No. C15-1701-1

In The

Supreme Court of the United States

October Term 2014

ROYAL HARKONNEN OIL COMPANY,

Petitioner,

v.

UNITED STATES,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Fourteenth Circuit in Case No. 15-1701

BRIEF OF PETITIONER
ROYAL HARKONNEN OIL COMPANY

Team # 80
Counsel for Petitioner
Royal Harkonnen Oil Company.

November 24, 2014

QUESTIONS PRESENTED

I. Whether Royal Harkonnen is entitled to the foreign tax credit when the tax, based on its "predominant character", was a creditable tax under 26 U.S.C. § 901 and in the alternative an "in lieu of" tax under 26 U.S.C. § 903.

II. Whether Royal Harkonnen's tax payment to Inter-Sietch Fremen Independence League constitutes a "tax" under 26 U.S.C. § 901.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

CASES

IRS ADMINISTRATIVE GUIDANCE

SECONDARY SOURCES

OPINIONS BELOW

The Central District Court of New Tejas ruled in favor of Respondent and denied the tax refund requested by Royal Harkonnen. The Petitioner appealed the decision from the District Court and the United States Court of Appeals for the Fourteenth Circuit affirmed. R. at ¶ 41-4.

STATEMENT OF JURISDICTION

This Court has jurisdiction to grant certiorari upon the petition of any party pursuant to 28 U.S.C. § 1254(1). The United States Court of Appeals for the Fourteenth Circuit entered judgment on October 1, 2014, and Petitioner timely filed its petition. This Court granted certiorari in the October Term 2014.

STATUTORY PROVISIONS INVOLVED

The relevant portions of Section 901 and Section 903 of the Internal Revenue Code, 26 U.S.C. § 901, 26 U.S.C. § 903, and Treasury Regulations § 1.901-2 and § 1.903-1 are reproduced in the appendix of this brief.

STATEMENT OF THE CASE

I. Background

The Royal Harkonnen Oil Company (Royal Harkonnen) is a Delaware corporation with its principal place of business in New Tejas. R. at ¶ 1, n. 1. Royal Harkonnen was interested in extracting oil and natural gas deposits located in The Republic of Arrakis (Arrakis). R. at ¶ 1, n. 2. The Republic of Arrakis contains a large area of natural oil and gas deposits commonly known as the Caladan Oil Field. R. at ¶ 1. During 2008 there was unrest in the area known as the Sietch Dunes in the northern region of Arrakis amongst the dissidents of the Sietch Empire. R. at ¶ 7. The Sietch Dunes includes a 62,000 square mile portion of the Caladan Oil Field. R. at ¶ 7. In 2010, the Independent People of Sietch (IPS) declared independence from Arrakis and declared themselves the controlling political regime of the Sietch Dunes. R. at ¶ 15. Paul Atreides was appointed the leader of IPS. R. at ¶ 16. After a period of turmoil, the Sietch Dunes Peace Treaty (Peace Treaty) was entered into between Arrakis and IPS. R. at ¶ 17. Under the Peace Treaty, the Sietch Dunes region became the Sietch State and the parties agreed to appoint Paul Atreides as the Vice President of Arrakis, serving in the cabinet of the President. R. at ¶ 17. Further, the Arrakis Constitution was amended to create the post of the Vice President, the Sietch Counsel to conduct judicial functions, and limit the Vice President's term to one year and power to levy a single tax. R. at ¶ 18. Pursuant to his power, Paul Atreides declared a single tax of 10% on all income generated in the state. R. at ¶ 20.

At the end of 2010, a group known as the Inter-Sietch Fremen Independence League (IFIL) launched a rebellion in the Sietch State. R. at ¶ 24. IFIL was concentrated in the region of the Sietch Dunes known as the "Badlands," where Unit # 12 of the Royal Harkonnen operations was located. R. at ¶ 29-30. IFIL was led by Jessica Mohiam who was believed to be the rightful heir of the Sietch Throne. R. at ¶ 24. Mohiam had been unanimously elected to be the Leader Elect of

IFIL. R. at ¶ 27. An individual need only pledge its membership to IFIL in order to vote in the election. R. at ¶ 27. In early 2011, neighboring countries Al Dhanab and Anbus, as well as France and Russia, formally recognized IFIL as a legitimate government and independent state of the Sietch Dunes region. R. at ¶ 28. The President of the United States also declared it wanted to establish trade relations with IFIL as a "sovereign friend of the United States." R. at ¶ 34.

