a tax or a royalty interest. *See e.g., Exxon*, 113 T.C. at 355; *Phillips*, 104 T.C. at 295. The U.S. Tax Court has distinguished between a tax and a royalty paid to a foreign government by reference to several factors. As explained above, those factors include, how the levy was enacted; the timing of the levy's enactment as compared to when the specific economic

[7] A U.S. taxpayer may also rebut this presumption by showing that, in practice, the levy treated the dual capacity taxpayer in the same manner as it treated others subject to the levy. *See* Treas. Reg. § 1.901-2A(a)(1). Because the IFIL levy was specific to a Harkonnen-operated drilling station, Harkonnen cannot show that in practice the levy applied to others, or that it treated others similarly to Harkonnen.

benefit was granted; whether the levy granted additional benefits to the payer; whether any royalties were paid separate from the levy and whether those royalties constituted substantial compensation for the specific economic benefit; how the levy was administered; and how the levy was structured. *See id.* at 293–297; *Exxon*, 113 T.C. at 350–56. Ultimately, the distinction "can only be determined by an examination of the particularities involved in the imposition of the charges." *Phillips*, 104 T.C. at 295.

On balance, Harkonnen cannot rebut the presumption that the IFIL levy was an additional royalty payment, and not a tax. As with the Arrakis levy, Harkonnen's rights under its oil and gas lease with IFIL arose contemporaneously with its obligation to pay the levy. *Cf. Phillips*, 104 T.C. at 290 (finding a levy to be a tax and not a royalty where the levy arose *after* the country granted a corporation petroleum licenses and the "petroleum licensees were not granted additional rights" for payment of the levy). Also, like the Arrakis levy, the IFIL levy was unilaterally imposed by an autocratic leader, and not a separate body "responsible for tax legislation." *Id.* at 296.

Furthermore, although the levy's structure was analogous to a net income tax, the way in which IFIL administered the levy indicates that it was in fact a royalty payment. "[S]eparate administration is a fact relevant to creditability determinations." *Id.* at 297. Significantly, when Harkonnen gave IFIL a check for its obligation under the levy, IFIL deposited the funds into a private Swiss bank account—the same bank account that it used to store Harkonnen's payment of the five-percent royalty. R. at 14. Once IFIL comingled the funds, the royalty payment was not "independent of the other." *Id.*; *cf. id.* ("The facts reveal that the administration of license grants and the collection of royalties was delegated to the Ministry of Petroleum, while the administration of all taxes, including the special charge, was delegated to the Ministry of Finance."). Finally, the five-percent royalty was significantly less than the typical royalty charged for oil and gas extraction. *See Exxon*, 113 T.C. at 341 (stating that a "12½-percent royalty rate was approximately the same as the royalty rate that was used by most oil-producing countries throughout the world."). Consequently, the five-percent royalty on its own was not "substantial" compensation for the right to extract oil using Unit #12. *Phillips*, 104 T.C. at 293. Harkonnen cannot rebut the presumption that its payment of the IFIL levy was an additional royalty for the right to extract IFIL-controlled petroleum resources.

2. Harkonnen's payments to IFIL were not compulsory, and are therefore not taxes, because Harkonnen failed to exhaust all practical and effective remedies to eliminate its obligation to pay the levy.

Harkonnen's payments to IFIL also fail to meet the third requirement of the regulations' definition a tax: they were not compulsory. By its very nature, a tax must be a compulsory payment. *See* Treas. Reg. § 1.901-2(a)(2) ("A foreign levy is a tax if it requires *compulsory* payment"). Non-compulsory payments do not result in foreign tax credit. *Id.*

Any payments that exceed the taxpayer's true liability under foreign tax law are considered non-compulsory, and thus are not a payment of tax. Treas. Reg. § 1.901-2(e)(5). The regulations provide that an amount paid does *not* exceed the taxpayer's true foreign tax liability if the taxpayer failed to "exhaust all effective and practical remedies" to reduce, over time, the taxpayer's foreign tax liability. *Id.* The regulations consider a remedy "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." *Id.*

