No. C15-1701-1

In The

Supreme Court of the United States

October Term 2014

ROYAL HARKONNEN OIL COMPANY,

Petitioner,

v.

UNITED STATES,

Respondent.

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

BRIEF FOR RESPONDENT

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November 24, 2014

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QUESTIONS PRESENTED

1. Is the Arrakis Foreign Tax creditable under Section 901 or 903 of the Internal Revenue Code, where the taxpayer received the benefit of the ability to extract and sell Arrakisian natural resources, the Tax's newly allowed deductions are capped at an amount lower than that allowed by Arrakis citizens, and Arrakis also imposes a tax that generally reaches the net income of its citizens?

2. Is a levy imposed by IFIL, a dissident group with proven connections to a known terrorist group, creditable under Section 901 or 903 of the Internal Revenue Code, where IFIL imposed the levy on a single well through a forceful takeover, the levy was the second in Sietch State despite a constitutional amendment allowing only one tax, and the taxpayer's only action taken in an attempt to reduce its tax liability was to rely on a statement that Arrakis recognizes IFIL?

STATEMENT OF JURISDICTION

This case is properly within the subject matter jurisdiction of federal courts pursuant to 28 U.S.C. § 1331. The United States Court of Appeals for the Fourteenth Circuit entered its judgment on October 1, 2014. (R. at 2.) Petitioner filed for writ of certiorari, which this Court granted. This Court has jurisdiction under 28 U.S.C. § 1254(1).

STATEMENT OF THE CASE

Statement of Facts

Petitioner Royal Harkonnen Oil Company is a domestic corporation incorporated in Delaware that is engaged in the business of extracting natural resources domestically and abroad. (*See* R. at 2.) Harkonnen began exploring the possibility of extracting oil and gas from Arrakis's Caladan Oil Field in 2007. (R. at 2.) Harkonnen expressed concerns about profitability based on the potential for high royalty demands by Arrakisian president Jules Corrino, whose family owns the country's mineral rights. (R. at 3.) In fact, Harkonnen even considered the possibility of developing a different reservoir near Caladan Oil Field in the countries of Anbus and Al Dhanab. (R. at 3.) However, the Caladan Oil Field was attractive to Harkonnen because it contained 150 million barrels of oil equivalent in 231,000 square miles, so Harkonnen proceeded to negotiate with Corrino to develop the Caladan Oil Field in February of 2008. (R. at 2–3.)

The Republic of Arrakis was formed in 1952 after the Bloody Ten Year War resulted in the Eternal Arrakis Empire conquering the Sietch Empire. (R. at 3.) The two empires experienced significant religious conflict prior to the war. (R. at 3.) After the war, the conflicts continued and resulted in many uprisings by citizens with Sietch ancestry (*e.g.*, R. at 5, 8), a population concentrated within the Sietch Dunes area of Arrakis. (R. at 5.) One such uprising occurred in April 2008 when dissidents tried to declare their independence and the Arrakis military seized a victory in a fight that claimed 15,000 Sietch Dune casualties. (R. at 5–6.) Another uprising occurred in March 2010, when the Independent People of Sietch declared their independence from Arrakis. (R. at 8.)

During both uprisings, the United States Department of State expressed its concerns and committed itself to monitoring the situations to ensure Arrakis did not commit any atrocities. (R. at 6, 7.) The State Department had to monitor the situation because Arrakis, having never ratified the Geneva Convention, was known to execute enemy combatants instead of quartering prisoners of war. (R. at 6.) Harkonnen was aware of the State Department's concerns and requested clarification from President Corrino. (R. at 6.) President Corrino said there was no need to worry and Harkonnen did not press the is

sue further. (R. at 6.) During the second uprising, the State Department labeled Arrakis a "Dangerous State" and withdrew its Arrakisian embassy from Arrakken, the capital of Arrakis. (R. at 8.)

This later uprising eventually resulted in the Sietch Dunes Peace Treaty, which provided that the Sietch Dunes region would thereafter be known as Sietch State and would be a political subunit of Arrakis. (R. at 8.) President Corrino then amended the Arrakis Constitution, providing for the position of Vice President, which was to be held only by those with Sietch blood. (R. at 9.) Among the Vice President's powers was the ability to decree and levy a single tax within Sietch State. (R. at 9.) In April 2010, Sietch State elected its first Vice President, Paul Atreides. (R. at 9.) Vice President Atreides issued a Sietch State tax in April 2010. (R. at 10.) The Sietch State tax was imposed on all income earned in Sietch State by citizens and foreign entities alike. (R. at 10.) This tax applied uniformly at a rate of ten percent of all gross income minus applicable deductions. (R. at 10.)

Until recently, the Arrakis Tax Code applied only to those whose bloodlines traced back to the Sietch or Arrakis thrones, and those subjects were the only ones who were provided any legal protections. (R. at 4.) The Arrakis Tax Code included deductions similar to those available under the Internal Revenue Code of the United States. (R. at 4.) Consequentially, because only those with Sietch or Arrakisian blood could be taxed, the taxes and deductions under

the Arrakis Tax Code (and thus the legal protections available to taxpayers) did not apply to foreign individuals or entities. (R. at 4.) However, in March 2008, President Corrino enacted the Republic of Arrakis Foreign Value Tax, which applied to "all foreign entities that operate machinery" in Arrakis. (R. at 4.) The tax was calculated by multiplying the foreign entity's gross receipts by a percentage. (R. at 4.) In June 2008, President Corrino set the percentage at forty-five percent and renamed the levy the Republic of Arrakis Foreign Tax. (R. at 7.)

Harkonnen signed oil and gas leases with both Arrakis and Sietch State. (R. at 7, 10.) The Arrakis Lease, which Harkonnen signed in June 2008, covered the entire 231,000 square-mile Caladan Oil Field. (R. at 7.) The Arrakis Lease provided for a bonus payment of fifty-five million dollars and royalty payments of fifteen percent to the government of Arrakis. (R. at 7.) At that time, Harkonnen also agreed to pay the original Foreign Value Tax levied by Arrakis. (R. at 7.) The Sietch Lease, which Harkonnen entered into with Sietch through Vice President Atreides after his election in April 2010, covered the 62,000 square-mile portion of the Caladan Oil Field lying within Sietch State. (R. at 6, 10.) The Sietch Lease provided for a bonus payment of five million dollars and royalty payments of five percent to Vice President Atreides. (R. at 10.)

In July 2010, a group with known terrorist affiliations called the Inter-Sietch Fremen Independence League (IFIL), dissatisfied with the election of Vice President Atreides, rebelled in Sietch State. (R. at 11.) The group insisted Atreides resign and be replaced with their leader, Jessica Mohiam. (R. at 11.) IFIL was organized in 2008 with the financial assistance of Al Dhanab and Anbus. (R. at 12.) Al Dhanab and Anbus both have significant power in electing IFIL's leader, each having three of the seven total electoral votes (with the remaining electoral vote belonging to all IFIL members). (R. at 12.) In exchange for their financial support, Mohiam promised Al Dhanab and Anbus to promote economic development for Sietchians and to denounce the Bene Gesserit, a well-known terrorist group in the region. (R. at 12.) While Al Dhanab and Anbus have recognized IFIL as a "legitimate foreign government" (R. at 12), the United States Department of State classified IFIL as an "independent splinter group of the Bene Gesserit." (R. at 11.) Although they have publicly denounced each other (R. at 11, 13), Mohiam is undeniably connected to the organization. (*See* R. at 11.) Mohiam's mother helped found the Bene Gesserit and likely heavily influenced her at least until Mohiam reached the age of 18. (*See* R. at 11.)

