NO. C15-1701-1

In the Supreme Court of the United States

ROYAL HARKONNEN OIL COMPANY,

Petitioner,

v.

UNITED STATES,

Respondent.

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

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BRIEF FOR PETITIONER

Team # 90
Counsel for Petitioner

QUESTIONS PRESENTED

I. IN LIGHT OF THE FOREIGN TAX CREDIT'S PRIMARY PURPOSE OF AVOIDING DOUBLE TAXATION, DID THE FOURTEENTH CIRCUIT ERR BY HOLDING THAT HARKONNEN OIL'S PAYMENTS TO ARRAKIS UNDER THE REPUBLIC OF ARRAKIS FOREIGN TAX ("RAFT") WERE NOT CREDITABLE UNDER EITHER §§ 901 OR 903 EVEN THOUGH RAFT HAD THE PREDOMINANT CHARACTER OF A U.S. INCOME TAX?

II. GIVEN THAT THE INTER-SIETCH FREMEN INDEPENDENCE LEAGUE ("IFIL") HAS SATISFIED THE CRITERIA FOR QUALIFYING AS A STATE IN ACCORDANCE WITH PRINCIPLES OF INTERNATIONAL LAW, DID THE FOURTENTH CIRCUIT ERR BY DENYING FOREIGN TAX CREDIT TO HARKONNEN OIL FOR ITS TAX PAYMENTS TO IFIL?

TABLE OF CONTENTS

TABLE OF AUTHORITIES

UNITED STATES SUPREME COURT CASES

UNITED STATES COURT OF APPEALS CASES

UNITED STATES DISTRICT COURT CASES

UNITED STATES TAX COURT CASES

UNITED STATES COURT OF FEDERAL CLAIMS CASES

UNITED STATES COURT OF CLAIMS CASES

UNITED STATES STATUTES

SECONDARY SOURCES

OPINION BELOW

A recitation of the decision of the Fourteenth Circuit can be found in the Record at (C. 1-21.)

STATEMENT OF JURISDICTION

The Fourteenth Circuit Court of Appeals rendered its decision on October 1, 2014. Subsequently, Royal Harkonnen Oil Company filed this timely petition for a writ of certiorari, which this Court granted. This Court has jurisdiction pursuant to 26 U.S.C. § 1254(1).

STATUTORY PROVISIONS

The pertinent portions of 26 I.R.C. §§ 901 and 903, the corresponding regulations of the United States Treasury Department, §§ 1.901-2 and 1.903-1, and all other relevant statutory provisions are set forth in the Appendix to this brief.

STATEMENT OF THE CASE

Factual Background

The Petitioner, Royal Harkonnen Oil Company ("Harkonnen Oil") is a United States corporation operating in the Republic of Arrakis ("Arrakis"), a foreign country. In February 2008, Harkonnen Oil began negotiating with the Republic of Arrakis for exclusive rights to develop the Caladan Oil Field, which covers 231,000 square miles containing 150 billion barrels of oil equivalent. (C. 3.) In June 2008, Harkonnen Oil signed an oil and gas lease (the "Arrakis lease") to develop the entire 231,000 miles of the Caladan Oil Field. (C. 7.) Pursuant to the lease, Harkonnen Oil was required to pay a one-time bonus of $55 million and a royalty of 15 percent. (C. 7.) In January 2009, Harkonnen Oil produced the first barrels of crude oil under the lease; by October of that year, daily production equaled 858,000 (C. 7.) Production continued throughout 2011, the taxable year at issue. (C. 18.)

As a foreign corporation, Harkonnen Oil was subject to the tax on foreign corporations, the Republic of Arrakis Foreign Tax ("RAFT"), which, at one time, had been named the Republic of Arrakis Foreign Value Tax ("RAFVT"). (C. 5; 15.) RAFT—which was enacted by the President of Arrakis, Jules Corrino—in an effort to "modernize" the dated Arrakis Tax Code, is imposed on "all foreign entities that operate machinery" in Arrakis. (C. 5.) Like the United States's income tax on corporations,, the base of RAFT is computed by taking gross receipts generated by the operation of that business, less applicable deductions, which amount is then multiplied by 33 percent. (C. 5; 15.) Because of Arrakis's religious beliefs and perspectives, however, the deductions were capped at 95 percent. (C. 15.)

To ensure the enforcement of the tax, Arrakis required that all income generated in Arrakis be deposited into the Central Bank of Arrakis ("the Central Bank"). (C. 15.) The Central Bank would withhold the taxable amount, distribute it directly to the Arrakis Treasury Department, and then remit the remainder to the foreign entity. (C. 5.) In 2011, Arrakis, through President Corrino, issued Proclamation 102 as a modification to RAFT. The Proclamation afforded to foreign corporations the same deductions available to Arrakis citizens. These deductions—the U.S. Internal Revenue Service has stipulated—"match [the] available deductions under the United States Tax Code." (C. 4., n 7); (C. 15.)

During the time that Harkonnen Oil was operating its oil business in Arrakis, a group of people named the Independent People of Sietch ("IPS"), declared their independence from Arrakis and ultimately formed a newly recognized, independent state named Sietch State. Subsequently, in 2010, another group, called the Inter-Sietch Fremen Independence League ("IFIL") acquired control over a specific region within the Sietch State known as the "Badlands."

IFIL's government structure consists of a single leader who is chosen through an election process similar to that of the United States. IFIL's leader, Jessica

Mohiam, has negotiated agreements with Arrakis, the U.S., and a number of Arrakis's neighboring countries, including Anbus and Al Dhanab; Mohiam has the capacity to engage in formal relations with other such entities. (C. 11-13.)

After concentrating in the Badlands, IFIL expanded its control beyond the Badlands to another portion of Sietch State, exercising control of, among other territory, a drilling station operated by Harkonnen Oil. (C. 13.) Shortly after IFIL took control of that area, Harkonnen Oil and IFIL entered into an oil and gas lease stating that Harkonnen Oil would pay a bonus of $550,000 and a five percent royalty to IFIL ("the IFIL lease"). (C. 13.) IFIL further declared that the income from Unit 12 would be taxed at two percent. (C. 13.) After the negotiations, Harkonnen Oil petitioned the Holy Royal Court of Arrakis for a determination of the status of IFIL and its ability to levy a tax. (C. 14.) That court issued a public opinion declaring that "Arrakis recognizes IFIL as a part of Sietch." (C. 14.)

In April 2011, the President of the United States issued Executive Order 14012, establishing that IFIL "is a sovereign friend of the United States, whom [the U.S.] would like to establish trade relations with." (C. 14.) The Order also stated that the U.S. would always continue to help individuals around the world obtain freedom. (C. 14.) For the remainder of 2011, Harkonnen Oil's production of the oil field continued unhindered. Ultimately, Harkonnen Oil paid the 33% tax under RAFT (less applicable deductions from total income generated by the oil field operations), and it paid the two percent tax to IFIL for income generated by Unit #12. (C. 16.) Harkonnen Oil then attempted to claim a foreign tax credit, pursuant to I.R.C. §§ 901 and 903, against its U.S. income tax liability for its RAFT tax payment to Arrakis and its payment to IFIL. (C. 16.)

Procedural History

After Harkonnen Oil filed its claim for the foreign tax credits, the IRS performed an audit, and finally denying credit for payments to Arrakis made pursuant to RAFT and for payments to IFIL. (C. 16-17.) The district court affirmed the IRS's conclusions, and Harkonnen Oil appealed to the Fourteenth Circuit, which affirmed the district court with a published opinion, which opinion is set forth in the Record at 1-20. Harkonnen Oil now seeks certiorari review.

SUMMARY OF THE ARGUMENT

Creditability of RAFT Under I.R.C. § 903

The Fourteenth Circuit erred by deciding that Harkonnen Oil's payments under RAFT were not creditable under §§ 901 or 903. Because the substantive economic effect of RAFT has the predominant character of an income tax in the U.S. sense, RAFT is creditable under § 901. Even if this Court concludes that RAFT did not have the predominant character of a U.S. income tax, RAFT is creditable as a tax in lieu of an income tax under § 903, because the treasury regulations provide credit for a withholding tax on gross income. Congress enacted § 903 as a means for promoting the foreign tax credit's primary objective of avoiding double taxation. To hold that RAFT is not creditable under § 903 would read the reason for the regulation out of the regulation. Finally, by refusing to base its creditability analysis on the substance of RAFT, and looking only to the name and form of the tax, the Fourteenth Circuit erred.

The foreign tax credit was designed to allow U.S. corporations operating in a foreign country to claim a credit for the "income, war profits, and excess profit taxes" that the corporation paid to the foreign country. The primary objective of the foreign tax credit was "to mitigate the evil of double taxation." Under current U.S. revenue laws, 26 USC § 901 allows U.S. corporations operating abroad to choose to claim a credit, as opposed to a deduction, against their U.S. income tax liability for "income, war profits, and excess profits taxes" paid to a foreign country (the "foreign tax credit").

To be creditable under § 901, the U.S. corporation's payment to a foreign country (a "foreign levy") must be an "income tax." In this case, it is undisputed that the Republic of Arrakis Foreign Tax ("RAFT") is "a tax" within the meaning of § 1.901-2(a)(2). The dispositive issue is whether it is an "income tax." Because the predominant character of RAFT is that of an income tax in the U.S. sense, Harkonnen Oil's RAFT payment to the Republic of Arrakis is creditable under § 901.

The trial court set forth two separate bases for its holding that RAFT was not "similar or akin" to a U.S. income tax: (1) that the RAFT had been named a"value tax, with only the name of the tax being changed at a later date (as opposed to the substance of the levy)" (C. 17.) and (2) that, by only permitting 95% recovery of significant costs and expenses, RAFT failed to reach net income. Both of these grounds constitute error.

The Fourteenth Circuit erroneously concluded that the RAFT was not "similar or akin" to a U.S. income tax merely because the RAFT had—at one time—been named a "value tax." The decision of whether a foreign tax is creditable under § 901 (or § 903) necessarily turns on the precise meaning of the words in the statute that grants the credit to the corporation in the first place. There is nothing in the language of § 901 suggesting that, in allowing the credit for foreign tax payments, U.S. courts should defer to foreign characterizations and classifications of tax legislation. In analyzing the creditability of a foreign tax, the "crucial inquiry" for this Court is the tax's substantive economic effect and not its name. By looking to the name that Arrakis had assigned to the tax, instead of looking to its substance, the 14th Circuit erred.