In May 2011, the President of Arrakis, Vice President of the Sietch State, and Leader Elect Mohiam met with Royal Harkonnen at the First Annual Caladan Oil Field Conference. R. at ¶ 35. During the conference, the leaders held numerous meetings and agreed on the final tax rates to be levied upon Royal Harkonnen's separate activities within the Caladan Oil Field. R. at ¶ 35.

II. The Republic of Arrakis Foreign Tax

The Republic of Arrakis imposes a tax on residents of Arrakis under the Arrakis Tax Code (Arrakis Tax). R. at ¶ 4. The Arrakis Tax rate is based on whether the resident historically would have been a subject of the Sietch throne or the Arrakis throne and is calculated by taking gross receipts, minus deductions, multiplied by the applicable tax rate. R. at ¶ 4. The Republic of Arrakis tax is not imposed on income earned by foreign individuals or entities residing or doing business in Arrakis. R. at ¶ 4.

In order to properly tax income generated by foreign individuals the President of Arrakis drafted a tax initially labeled "Republic of Arrakis Foreign Value Tax." R. at ¶ 5. The tax applies to all foreign entities that operate machinery in Arrakis and is determined by calculating gross receipts generated by the foreign corporation's operations multiplied by the applicable tax percentage. R. at ¶ 5. To regulate the payment of this tax, the Arrakis Tax required income generated by the foreign corporation to be deposited in the Central Bank of Arrakis. R. at ¶ 6. Once the income is received by the bank, the taxed funds are distributed directly to the Arrakis Treasury. R. at ¶ 6.

The Republic of Arrakis Foreign Value Tax was eventually renamed to the "Republic of Arrakis Foreign Tax" (RAFT) and was given a rate of 33%. R. at ¶ 13, 35. Additionally, the President of Arrakis issued Proclamation 102 stating that foreign corporations would be allowed tax deductions from gross income capped at 95%. R. at ¶ 36.

III. The Inter-Sietch Fremen Independence League Tax

After IFIL's territory expanded beyond the Badlands, including Unit #12 of Royal Harkonnen's operations, Harkonnen met with Mohiam to discuss its financial obligations to IFIL. R. at ¶ 30, 31. During the meeting, an oil and gas lease was agreed upon between Royal Harkonnen and IFIL. R. at ¶ 31. Royal Harkonnen agreed to pay a bonus of $550,000 and a five percent royalty to IFIL. R. at ¶ 31. In addition, IFIL imposed a two percent tax upon the income of Unit #12, which would be calculated by taking gross-receipts of Unit #12, minus deductions, multiplied by two percent. R. at ¶ 31.

Royal Harkonnen questioned the two percent tax imposed by IFIL and sought the advice of the President of Arrakis regarding how to handle the demanded tax. R. at ¶ 31. The President told Royal Harkonnen that all tax disputes were handled by the Holy Royal Court of Arrakis, which is the highest court in the Republic of Arrakis. R. at ¶ 4 n.6, 31. Following the advice of the President, Royal Harkonnen petitioned the Holy Royal Court regarding IFIL's status and ability to levy tax and was told "Arrakis recognized IFIL as a part of Sietch." R. at ¶ 32. Two days after the Holy Royal Court's determination, Royal Harkonnen paid the IFIL two percent tax as directed. R. at ¶ 33.