In March 2011, IFIL took control of the Badlands, a Sietch State region, by force. (R. at 13.) Soon thereafter, IFIL expanded and used force to take control of Unit 12, one of Harkonnen's drilling stations. (R. at 13.) IFIL ac-

cused Harkonnen of slant drilling and promised not to return control of the well to Harkonnen "until they rectif[ied] their insolence and pa[id] tribute." (R. at 13.) On behalf of IFIL, Mohiam demanded a $550,000 bonus payment and a five percent royalty. (R. at 13.) In addition, Mohiam decreed a tax on Unit 12 based on gross receipts minus deductions multiplied by two percent. (R. at 13.) In response, Harkonnen signed a third oil and gas lease, agreeing to pay IFIL the bonus and royalty. (R. at 13.) Harkonnen refused to pay the tax, however. (R. at 13.) Instead, it asked President Corrino for advice, and President Corrino directed it to the Holy Royal Court. (R. at 13.) When the Holy Royal Court stated, "Arrakis recognizes IFIL as part of Sietch," Harkonnen made the payments to IFIL, including the payment for the tax. (R. at 13.) That Arrakis recognized IFIL was the only information the Holy Royal Court provided to Harkonnen. (R. at 13.) Mohiam used twenty percent of the payments to pay tribute to Al Dhanab and Anbus. (R. at 14.)

The following month, Atreides and Mohiam tied in the second election for Vice President of Sietch State. (R. at 14.) Vice President Atreides was declared the winner. (R. at 14.) The United States supervised the election but never certified its results. (R. at 14.) The United States issued Executive Order 14012, which pronounced that "IFIL [was] a sovereign friend of the United States, whom we would like to establish trade relations with." (R. at 14.) To date, there is no evidence that those relations have been established.

The First Annual Caladan Oil Field Conference took place in May of 2011. (R. at 15.) Mr. Harkonnen, President Corrino, Vice President Atreides, and Mohiam were all present at the conference. (R. at 15.) Sietch State's tax and IFIL's levy on Unit 12 remained at ten and two percent, respectively, and Corrino agreed to lower the Arrakis Foreign Tax rate from forty-five to thirty-three percent. (R. at 15.) Additionally, following the conference, President Corrino issued Proclamation 102, which allowed foreign corporations to take the same kinds—but not the same amounts—of tax deductions available to Arrakis citizens. (R. at 15.) Foreign corporations still cannot take one hundred percent of their deductions but are limited to ninety-five percent of the amount available to Arrakis citizens because foreign entities are not considered "true believer[s]." (R. at 15.)

Procedural History

After Harkonnen filed its United States Tax Return in March 2012 for the 2011 tax year, it claimed foreign tax credits under Sections 901 and 903 for the same tax year. (R. at 16.) Harkonnen claimed credits for all three payments, but the Internal Revenue Service performed an audit and determined that only the payment to Sietch State was creditable. (R. at 16–17.) The I.R.S. decided that the payments to the Republic of Arrakis were not creditable because the Arrakis Foreign Tax did not sufficiently reach net income. (R. at 16–17.) Additionally, the I.R.S. found that the IFIL levy was not cred-

itable because IFIL was not a valid taxing entity, the tax was not valid because it violated the Sietch Dunes Peace Treaty, and Harkonnen had failed to exhaust its remedies in challenging the tax. (R. at 17.)

Harkonnen attempted to negotiate with the I.R.S., but negotiations proved unsuccessful. (R. at 17.) Harkonnen then sued for a refund in the Central District Court of New Tejas. (R. at 17.) The district court agreed with the I.R.S.'s decision and entered judgment in favor of the United States, holding that the payments to Arrakis and IFIL were non-creditable. (R. at 17.) Harkonnen then appealed to the United States Court of Appeals for the Fourteenth Circuit, which affirmed the decision of the district court on October 1, 2014. (R. at 2.)

The Fourteenth Circuit agreed with the district court's reasoning and held that the payments to Arrakis and IFIL were not creditable. (R. at 17, 18.) The court reasoned that the Arrakis Foreign Tax was not an income tax in the U.S. sense as defined by Section 901 because it did not reach net income, nor did it allow for the recovery of costs and expenses. (R. at 17.) The court also held that the Arrakis Foreign Tax was not a tax in lieu of an income tax and was therefore not creditable under Section 903. (R. at 18.) Finally, the court determined that Harkonnen's payment to IFIL was not creditable because IFIL was not a valid taxing entity, the tax violated the Arrakis Constitu-

tion, and Harkonnen failed to exhaust its remedies to reduce its liability under Arrakisian law. (R. at 18.) Harkonnen filed a petition for a writ of certiorari, and the Supreme Court of the United States granted the petition. (R. at 1.)

SUMMARY OF THE ARGUMENT

The purposes of foreign tax credits are to avoid double taxation and help the United States be competitive in foreign markets. Tax credits are a matter of legislative grace that should be strictly construed against the taxpayer. Neither Harkonnen's payment to Arrakis nor its payment to IFIL is creditable under Section 901 or Section 903 of the Internal Revenue Code.

Harkonnen's payment to Arrakis is not creditable under Section 901 because it does not meet the requirements of a tax, nor is it an income tax in the U.S. sense. Additionally, Harkonnen's alternative argument under Section 903 also fails because the levy does not qualify as a tax in lieu of an income tax either. The first requirement for creditability under Section 901 is that the foreign levy be a tax, which means the payment must be compulsory and the foreign country levying the tax must have the authority to do so. Harkonnen's payment is not compulsory because Harkonnen received an economic benefit in exchange for its payment.

Not only is the payment to Arrakis not a tax, but the payment is also not an income tax in the U.S. sense. The requirement that a tax have the predominant character of an income tax in the U.S. sense effectuates the purpose

of the foreign tax credit because it ensures credit will only be given if it will help avoid the evils of double taxation. The Arrakis Foreign Tax is not an income tax in the U.S. sense because it fails to reach net income. It fails to reach net income because it does not allow for the deduction of significant costs and expenditures. In fact, the Arrakis Foreign Tax provides for no allowance whatsoever that may potentially be considered to compensate for the disallowed deductions. Finally, the Arrakis Foreign Tax does not qualify as a tax in lieu of an income tax and therefore does not meet the requirements for creditability under Section 903. The levy is not a tax in lieu of an income tax because it is imposed in addition to, and not as a substitution for, Arrakis's generally imposed income tax that unquestionably reaches the net gain of Arrakisians.

Likewise, Harkonnen's payment to IFIL is not creditable under Section 901 or Section 903. To be creditable, a foreign levy must be imposed pursuant to the authority of a valid taxing entity, and the taxpayer must exhaust its remedies in an effort to reduce its tax liability. In addition, the levy must be a tax, which means it cannot be a penalty. Here, IFIL is not a valid taxing entity because it is not a sovereign entity with the authority to levy taxes; it is a rebel group with proven terrorist affiliations. Thus, public policy dictates that the United States not encourage trade with IFIL and foreign tax credits would encourage such trade. Additionally, Harkonnen has not met its burden to

prove that its payment was compulsory because it has not shown that its interpretation of foreign law was reasonable or that it exhausted its remedies in attempting to decrease its tax liability. Harkonnen has not shown its interpretation of Arrakis law was reasonable because it had constructive notice that its interpretation was erroneous. This is because the Arrakis Constitution allows for only one tax in Sietch State. Harkonnen has also not exhausted its remedies because, when IFIL took over one of its drilling units by force, Harkonnen did nothing more than seek a general statement from the Holy Royal Court regarding IFIL's legal status in Arrakis.