<u>Creditability of RAFT Under I.R.C. § 903</u>

Even if RAFT does not satisfy the net gain requirements under § 1.901-2(b), it is creditable as an in-lieu tax under I.R.C. § 903. In this case, because the Fourteenth Circuit refused to "move past the form" of RAFT in deciding whether the tax was creditable as an in-lieu tax under § 903, that court erred. As explained in more detail above in Section I-A of this brief, the way that the foreign country characterizes its tax is not controlling in determining creditability. *See id.* The form or label of the foreign tax is not dispositive.

Furthermore, although the Fourteenth Circuit *correctly* held that RAFT was a withholding tax, that court erred by concluding that, as a withholding tax, RAFT was not creditable under § 903. The Fourteenth Circuit's holding directly conflicts with the plain language and legislative purpose of the foreign tax provisions, and it is inconsistent with the caselaw interpreting them. Concerned that the provisions of § 901 provided "too narrow a base" for determining the availability of the foreign tax credit, Congress enacted § 903. In the report of the Senate Finance Committee on the enactment of § 903, Congress explicitly stated that it had deemed it desirable to extend the scope of § 901 to allow credit for a tax imposed as a substitute for a net income tax even though measured by gross income. Congress designed § 903 to allow credit for foreign taxes levied on gross income.

There need be no functional connection between the foreign income tax and the in-lieu tax, no coordination of rates, no effort to approximate the amount of the general income tax or to reach the same subject matter or to replace the normal formula for computing income by a special formula designed to achieve the same or roughly the same amount. The plain language of § 1.903-1 makes clear that a foreign tax based on gross receipts is creditable: It is immaterial whether the base of the income tax bears any relation to realized net income. The base of the tax, for example, may be gross income, gross receipts or sales, or the number of units produced or exported.

A foreign levy is an "in lieu" tax if it satisfies three requirements: (1) the levy must be "a tax" within the meaning of § 1.901-2(a)(2); (2) the tax must satisfy the substitution requirement under § 1.903-1(b); and (3) the tax cannot be dependent on the availability of a tax credit in another country (a "soak-up" tax). In this case, there is no dispute that the levy imposed by Arrakis under RAFT was a tax within the meaning of § 1.901-2(a)(2). RAFT satisfies the substitution requirement because it was a withholding tax imposed in lieu of, and not "in addition to," an income tax otherwise generally imposed. A withholding tax on gross income, such as RAFT in this case, satisfies the substitution requirement. For these reasons, the Fourteenth Circuit erred.

IFIL's Authority to Impose a Tax

Finally, the Fourteenth Circuit erred by holding that Executive Order 14012 and the ruling of the Holy Royal Court were insufficient to establish that IFIL was a sovereign political entity and hence a valid taxing authority. Because IFIL is recognized as a sovereign state by the U.S., a determination that is exclusively the function of the Executive Branch—and not the judiciary—the Fourteenth Circuit erred by holding that the Executive Order was "insufficient" to establish that IFIL had the jurisdiction to tax.

With respect to the creditability of Harkonnen Oil's payments to IFIL, the question before this Court is essentially whether IFIL had jurisdiction to impose a tax. The determination of whether a foreign taxing entity has jurisdiction to tax is an implicit requirement for establishing that the foreign levy was "a tax" within the meaning of § 1.901-2(a)(2). To be a valid taxing authority, the foreign taxing entity must be a "foreign country" within the meaning of § 901 and under principles of international law. Basically defined, a foreign state ("a state") is an entity that has a defined territory and a permanent population, under the control of its own government, and that engages in, or has the capacity to engage in, formal relations with other such entities. An entity does not have to have any particular form of government to qualify as a state, but there must be some authority exercising governmental functions, and the authority must be capable of representing the state in international relations.

In the instant case, because IFIL is a legitimate state government, the Fourteenth Circuit erred by concluding that IFIL was not a valid taxing authority. IFIL has acquired control of specific territory within the Sietch State, namely the region known as the "Badlands" where, after acquisition, there was a "concentration" of the IFIL population. IFIL later expanded its control to another portion of Sietch State, taking control of, among other territory, a drilling station operated by Harkonnen Oil. The fact that IFIL's permanent boundaries have not been settled has no bearing on determining whether the territory criterion has been satisfied. Furthermore, IFIL has its own government whose structure consists of a single leader who is chosen through an election process, and that leader, Jessica Mohian, has the capacity to engage in formal relations with other such entities. Mohian has engaged in a number of political, economic, and financial relations with other countries and entities, including Arrakis (entering into the agreement for a permanent establishment in Arrakis), Harkonnen Oil, a U.S. corporation (entering into the "IFIL lease"), and the neighboring countries, Anbus and Al Dhanab.

Additionally, although the initial takeovers by IFIL were "forceful," IFIL and Arrakis later agreed to establish a permanent location for IFIL. Furthermore, because Arrakis and Sietch State have acquiesced to IFIL's occupancy and claim to the Badlands and beyond, IFIL is entitled to the benefit of having doubts as to the validity of its state status in its favor. For these reasons, this Court should conclude that IFIL, as an independent state, was a valid taxing authority.

Harkonnen Oil's Exhaustion of Effective and Practical Remedies

Harkonnen Oil satisfied the requirement under § 1.901-2(g) that it exhaust the remedies available to it before claiming a tax credit for RAFT. In this case, Harkonnen Oil satisfied the requirement that it pursue all available alternatives or remedies, because the amount of tax paid to IFIL was determined by Harkonnen Oil in a manner that was consistent with the reasonable interpretation and application of the substantive and procedural provisions of Arrakis law. Because the amount paid was consistent with a reasonable interpretation of Arrakis law, the amount did not exceed the amount of Harkonnen Oil's liability for tax under Arrakis law and was therefore *not* noncompulsory.

Harkonnen Oil's interpretation or application of Arrakis law was reasonable and because it relied in good faith on the advice of the Arrakis President. An interpretation of foreign law is "not reasonable if there is ... constructive notice (e.g., a published court decision)" to the taxpayer that the interpretation is likely to be erroneous. Harkonnen Oil sought from the President of Arrakis advice as to whether IFIL was a valid taxing authority. After being informed that all legal tax disputes were handled by the Holy Royal Court of Arrakis, Harkonnen Oil petitioned that court for a determination of the status of IFIL, which court concluded that IFIL was recognized as a part of Sietch State. Notwithstanding that fact, Harkonnen Oil's reliance on the President's advice to seek a determination from the Holy Royal Court was reasonable because it was made in good faith, and the President should be considered as a competent advisor with respect to the avenues of relief available under Arrakis law. In addition, Harkonnen Oil's interpretation of the Arrakis law is not unreasonable, because the Arrakis court's published opinion announcing that IFIL had been formally recognized as a part of Sietch constitutes constructive notice and there is nothing indicating that the interpretation of that opinion—that IFIL is a valid taxing authority—is likely to be erroneous. The costs of seeking these determinations was reasonable in light of the amount of taxes at issue. For these reasons, this Court should conclude that Harkonnen Oil met the requirement under § 1.901(g) that it exhaust all effective and practical remedies in the foreign country.

ARGUMENT

I. BECAUSE RAFT HAS THE PREDOMINANT CHARACTER OF AN INCOME TAX, AND BECAUSE IT SATISFIES THE SUBSTITUTION REQUIREMENT UNDER § 1.903-1(B), THE REPUBLIC OF ARRAKIS FOREIGN TAX ("RAFT") IS A CREDITABLE TAX UNDER 26 USC §§ 901 AND 903.

The Fourteenth Circuit erred by deciding that Harkonnen Oil's payments under RAFT were not creditable under §§ 901 or 903. Because the substantive economic effect of RAFT has the predominant character of an income tax in the U.S. sense, RAFT is creditable under § 901. Even if this Court concludes that RAFT did not have the predominant character of a U.S. income tax, RAFT is creditable as a tax in lieu of an income tax under § 903, because the treasury regulations provide credit for a withholding tax on gross income. Congress enacted § 903 as a means for promoting the foreign tax credit's primary objective of avoiding double taxation. To hold that RAFT is not creditable under § 903 would read the reason for the regulation out of the regulation. Finally, by refusing to base its creditability analysis on the substance of RAFT, and looking only to the name and form of the tax, the Fourteenth Circuit erred.

When Congress enacted the federal income tax of 1913, it chose to tax corporations operating in a foreign country even after those corporations had already been taxed by the foreign country. Although the taxes imposed by the government of the foreign country were fully deductible in computing taxable income in the U.S., a U.S. corporation operating abroad was nevertheless subject to taxation in both the foreign country and in the U.S. *See Phillips Petroleum Co. v. C.I.R.*, 104 T.C. 256, 284 (1995). Recognizing the heavy burden that this "double taxation" placed on U.S. corporations operating in foreign countries, the U.S. in 1918 enacted the foreign tax credit provisions. *Id.* at 283.

The foreign tax credit was designed to allow U.S. corporations operating in a foreign country to claim a credit for the "income, war profits, and excess profit taxes" that the corporation paid to the foreign country. The primary objective of the foreign tax credit was "to mitigate the evil of double taxation." *See Burnet v. Chicago Portrait Co., 285 U.S. 1 (1932); United States v. Goodyear Tire & Rubber*

Co., 493 U.S. 132, 139 (1989) (explaining that the history of the foreign tax credit "clearly demonstrates" that it was intended to eliminate double taxation). The secondary objective of the foreign tax credit was "to encourage, or at least not to discourage, American foreign trade." *Phillips Petroleum*, 104 T.C. at 284 (citing *Commissioner v. Am. Metal Co.*, 221 F.2d 134, 136 (2d Cir. 1955)). In this sense, the foreign tax credit provisions were intended to neutralize the effect of U.S. tax consequences on corporate taxpayers' decisions about where to conduct business most productively. *See Salem Fin., Inc. v. United States*, 112 Fed. Cl. 543, 582 (2013); Bittker and Lokken, Introductory § 72.1, n. 2. Since their enactment in 1918, the foreign tax credit provisions have remained relatively unchanged. *Id.*

Notwithstanding the objectives of the foreign tax credit, the judiciary's definition and analysis of what kind of payments to foreign countries constitute "income, war profits, and excess profits taxes," has evolved case by case. *See Phillips Petroleum*, 104 T.C. at 284. In 1983, in an effort to resolve any ambiguities in the language of the foreign tax credit provisions, the Treasury Department promulgated 26 CFR § 1.901-2. *Texasgulf, Inc. v. C.I.R.,* 172 F.3d 209 (2d Cir. 1999). The treasury regulations outline the guiding principles established by prior case law. *Phillips Petroleum*, 104 T.C. at 284.