PROCEDURAL HISTORY

In 2011, Royal Harkonnen timely filed its tax returns. In its returns it claimed foreign tax credits for taxes paid pursuant to the taxing authority of Arrakis, the Sietch State and IFIL. The Internal Revenue Service (IRS) performed an audit and determined that Royal Harkonnen's payments to Arrakis and IFIL did not qualify as creditable foreign tax credits and declared a deficiency against Royal Harkonnen. R at ¶ 38, 39. The IRS denied the credit for payments to Arrakis because it determined that the tax failed to reach "net income" and also was not in-lieu of a generally applicable tax. Further, the IRS determined the creditability of the IFIL tax under the view that IFIL was not a proper taxing authority, the tax violated the Sietch Dunes Peace Treaty, and that Royal Harkonnen failed to exhaust its remedies to reduce its tax liability. R. at ¶ 39. Royal Harkonnen paid the deficiency, demanded a refund, and filed suit in the Central District Court of New Tejas. R. at ¶ 40. The District Court held that the IRS properly denied the foreign tax credits and the Court of Appeals for the Fourteenth Circuit affirmed. R. at ¶ 40, 44. This appeal followed.

SUMMARY OF THE ARGUMENT

I.

Royal Harkonnen is entitled to a foreign tax credit for taxes paid to Arrakis because the Republic of Arrakis Foreign Tax (RAFT) is a creditable tax under Section 901 and in the alternative a creditable tax under Section 903. Under Section 901, the RAFT meets the elements of the predominant character test: (1) realization, (2) gross-receipts, and (3) net income. Therefore, the predominant character of the RAFT is a tax in the U.S. sense as it is likely to meet net gain and is creditable under Section 903. Further, even if the RAFT is not creditable under Section 901, it is still creditable as an "in lieu of" tax under Section 903. The RAFT is compulsory and is imposed pursuant to Arrakis' authority to levy taxes in its role as a revenue raiser. Further, it is applied in substitution to a generally imposed Arrakis income tax. Because this is all the statute, the Regulations, and the case law require to establish creditability under Section 901 or 903, the RAFT is creditable, and the of the Fourteenth Circuit should be reversed.

II.

The tax paid to IFIL qualifies as a "tax" under Section 901 because it was imposed by a foreign country with the authority to levy taxes and was a compulsory payment. IFIL is a sovereign state, and thus a "foreign country" under Section 901, because it has a defined territory, a permanent population, a government, and the ability to engage in formal relations with other states. IFIL has the authority to levy taxes because the power to tax is an implied power of a sovereign state. Additionally, the IFIL tax was not an impermissible second tax and did not violate the Sietch Dunes Peace Treaty or the Arrakis Constitution.

Royal Harkonnen's tax payment to IFIL is compulsory because it made a reasonable interpretation of the foreign law and exhausted all effective and practical remedies in an attempt to lower its tax liability. The standard only requires an exhaustion of all *effective and practical* remedies, and Royal Harkonnen satisfied this requirement when it petitioned the highest court in Arrakis for a determination on IFIL's taxing authority. The IRS improperly denied Royal Harkonnen's claimed foreign tax credits for the payment it made to IFIL because the payment was a "tax." Accordingly, the decision of the Fourteenth Circuit should be reversed.

ARGUMENT

I. Royal Harkonnen is Entitled to a Foreign Tax Credit for Taxes Paid to the Republic of Arrakis

This court should reverse the Fourteenth Circuit's decision and hold that a foreign tax credit should have been granted to Royal Harkonnen for taxes paid to Arrakis because the Republic of Arrakis Foreign Tax (RAFT) is a creditable tax under Section 901 and in the alternative a creditable tax under Section 903. A foreign tax credit allows a United States (U.S.) corporation to reduce its income tax liability dollar for dollar. 26 U.S.C. § 901 (2010). The lower a corporation's income tax liability, the smaller the tax rate applied. 26 U.S.C. § 11 (1993). Royal

Harkonnen properly sought a foreign tax credit for taxes paid to Arrakis in order to lower the tax rate applied to their income tax liability. A corporation is allowed to reduce its U.S. income tax liability for proper taxes paid in a foreign country. *Chamberlin v. Comm'r*, 207 F.2d 462, 468 (6th Cir. 1953) ("The general principle is well settled that a taxpayer has the legal right to decrease the amount of what otherwise would be his taxes.").