Harkonnen's payment to IFIL is also non-creditable because IFIL's levy was a penalty and not a tax. IFIL used force to take control of Harkonnen's drilling unit, accused Harkonnen of slant drilling, and demanded payment before returning control of the unit to Harkonnen. Therefore, it is clear that the payment to IFIL was a penalty, not a tax, because it was punishment for slant drilling instead of a widely imposed contribution to provide support for the government.

Accordingly, because Harkonnen's payment to Arrakis is not compulsory and the Arrakis Foreign Tax does not have the predominant character of an income tax in the U.S. sense, nor is it in lieu of such an income tax, the Arrakis

Foreign Tax is not creditable. Moreover, because IFIL is not a valid taxing entity, Harkonnen has not proven its payment was compulsory, and the IFIL levy is a penalty rather than a tax, the IFIL levy is not creditable either.

STANDARD OF REVIEW

Appellate courts review questions of law arising from statutory interpretation *de novo*. *Pierce v. Underwood*, 487 U.S. 552, 558 (1988). However, determinations by the IRS are entitled to a presumption of correctness. *United States v. Fior D'Italia, Inc.*, 536 U.S. 238, 242 (2002). Thus, the burden of overcoming that presumption lies with the taxpayer. *Conway v. United States*, 326 F.3d 1268, 1278 (Fed. Cir. 2003).

ARGUMENT

Section 901 of the Internal Revenue Code granted the foreign tax credit as a tool to make the United States more competitive in foreign markets and to facilitate international business transactions by eliminating double taxation. *United States v. Goodyear Tire & Rubber Co.*, 493 U.S. 132, 139 (1989); *W.K. Buckley, Inc. v. Comm'r*, 158 F.2d 158, 161 (2d Cir. 1946); *see also* Stanley S. Surrey, *Current Issues in the Taxation of Corporate Foreign Investment*, 56 Colum. L. Rev. 816, 818, 848 (1956). A statutory provision like Section 901 or 903 that grants credits, deductions, and other exemptions "is a matter of legislative grace" and should therefore be strictly construed. *INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 84 (1992) (quoting *Interstate Transit Lines v. Comm'r*,

319 U.S. 590, 593 (1943)). Neither Harkonnen's payment to the Republic of Arrakis nor its payment to IFIL qualifies for foreign tax credits under Section 901 or 903 of the Code. Thus, both the district court and the court of appeals correctly denied both credits, and this Court should affirm those decisions.

I. Harkonnen's payment to Arrakis is not creditable because it was not a compulsory payment, its predominant character is not that of an income tax in the U.S. sense, and it is not in lieu of such a tax.

Section 901 allows American citizens and corporations a credit for "the amount of any income, war profits, and excess profits taxes paid or accrued during the taxable year to any foreign country[1] or to any possession of the United States." 26 U.S.C. § 901(b)(1) (2012). In 1983, the Secretary of the Treasury promulgated Regulation 1.901-2 in an attempt to provide guidance regarding what constitutes "income, war profits, [or] excess profits taxes" (which, for simplicity, the Regulations refer to as "income tax") for purposes of Sections 901 and 903. *See* Treas. Reg. § 1.901-2 (2014). The Supreme Court has noted that the Treasury Regulations deserve the courts' respect and defer-

[1] The Treasury Regulations define "foreign country," Treas. Reg. § 1.901-2(g)(2), and the Code disallows credits for taxes paid to certain foreign countries. 26 U.S.C. § 901(j). Among countries for which credits are disallowed are those countries "with respect to which the United States has severed diplomatic relations." 26 U.S.C. § 901(j)(2)(A)(ii). The United States declared Arrakis a "Dangerous State" in March of 2010. However, because the State Department removed the designation in July of 2010, subsection (j) never applied to Arrakis. As such, a discussion of Section 901(j) and the denial of tax credits with regard to Section 901(j) countries is reserved for the section discussing taxes imposed by IFIL. *See infra* pp. 34–37.

ence. *Comm'r v. Portland Cement Co.*, 450 U.S. 156, 169 (1981). According to the Regulations, to meet Section 901's definition of income tax and therefore be creditable, a foreign levy must be a tax and its "predominant character" must be "that of an income tax in the U.S. sense." Treas. Reg. § 1.901-2(a)(1).

Harkonnen's payment to the Republic of Arrakis is not creditable because the levy does not meet Section 901's definition of a tax and its predominant character is not that of an income tax in the U.S. sense. Additionally, because the levy does not meet the substitution requirement of Section 903, Petitioners alternative argument that the levy is in lieu of an income tax also fails.

A. The Arrakis Foreign Tax is not a compulsory payment and is thus not a tax because it results in Harkonnen receiving a specific economic benefit, and Harkonnen has not met its burden to establish which part of the payment is a tax.

The first requirement for a foreign levy to qualify as a creditable income tax under Section 901 is that it be a tax. Treas. Reg. § 1.901-2(a)(1)(i). To be a tax, the levy must be "a compulsory payment pursuant to the authority of a foreign country to levy taxes." Treas. Reg. § 1.901-2(a)(2)(i). A taxpayer is a dual capacity taxpayer if it is subject to a foreign levy and also receives some specific economic benefit. *See id.* § 1.901-2(a)(2)(ii). Because they receive economic benefits, dual capacity taxpayers' payments might not always be entirely compulsory. *See id.* The Treasury Regulations define a 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." *Id.* § 1.901-2(a)(2)(ii)(B). The regulations specifically provide that the right to extract oil owned by the government of a foreign country is a specific economic benefit because such a right is not generally conferred upon everyone on substantially the same terms. *Id.* Because levies apply differently to dual capacity taxpayers than to other taxpayers similarly situated, the levies must be analyzed as applied to the dual capacity taxpayers in determining whether the levy is creditable. *Id.* § 1.901-2A(a)(1) (2014). Dual capacity taxpayers cannot show their payments are compulsory (and therefore claim foreign tax credits) unless they can show the extent to which their payment is a tax as opposed to a payment for the economic benefit they received. Treas. Reg. § 1.901-2(a)(2)(i).

Harkonnen is a dual capacity taxpayer because it receives the specific economic benefit of the right to extract government-owned natural resources in exchange for its payment under the Arrakis Foreign Tax. Although Corrino's family owns the mineral rights in Arrakis, when Corrino negotiated and signed the oil and gas lease with Harkonnen, he did so on behalf of the government of Arrakis. Harkonnen paid its royalty and bonus payments under the lease to Arrakis, not to President Corrino personally. This is clear evidence that the minerals in Arrakis are held by President Corrino but ultimately owned by the Arrakasian government. As such, the per se rule of Treasury Regulation § 1.901-1(a)(2)(ii)(B) applies, and Harkonnen is necessarily a dual

capacity taxpayer who has failed to show which part of its payment is a tax and which part is payment for the benefit of mineral extraction rights.

Even to the extent that Harkonnen might argue the Arrakis Foreign Tax applies to it in substantially the same manner as others similarly situated, the regulations provide a per se rule that the right to extract natural resources owned by a foreign government is necessarily a specific economic benefit. Moreover, the tax does not apply in the same manner to everyone similarly situated. The tax applies to all foreign entities that operate machinery in Arrakis. Thus, the tax would not apply equally to an oil extraction corporation and, for example, a construction corporation. This is because the construction corporation, while receiving income based on its operations in the foreign country, would not receive the benefit of the right to extract and sell natural resources owned by Arrakis. Harkonnen, however, did receive this benefit when it produced 858,000 barrels of oil per day.

Because Harkonnen is subject to the Arrakis Foreign Tax and receives an economic benefit, it is a dual capacity taxpayer. As a dual capacity taxpayer, Harkonnen has the burden to show which portion of its payment is a tax and which portion is a payment for the benefit of the ability to extract oil. Because Harkonnen has not met this burden, its claimed credit was properly denied.