Where the U.S. taxpayer's purported foreign tax liability has been calculated in a manner that is inconsistent with foreign law, the taxpayer may only claim a foreign tax credit if it seeks an adjustment to reduce or eliminate that liability with a competent authority or through other administrative remedies. *See Schering Corp. v. Comm'r*, 69 T.C. 579, 602 (1978); Treas. Reg. § 1.901-2(e)(5); Rev. Rul. 92-75, 1992-2 C.B. 197. This burden may require the taxpayer to seek relief from multiple authorities or make multiple demands for relief. *Procter & Gamble Co. v. United States*, 2010 WL 2925099, at *1 (S.D. Ohio 2010). In *Procter & Gamble*, a domestic corporation sought foreign tax credit for taxes paid on income royalties it received from one of its affiliated subsidiaries, which operated the corporation's business in Japan and Korea. *Id.* at *7. When the affiliate paid its royalty to the parent company, the affiliate withheld and paid a ten-percent tax to Japan. *Id.* A subsequent audit by Korea determined that the royalty income was derived from Korea, and concluded that the royalty should be taxable in Korea at fifteen percent. *Id.* The corporation's Korean counsel informed the corporation that the tax was properly assessed and would be difficult to challenge. *Id.* The corporation did not seek further relief, either in Japan or Korea. *Id.* The corporation then sought foreign tax credit for its payments to both Japan and Korea, which the Service denied. *Id.* The court also denied foreign tax credit for the corporation's payment to Japan for failure to exhaust all practical and effective remedies. *Id.* at *8. The court reasoned that once the Korean taxing authority concluded that the royalty was Korean-sourced, the corporation "should have sought a redetermination of the source of the royalty income under Japanese law . . . with regards to [the corporation's] liability in Japan." *Id.* at *8.

Under the regulatory framework, Harkonnen's payments to IFIL were not compulsory. After Mohiam declared the two-percent levy on Harkonnen's profits from Unit #12, Harkonnen petitioned the Holy Royal Court of Arrakis for a determination of whether IFIL held lawful authority to institute the levy. R. at 14. The day after receiving Harkonnen's petition, the Holy Royal Court delivered an answer: "Arrakis recognizes IFIL as a part of Sietch." R. at 14. However, as with the corporation's legal advice in *Procter & Gamble*, the Holy Royal Court's declaration solved only a portion of the liability problem. It left unanswered the more critical question: "if IFIL is a part of Sietch, then does the IFIL levy violate the Arrakis Constitution?" Like in *Procter & Gamble*, Harkonnen "should have sought a redetermination" with the Holy Royal Court. *Procter & Gamble*, supra, at *8.

A second petition from Harkonnen to the Holy Royal Court would neither have been futile nor unreasonable. *Cf.* Treas. Reg. § 1.901-2(e)(5)(ii), Ex. 3. It took only one day from the enactment of the levy for Harkonnen to prepare its petition for the court; one day for the court to give an answer. R. at 14. A second petition therefore would not have added an unreasonable cost.

Moreover, a second petition would have had a reasonable likelihood of success. The Arrakis Constitution allows the Sietch State to enact only one tax. R. at 9. The power of enacting that tax rests solely with the Vice President of Arrakis. R. at 9. On March 22, 2011—the date on which Mohiam enacted the levy on Unit #12's profits—

Paul Atreides was the Vice President of Arrakis. R. at 9. Mohiam thus had no authority to levy a tax in Sietch. Additionally, on April 16, 2010, Atreides exercised his power under the Arrakis Constitution and decreed the lone tax applicable in Sietch. R. at 10. Thus, if IFIL is a part of Sietch (as the Holy Royal Court recognized),[8] then IFIL's levy constitutes an unconstitutional second tax. Had Harkonnen presented either of these arguments to the Holy Royal Court, it would have had a reasonable likelihood of invalidating the two-percent levy on Unit #12's profits, thereby eliminating any apparent liability pursuant the levy.

By failing to inquire of these or other remedies and nevertheless seeking foreign tax credit for its payments to IFIL, Harkonnen effectively seeks to have the "United States foot the bill through the credit system." *Procter & Gamble*, supra, at *8. When a domestic taxpayer is allowed to claim foreign tax credit without first having exhausted all practical and effective remedies, "double taxation is avoided, but the U.S. Treasury is saddled with the cost." Paul C. Rooney & Nelson Suit, *Competent Authority*, 49 Tax L. 675, 682–683 (1996). Allowing foreign tax credit without a *substantial* exhaustion of remedies requirement also leaves beneficial provisions of foreign tax law without teeth. This Court should not construe the foreign tax credit regulations in a manner that leaves the taxpayer with little incentive to challenge erroneous foreign taxes. Because Harkonnen failed to lodge a sufficient challenge to IFIL's levy, its payments pursuant to that levy were not compulsory.

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[8] Even if the Holy Royal Court meant that IFIL was part of Sietch, but not the Sietch State, as the dissenting judge below assumed, a second petition to the Holy Royal Court for clarification of IFIL's taxing authority in Arrakis still would not have been unreasonable or futile.

The purpose of eliminating double taxation is served only if the domestic corporation actually faces double taxation. When a foreign levy is not actually a tax, the domestic corporation does not face the burden of double taxation and is not entitled to foreign tax credit. Because the IFIL levy is not a tax, no credit should be allowed for it under Section 901. The Fourteenth Circuit correctly determined that Harkonnen's payments to IFIL are not eligible for foreign tax credit.

CONCLUSION

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

Respectfully submitted,

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ATTORNEYS FOR RESPONDENT

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APPENDIX "A"

26 U.S.C. § 901 (2012)

§ 901. Taxes of foreign countries and of possessions of the 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; 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"

26 U.S.C. § 903 (2012)

§ 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.