A. The Republic of Arrakis Foreign Tax is a creditable tax under 26 U.S.C. § 901 because it meets the "predominant character" test

The RAFT is a creditable tax under Section 901 because it meets the predominant character test. Section 901 of the Internal Revenue Code (the "Code") allows a U.S. corporation to claim a credit against its U.S. income-tax liability for income taxes paid to a foreign country. 26 U.S.C. § 901(a), (b)(1). A foreign tax must be "creditable" in order for the U.S. corporation to take advantage of foreign tax credits. Treas. Reg. § 1.901-2 (2012). In order to determine whether or not the tax is creditable, the Treasury Regulations (the "Regulations") apply the "predominant character test." Treas. Reg. § 1.901-2(a)(1)(ii). The predominant character test assess whether or not the substances of the tax is that of a tax in the "U.S. sense." Treas. Reg. § 1.901-2(a). The "U.S. sense" means that the foreign tax in substance is applied in the same fashion as a U.S. income tax. *Biddle v. Comm'r.*, 302 U.S. 573, 579 (1938) (discussing the identical common law requirement that the foreign tax will be found creditable where it is analogous to a U.S. tax). Therefore, if the predominant character of the taxes paid by Royal Harkonnen to Arrakis are similar in substance to those they would have paid in the U.S., it is a creditable tax.

Under the predominant character test, in order to determine whether a foreign tax is a tax in the U.S. sense it must reach net gain. Treas. Reg. § 1.901-2 (a)(3)(i). A foreign tax is likely to reach net gain if the substance of the tax satisfies the following three tests: (1) realization, (2) gross-receipts, (3) and net-income.[1] Treas. Reg. § 1.901-2(b)(1); *see generally Inland Steel Co. v. United States*, 230 Ct. Cl. 314, 677 F.2d 72 (1982), *Bank of America Nat'l Trust & Sav. Ass'n v. United States*, 459 F.2d 513 (1972), *Bank of America Nat'l Trust & Sav. Ass'n v. Comm'r*, 61 T.C. 752 (1974) (establishing the common law "net gain" requirement). Satisfaction of these three steps are important because it allows the Internal Revenue Service (IRS) to properly assess whether the foreign tax is similar in substance to a U.S. tax. *Eisner v. Macomber*, 252 U.S. 189, 207-08 (1920). The U.S. and the foreign tax must to be similar because the IRS will not be able to assess an accurate credit for a foreign tax paid that is not determined on the same basis as an U.S. tax.

When assessing whether a tax adheres to the Code, the IRS will look to the substance of the foreign tax and not its form. Looking to the substance of a tax means evaluating whether the tax sufficiently satisfies the Code in spirit, whereas

[1] The Regulations impose a fourth requirement, unrelated to the predominant character test, that the foreign income tax must not be a "soak-up" tax in order to be creditable. Treas. Reg. § 1.901-2(c). A soak-up tax is a tax that is imposed by the foreign country solely for the purposes of receiving an available foreign tax credit in another country. *Id.* The RAFT is imposed on every foreign entity operating machinery in Arrakis regardless of the availability of any other foreign tax credit and therefore meets the soak-up requirement for a creditable tax. *Id.*

looking to the form of a tax means strict adherence to the exact language of the Code. The principal that the substance of a tax trumps the form of the tax is a general fixture of U.S. tax law and in foreign tax credit cases in particular. *Estate of Weinert v. Comm'r*, 294 F.2d 750, 755 (5th Cir. 1961) ("[t]he principle of looking through form [of the tax] to substance . . . is the cornerstone of sound taxation."). This principle is exactly mirrored in the Regulations' "predominant character test" which directs the IRS to look to the substance of a foreign tax to determine its creditability. Treas. Reg. § 1.901-2(a), (b); *Biddle*, 302 U.S. at 578-79 (rejecting the notion that the creditability of a foreign tax should depend upon the characterization of the tax by the foreign entity and instead on the manner in which the tax is applied).