B. The Arrakis Foreign Tax is not creditable because its predominant character is not that of an income tax in the U.S. sense.

Even if this Court determines the Arrakis Foreign Tax was a compulsory payment that was not in exchange for an economic benefit, the levy is still not creditable because it does not fall within the definition of an income tax for which foreign tax credits are allowed under the Code and Regulations. Cases interpreting Section 901 prior to the adoption of Treasury Regulation § 1.901-2 attempted to define the term "income," which resulted in a "tortuous history" full of "vagaries, confusion, and seeming contradictions." *Texasgulf, Inc. v. Comm'r*, 172 F.3d 209, 214 (2d Cir. 1999) (quoting *Bank of Am. Nat'l Trust & Sav. Ass'n v. Comm'r*, 61 T.C. 752, 759 (1974)). Most courts that interpreted the statute agreed, however, on the basic principle that income is restricted to gain and thus does not include gross amounts without any deductions or allowances. *See, e.g.*, *Keasbey & Mattison Co. v. Rothensies*, 133 F.2d 894, 897 (3d Cir. 1943).

Thus, courts agreed that Section 901 was meant to allow credits for foreign taxes that reached net income, and many early decisions that denied the credits did so because the court held that the foreign levy did not reach net income. *See, e.g.*, *id.* (denying credit for taxes paid or accrued under the Quebec Mining Act on the basis of the gross value of the company's output for the year); *St. Paul Fire & Marine Ins. Co. v. Reynolds*, 44 F. Supp. 863 (D. Minn. 1942) (denying credit for taxes paid or accrued under a Canadian premium tax

on insurance companies based on gross receipts and imposed regardless of whether the company realized a gain or suffered a loss); *Eitingon-Schild Co. v. Comm'r*, 21 B.T.A. 1163 (1931) (denying credit for a French turnover tax imposed on exporters of fur based on gross receipts from sales or commissions); *Bank of Am. Nat'l Trust & Sav. Ass'n v. Comm'r*, 61 T.C. 752 (1974) (denying credits for taxes that were based on banks' gross receipts and that did not allow deductions for expenses), *aff'd*, 538 F.2d 334 (9th Cir. 1976); *Inland Steel Co. v. United States*, 677 F.2d 72 (Ct. Cl. 1982) (denying credits for a mining tax that did not allow deductions for costs such as interest, royalty payments, depletion, or preproduction and development).

United States income taxes reach net income because they are based on gross income less deductions; instead of applying a tax percentage to taxpayers' gross income, taxes are calculated by multiplying taxable income, which is gross income less deductions, by a percentage. *See* 26 U.S.C. § 63 (2012). To fall within the definition of an income tax under Sections 901 and 903 and therefore be creditable, foreign taxes must have that same predominant character—the predominant character of an income tax in the U.S. sense. *See* Treas. Reg. § 1.901-2(a)(1) (2014). A levy must be a tax in the U.S. sense because courts have long recognized the necessity of using the principles of United States revenue laws in determining whether an income tax has been paid to a foreign country. *See Biddle v. Comm'r*, 302 U.S. 573, 578–79 (1938). To be a

tax, a levy must require mandatory payment under a country's authority to lay taxes. Treas. Reg. § 1.901-2(a)(2). For a tax to have the predominant character of an income tax in the U.S. sense, it must be "likely to reach net gain in the normal circumstances in which it applies," and it must not be a "soak-up tax" (a tax whose liability depends on a credit being available). *Id.* § 1.901-2(a)(3).

Treasury Regulation Section 1.901-2(b) sets out a three-part test for determining whether a tax is likely to reach net gain. *Id.* § 1.901-2(b). The test indicates the Treasury's intention that the foreign levy be creditable only if it reaches net gain, which "consists of realized gross receipts reduced by significant costs and expenses attributable to such gross receipts." *PPL Corp. v. Comm'r*, 133 S. Ct. 1897, 1898 (2013). The tax must meet all three requirements in order to be considered to reach net gain. *Id.* § 1.901-2(b)(1). First, the tax must meet the realization requirement. *Id.* § 1.901-2(b)(2). The tax meets this requirement if it is imposed at a time after some realization or pre-realization event such that, if imposed in the United States, it would trigger a United States income tax. *Id.* Second, the tax must meet the gross receipts requirement. *See id.* § 1.901-2(b)(3). The tax meets this requirement if it is imposed on the basis of either actual gross receipts or "[g]ross receipts computed under a method that is likely to produce an amount that is not greater than fair market value." *Id.* Lastly, the tax must meet the net income requirement.

Id. § 1.901-2(b)(4). The usual manner in which taxes meet this requirement is when, in calculating its base, gross receipts are reduced by either the amount of the "significant costs and expenses" or some allowance that "effectively compensate[s]" for the disallowance of such expenses. *Id.*

In very rare cases, a tax based on gross receipts that does not account for expenses may meet the net income requirement, but this is only possible in the unusual situation in which a company's expenses are never high enough to offset gross income. *Id.* § 1.901-2(b)(4)(i). Again, the foreign tax must be evaluated based on principles of United States tax law for purposes of determining whether it reaches net gain; characterization under foreign law does not control. *H.W. Gossard Co. v. Comm'r*, 119 F.2d 346, 348 (7th Cir. 1941) (quoting *Biddle*, 302 U.S. at 578).

An application of the Regulation's three-part test clearly shows that the Arrakis Foreign Tax did not reach Harkonnen's net income. Admittedly, the levy was imposed on realized income and on the basis of gross receipts. However, the levy does not reach net gain because it does not deduct from gross receipts significant costs and expenditures in an effort to reach net gain, and there is no evidence that Harkonnen was almost certain to always realize gains and never operate at a loss. In fact, Harkonnen was so uncertain as to whether it would be able to operate at a profit due to likely royalty demands from Arrakis, it considered developing a different reservoir in nearby coun-

tries. Thus, it is clear that this was not one of those exceptional levies that did not have to meet the net gain requirement with regard to Harkonnen because Harkonnen was not certain to operate at a profit.

1. The Arrakis Foreign Tax does not reach net income because it does not allow for the deduction of significant costs and expenditures.

Most cases to interpret the Regulation's three-part test focus on the net income requirement. *E.g.*, *Texasgulf, Inc. v. United States*, 17 Cl. Ct. 275 (1989); *Texasgulf, Inc. v. Comm'r*, 172 F.3d 209 (2d Cir. 1999); *Phillips Petroleum Co. v. Comm'r*, 104 T.C. 256 (1995); *Int'l Bus. Machs. Corp. v. United States*, 38 Fed. Cl. 661 (1997); *Exxon Corp. v. Comm'r*, 113 T.C. 338 (1999); *Entergy Corp. v. Comm'r*, 683 F.3d 233 (5th Cir. 2012); *PPL Corp. v. Comm'r*, 133 S. Ct. 1897 (2013); *Albemarle Corp. v. United States*, -- Fed. Cl. --, 2014 WL 5463032 (2014). The critical issue in determining whether the net income requirement is met is whether the tax is based on gross receipts *less significant costs and expenditures*, such that reaching net income is a likely result of the tax. *E.g.*, *Inland Steel Co.*, 677 F.2d at 84; *Texasgulf, Inc.*, 17 Cl. Ct. at 287.