Under current U.S. revenue laws, 26 USC § 901 allows U.S. corporations operating abroad to choose to claim a credit, as opposed to a deduction, against their U.S. income tax liability for "income, war profits, and excess profits taxes" paid to a foreign country (the "foreign tax credit"). 26 U.S.C. § 901(a)-(b)(1).[1] With respect to determining what taxes are creditable under § 901, the treasury regulations collectively refer to "income, war profits, and excess profits taxes" as "income taxes." 26 CFR 1.901-2. In this case, whether RAFT is a war profits or excess profits tax is not at issue; instead, the question is whether RAFT qualifies as an income tax.

To be creditable under § 901, the U.S. corporation's payment to a foreign country (a "foreign levy") must be an "income tax."[2] The payment is an income tax if and only if (1) it is "a tax" and (2) the "predominant character" of the tax is "that of an income tax in the U.S. sense." 26 C.F.R. § 1.901-2(a)(1)(i)-(ii). Unless otherwise provided for in 26 C.F.R. § 1.901-2, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. 26 C.F.R. § 1.901-2(a)(1).[3]

In this case, it is undisputed that the Republic of Arrakis Foreign Tax ("RAFT") is "a tax" within the meaning of § 1.901-2(a)(2).[4] The dispositive issue is whether it is an "income tax." To determine whether the tax is an income tax and is thus creditable under § 901, the only question before this Court is whether the "predominant character" of RAFT was "that of an income tax in the U.S. sense." *See* 26 C.F.R. § 1.901-2. The determination of whether the particular facts of this case come within the meaning of § 901 must be decided in light of the established

[1]A foreign levy is an income tax if and only if (1) it is "a tax" and (2) the "predominant character" of the tax is "that of an income tax in the U.S. sense." 26 CFR 1.901-2(a)(1)(i)-(ii).
[2]In an effort to avoid using the word "tax," the U.S. government refers to a payment to foreign governments as a "foreign levy." 26 CFR 1.901.2(a)(1). Whether a foreign levy is an income tax is determined independently for each separate levy.
[3] Creditability is an all or nothing proposition. PPL Corp. v. C.I.R., 665 F.3d 60 (3d Cir. 2011)
[4] A foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. 26 C.F.R. § 1.901-2(b)(2).

and settled policy against double income taxation. *Am. Metal Co.*, 221 F.2d at 137 (2d Cir. 1955).

Because the predominant character of RAFT is that of an income tax in the U.S. sense, Harkonnen Oil's RAFT payment to the Republic of Arrakis is creditable under § 901. To hold that Harkonnen Oil's payments under RAFT are not creditable because the 95 percent cap on deductions precludes recovery of only an insignificant amount of Harkonnen Oil's costs and expenses would read the reason for the regulation – i.e., to avoid double taxation – out of the regulation. In the alternative, this Court should hold that the payments under RAFT are creditable as a tax paid in lieu of an income tax under § 903, because RAFT was imposed as a legitimate substitute for an income tax otherwise generally imposed.

A. Because the predominant character of RAFT is that of an income tax in the U.S. sense, Harkonnen Oil Company's RAFT payment to the Republic of Arrakis is creditable under § 901.

The trial court set forth two separate bases for its holding that RAFT was not "similar or akin" to a U.S. income tax: (1) that the RAFT had been named a "value tax, with only the name of the tax being changed at a later date (as opposed to the substance of the levy)" (C. 17.) and (2) that, by only permitting 95 percent recovery of significant costs and expenses, RAFT failed to reach net income. Both of these grounds constitute error. This section of Harkonnen Oil's brief addresses each of these grounds, respectively.

1. The 14th Circuit incorrectly concluded that only the name of the RAFT had changed ("as opposed to the substance").

The Fourteenth Circuit erroneously concluded that the RAFT was not "similar or akin" to a U.S. income tax merely because the RAFT had—at one time—been named a "value tax." (C. 17.) The court failed to recognize that when Arrakis changed the tax's name from "Republic of Arrakis Foreign Value Tax" to "Republic of Arrakis Foreign Tax," it also changed its substance. The substantive changes resulted in a tax—RAFT—that is "similar or akin" to a U.S. income tax. Because the substance of the RAFT is the same as a U.S. income tax, it is creditable under § 901.

The decision of whether a foreign tax is creditable under § 901 (or § 903) necessarily turns on "the precise meaning of the words in the statute" that grants the credit to the corporation in the first place. *Biddle v. C.I.R.*, 302 U.S. 573, 578 (1938) (analyzing 26 U.S.C. § 131, the substantively identical predecessor to § 901). Because tax credits are products of legislative grace, the provisions affording such credits must be strictly construed. *Texasgulf, Inc. v. C.I.R.*, 172 F.3d at 214. The expression of Congress's will to grant the credit must be taken to conform to its own criteria, "unless the statute, by express language or necessary implication, makes the meaning of … and hence the operation of the statute" depend upon the way that a foreign country characterizes its tax laws. *Biddle*, 302 U.S. at 578. Section § 901—the statute allowing the credit for taxes paid in lieu of an income tax under § 903—contains no such language. *Id.*

There is nothing in the language of § 901 suggesting that, in allowing the credit for foreign tax payments, U.S. courts should defer to foreign characterizations and classifications of tax legislation. *See PPL Corp. v. C.I.R.*, 133 S. Ct. 1897, 1902 (2013) (quoting *Biddle*). Thus, with respect to the U.S. creditability analysis, the way that a foreign government characterizes its tax is not dispositive. *See PPL Corp.*, 133 S. Ct. at 1905; *see also Inland Steel Co. v. United States*, 677 F.2d 72, 80 (Ct. Cl. 1982). The label and form of the foreign tax is not determinative of whether the tax will be credited against a corporation's U.S. tax liability. *Bank of Am. Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d 513, 519 (Ct. Cl. 1972).

Harkonnen Oil does not dispute that the name of the tax changed. The tax was originally named the "Republic of Arrakis *Foreign Value* Tax" and, in 2008, the tax was renamed as the "Republic of Arrakis *Foreign* Tax." (emphasis added.) By the time that Harkonnen Oil filed its taxes in 2011—the tax year at issue in this case—not only had the name of the RAFVT changed but so had the substance.

Traditionally, the Arrakis Tax Code taxed the income of Arrakis citizens. The Code, however, did not tax income earned by foreign corporations doing business in Arrakis. In 2008, President Corrino enacted RAFVT, which taxed all foreign entities that operated on Arrakis territory. (C. 5.) The tax base of RAFVT was to be calculated by taking gross receipts generated by a foreign corporation then multiplying that amount by a tax percentage, which was "to be determined" at a later date. (C. 5.) Less than four months later, President Corrino changed the name of RAFVT to RAFT and simultaneously announced that the tax percentage would be 45 percent.[5] (C. 7.) In 2011, the RAFT tax rate was lowered to 33

[5]Because the name change of the tax and the imposition of the 45% tax rate occurred simultaneously, it is arguable that RAFVT never really had any legitimate substance. (RAFVT was

percent. (C. 15.) Also around that time, Arrakis issued Proclamation 102, which entitled foreign corporations to "all deductions available to Arrakis citizens." (C. 15.)

Although *RAFVT* had established the basic formulaic method for calculating taxable income of foreign corporations in Arrakis, the actual percentage by which gross receipts would be reduced was never established. (C. 5.) Thus, under RAFVT, it would have been impossible to calculate any kind of tax base. Instead, it was *RAFT* that imposed the tax percentage at 45 percent, making it possible to determine the amount of a foreign corporation's taxable income. (C. 7.) And, it was RAFT that subsequently modified that percentage to 33 percent. (C. 15.) More important, however, was Proclamation 102, which further amended the method of calculating the base of taxable income under RAFT by permitting foreign corporations to claim "all deductions available to Arrakis citizens." (C. 15.) The deductions available to Arrakis citizens—*the IRS has stipulated*—"match" the deductions available to U.S. citizens.

Because of Proclamation 102, the *substance* of the RAFT tax base was modified and the modifications resulted in a tax on foreign corporations that was calculated by reducing gross receipts by 33 percent less the applicable IRS-approved deductions. The RAFT tax base, therefore, was substantively different from the RAFVT, which existed for less than four months and purported to calculate taxable income by reducing gross receipts by a tax percentage that was "to be determined."

originally drafted to calculate gross receipts generated by the corporation multiplied by a tax percentage to be determined at a later date—later determined as 45%).

For these reasons, the RAFT changed not only the name of the former tax under RAFVT but also the substance—a grave oversight on behalf of the Fourteenth Circuit.

This Court looks to the substance of a foreign tax and not the form or label that the foreign government has assigned it. *See, e.g.*, *PPL Corp.*, 133 S. Ct. 1897. In analyzing the creditability of a foreign tax, the "crucial inquiry" for this Court is the tax's substantive economic effect and not its name. By looking to the name that Arrakis had assigned to the tax, instead of looking to its substance, the 14th Circuit erred.

2. The 14th Circuit incorrectly concluded that RAFT failed to permit recovery of significant costs and expenses on the ground that RAFT capped deductions for foreign corporations at 95 percent.

A proper focus on the substance of RAFT requires this Court to overturn the decision of the lower court. Because the RAFT's 95 percent cap on deductions permits recovery of significant costs and expenses, the tax is an income tax in the U.S. sense and is therefore creditable under § 901. *See* 26 CFR § 1.901-2(b)(4)(i). Furthermore, the Fourteenth Circuit should have given some deference to the fact that the 95 percent cap on deductions is based on Arrakis's religious perspective.

A foreign tax is that of an income tax in the U.S. sense if the foreign tax is "likely to reach net gain in the normal circumstances in which it applies." 26 CFR 1.901-2. A foreign tax is likely to reach net gain if the tax, judged on the basis of its predominant character, satisfies the three requirements set forth in 26 CFR §§ 1.901-2(b)(2), (b)(3), and (b)(4): the realization, gross receipts, and net income requirements, respectively. Together, these three requirements track the traditional definition of a U.S. income tax and indicate that "net gain (also referred to as net income) consists of realized gross receipts reduced by significant costs and expenses attributable to such gross receipts." *PPL Corp.*, 133 S. Ct. at 64.

1. The Realization Requirement

Although the realization requirement is not specifically challenged in our case, briefly addressing this requirement will provide additional context for the Court. Section 1.901-2(b)(2) of the treasury regulations requires, as a general rule, that the foreign tax be imposed only on income that is "realized" under U.S. tax principles. (App. 5). Essentially, the realization requirement means that the foreign tax should be imposed on income (as distinct from capital, consumption, imputed value, or some other non-income amount) and that the tax should not be imposed before income is actually realized by the taxpayer.[6] Tax Portfolio 901-2d. These two aspects work together to ensure that the foreign government is not taxing some "non-income" amount; this mechanism is intended to prevent the income from appearing in the tax base more than once.