It is necessary to look to the substance of a foreign tax because if the Code required strict adherence, it would be unlikely that the IRS would find a foreign tax which exactly mirrors a U.S. income tax and as such rarely would a foreign tax meet the predominant character test. *Comm'r v. Court Holding Co.*, 324 U.S. 331, 334 (1945) ("[t]o permit the true nature of a transaction to be disguised by mere formalisms . . . would seriously impair the effective administration of tax polic[y].") It is important that a proper foreign tax paid meet the predominant character test in order to not undermine the important policy purposes for the foreign tax credit. *Burnet v. Chi. Portrait Co.*, 285 U.S. 1, 9 (1932) (explaining that one of the foreign tax credit's central aims is to reduce the double taxation burden for U.S. taxpayers paying taxes in foreign countries). Therefore, the predominant character of a tax may be an income tax in the U.S. sense despite the label or form of the tax. *Inland Steel Co.*, 677 F.2d at 80.

Applying the substance-based standard that is compelled by the Code, the Regulations, and case law, there should be no dispute that the RAFT is creditable under Section 901. By operating as a 33% tax on the excess profits of Royal Harkonnen, the substance of the RAFT, in the normal circumstances in which it applies, is a tax in the U.S. sense since the predominant character of the tax is one that sufficiently reaches net gain. R. at ¶ 35.

1. The Republic of Arrakis Foreign Tax meets the realization test as the tax is levied on realized income of Royal Harkonnen

Under the Regulations, the realization test is satisfied if the foreign tax is imposed on income that is actually received by the taxpayer or upon the occurrence of a sale of property or other disposition. Treas. Reg. § 1.901-2(b)(2)(i)(A). Here, the profit being taxed by the RAFT is realized income because it is based on actual profits generated from Royal Harkonnen's production of the Caladan Oil Field and is distinct from any non-income amounts. 26 U.S.C. § 61(a) (1984); R. ¶ 37; *Texasgulf, Inc. v. United States*, 84 AFTR 2d 99-6642 (Ct. Cl., Oct. 15, 1999) (holding that a tax that was calculated on the basis of the sale of minerals met the realization requirement). Additionally, Royal Harkonnen is a calendar year tax accounting corporation (R. at ¶ 39, n. 14) whose tax liability is computed on its profits earned over a twelve-month period. 26 U.S.C. § 441(a) (2007). Therefore, the RAFT was not imposed prematurely or before the benefit of the profits were actually received ("realized") by Royal Harkonnen as the tax was levied at the close of the twelve-month period, not before. 26 U.S.C. § 1001(c) (1993); R. at ¶ 37. As such, the RAFT meets the realization requirement for a creditable tax. Treas. Reg. § 1.901-2(b)(2).

2. The Republic of Arrakis Foreign Tax meets the gross-receipts test as the tax liability is calculated with gross-receipts of Royal Harkonnen

The Regulations' gross-receipts test is satisfied if the foreign tax is imposed on Royal Harkonnen's gross receipts -- total profits earned from the corporation's operations in the foreign country. Treas. Reg. § 1.901-2(b)(3)(i)(A)-(B). Here, the RAFT satisfies the gross-receipts test because it is applied to Royal Harkonnen's gross receipts (profits) from the production of oil and is not applied to income from other sources. R. at ¶ 5. ("The tax is determined by calculating gross receipts . . ."); *Texasgulf,* 84 AFTR 2d 99-6642 (holding that a tax calculation based on the total value of recovered product was based on gross receipts); 26 U.S.C.§ 61(a)(2) (1984). Because the RAFT was levied only on profits derived by Royal Harkonnen from its oil production in Arrakis, the RAFT satisfies the gross-receipts test. Treas. Reg. § 1.901-2(b)(3)(i)(A)-(B).