In *Phillips Petroleum Co. v. Commissioner*, the court held that Norwegian taxes on United States corporations engaged in the business of extracting oil in Norway were creditable under Section 901 because they reached net income by deducting from gross receipts significant expenses such as changes in inventory. *Phillips Petroleum Co.*, 104 T.C. at 313, 317. Deductible expenses

included operating expenses, inventory changes, business losses and depreciation, interest and dividends, mineral deposits and extraction costs, and bad debt. *Id.* at 271–73. On the other hand, in *International Business Machines Corp. v. United States*, the Federal Claims Court held that an Italian tax did not meet the net income requirement as applied to nonresident corporate taxpayers because it was calculated on the basis of gross receipts without subtracting costs, expenses, or capital expenditures. *Int'l Bus. Machs. Corp.*, 38 Fed. Cl. at 678.[2]

Prior to the enactment of Proclamation 102, the Arrakis Foreign Tax very clearly did not reach net income because it was calculated by multiplying the total gross receipts earned in Arrakis by a percentage. Unlike the Sietch State tax, which was based on gross income minus costs and expenses, the creditability of which is not being challenged here, the Arrakis Foreign Tax did not reach net income because it did not allow for the deduction of costs or expenses. It was clear at the time Harkonnen signed its oil and gas lease with President Corrino that the original Arrakis Foreign Value Tax made no allowance for expenses. Thus, when Harkonnen signed the lease, it was put on no-

[2] The Court in *International Business Machines Corp.* interpreted both the temporary regulations in effect in 1982 and the final regulations that replaced them in 1983. *See Int'l Bus. Machs. Corp.*, 38 Fed. Cl. at 677–81. The court held that the net income requirement was met under the temporary regulations, which provided for an exception for changes on fixed income. However, this exception does not appear in the final regulations and the taxpayer therefore conceded that the net income requirement was not met for the 1983 tax year. *See id.* at 680.

tice that it was subject to a tax based on gross receipts and it agreed to pay such a tax. Because the purpose of allowing a foreign tax credit is to avoid double taxation and Harkonnen was aware of the nature of the tax and agreed to pay it anyway, there is no danger of unfair double taxation in this case.

Nor does the 2008 so-called amendment of the tax change the analysis. When President Corrino "amended" the tax, the only change was the removal of the word "value" from the title. Because foreign taxes must be evaluated based on principles of United States tax law and the substance of the tax controls over its form, President Corrino's renaming of the tax does not change the determination that the tax does not reach net income. The removal of the word "value" did not alter the fact that the tax was based on gross receipts without subtracting costs and other items deductible under the United States Code to reach net income.

Even with the enactment of Proclamation 102, the Arrakis Foreign Tax still fails to reach net income. Proclamation 102 allowed foreign taxpayers to deduct the same kinds of costs and expenses that Arrakis citizens could. However, because the maximum deduction for expenses under Proclamation 102 was ninety-five percent of the allowable deductions for Arrakisians, the deductions are not significant enough to reach net income. Even though the levy allows a deduction of ninety-five percent of a taxpayer's costs, costs incurred in the extraction of 858,000 barrels of oil per day are so significant that even the

disallowed five percent is significant. Additionally, because the Foreign Tax applies differently to "non-believers," it looks like a tax on religion and not on income. Thus, the Arrakis Foreign Tax does not reach net income and is therefore not creditable.

2. The Arrakis Foreign Tax does not provide allowances that effectively compensate for the disallowed deductions.

When a levy is determined not to reach net income because it disallows deductions for significant costs and expenditures, it is sometimes nonetheless held to reach net income if it provides for an allowance that effectively compensates for the disallowed deductions. Here, however, the Arrakis Foreign Tax does not provide for any such allowances. The *Texasgulf* cases dealt with the creditability of the Ontario Mining Tax, a levy imposed on companies extracting minerals in Ontario. *See Texasgulf, Inc.*, 17 Cl. Ct. at 282; *Texasgulf, Inc.*, 172 F.3d at 215. Texasgulf was a domestic corporation subject to the Ontario Mining Tax, and it claimed foreign tax credits. *Texasgulf, Inc.*, 17 Cl. Ct. at 275; *Texasgulf, Inc.*, 172 F.3d at 209.

In the 1989 case (*Texasgulf I*), two versions of the mining tax were at issue, for taxable years 1968 and 1969, both of which were based on total "profits." The Tax assessed "profits" based on (1) gross receipts if the extracted minerals were sold; (2) fair market value of the minerals once extracted if the minerals were not sold; or (3) if the fair market value could not be determined, the mine assessor's appraised value based on gross receipts minus a processing

allowance. *Texasgulf, Inc.*, 17 Cl. Ct. at 282. The processing allowance was the greater of fifteen percent of the company's income or eight percent of the previous year's processing assets. *Id.* at 282. The Tax expressly disallowed deductions for equipment costs, investment capital and interest, depreciation, royalties, and development costs. *Id.* at 283 n.8. The court held that these disallowed deductions were "significant." *Id.* at 287. Additionally, the court held that the processing allowance did not effectively compensate for the significant disallowed deductions because the allowance could be taken by any corporation regardless of actual processing costs, and only about fifteen of the fifty companies filing Mining Tax returns claimed the processing allowance. *Id.* at 283. Thus, the Tax did not reach net income and was therefore not a creditable income tax in the U.S. sense. *Id.* at 290.

The 1999 *Texasgulf* case (*Texasgulf II*), on the other land, dealt with a later version of the Ontario Mining Tax, which the court held to be creditable. In that case, the 1972 Tax was at issue for tax years 1978, 1979, and 1980. *Texasgulf, Inc.*, 172 F.3d at 211. Like the Mining Tax examined in *Texasgulf I*, this tax was based on the mine's "profits," and it assessed "profits" based on gross receipts or actual or appraised fair market value. *Id.* at 211–12. However, the 1972 tax allowed for the deduction of certain "expenses, payments, allowances, and deductions," including costs for research, mine development, salaries, operating expenses, and a depreciation allowance. *Id.* at 212. While

this version of the Tax did not include all previously disallowed deductions—interest, cost depletion, and royalties were expressly disallowed—the court held its processing allowance did effectively compensate for the disallowed deductions because less than thirty-three percent of the Mining Tax returns showed expenses in excess of the allowance. *Id.* at 212, 215. Additionally, where non-recoverable expenses were reported, they only comprised one percent of the gross receipts of all corporations in the industry. *Id.* at 214. Thus, because the 1972 Tax allowed for the deduction of some expenses and the processing allowance effectively compensated for the remaining disallowed deductions, the court held that the tax reached net income and was therefore creditable. *Id.* at 217.

Similarly, in *Exxon Corporation v. Commissioner*, the court held that a United Kingdom petroleum revenue tax was creditable, even though it did not allow deductions for interest expenses, because available allowances effectively compensated for the disallowed deductions. *Exxon Corp.*, 113 T.C. 338. There, the tax permitted the consideration of special allowances including "uplift" deductions, or a percentage of capital expenditures. *Id.*

There is no indication that the Arrakis Foreign Tax provides any allowance of any kind that could potentially compensate for the disallowed deductions. There is no evidence that Arrakis provided Harkonnen with an allowance for processing expenses or any other expenses of any kind. Harkonnen

has not produced evidence of industry-wide statistics that might explain its contention that expenses were somehow accounted for in the calculation of this tax. Therefore, Harkonnen has clearly not met its burden of showing the Arrakis Foreign Tax reached net income.

C. The Arrakis Foreign Tax is not in lieu of an income tax in the U.S. sense because it does not meet the substitution requirement under Section 903.