The realization requirement is satisfied if, based on the predominant character of the tax, the foreign tax base is generally composed of realized income. § 1.901-2(b)(1). The regulations "liberalized" prior standards set forth by the courts.[7] The liberalizations seem to have been made because realization is not a

[6]However, the regulations contain exceptions allowing pre-realization events to be taxed in some cases, which exceptions "almost engulf the general rule." Tax Portfolio 901-2d, p.3.

[7]For example, in *American Metal Co.*, a Mexican tax imposed upon the removal of minerals and levied when the minerals were sold, utilized, or shipped was not an income tax. The treasury regulations, however, would permit the taxation of income from mineral production at the point of extraction or incorporation into a manufacturing process. Tax Portfolio 901-2d.

fundamental characteristic of the U.S. tax system. Tax Portfolio 901-2d. In fact, some tax experts wonder why the requirement was not simply eliminated. Tax Portfolio 901-2d. In this case, the Arrakis tax is not a tax on capital, consumption, or any other non-income amount, and there is nothing in the Arrakis Tax Code, or RAFT, specifically, indicating that Harkonnen Oil's profits, once remitted to it by the Central Bank, would appear in the tax base at a later time. For these reasons, and in light of the consensus that the realization requirement is not even a fundamental characteristic of the U.S. tax system, this Court should conclude that this requirement is satisfied.

2. The Gross Receipts Requirement

The gross receipts requirement is not specifically challenged in this case, but a brief analysis will provide additional context for the Court. In pertinent part, § 1.901-2(b)(3) provides that "[a] foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of gross receipts." A foreign tax imposed on the basis of gross receipts satisfies this requirement. § 1.901-2(b)(3); *Entergy Corp. & Affiliated Subsidiaries v. C.I.R.*, 683 F.3d 233, 235 (5th Cir. 2012) (Generally, the starting point for calculating income subject to a creditable foreign income tax must be actual gross receipts.). In this case, RAFT satisfies the gross receipts requirement because the tax is, undisputedly, imposed on the basis of gross receipts. (C. 5.) ("The tax is determined by calculating the gross receipts generated by a corporation's operations occurring in Arrakis....").

3. The Net Income Requirement

A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts to permit "[r]ecovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts." 26 C.F.R. § 1.901-2(b)(4)(i)(A). Second, if the tax does not allow for a direct deduction of costs and expenses (as contemplated by § 1.901-2(b)(4)(i)(A)), the net income requirement may nevertheless be satisfied if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts to permit "[r]ecovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses."[8] *See* 26 C.F.R. § 1.901-2(b)(4)(i)(B). Third, a foreign tax that does not permit recovery of one or more significant costs or expenses, but that does provide for allowances that "effectively compensate" for the nonrecovery of such significant costs or expenses, will satisfy the net income requirement. 26 C.F.R. § 1.901-2(b)(4)(i).

When read together, and in light of the legislative purpose of § 901 to avoid double taxation, the three significant-cost-recovery provisions demonstrate that, as long as the foreign country has some mechanism in place allowing for the reduction of the tax base permitting compensation to the U.S. corporation for the significant

[8]The regulations provide that a tax can satisfy the net income requirement without allowing a deduction for other income taxes. Bittker and Lokken at *9-10. Generally, a foreign tax will satisfy the net-income requirement if, measured by its predominant character, the tax permits recovery of the significant costs and expenses relating to the income. *Exxon Corp. v. C.I.R.*, 113 T.C. 338 (1999).

costs and expenses of operating its business in the foreign country, then the net income requirement will be met. Although this Court has not addressed the specific issue, the plain language of the three significant-cost-recovery provisions in the treasury regulations indicate that a foreign tax scheme need not allow for a full or total recovery of the significant costs in order for the tax to satisfy the net-income requirement.

As a starting point, the treasury regulations require only that the foreign tax satisfy the net income requirement in its "predominant character." *PPL Corp.*, 133 S. Ct. at 1905. The language of the significant-cost-recovery provisions under § 1.901-2(b)(4) is consistent with the "predominant character" approach. The first significant-cost-recovery provision—§ 1.901-2(b)(4)(i)(A)—requires only that the foreign tax use "reasonable principles" to attribute costs and expenses to gross receipts. Foreign principles, the regulations provide, may be reasonable "*even if they differ from principles that apply under the [U.S. Tax Code]*." § 1.901-2(b)(4)(i) (emphasis added).

The second significant-cost-recovery provision—§ 1.901-2(b)(4)(i)(B)—provides that the net income requirement will be met *even if* the foreign tax computes the reduction of gross receipts under a method that is "*likely to produce* an amount that "*approximates*," recovery of such significant costs and expenses.[9] And, "even if gross receipts are not reduced by *some such items*," a foreign tax

[9]Stated otherwise, under this second method of computing SCR, the foreign tax will satisfy the net-income requirement if it is computed in a way that permits recovery of an amount that is "close or near" to the full amount of the corporation's costs and expenses. *See* Oxford English Dictionary (defining the verb "approximate" as "close or near" or approaching "similarity, identity, or accuracy, in any respect").

whose base, in its predominant character, is computed by the methods described under (A) or (B) of this section will satisfy the net-income requirement. *See* § 1.901-2(b)(4)(i) (emphasis added). Finally, the third significant-cost-recovery provision requires only that the foreign tax "effectively compensate" the foreign corporation for its significant costs and expenses. A denial of allowances for some significant costs, therefore, does not necessarily disqualify the tax. Bittker & Lokken, ¶ 72.4; *see also Bank of America*, 459 F.2d 513, 524 (Ct. Cl. 1972) ("We believe the authors of the [senate] report [on §§ 901 and 903] did not mean to blanket within their exclusion of gross income tolls those gross income taxes expected to fall in the end upon net gain and thus to approximate a net income levy.").

Federal court decisions are consistent with these constructions of § 901 and 26 C.F.R. § 1.901-2(b)(4)—that is, that the foreign tax can satisfy the net-income requirement even if the tax does not permit full or total recovery of the significant costs and expenses. *See e.g.*, *PPL Corp.*, 133 S. Ct. at 1897; *Phillips Petroleum Co.*, 104 T.C. at 312. In determining whether the foreign tax is likely to reach net income in the U.S. sense, the income subject to the foreign tax must only be "analogous" to the type of net income reached by the U.S. income tax. *Id.* In other words, the foreign method of determining tax "need not conform strictly" to the manner in which income taxes are computed under our U.S. laws. *Id.* (citing *Inland Steel*, 677 F.2d at 84). Rather, to be creditable under § 901, the foreign tax must only be the "substantial equivalent" of the way that "net income" is used and understood in our own revenue laws. *Phillips Petroleum Co.*, 104 T.C. at 312.

In *Phillips Petroleum*, the U.S. tax court analyzed the creditability of three Norwegian taxes and, specifically, the net income requirement. *Id.* at 312-15. With each of the Norwegian taxes, gross receipts for crude oil were determined by applying norm prices to the number of barrels of oil passing the norm price point during the year. *Id.* at 313. The deductions allowed under the taxes were "broad" and "sizeable," but there were restrictions on deductibility of some costs and expenses. *Id.* Although the court did not specify a percentage, it stated that "[t]he restrictions on the deductibility of expenses were fewer than those found under U.S. tax laws." *Id.* The deductions, although "broad" and "sizeable" were restrictions nonetheless. *Id.* After modifications were made to the Norwegian tax code, the three taxes disallowed deductions when calculating the taxable base for other Norwegian taxes and disallowed deductions for sales commissions and a 50 percent offset limitation. *Id.*

The court held that, because the failure of a tax to allow the deduction of an income tax imposed on the same gross receipts was "not a substantial deviation from the definition of net income," the three Norwegian taxes satisfied the net income requirement. *Id.* at 314. The court also concluded that, because the costs associated with sales commissions were "insignificant," disallowing a deduction for them was not a substantial deviation from the U.S. definition of net income. *Id.*

As illustrated in *Phillips Petroleum Co.*, if the *base* of the foreign tax is computed, "without substantial deviation," by reducing gross receipts by the costs and expenses attributable, under reasonable principles, to such gross receipts, then the net-income requirement is met. *See Phillips Petroleum Co.*, 104 T.C. at 312; *See also* 26 C.F.R. § 1.901-29(b)(4). A foreign tax substantially deviates from the U.S.'s definition of net income only in a limited number of circumstances. For example, a foreign tax may be considered a "substantial deviation," for example, if it effectively denies the recovery of significant costs and expenses. *See PPL Corp.* 113 S. Ct. 1897 (2013); *Phillips Petroleum Co.*, 104 T.C. at 312 (concluding that a deduction that was limited to 50 percent of onshore losses and not deductible from the taxable base of the company's income was creditable). *See also* 26 C.F.R. § 1.901-2(b)(4) (Exs. 1-3). A foreign tax may also be a substantial deviation if there is a "meaningful difference" between the way that the U.S. calculates net income and the way that the foreign tax is calculated. *See PPL Corp.*, 133 S. Ct. at 312 (with "no meaningful difference" in the accounting principles used to calculate a British tax, this Court accepted the parties' stipulation that the tax was in fact a tax on net income).

In this case, the 14th Circuit erred by holding that Arrakis's 95 percent cap on deductions for foreign corporations did not permit recovery of significant costs, because RAFT, in conjunction with Proclamation 102, permits the recovery of significant costs and expenses. RAFT is a tax imposed on gross receipts, minus the applicable deductions, multiplied by a tax percentage rate of 33 percent. Given that the IRS has stipulated that the deductions available to foreign corporations match those available under the U.S. Tax Code, the way that RAFT is calculated is not a substantial deviation from the U.S.'s definition of net income. *See* I.R.C. § 63

("[T]he term 'taxable income' means gross income minus the deductions allowed by this chapter.") (App. A-1.)

The fact that Arrakis caps deductions at 95 percent is not a substantial deviation from the U.S.'s definition of net income. RAFT need only be calculated in a way that is "likely to produce an amount that approximates" recovery of Harkonnen Oil significant costs and expenses. *See* § 1.901-2(b)(4); *Seatrain Lines, Inc. v. C.I.R.*, 46 B.T.A. 1076, 1080 (1942) (if a foreign tax attempts to approximate deductions by using some formula that closely approximates net income, then such a tax could be creditable under § 901);[10] *Phillips Petroleum Co.*, 104 T.C. 256 (1995) (The foreign tax base need only be "analogous" to the type of net income reached by U.S. income taxes); *Oxford English Dictionary* (the definition of the verb "approximate" is "close or near"). Furthermore, five percent of costs and expenses is insignificant, especially when mitigated by the fact that the tax rate under RAFT (33 percent) is two percent lower than the U.S.'s tax on corporations (35 percent). An allowance for the recovery of 95 percent of costs and expenses is effective compensation. RAFT thus has the predominant character of a U.S. income tax.