3. The Republic of Arrakis Foreign Tax meets the net income test as it allows for the deduction of significant expenses from profits of Royal Harkonnen

The net income test of the Regulations requires that a foreign tax must be imposed only on net income. Treas. Reg. § 1.901-2(b)(4)(i)(A). Net income is profits minus significant costs or expenses. *Id.* The RAFT meets the net income requirement, because the RAFT is applied to the profits of Royal Harkonnen minus significant expenses in the normal circumstances in which it is levied. *Bank of America Nat'l Trust & Sav. Ass'n*, 459 F.2d at 519-20.

The Code allows a corporation to deduct, or subtract, from its profits expenses generated in the operation of its business. 26 U.S.C. § 162 (2011). The purpose of a deduction is to allow a corporation to recover significant expenses spent generating income thereby reducing the corporation's overall taxable income. *Id.* In order for a foreign income tax to be a tax in the U.S. sense, it must also allow a taxpayer to reduce its profits by its expenses. The foreign tax does not have to allow the foreign corporation to subtract all of its expenses, only the corporation's significant expenses. *Texasgulf, Inc. v. Comm'r*, 172 F.3d 209, 211-13 (2d Cir. 1999). The RAFT allows foreign corporations to subtract 95% of significant costs or expenses from their profits and is therefore imposed on net income. R. at ¶ 36.

In *Bank Of America National Trust & Savings Association v. United States*, the court was concerned with whether the percentage of deductible expenses under the foreign tax law sufficiently allowed for the deduction of significant expenses. 459 F.2d at 523-24. The court found that if the deductions allow for the removal of significant expenses and the remaining non-deductible expenses were insignificant, the tax was still found to reach net income. *Id.* This view set the standard for analyzing whether the foreign tax sufficiently meets net income and was further supported by *Inland Steel Co. v. United States*, where the Claims Court concluded that only large-scale omission of significant costs would make it unlikely that a tax would reach net gain. 677 F.2d 72 at 72-87.

Following these decisions, the IRS came out in support of the standard in *Bank of America* and *Inland Steel* of examining the structure of the tax and the significance of disallowed deductions, and further clarified that a deduction must only be allowed for significant expenses and that reasonable limitations to the recovery of certain expenses would be acceptable. News Release, IR 1638, July 14, 1976, 6 Fed. Taxes (P-H) ¶ 55,387; Rev. Rul. 78-61, 1978-1 C.B. 221 (ruling that a tax will be almost certain to reach net income if significant expenses are deductible); *Bank of America Nat'l Trust & Sav. Ass'n*, 61 T.C. at 760 (stating that, under the statute, a tax need not permit recovery of all significant costs and expenses and need only reach "*some net gain*" to be creditable (emphasis added)); *Inland Steel*, 677 F.2d at 84; Treas. Reg. § 1.901-2(b)(4)(i) (holding that a tax satisfies the net income prong when it "is almost certain to reach some net gain"). The Regulations further mirror this view and hold that a tax that allows a deduction for significant expenses, in substance, is a tax that is likely to reach net income. Treas. Reg. § 1.901-2(b)(4)(i)(A) (requiring the recovery of only "*significant* costs and expenses attributable" (emphasis added)). Therefore, a foreign tax does not have to allow for the recovery of every or all significant costs and expenses. *Id.*

Because the RAFT allows a foreign corporation to subtract 95% of its business and operating expenses, the RAFT successfully reaches net income. R. ¶ at 36. In Revenue Ruling 72-346, the IRS considered a tax that only allowed for a 75% deduction from profits and found that the tax was creditable and that a percentage limitation on the deduction of expenses did not preclude a foreign tax from properly reaching net income. Rev. Rul. 72-346, 1972-2 C.B. 436. As such, applying the standard from the case law and the Regulations, the RAFT in substance allows for the recovery of significant costs and expenses through its 95% deduction and therefore is a tax whose substance sufficiently reaches net income.