Section 903 provides an alternative method for a foreign levy to meet the definition of income tax for the purpose of foreign tax creditability. *See* 26 U.S.C. § 903 (2012). Under this section, a foreign levy constitutes an income tax, and is therefore creditable, if it is "in lieu of" such a tax. *Id.* A foreign levy is in lieu of an income tax if it is a tax and it meets the substitution requirement by operating "as a tax imposed in substitution for, and not in addition to, an income tax." Treas. Reg. § 1.903-1(a), (b) (2014). Where a country imposes two taxes and one is generally understood to be an income tax, a taxpayer's exemption from that income tax does not result in a determination that the other tax substitutes for the income tax. *See id.* § 1.903-1(b)(1).

Accordingly, the I.R.S. determined that the Mexican Assets Tax Law enacted in 1988, and based on the value of assets of businesses with permanent establishments in Mexico, was not in lieu of an income tax. Rev. Rul.

91-45, 1991-2 C.B. 336. In that case, Mexico also imposed a tax that it called an income tax that actually reached net income; thus, the Assets Tax was in addition to, rather than in lieu of, the income tax. *Id.*

In determining whether a levy meets the substitution requirement, any other applicable income tax must be analyzed as it is imposed generally. Treas. Reg. § 1.903-1(b). Thus, if a taxpayer seeking credits is exempt from a general income tax but the general income tax is otherwise imposed on the income of other corporations in the industry, the other tax is in addition to the income tax and fails the substitution requirement. *Id.*

Thus, in *International Business Machines Corp. v. United States*, the Federal Claims Court denied credits to a taxpayer who was exempt from a general income tax but subject to an additional tax imposed on royalties. *Int'l Bus. Machs. Corp.*, 38 Fed. Cl. 661. In *International Business Machines Corp.*, an American corporation claimed credits for an Italian tax imposed on royalty payments it received in exchange for its Italian subsidiary's right to use its intellectual property. *Id.* at 662. Italy also imposed a national corporate income tax that taxed all income of corporations doing business in Italy. *Id.* at 682. The taxpayer was exempt from that national income tax pursuant to a treaty between the United States and Italy. *Id.* However, the court determined that the taxpayer's exemption was irrelevant because the national tax as generally

imposed reached the net income of corporations in the industry. *Id.* Therefore, the tax on royalties was in addition to, and not in lieu of, the national income tax and thus failed the substitution requirement. *Id.*

Finally, as with the definition of an income tax under Section 901, a levy does not meet the definition of a tax in lieu of an income tax under Section 903 if it is a "soak up" tax. *Id.* § 1.903-1(b)(2). As such, the I.R.S. determined that a Costa Rican tax on income paid to individuals or entities residing or doing business outside of the country was not in lieu of an income tax because it was only imposed if the amount taxed was creditable in another country. Rev. Rul. 2003-8, 2003-1 C.B. 290.

In addition to Harkonnen's creditability argument regarding the Arrakis Foreign Tax failing because it does not reach net income, Harkonnen's alternative argument that the Arrakis Foreign Tax is in lieu of an income tax also fails because the levy does not meet the substitution requirement of Section 903. Even though the Arrakis Foreign Tax is the only tax imposed by Arrakis upon foreign entities, it is still not in lieu of an income tax because Arrakis imposes a general income tax that reaches the net gain of its citizens. Therefore, just like the Assets Tax in Revenue Ruling 91-45 and the royalty tax in *International Business Machines Corp.*, the Arrakis Foreign Tax is in addition to a generally imposed tax. There is no practical difference in being exempt from an otherwise generally imposed tax because of citizenship and

because of a treaty between nations. Either way, the foreign country generally imposes a tax from which an American taxpayer is exempt, and the American taxpayer must pay a tax imposed in addition to the generally imposed tax. Accordingly, the Arrakis Foreign Tax fails the substitution test and is not creditable as a tax in lieu of an income tax.

II. The levy imposed by IFIL is not creditable because it was not imposed pursuant to the authority of a valid taxing entity, Harkonnen failed to show its interpretation of foreign law was reasonable or that it exhausted its remedies to decrease its tax liability, and the levy is a penalty rather than a tax.

Taxes imposed by different taxing authorities are separate levies and must be analyzed individually for purposes of determining whether they meet the definition of either an income tax under Section 901 or a tax in lieu of an income tax under Section 903. Treas. Reg. § 1.901-2(d)(1). IFIL's levy on Harkonnen is not creditable because IFIL is not a valid taxing entity. Additionally, Harkonnen failed to show its payment to IFIL was compulsory by proving its interpretation of foreign law was reasonable and that it exhausted its remedies in attempting to decrease its tax liability. In the alternative, even if this Court determines IFIL is a valid taxing entity and Harkonnen's payments were compulsory in accordance with a reasonable interpretation of foreign tax law, the payment is not creditable because it is a penalty rather than a tax.

A. Harkonnen's payments to IFIL are not creditable because IFIL is not a valid taxing entity.

To qualify as a creditable foreign tax, a payment must be compulsory and levied by a foreign country with the authority to lay taxes. Treas. Reg. § 1.901-2(a)(2)(i). The Supreme Court first examined the meaning of "foreign country" in analyzing a predecessor to Section 901 in 1932. *Burnet v. Chi. Portrait Co.*, 285 U.S. 1 (1932). The Court determined that, because the purposes of foreign tax credits were to facilitate foreign trade and avoid double taxation, the important factor was not the level of the government, but whether the government had the power to impose the levy. *Id.* at 8–9. Thus, the Court held that taxes imposed by New South Wales were creditable even though New South Wales was a subdivision of a foreign country and thus had a lesser international standing than the country of which it was a part. *Id.* at 9.

Since *Burnet*, the Treasury promulgated Regulation Section 1.901-2(g)(2), which further defined "foreign country" as "any foreign state, any possession of the United States, and any political subdivision of any foreign state or any possession of the United States." Treas. Reg. § 1.901-2(g)(2). This definition is consistent with the holding in *Burnet*, and the *Burnet* analysis remains instructive for the principle that the important factor in determining whether an entity meets the definition of "foreign country" is whether that entity is a sovereign governmental entity with the power to levy taxes.

The term "foreign country" has also been held to include instrumentalities of foreign countries' governments or entities working on the governments' behalf. *Amoco Corp. v. Comm'r*, 138 F.3d 1139, 1149 (7th Cir. 1998). In *Amoco Corp.*, a public authority owned by the government of Egypt assessed and collected taxes on behalf of the Egyptian government. *Id.* at 1140. At the end of each year, the authority's surplus was paid to the government. *Id.* at 1141. The court treated the public authority and the Egyptian government as a single entity because the authority acted as an instrumentality of the government and the taxpayer paid its taxes to the Egyptian government in an economic sense (the public authority was just an intermediary through which the money passed). *Id.* at 1149.

IFIL does not have standing as a governmental entity at any level. Unlike the taxing entity in *Burnet*, this is not a case where the United States is trying to avoid crediting taxes based on the fact that IFIL is a small government. Rather, IFIL's levy is not creditable because it is not a governmental entity with the authority to levy taxes. While it is true that the United States President declared IFIL "a sovereign friend of the United States," he did so after Harkonnen signed its oil and gas lease with IFIL and paid the tax. Even if IFIL was a legitimate governmental entity when it levied the taxes and signed the lease with Harkonnen, IFIL did not have the authority to levy the tax un

der the Arrakis Constitution. The Constitution, as amended in April 2013, states that there could only be one tax within Sietch State, and IFIL's tax was the second tax imposed on Harkonnen within Sietch State.