Moreover, the 95 percent cap on deductions stems from Arrakis's religious belief that a foreign corporation cannot have the same benefits as a "true believer." (C. 15.) RAFT has been blessed as "holy" by the religious head of Arrakis. "Forcing a country to violate its religious tenets" in order to mitigate the U.S.'s fear of under-taxation is "unconscionable." (C. 20.) (Layton, J., dissenting). In determining the

[10]The IRS, however, has treated taxes of this type as qualifying under § 903 rather than § 901 and has not acquiesced in the case. (Portfolio 901-D, p. 8.)

creditability of a foreign tax, this Court should give some deference to the foreign country's religious perspectives. *See, e.g.*, *Seatrain Lines, Inc.* 46 B.T.A. at 1080 (considering Cuban principles of tax and law although ultimately rejecting them). To hold that another country's religious beliefs should be disregarded in the context of analyzing the creditability of a foreign tax would effectively make the IRS the final arbiter of global trade and tax law. An executive agency cannot assume the role of international policymaking; such a role is better suited for Congress. (C. 20.) (Layton, J., dissenting).

To hold that RAFT is not an income tax in the U.S. sense, only because it disallows recovery of five percent of costs and expenses, would read the reason for the regulation—to avoid double taxation—out of the regulation. Above all, the overriding aim of the foreign tax credit to forestall double taxation of the earnings of the U.S. company on foreign soil—first by the other country and then by the U.S. *Metropolitan Life Ins.*, 375 F.2d at 838. A foreign corporation taxed in a foreign country at substantially the same rate as it would be taxed in the U.S. is subject to double taxation. By denying credit for RAFT, Harkonnen Oil will be required to pay to Arrakis the amount of the corporation's gross receipts, less applicable deductions, multiplied by 33 percent, *and* pay to America the amount of the corporation's gross receipts, less applicable deductions (capped at 95 percent), multiplied by 35 percent. Applying the "commonsense approach" delineated in *PPL Corp.*, and factoring in all of Harkonnen Oil's other payments for royalties and fees, if this Court upholds the 14th Circuit, Harkonnen Oil will have operated at a near, if not total, loss for the

2011 tax year. Such a holding would discourage not only Harkonnen Oil but also other individuals and corporations from pursuing or continuing future business operations in Arrakis thus undermining foreign tax credit's second objective of promoting the global economy.

Because the Fourteenth Circuit erred by refusing to consider the substance of RAFT, and because the predominant character of RAFT is that of a U.S. income tax, this Court should hold that RAFT is a creditable foreign tax under § 901. In the alternative, RAFT is creditable as a tax paid in lieu of an income tax under § 903 for the reasons discussed in the next section of this brief.

B. Even if RAFT does not satisfy the net gain requirements under § 1.901-2(b), it is creditable as an in-lieu tax under § 903.

Because the Fourteenth Circuit refused to "move past the form" of RAFT in analyzing the creditability of the tax, that court erred. The Fourteenth Circuit also erred, because its holding that RAFT, as a "withholding tax," was not creditable under § 903 is inconsistent with the plain language of the statute and such a holding undermines the purpose of the foreign tax credit and reads the reason for the regulation out of the regulation. RAFT is a creditable tax in lieu of an income tax because it is a substitute for an otherwise generally imposed income tax.

Section 903 of the U.S. Tax Code provides that "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." 26 I.R.C. § 903 (emphasis added). Such a tax is referred to as a tax "in lieu of" an income tax. For creditability purposes, a tax paid in lieu of an income tax is creditable as an "income tax" under 26 I.R.C. § 901. In determining whether a foreign tax is creditable as an in-lieu tax, this Court looks to the substantive effect of the tax, not its form. *See, e.g.*, *PPL Corp.*, 133 S. Ct. at 1905.

1. Because the Fourteenth Circuit failed to look to the substance of RAFT, and instead looked only to its name, the court erred.

In this case, because the Fourteenth Circuit refused to "move past the form" of RAFT in deciding whether the tax was creditable as an in-lieu tax under § 903, that court erred. In its opinion, the Fourteenth Circuit specifically held that it saw "no reason to move past the form of the Arrakis tax to see that 26 U.S.C. § 903 does not apply." (C. 18.) Such an artificial, rigid construction is unwarranted. *See PPL Corp.*, 133 S. Ct. at 1902.

As explained in more detail above in Section I-A of this brief, the way that the foreign country characterizes its tax is not controlling in determining creditability. *Id.* The form or label of the foreign tax is not dispositive. *See Inland Steel Co.*, 677 F.2d at 80. Instead, in deciding whether a foreign tax is creditable, this Court follows "substance over form" and takes a "commonsense approach" that looks to the substantive effect of the tax. *PPL Corp.*, 133 S. Ct. at 1900; 1905. This is because "tax law deals in economic realities, not legal abstractions." *Id.* at 1905 (quoting *Comm'r. v. Southwest Exploration Co.*, 350 U.S. 308, 315 (1956)).

Other than "see[ing] no reason to move past the form of the Arrakis tax," the Fourteenth Circuit provided no analysis for holding that § 903 did not apply to RAFT. (C. 18.) By failing to analyze the substance of RAFT, the Fourteenth

Circuit's decision is inconsistent with this Court's established principle that courts must look beyond the form of the foreign tax to its substance.

Furthermore, although the Fourteenth Circuit *correctly* held that RAFT was a withholding tax, that court erred by concluding that, as a withholding tax, RAFT was not creditable under § 903. The Fourteenth Circuit's holding directly conflicts with the plain language and legislative purpose of the foreign tax provisions, and it is inconsistent with the caselaw interpreting them.

2. Because the plain language and legislative purpose of the in-lieu provisions were designed to provide credit for taxes imposed on gross receipts, the Fourteenth Circuit's denial of credit under § 903 reads the reason for the regulation out of the regulation.

Section 903 was enacted as a means of bolstering the foreign tax credit's primary objective to avoid double taxation by extending the credit available under § 901 to tax imposed as a substitute for net income even when based on gross income. The Fourteenth Circuit's decision undermines these goals. Concerned that the provisions of § 901 provided "too narrow a base" for determining the availability of the foreign tax credit, Congress enacted § 903. *Bank of Am. Nat'l Trust & Sav. Ass'n. v. C.I.R.*, 61 T.C., 752, 761-62 (1974) (quoting the report of the Senate Finance Committee). Under the 1918 provisions, foreign taxes computed on a basis other than net income were generally found to be non-creditable. *See F.W. Woolworth Co. v. C.I.R.*, 54 T.C., 1233, 1261 (1970). In interpreting the term "income tax," the courts had consistently adhered to a concept of income tax rather closely related to our own, and if such foreign tax was not imposed upon a basis corresponding approximately to net income, it was not often recognized as a basis for credit. *Id.* at 1261.

In the report of the Senate Finance Committee on the enactment of § 903, Congress explicitly stated that it had "deemed it desirable to extend the scope of [§ 901]" to allow credit for a tax imposed as a substitute for a net income tax even though measured by gross income. *Bank of Am. Nat'l. Trust & Sav. Ass'n.*, 61 T.C. at 761-62. The in-lieu provision "clearly manifest[ed]" Congress's intent to extend the scope of creditable foreign income taxes beyond the narrow confines of the United States concept of a tax imposed upon net income. *F.W. Woolworth Co.*, 54 T.C. at 1261. By enacting the in-lieu provisions of § 903, Congress continued and expanded the foreign tax credit's primary purpose of preventing double taxation of the American corporation's foreign income. *Metropolitan Life Ins.*, 375 F.2d at 839.

Congress designed § 903 to allow credit for foreign taxes levied on gross income. Although courts initially construed § 903 as being applicable only when the foreign country had some administrative difficulty in calculating a U.S. corporation's net income, this interpretation was quickly repudiated. *See, e.g.*, *id.* The in-lieu provision was promulgated not for reasons growing out of the foreign country's administrative difficulties in calculating net income but because imposing the country's income tax on foreign corporations might be considered "bad policy" or inconsistent with the country's legal theory to levy the normal income tax upon a particular class or company. *Id.* That is, for creditability purposes, a tax paid in lieu of an income tax may be imposed by the foreign country "whatever reason the other country might consider it proper to substitute the 'in lieu' levy" for the ordinary income tax generally imposed. *Id.* In this way, there would be no discrimination against the American company operating abroad that is exempted from the ordinary foreign income tax – for administrative convenience or for reasons of policy or of legal theory – but is instead required to pay another type of tax in order to contribute to the other country's revenues. *Id.*

There need be no functional connection between the foreign income tax and the in-lieu tax, no coordination of rates, no effort to approximate the amount of the general income tax or to reach the same subject matter or to replace the normal formula for computing income by a special formula designed to achieve the same or roughly the same amount.[11] *Id.* If that had been Congress's objective, it would have only been necessary to declare that "'income, net profits and excess profits taxes' shall include taxes which 'in effect' or 'approximately' or 'in substance' reach income and profits rather than to provide – as Congress did – coverage of all taxes paid 'in lieu' of income taxes otherwise generally imposed." *Id.* at 611. Congress apparently recognized that taxing jurisdictions, exempting a type of business from the ordinary income tax, often substitute a wholly separate tax grounded in another theory and yielding a different amount. *Id.* The foreign tax credit must only be kept within "reasonable bounds" and tied to the fundamental purpose of preventing double

[11]In other parts of the very Revenue Act which adopts the 'in lieu' amendment to the foreign tax credit, Congress expressly used the 'in lieu' locution to refer to taxes which would clearly impose very different amounts upon the taxpayer. *See, e.g.*, §§ 185 and 222 of the Revenue Act of 1942, 56 Stat. 798, 895, 914. *Metro. Life Ins. Co.*, 375 F.2d at 843 (Ct. Cl. 1967)

taxation. *Id.* The corresponding treasury regulation, § 1.903-1, embodies these general propositions.