Nor is IFIL an entity that the Republic of Arrakis, Sietch State, Al Dhanab, or Anbus controls or created to collect taxes on its behalf. IFIL is instead a dissident group that organized itself and rebelled against Sietch State wanting to replace Atreides with Mohiam. IFIL deposited Harkonnen's payments into its bank account and then paid a small percentage of the total amount received to Al Dhanab and Anbus. Unlike the Egyptian public authority in *Amoco Corp.*, IFIL was formed for its own political reasons, demanded money from Harkonnen for control of Unit 12, and controlled where the money went. Thus, because IFIL is not the instrumentality of another foreign country, it must be analyzed to determine whether it is a foreign country with authority to levy taxes in its own right.

Section 901(j) of the Code narrows the scope of creditable foreign taxes by disallowing credits for payments made or accrued with respect to countries in the following four categories: (1) countries whose government the United States does not recognize, unless they are "otherwise eligible to purchase defense articles or services under the Arms Export Control Act," (2) countries with which "the United States has severed diplomatic relations," (3) countries with which the United States does not conduct diplomatic relations, and (4)

countries the Secretary of State has designated as ones that repeatedly support international terroristic acts. 26 U.S.C. 901(j)(2)(A). This section applies to such countries starting six months after the country becomes a Section 901(j) country and ending when the Secretary of State certifies that the country ceases to be such a country. *Id.* § 901(j)(2)(B). Finally, this section does not apply to deny a credit where the President waives the denial after determining that such a waiver is in the United States' best interest and will expand opportunities for United States companies in that country. *Id.* § 901(j)(5).

The I.R.S. has issued several Revenue Rulings since Section 901(j) was enacted listing countries to which the section applied and with respect to which foreign tax credits would be denied. The first such denial occurred under the Omnibus Budget Reconciliation Act of 1987, which was specifically aimed at denying foreign tax credits for South African taxes. Rev. Rul. 89-44, 1989-1 C.B. 237. Credits were so denied to disincentivize domestic entities from conducting business with South Africa in an effort to encourage actions to end apartheid. *Id.* South Africa was removed from the list in 1992 when it appeared the country might be making efforts to end apartheid. Rev. Rul. 92-63, 1992-2 C.B. 195.

Afghanistan, Albania, Angola, Cambodia, Cuba, Iran, Libya, North Korea, and Syria were also added to the list in 1987. *Id.* However, Libya was removed from the list by presidential waiver pursuant to Section 901(j)(5). Rev. Rul. 2005-3, 2005-1 C.B. 334. Iraq was removed from the list in 2004 pursuant to the Secretary of State's certification. Rev. Rul. 2004-103, 2004-2 C.B. 783. Countries currently designated as Section 901(j) countries are Cuba, Iran, North Korea, Sudan, and Syria. Rev. Rul. 2005-3, 2005-1 C.B. 334. While there are many Revenue Rulings listing countries to which Section 901(j) applies, nothing in the statute or regulations requires such a ruling for Section 901(j) to apply. *See* 26 U.S.C. 901(j); Treas. Reg. § 1-901.2. In fact, rulings by the I.R.S. are mere reports of determinations previously made by the Secretary of State. *See, e.g.*, Rev. Rul. 2005-3, 2005-1 C.B. 334; Rev. Rul. 2004-103, 2004-2 C.B. 783; Rev. Rul. 92-63, 1992-2 C.B. 195; Rev. Rul. 89-44, 1989-1 C.B. 237.

Even if this Court finds that IFIL is a valid taxing entity, and thus a "foreign country" for foreign tax credit purposes, Section 901(j) applies to deny credits with respect to any levies it imposes on United States citizens and corporations. Although the I.R.S. has not issued a Revenue Ruling designating IFIL as a Section 901(j) country, Section 901(j) nonetheless applies because the

United States does not currently conduct diplomatic relations with IFIL. Executive Order 14012 confirms this by mentioning that the United States wishes to establish relations with IFIL.

Additionally, although the Secretary of State has not specifically designated IFIL as a country that supports terroristic acts, IFIL should be considered as such a country because there is ample evidence that it does support such acts. Mohiam is associated with the Bene Gesserit, which both the State and Treasury Departments of the United States have recognized as a terrorist organization. The Bene Gesserit has publicly denounced Mohiam; however, the United Nations is currently investigating the matter and has yet to confirm that the Bene Gesserit's statements are genuine.

Even if Mohiam is found not to be a supporter of the Bene Gesserit, IFIL forcefully took over Harkonnen's drilling unit and demanded over half a million dollars. This money made IFIL more powerful and allowed them to pay their supporters, Al Dhanab and Anbus, and the use of violence and intimidation in the pursuit of political aims is the very definition of terrorism. *See Webster's New World Dictionary* 666 (4th ed. 2003). Thus, IFIL's levy is not creditable because it was not pursuant to the legitimate authority of a valid legal entity with the power to lay taxes, and crediting such a levy would encourage trade with known terrorists.

B. Harkonnen has not met its burden to prove that its payment to IFIL was compulsory by showing its interpretation of foreign tax law was reasonable and that it exhausted its remedies in an effort to decrease its tax liability.

Under the Treasury Regulations, only *compulsory* amounts of tax paid or accrued to a foreign country are creditable. Treas. Reg. § 1.901-2(e)(5). The Regulations provide that amounts are compulsory only if they do not exceed the amount for which the taxpayer is liable. *Id.* In other words, the payments cannot be voluntary. *See id.* Payments are considered compulsory and not voluntary as long as the taxpayer (1) determines the amount based on a reasonable interpretation of foreign law so as to reduce its liability, and (2) exhausts available remedies in an effort to eventually decrease its liability. *Id.* The burden of proving that the tax is compulsory falls squarely on the taxpayer. *See id.*

A taxpayer's interpretation and application of the foreign tax law is per se unreasonable if the taxpayer has notice, actual or constructive, that its interpretation is likely in error. *Id.* In interpreting and applying the foreign tax law, taxpayers are entitled to seek and rely upon information from competent foreign advisors[3] in order to ensure their interpretations are reasonable and

[3] Treas. Reg. § 1.901-2(e)(5) discusses "competent authority procedures available under applicable tax treaties" as well as taxpayers' rights to rely on information received from "competent foreign tax advisors." While the two terms refer to different concepts and standards, at least one court has mistakenly combined elements of the two. *See* John P. Dombrowski, *Foreign Tax Credits: The Recent Decision in Proctor & Gamble v. United States Allows Procedure to*

likely to lead to decreased liability. *Id.* While the regulations do not require the competent advisor to hold any particular office, they do require that the competent advisor be familiar with both the foreign tax law and the facts at issue in the taxpayer's case. *See id.*

Thus, the Federal Claims Court has held that a taxpayer's interpretation was reasonable where it had relied on advice provided by a foreign tax professor. *See Int'l Bus. Machs. Corp.*, 38 Fed. Cl. at 673. There, the corporate taxpayer sought advice from an Italian tax professor regarding whether it was liable for Italian taxes on certain royalties it earned in Italy. *Id.* at 669. Based on his review of the relevant facts, the Italian tax professor advised the corporation that it would most likely be found liable for the tax, so the corporation paid it. *Id.* at 673. Thus, because the taxpayer had relied on a competent source with knowledge of the facts and familiarity with Italian tax law, the court held the taxpayer's interpretation of the law was reasonable. *Id.* at 673.