The plain language of § 1.903-1 makes clear that a foreign tax based on gross receipts is creditable: It is "immaterial whether the base of the income tax bears any relation to realized net income. *The base of the tax, for example, may be gross income, gross receipts* or sales, or the number of units produced or exported." § 1.903-1(a) (emphasis added). The foreign country's purpose for imposing the foreign tax (e.g., whether it imposes the foreign tax because of administrative difficulty in determining the base of the income tax otherwise generally imposed) is also immaterial. § 1.903-1(a).

A foreign levy is an "in lieu" tax if it satisfies three requirements. First, the levy must be "a tax" within the meaning of § 1.901-2(a)(2). Second, the tax must satisfy the substitution requirement under § 1.903-1(b). Third, the tax cannot be dependent on the availability of a tax credit in another country, that is, the tax cannot be a "soak-up" tax. § 1.903-1(c). In this case, there is no dispute that the levy imposed by Arrakis under RAFT was a tax within the meaning of § 1.901-2(a)(2). This Court's review, therefore, is limited to whether RAFT satisfies the substitution requirement and whether it is a soak-up tax. For purposes of determining whether a foreign tax is an in-lieu tax under § 903, the same terms and principles used for purposes of § 901 apply and have the same meaning as those under § 901.[12]

[12]However, the credit is not limited to foreign taxes imposed under laws that are substantially identical to the U.S. Internal Revenue Code (the Code). U.S. income tax laws do not embody a

A foreign tax satisfies the substitution requirement if the tax "in fact operates as a tax imposed in substitution for, and not in addition to, an income tax … otherwise generally imposed." § 1.903-1(b). Although the regulations do not contain any definition of a "generally imposed income tax," § 1.903-1 provides that the foreign tax either is or is not a tax in lieu of an income tax in its entirety for all persons subject to the tax. § 1.903-1(a).[13] That is, a tax imposed on all members of a certain group of taxpayers or a tax on certain types of income for all taxpayers who generate such income is a generally imposed income tax. For example, a tax imposed on all foreign corporations is a generally imposed income tax even if that tax is not imposed on local corporations.

The most common type of in-lieu tax is a foreign tax analogous to the withholding taxes imposed by the U.S. on nonbusiness income of foreign corporations under §§ 871(a) and 881. For example: Country A has a generally imposed tax on net income. The nonbusiness income that a foreign corporation generates from Country A sources is exempt from that tax but is instead subject to a 20 percent gross income tax. The 20 percent tax is an in-lieu tax because it substitutes for the general income tax for a particular class of taxpayers and income. § 1.903-1(b)(3), Ex. 1; Bittker & Lokken, ¶ 72.4. The tax may be collected

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theoretically coherent conception of income taxation, common to the thinking of all enlightened lawmakers throughout the world; they are rather a product of complex political, administrative, and economic factors, many of which are unique to the United States. Close correspondence between U.S. and foreign law thus cannot be expected and is not necessary to achieve the policy of alleviating double taxation. What is required is that the predominant character of the U.S. and foreign taxes be enough alike that, in most cases, it can realistically be said that the same thing is being taxed by the two countries. Bittker & Lokken, ¶ 72.4.

[13]A tax on only one industry – banks, for example – is not a generally imposed income tax. Tax Portfolio 901-2d: The Creditability of Foreign Taxes—General Issues, *2 (referring to § 1.901-2(A)(e)(8), Ex. 5)

by requiring Country A payors to withhold tax and remit it to the Country A tax authorities. § 1.903-1(b)(3), Ex. 2; Bittker & Lokken, ¶ 72.4. However, the in-lieu tax need not be based on rules identical to those of the U.S. § 1.903-1(b).

In addition to fulfilling the purpose of avoiding double taxation, the requirements for creditability under §§ 903 and 1.903-1 effectively serve the foreign tax credit's secondary objective of fostering a robust global economy. The substitution requirement protects the U.S.'s and the foreign country's liberty to negotiate tax rates on an individual basis. Most of the caselaw dealing with § 903 involves countries that have elaborate, multi-layered tax schemes that impose a number of different taxes on a number of different groups or classes of taxpayers; in most of these situations, there is either a treaty, contract, or agreement between the U.S. corporation and the foreign country by which the parties agree to a tax rate that is lower than the generally imposed income tax for the corporation. *See, e.g.*, *Int'l Bus. Machs*, 38 Fed. Cl. 661. In such cases, the prerequisite of a generally imposed income tax makes sense, because the existence of such a tax, coupled with the exemption therefrom, demonstrates that the in-lieu tax is in fact a substitute for an otherwise creditable income tax.

However, in cases in which there is only a single tax imposed on the corporation, such as the instant case, requiring the existence of a generally imposed income tax but basing the denial of a credit for such a tax on the absence of a generally imposed income tax reads the reasons for the regulation out of the regulation.

3. **Because RAFT constituted a withholding tax thus necessitating a credit under § 903, the Fourteenth Circuit erred by concluding that § 903 did not apply.**

RAFT satisfies the substitution requirement because it was a withholding tax imposed in lieu of, and not "in addition to," an income tax otherwise generally imposed. A withholding tax on gross income, such as RAFT in this case, satisfies the substitution requirement.[14] *See* § 1.903-1(b)(3) (Exs. 1, 2.) Although some sources have construed the regulations to mean that § 903 cannot be satisfied without a generally imposed income tax by the foreign country, this interpretation—if applied in every case—would read the reason for the regulation out of the regulation, especially in cases, such as this one, in which there is only a single tax imposed.

Here, RAFT was a single tax imposed on all foreign corporations, such as Harkonnen Oil. As such, RAFT was the generally imposed tax. Under the way that the in-lieu tax regulations have been interpreted, Harkonnen Oil should be credited with an in-lieu tax if it was exempt from RAFT but had paid another, separate tax on income, for example, a tax on its gross receipts, instead of paying pursuant to RAFT. In this case, requiring the existence of a generally imposed income tax would be arbitrary and contrary to the reason for the foreign tax credit.

Avoiding the double taxation of income is not a value that is unique to America, though, it is a value that is shared among the members of the

[14]*See, e.g., Missouri Pac. Railroad v. United States*, 392 F.2d 592 (Cl. Ct. 1986) (holding that, regarding a U.S. company leasing cars to people in foreign countries, the foreign country's imposition of a tax on gross rental income instead of the generally imposed income tax on rental profits qualified for credit under § 903).

international community. The U.S. has entered into treaties with almost 70 countries, the primary purpose of most of being the avoidance of the double taxation of income.[15] This Court has exalted the importance of uniformly interpreting and applying internationally-shared standards. In *Banco Nacional de Cuba v. Sabbatino*, this Court explained that "[i]t should be apparent that the greater the degree of codification or consensus concerning a particular area of international law, the more appropriate it is for the judiciary to render decisions regarding it," because "the courts can then focus on the application of an agreed principle to circumstances of fact rather than on the sensitive task of establishing a principle not inconsistent with the national interest or with international justice." 376 U.S. 398, 428 (1964).

RAFT is a tax on gross receipts less 33 percent, which percentage was withheld by the Central Bank. Forcing Harkonnen Oil to pay Arrakis's 33 percent tax in addition to the U.S.'s 35 percent tax on corporations, plus its royalty payments, bonus payments, and other payments to Arrakis, Sietch State, and IFIL, would render Harkonnen Oil's business operations in Arrakis useless and unprofitable. With no compelling policy reason to deny credit for Harkonnen Oil's payments under RAFT as an in-lieu tax, this Court should hold that the Fourteenth Circuit erred.

II. Because IFIL Executive Order 14012 and the ruling by the Holy Court establish that IFIL was a "foreign country" within the meaning of § 901, and because Harkonnen Oil exhausted the effective and practical remedies under Arrakis law, the Fourteenth Circuit erred by denying credit to Harkonnen Oil for its payments to IFIL.

[15] Internal Revenue Service, U.S. Tax Treaties: A to Z, *available at* http://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties---A-to-Z.

The Fourteenth Circuit erred by holding that Executive Order 14012 and the ruling of the Holy Royal Court were insufficient to establish that IFIL was a sovereign political entity and hence a valid taxing authority. (C. 18.) Because IFIL is recognized as a sovereign state by the U.S., a determination that is exclusively the function of the Executive Branch—and not the judiciary—the Fourteenth Circuit erred by holding that the Executive Order was "insufficient" to establish that IFIL had the jurisdiction to tax.

A. IFIL is a foreign country within the meaning of § 901.

With respect to the creditability of Harkonnen Oil's payments to IFIL, the question before this Court is essentially whether IFIL had jurisdiction to impose a tax. The determination of whether a foreign taxing entity has jurisdiction to tax is an implicit requirement for establishing that the foreign levy was "a tax" within the meaning of § 1.901-2(a)(2). Section 1.901-2(a)(2)(i) provides that a foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes. Whether a foreign levy requires a compulsory payment pursuant to a foreign country's authority to levy taxes is determined by principles of U.S. law and not by principles of the law of the foreign country. § 1.901-2(a)(2)(i). "The assertion by a foreign country that a levy is pursuant to the foreign country's authority to levy taxes is not determinative that, under U.S. principles, it is pursuant thereto." § 1.901-2(a)(2)(i).

To be a valid taxing authority, the foreign taxing entity must be a "foreign country" within the meaning of § 901 and under principles of international law. *See*

§ 412, RESTATEMENT (THIRD) OF THE FOREIGN RELATIONS LAWS OF THE UNITED STATES (1987) ("A state may exercise jurisdiction to tax a person … on the basis of (a) nationality, (b) domicile, or (c) residence."). The term foreign country means "any foreign state" and includes "any political subdivision of any foreign state." § 1.901-2(g)(2). It is undisputed in this case that Sietch State is an independent state and a valid taxing authority. The question that this Court must answer is whether IFIL constitutes a state, or political subdivision, so as to be a valid taxing authority.

Basically defined, a foreign state ("a state") is an entity that has a defined territory and a permanent population, under the control of its own government, and that engages in, or has the capacity to engage in, formal relations with other such entities. § 201, RESTATEMENT (THIRD). However, any entity may satisfy the territorial requirement for statehood even if its boundaries have not been finally settled, or if one or more of its boundaries are disputed, or if some of its territory is claimed by another state. § 201, RESTATEMENT (THIRD). To qualify as a state, the population of the entity must be "significant and permanent." § 201, RESTATEMENT (THIRD). A significant number of permanent inhabitants in the territory satisfies this requirement. § 201, RESTATEMENT (THIRD).

An entity does not have to have any particular form of government to qualify as a state, but there must be some authority exercising governmental functions, and the authority must be capable of representing the state in international relations. § 201, RESTATEMENT (THIRD). A "government" is a political agency through which the "state" acts in international relations. *Lehigh Valley R. Co. v. State of Russia*, 21

F.3d 396 (2d Cir. 1927). The state government must at least be competent, as defined within its own constitutional system, to conduct international relations with other states, and it must have the political, technical, and financial capabilities to conduct such relations. § 201, RESTATEMENT (THIRD). However, the standard for satisfying the requirement of having an "effective" government is "very loose." § 201, RESTATEMENT (THIRD). The fact that the state's internal affairs become anarchic for an extended period of time does not disqualify the entity from being a state. § 201, , RESTATEMENT (THIRD), cmt. 3.

Likewise, military occupation does not terminate statehood. Any government, "however violent and wrongful in its origin, must be considered a de facto government if it was in the full and actual exercise of sovereignty over a territory and people large enough for a nation." *Kadic v. Karadzic*, 270 F.3d 232, 244 (2d Cir. 1995) (internal citations omitted).

In *Kadic*, the Second Circuit addressed the issue of whether a group within the self-proclaimed Bosnian-Serb republic was a state or lawful authority. *See id.* There, a political group referred to as "Srpska," consisted of a three-man presidency, it had a legislature, and its own currency. *Id.* at 244. Srpska exercised actual control over defined territory within the recognized nation of Bosnia-Herzegovina, controlled populations within its power, and had entered into agreements with other governments. *Id.* at 245. The court held that, for those reasons, the Srpska "regime" satisfied the criteria for qualifying as a state in all aspects of international law. *Id.*

As *Kadic* demonstrates, in addition to the criteria discussed above in this section, to be a state, an entity must claim to be a state. § 201, Restatement (Third); *See Kadic* at 244. Ordinarily, the determination of whether an entity qualifies as a state is made by other states when they decide whether to treat the entity as a state, but formal recognition of the state by other states is not required. *Kadic*, 270 F.3d at 244. Recognition may occur by a manifestation of intent or by a public declaration of an authorized official. *KMW Int'l. v. Chase Manhattan Bank, N.A.*, 606 F.2d 10 (2d Cir. 1979). Although recognized states enjoy certain privileges that non-recognized states do not, non-recognized states "are not a juridical nullity"—U.S. courts have regularly given effect to the "state" action of unrecognized states. *Kadic*, 270 F.3d at 244. The basic rule under international law is that it is within each state's domestic jurisdiction to decide who are its nationals. *Stserba v. Holder*, 646 F.3d 964, 973 (6th Cir. 2011).

In the instant case, because IFIL is a legitimate state government, the Fourteenth Circuit erred by concluding that IFIL was not a valid taxing authority. IFIL has acquired control of specific territory within the Sietch State, namely the region known as the "Badlands" where, after acquisition, there was a "concentration" of the IFIL population. IFIL later expanded its control to another portion of Sietch State, taking control of, among other territory, a drilling station operated by Harkonnen Oil. (C. 13.) The fact that IFIL's permanent boundaries have not been settled has no bearing on determining whether the territory criterion has been satisfied. *See* § 201, RESTATEMENT (THIRD). Furthermore, IFIL has its own government whose structure consists of a single leader who is chosen through an election process, and that leader, Jessica Mohian, has the capacity to engage in formal relations with other such entities. Mohian has engaged in a number of political, economic, and financial relations with other countries and entities, including Arrakis (entering into the agreement for a permanent establishment in Arrakis), Harkonnen Oil, a U.S. corporation (entering into the "IFIL lease"), and the neighboring countries, Anbus and Al Dhanab.

Additionally, although the initial takeovers by IFIL were "forceful," IFIL and Arrakis later agreed to establish a permanent location for IFIL. *See Brunell v. U.S.*, 77 F. Supp. 68, 70-71 (S.D.N.Y. 1948) (A claim of sovereignty over territory depends on "firm possession" and the intention and capacity to hold the territory so acquired). Furthermore, because Arrakis and Sietch State have acquiesced to IFIL's occupancy and claim to the Badlands and beyond, IFIL is entitled to the benefit of having doubts as to the validity of its state status in its favor. *See U.S. v. Fullard-Leo*, 156 F.2d 756 (9th Cir. 1946).

Furthermore, it is well established that, this Court's inquiry into that entity's state status should begin and end with the Executive Branch's determination of whether a foreign entity is a state. Although recognition by other states is not formally required, for purposes of interpreting U.S. laws that require the existence of a valid authority, political recognition of the foreign entity is "exclusively a function of the Executive." *Sabbatino*, 376 U.S. at 410 (1964). The recognition of a sovereign entity by the U.S. resolves any ambiguity that might have been thought to exist. *See id.* at 420.

In this case, the Fourteenth Circuit erred by refusing to take Executive Order 14012 into consideration. Executive Order 14012 declared that IFIL is a "sovereign friend of the United States" with whom the U.S. "would like to establish trade relations with." (C. 14.) In addition to this declaration, the U.S., along with the U.N., agreed "to look at IFIL for determination." (C. 14.) These two official statements indicate the U.S.'s intention to recognize IFIL as a sovereign authority. Such an intent is sufficient to hold that the U.S. has recognized IFIL as a valid foreign state. *See KMW Int'l.*, 606 F.2d at 10 (Recognition may occur by a manifestation of intent or by a public declaration of an authorized official); *see also Phillips Petroleum*, 104 T.C. at 256-57 (considering a Norwegian Royal Decree as evidence of a foreign entity's intent and authority to tax, and concluding that the Ministry had imposed the extra tax pursuant to the exercise of its sovereign taxing power as owner of petroleum resources. *Phillips Petroleum*, 104 T.C. at 257.

In this case, because the Fourteenth Circuit improperly refused to consider the Executive Order and the ruling of the Holy Royal Court of Arrakis, this Court should hold that the Fourteenth Circuit erred by concluding that IFIL did not qualify as a state or political subdivision.

B. Because the amount paid to IFIL was determined by Harkonnen Oil in a manner consistent with a reasonable interpretation of Arrakis law, the Fourteenth Circuit erred by holding that Harkonnen Oil failed to exhaust the available effective and practical remedies.

Harkonnen Oil satisfied the requirement under § 1.901-2(g) that it exhaust the remedies available to it before claiming a tax credit for RAFT. Under 26 C.F.R. § 1.901-2(g), an amount paid does not exceed the amount of such liability if the amount paid is determined by the taxpayer in a manner that is consistent with a reasonable interpretation and application of the substantive and procedural provisions of foreign law (including applicable tax treaties) in such a way as to reduce, over time, the taxpayer's reasonably expected liability under foreign law for tax, and if the taxpayer exhausts all effective and practical remedies.

In *Procter & Gamble*, the court held that the plaintiff failed to exhaust all practical and effective remedies before claiming its tax credit. A.F.T.R.2d 2010-5311 at *9 (S.D. Ohio 2010). The Court reasoned that the plaintiff, P&G, had only produced evidence discussing the "likelihood" of appeal in its tax case and, because it did not produce any evidence of advice, analysis, or counsel regarding the foreign country's avenues of recovery for taxes paid, it had failed to exhaust all effective and practical remedies. *Id.* Although P&G sought from counsel legal advice about the source of P&G's income counsel, that advice did not address the availability of other methods of relief available in the foreign country. *Id.* Instead, the court concluded, P&G should have sought a redetermination of the source of its royalty income. *Id.*

The *Procter & Gamble* court explained that the reason for requiring U.S. corporations to exhaust all their remedies in the foreign country before seeking redress from the U.S. is so that the corporation can effectively and practically reduce their foreign tax payments; to require something less would create a moral hazard. *Id.* at *7. "Taxpayers would have no incentive to challenge any foreign tax whether or not properly imposed, thereby leaving the United States to foot the bill through the credit system. In such case, double taxation has been avoided, but the U.S. Treasury is saddled with the cost." *Id.* at *8 (internal citations and quotation marks omitted).

In this case, Harkonnen Oil satisfied the requirement that it pursue all available alternatives or remedies, because the amount of tax paid to IFIL was determined by Harkonnen Oil in a manner that was consistent with the reasonable interpretation and application of the substantive and procedural provisions of Arrakis law. *See* 26 C.F.R. § 1.901-2(e)(5)(i). Because the amount paid was consistent with a reasonable interpretation of Arrakis law, the amount did not exceed the amount of Harkonnen Oil's liability for tax under Arrakis law and was therefore *not* noncompulsory. *See id.*

Harkonnen Oil's interpretation or application of Arrakis law was reasonable and because it relied in good faith on the advice of the Arrakis President. *See* 26 C.F.R. § 1.901-2(e)(5). An interpretation of foreign law is "not reasonable if there is ... constructive notice (e.g., a published court decision)" to the taxpayer that the interpretation is likely to be erroneous. *Id.* "In interpreting foreign tax law, a taxpayer may generally rely on advice obtained in good faith" from competent tax authorities to whom the taxpayer has disclosed the relevant facts. *Id.*

Harkonnen Oil sought from the President of Arrakis advice as to whether IFIL was a valid taxing authority. (C. 14.) After being informed that all legal tax disputes were handled by the Holy Royal Court of Arrakis, Harkonnen Oil petitioned that court for a determination of the status of IFIL, which court concluded that IFIL was recognized as a part of Sietch State. (C. 14.) Unlike the petitioner in *Procter & Gamble*, Harkonnen Oil sought a determination as to the validity of the taxing authority, IFIL, before paying the tax. Notwithstanding that fact, Harkonnen Oil's reliance on the President's advice to seek a determination from the Holy Royal Court was reasonable because it was made in good faith, and the President should be considered as a competent advisor with respect to the avenues of relief available under Arrakis law. In addition, Harkonnen Oil's interpretation of the Arrakis law is not unreasonable, because the Arrakis court's published opinion announcing that IFIL had been formally recognized as a part of Sietch constitutes constructive notice and there is nothing indicating that the interpretation of that opinion—that IFIL is a valid taxing authority—is likely to be erroneous. The costs of seeking these determinations was reasonable in light of the amount of taxes at issue. *See id.*

Finally, Harkonnen Oil was not required to invoke "competent authority procedures" because it had no treaty with Arrakis, Sietch State, or IFIL. *See* § 1.901-2(e)(5) (taxpayer is required to exhaust "all effective and practical remedies, including invocation of *competent authority procedures available under applicable tax treaties*"). Because the Holy Royal Court was the sole arbiter of legal tax disputes, and because Harkonnen Oil's interpretation of that court's ruling was reasonable, this Court should hold that Harkonnen Oil satisfied the requirement under § 1.903-1(e)(5) that it exhaust effective and practical remedies.