The second requirement for a tax to be considered compulsory is that the taxpayer must exhaust its remedies in an effort to eventually decrease its foreign tax liability. *Id.* Taxpayers are not required to use futile attempts to exhaust their remedies. *Schering Corp. v. Comm'r*, 69 T.C. 579, 601–02 (1978) (holding that the taxpayer did not have to challenge a tax that it was required

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Override Statutory Intent, 44 U. Tol. L. Rev. 405, 420 (2013). Because there was no tax treaty between IFIL and the United States in the instant case, Respondent focuses its discussion on competent foreign tax advisors.

to pay under Swiss law in order to exhaust its remedies). However, a taxpayer does have to use all remedies that are "effective and practical." Treas. Reg. § 1.901-2(e)(5)(i). The effectiveness and practicality of remedies are determined using a cost-benefit analysis. *See id.* In other words, for the remedy to be "effective and practical," the benefits, including the amount of relief and the likelihood that the remedy will successfully decrease the taxpayer's liability, must outweigh the costs, including offsetting risks and potential additional liabilities, of the remedy. *Id.*; *Int'l Bus. Machs. Corp.*, 38 Fed. Cl. at 668–69.

Thus, in *International Business Machines Corp.*, the court held that the taxpayer had exhausted all practical and effective remedies by making every effort at its disposal to challenge the tax, including litigating the issue in an Italian court, *id.* at 675, despite advice from a competent advisor that its argument was a "near certain loser." *Id.* at 673. The court held the taxpayer had exhausted its remedies even though the litigation was incomplete. *Id; see also* Rev. Rul. 70-290, 1970-1 C.B. 160 (holding that, where a taxpayer litigates its liability for a foreign tax, the taxpayer does not have to exhaust all appellate reviews before it can claim a foreign tax credit under Section 901).

Harkonnen's payment to IFIL is not creditable because Harkonnen has not met its burden to prove that the payments were compulsory. First, Harkonnen has failed to show its payment was based on a reasonable interpretation of foreign law in a way that would reduce Harkonnen's tax liability.

Harkonnen's interpretation was per se unreasonable because it had constructive notice that its interpretation was erroneous. Under the Sietch Dunes Peace Treaty and subsequent amendment to the Arrakis Constitution, only one tax can be levied in Sietch State, and Harkonnen paid two, one to Sietch State and one to IFIL. Thus, Harkonnen should have known that it would be unreasonable to interpret the foreign law in such a way that assumed IFIL's taxing authority was valid.

Additionally, IFIL had been associated with the Bene Gesserit, and Harkonnen therefore had constructive notice that IFIL was most likely not a valid taxing entity. Despite having such notice, Harkonnen did nothing more than petition the Holy Royal Court for a general statement about IFIL's status, and it treated the Court's response as sufficient even though it said nothing about IFIL's ability to levy a tax. The Holy Royal Court's statement that "Arrakis recognizes IFIL as part of Sietch" did not indicate whether it believed IFIL could levy taxes, and it was much less sufficient than the Italian tax professor's informed assessment of whether the taxes were owed in *International Business Machines Corp.* Furthermore, Harkonnen did not provide the Holy Royal Court with the facts of its case, so even assuming the Holy Royal Court was a competent advisor familiar with Arrakisian law, it could not possibly have provided Harkonnen with an informed analysis of the law as it applied to Harkonnen's situation.

Harkonnen also failed to exhaust its administrative remedies. Harkonnen did not challenge IFIL's tax in the Holy Royal Court. However, unlike the tax at issue in *Schering Corp.*, Harkonnen did not rely on a foreign advisor's statement in deciding not to challenge the tax. Instead, it paid the tax based on the Holy Royal Court's statement that IFIL was a recognized part of Sietch, and then it claimed a credit in the United States. In *Schering Corp.*, the court found that the taxpayer had exhausted its remedies even though the challenge was still pending in the Italian court; however, here, Harkonnen had no plan of challenging IFIL's levy in an Arrakasian court. The costs of seeking a remedy to lower its liability, which might include litigation costs and lost profits from the production of Unit 12, could not have possibly outweighed the benefits, which included avoiding not only the two percent tax for several years but over half a million dollars in bonus and royalty payments as well.

Furthermore, depending on well spacing and drilling techniques, Harkonnen may have been able to make up for any lost profits from Unit 12 through the production of one of its other wells. For these reasons, Harkonnen has not met its burden to show that its interpretation of foreign law was reasonable or that it exhausted its remedies before paying the foreign tax and seeking a credit.

C. Alternatively, IFIL's levy is not creditable because it is a penalty rather than a tax.

As in the context of Harkonnen's status as a dual capacity taxpayer, a foreign levy must meet the definition of a tax in order to be creditable. Treas. Reg. § 1.901-2(a)(1)(i). A levy is a tax if it is imposed pursuant to a foreign country's authority to lay taxes and is compulsory. *Id.* § 1.901-2(a)(2)(i). To be compulsory, the levy must meet the dual capacity requirements and it must not be a "penalty, fine, interest, or similar obligation." *Id.* Principles of U.S. law control in determining the nature of the tax. *Id.* This Court has described a penalty as "punishment for an unlawful act or omission." *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 224 (1996); *see also United States v. La Franca*, 282 U.S. 568, 572 (1931).

In *La Franca*, the court found a "tax" to be a penalty because it doubled the generally imposed regular tax on sellers of liquor in the event that the taxpayers sold liquor illegally. *La Franca*, 282 U.S. at 571–72. The Court reasoned that the purpose of the supposed tax was not to contribute to the support of the government but to punish wrongdoers, and therefore, its true nature was not that of a tax but a penalty. *Id.* at 572. Similarly, in *Reorganized CF & I Fabricators*, the Court held that a so-called tax on funding deficiencies of pension plans was a penalty instead of a tax because its purpose was to punish employers who failed to correct such deficiencies. *Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. at 225.

Even if this Court determines that IFIL is a valid taxing entity and that Harkonnen exhausted its administrative remedies in challenging the tax, Harkonnen's argument for creditability still fails. Harkonnen's payment to IFIL is not creditable under Section 901 or 903 because the levy imposed by IFIL is a penalty, not a tax. IFIL's so-called tax is a penalty in much the same way as the penalties on illegal liquor sales in *La Franca* and on the funding of deficient pension plans in *Reorganized CF & I Fabricators*. IFIL took control of Unit 12 by force, alleging that Harkonnen had engaged in slant drilling operations. IFIL then proclaimed that it would continue to control Unit 12 operations until Harkonnen paid for its wrongdoing. Finally, IFIL returned control of operations of Unit 12 to Harkonnen upon its payment of the "tax," which suggests that the payment was in satisfaction of IFIL's demands that Harkonnen pay for its offense.

CONCLUSION

The I.R.S., district court, and court of appeals correctly concluded that both the Arrakis Foreign Tax and the levy imposed by IFIL were not creditable under Section 901 or Section 903 of the Internal Revenue Code.

Harkonnen's payment pursuant to the Arrakis Foreign Tax was not compulsory because Harkonnen, as a dual capacity taxpayer, failed to show which portion of the payment was for tax purposes. Additionally, the Arrakis Foreign Tax does not have the predominant character of an income tax in the

U.S. sense because it does not reach net income. Finally, the Arrakis Foreign Tax is not in lieu of an income tax in the U.S. sense because it is in addition to, instead of a substitution for, a generally imposed national income tax that reaches net gain.

The levy imposed by IFIL is not creditable under Section 901 or Section 903 either. IFIL is not a valid taxing entity because it is associated with a known terrorist group and it is not a sovereign entity with taxing authority. Furthermore, Harkonnen failed to show that it took reasonable steps to ensure that its interpretation of the foreign law was correct. Harkonnen also failed to show that it exhausted its remedies in attempting to reduce its tax liability. Finally, even if IFIL is a valid taxing entity and Harkonnen exhausted its remedies, the IFIL levy is not creditable because it is a penalty rather than a tax.

It is for these reasons that this Court should affirm the Court of Appeals for the Fourteenth Circuit and deny foreign tax credits for Harkonnen's payments to Arrakis and IFIL.

Respectfully Submitted,

/s/_____

Attorneys for Respondent