CONCLUSION

For the foregoing reasons, this Court should reverse the judgment of the Fourteenth Circuit and remand the cause for proceedings consistent with this Court's decision.

<u>TABLE OF CONTENTS FOR APPENDIX</u>

United States Code Provisions

United States Treasury Regulations

APPENDIX

UNITED STATES CODE PROVISIONS

26 I.R.C. § 63. Taxable income defined.

(a) In general.--Except as provided in subsection (b), for purposes of this subtitle, the term "taxable income" means gross income minus the deductions allowed by this chapter (other than the standard deduction).

* * * * *

26 I.R.C. § 901. Taxes of foreign countries and of possessions of United States

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

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

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

(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).

....

(m)(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....

* * * * *

26 I.R.C. § 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.

* * * * *

26 I.R.C. § 1254. Courts of appeals; certiorari; certified questions

Cases in the courts of appeals may be reviewed by the Supreme Court by the following methods:

> **(1)** By writ of certiorari granted upon the petition of any party to any civil or criminal case, before or after rendition of judgment or decree;
>
> **(2)** By certification at any time by a court of appeals of any question of law in any civil or criminal case as to which instructions are desired, and upon such certification the Supreme Court may give binding instructions or require the entire record to be sent up for decision of the entire matter in controversy.

<u>**UNITED STATES TREASURY REGULATIONS**</u>

26 C.F.R. § 1.901-2. Income, war profits, or excess profits tax paid or accrued.

(a) Definition of income, war profits, or excess profits tax—

> **(1) In general.** Section 901 allows a credit for the amount of income, war profits or excess profits tax (referred to as "income tax" for purposes of this section and §§ 1.901–2A and 1.903–1) paid to any foreign country. Whether a foreign levy is an income tax is determined independently for each separate foreign levy. A foreign levy is an income tax if and only if--
>
> > **(i)** It is a tax; and
> >
> > **(ii)** The predominant character of that tax is that of an income tax in the U.S. sense.
>
> Except to the extent otherwise provided in paragraphs (a)(3)(ii) and (c) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax. Paragraphs (a), (b) and (c) of this section define an income tax for purposes of section 901. Paragraph (d) of this section contains rules describing what constitutes a separate foreign

levy. Paragraph (e) of this section contains rules for determining the amount of tax paid by a person. Paragraph (f) of this section contains rules for determining by whom foreign tax is paid. Paragraph (g) of this section contains definitions of the terms “paid by,” “foreign country,” and “foreign levy.” Paragraph (h) of this section states the effective date of this section.

(2) Tax—

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

(ii) Dual capacity taxpayers—

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

(B) Specific economic benefit. For purposes of this section and §§ 1.901–2A and 1.903–1, the term "specific economic benefit" means an economic benefit that is not made available on substantially the same terms to substantially all persons who are subject to the income tax that is generally imposed by the foreign country, or, if there is no such generally imposed income tax, an economic benefit that is not made available on substantially the same terms to the population of the country in general. Thus, a concession to extract government-owned petroleum is a specific economic benefit, but the right to travel or to ship freight on a government-owned airline is not, because the latter, but not the former, is made generally available on substantially the same terms. An economic benefit includes property; a service; a fee or other payment; a right to use, acquire or extract resources, patents or other property that a foreign country owns or controls (within the meaning of paragraph (a)(2)(ii)(D) of this section); or a reduction or discharge of a contractual obligation. It does not include the right or privilege merely to engage in business generally or to engage in business in a particular form.

....

....

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

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

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

(b) Net gain—

(1) In general. A foreign tax is likely to reach net gain in the normal circumstances in which it applies if and only if the tax, judged on the basis of its predominant character, satisfies each of the realization, gross receipts, and net income requirements set forth in paragraphs (b)(2), (b)(3) and (b)(4), respectively, of this section.

(2) Realization--(i) In general. A foreign tax satisfies the realization requirement if, judged on the basis of its predominant character, it is imposed....

....

(3) Gross receipts—(i) In general. A foreign tax satisfies the gross receipts requirement if, judged on the basis of its predominant character, it is imposed on the basis of--

(A) Gross receipts; or

(B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value.

A foreign tax that, judged on the basis of its predominant character, is imposed on the basis of amounts described in this paragraph (b)(3)(i) satisfies the gross receipts requirement even if it is also imposed on the basis of some amounts not described in this paragraph (b)(3)(i).

....

(4) Net income--(i) In general. A foreign tax satisfies the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts (including gross receipts as computed under paragraph (b)(3)(i)(B) of this section) to permit--

(A) Recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or

(B) Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.

A foreign tax law permits recovery of significant costs and expenses even if such costs and expenses are recovered at a different time than they would be if the Internal Revenue Code applied, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery. For example, unless the time of recovery is such that under the circumstances there is effectively a denial of such recovery, the net income requirement is satisfied where items deductible under the Internal Revenue Code are capitalized under the foreign tax system and recovered either on a recurring basis over time or upon the occurrence of some future event or where the recovery of items capitalized under the Internal Revenue Code occurs less rapidly under the foreign tax system. A foreign tax law that does not permit recovery of one or more significant costs or expenses, but that provides allowances that effectively compensate for nonrecovery of such significant costs or expenses, is considered to permit recovery of such costs or expenses. Principles used in the foreign tax law to attribute costs and expenses to gross receipts may be reasonable even if they differ from principles that apply under the Internal Revenue Code (e.g., principles that apply under section 265, 465 or 861(b) of the Internal Revenue Code). A foreign tax whose base, judged on the basis of its predominant character, is computed by reducing gross receipts by items described in paragraph (b)(4)(i)(A) or (B) of this section satisfies the net income requirement even if gross receipts are not reduced by some such items. A foreign tax whose base is gross receipts or gross income does not satisfy the net income requirement except in the rare situation where that 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 or gross income,

> respectively, 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. Thus, a tax on the gross receipts or gross income of businesses can satisfy the net income requirement only if businesses subject to the tax are almost certain never to incur a loss (after payment of the tax). In determining whether a foreign tax satisfies the net income requirement, it is immaterial whether gross receipts are reduced, in the base of the tax, by another tax, provided that other tax satisfies the realization, gross receipts and net income requirements.
>
> ....

(c) Soak-up taxes--(1) In general. Pursuant to paragraph (a)(3)(ii) of this section, the predominant character of a foreign tax that satisfies the requirement of paragraph (a)(3)(i) of this section is that of an income tax in the U.S. sense only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the tax against income tax liability to another country. Liability for foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only if and to the extent that the foreign tax would not be imposed on the taxpayer but for the availability of such a credit. See also § 1.903–1(b)(2).

....

(d) Separate levies--(1) In general. For purposes of sections 901 and 903, whether a single levy or separate levies are imposed by a foreign country depends on U.S. principles and not on whether foreign law imposes the levy or levies in a single or separate statutes. A levy imposed by one taxing authority (*e.g.*, the national government of a foreign country) is always separate for purposes of sections 901 and 903 from a levy imposed by another taxing authority (e.g., a political subdivision of that foreign country)....

....

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

> **(2) Refunds and credits--(i) In general.** An amount is not tax paid to a foreign country to the extent that it is reasonably certain that the

amount will be refunded, credited, rebated, abated, or forgiven. It is not reasonably certain that an amount will be refunded, credited, rebated, abated, or forgiven if the amount is not greater than a reasonable approximation of final tax liability to the foreign country.

....

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

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26 C.F.R § 1.903-1 Taxes in lieu of income taxes.

(a) In general. Section 903 provides that 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 ("income tax") otherwise generally imposed by any foreign country. For purposes of this section and §§ 1.901–2 and 1.901–2A, such a tax is referred to as a "tax in lieu of an income tax"; and the terms "paid" and "foreign country" are defined in § 1.901–2(g). A foreign levy (within the meaning of § 1.901–2(g)(3)) is a tax in lieu of an income tax if and only if--

> **(1)** It is a tax within the meaning of § 1.901–2(a)(2); and
>
> **(2)** It meets the substitution requirement as set forth in paragraph (b) of this section.

The foreign country's purpose in imposing the foreign tax (e.g., whether it imposes the foreign tax because of administrative difficulty in determining the base of the income tax otherwise generally imposed) is immaterial. It is also immaterial whether the base of the foreign tax bears any relation to realized net income. The base of the tax may, for example, be gross income, gross receipts or sales, or the number of units produced or exported. Determinations of the amount of a tax in lieu of an income tax that is paid by a person and determinations of the person by whom such tax is paid are made under § 1.901–2(e) and (f), respectively, substituting the phrase "tax in lieu of an income tax" for the phrase "income tax" wherever the latter appears in those sections. Section 1.901–2A contains additional rules applicable to dual capacity taxpayers (as defined in § 1.901–2(a)(2)(ii)(A)). The rules of this section are applied independently to each separate levy (within the meaning of §§ 1.901–2(d) and 1.901–2A(a)) imposed by the foreign country. Except as otherwise provided in paragraph (b)(2) of this section, a foreign tax either is or is not a tax in lieu of an income tax in its entirety for all persons subject to the tax.

(b) Substitution—

> **(1) In general.** A foreign tax satisfies 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. However, not all income derived by persons subject to the foreign tax need be exempt from the income tax. If, for example, a taxpayer is subject to a generally imposed income tax except that, pursuant to an agreement with the foreign country, the taxpayer's income from insurance is subject to a gross receipts tax and not to the income tax, then the gross receipts tax meets the substitution requirement notwithstanding the fact that the taxpayer's income from other activities, such as the operation of a hotel, is subject to the generally imposed income tax. A comparison between the tax burden of this insurance gross receipts tax and the tax burden that would have obtained under the generally imposed income tax is irrelevant to this determination.

(2) Soak-up taxes. A foreign tax satisfies the substitution requirement only to the extent that liability for the foreign tax is not dependent (by its terms or otherwise) on the availability of a credit for the foreign tax against income tax liability to another country. If, without regard to this paragraph (b)(2), a foreign tax satisfies the requirement of paragraph (b)(1) of this section (including for this purpose any foreign tax that both satisfies such requirement and also is an income tax within the meaning of § 1.901–2(a)(1)), liability for the foreign tax is dependent on the availability of a credit for the foreign tax against income tax liability to another country only to the extent of the lesser of--

(i) The amount of foreign tax that would not be imposed on the taxpayer but for the availability of such a credit to the taxpayer (within the meaning of § 1.901–2(c)), or

(ii) The amount, if any, by which the foreign tax paid by the taxpayer exceeds the amount of foreign income tax that would have been paid by the taxpayer if it had instead been subject to the generally imposed income tax of the foreign country.