Further, the record is silent as to what specific expenses the 95% deduction covers and it can therefore be reasonably concluded that the 5% disallowed deductions are for insignificant expenses such as capital expenditures or the 15% royalty payments to Arrakis made under the lease and not significant expenses such as interest, operating expenses or losses. R. at ¶ 13; former Temp. Regs. § 4.901-2(e), Ex. 24 (explaining that a disallowance of a deduction for royalties would not hold a tax not creditable); Rev. Rul. 78-222, 1978-1 C.B. 232 (stating that reasonable limitations on the recovery of capital expenditures are acceptable); *Texasgulf*, 172 F.3d at 214 (describing operating expenses and losses as significant expenses); *Exxon Corp. v. Comm'r*, 113 T.C. 338, 338 (1999) (describing interest as a significant expense). Therefore, the RAFT is a tax that is levied on the net income of a foreign taxpayer in the normal circumstances to in which it applies.

Because the RAFT tax meets the realization, gross-receipts, net income, and soak-up tax requirements, the RAFT reaches net gain in the normal circumstances in which it applies and therefore it's predominant character is a tax in the U.S. sense. As such, the RAFT is a creditable tax under Section 901.

B. Even if the Republic of Arrakis Foreign Tax is not a creditable tax under 26 U.S.C. § 901, it is a creditable "in-lieu of" tax under 26 U.S.C. § 903

A tax that does not qualify as a creditable tax under Section 901 because it is not a sufficient tax on net income will still be found creditable if the tax is determined to be imposed "in lieu of" an income tax that is otherwise generally imposed. 26 U.S.C. § 903 (2004). Therefore, even if the RAFT does not reach net income it may still be a creditable tax under Section 903. In order for a tax to be creditable under Section 903 it must be a tax within the meaning of Regulation Section 1.901-1(a)(2), and meet the substitution requirements.[2] Treas. Reg. § 1.903-1 (1983). Because the RAFT is a tax under the Regulations, the Arrakis Tax is a generally imposed income tax, and the RAFT operates as a tax in-lieu of the generally imposed Arrakis Tax, the RAFT tax is creditable under Section 903.

1. The Republic of Arrakis Foreign Tax is a tax within the meaning of the Regulations

Under Section 1.901-1(a)(2) of the Regulations, a foreign levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy a tax. Treas. Reg. § 1.901-1(a)(2)(i). The RAFT is imposed pursuant to Arrakis' authority to levy taxes in its role as a revenue raiser and not for the purpose of regulation or any other reason. R. at ¶ 5, n. 8; *Phillips Petroleum Co. v. Comm'r*, 104 T.C. 256, 295 (1995). Further, the RAFT is a compulsory payment of 33% on all profits generated by foreign corporations that operating machinery in Arrakis.

[2] Additionally, the in lieu of tax must not be a soak-up tax. Under 1.903-1(b)(2), the RAFT is not a soak-up tax whose existence is solely for the benefit of a foreign tax credit as discussed above in Part I.A.

R. at ¶ 5. Finally, the funds received from payment of the RAFT are transferred to the Arrakis Central Bank before distribution to the Arrakis Treasury and are not used as compensation to Arrakis for a specific good, privilege or service provided or payment to receive a particular economic benefit from the Arrakis government. R. at ¶ 6; *Exxon*, 113 T.C. at 338; Rev. Rul. 71-49, 1971-1 C.B. 103 (providing that payments of this kind would not be seen to be a tax). Therefore, the RAFT is a tax within the meaning of Section 1.901-1(a)(2) as it is a compulsory payment made for the purpose of raising revenue within the Arrakis.

2. Arrakis has a generally imposed income tax and the Republic of Arrakis Foreign Tax operates as a tax imposed in substitution for and not in addition to the generally imposed income tax

The substitution requirements of the Regulations provide that the foreign country must have a generally imposed income tax and the foreign tax must be applied "in lieu" of such generally imposed tax. Treas. Reg. § 1.903-1. First, under the Arrakis Tax Code there exists a generally imposed income tax on all Arrakis residents (Arrakis Tax). R. at ¶ 4. The Arrakis Tax does not apply to nonresidents of Arrakis as the nonresident is not from the bloodlines of the Arrakis or Sietch Thrones. R. at ¶ 4. However, the Arrakis Tax is still meets the standard of being generally applied, despite the fact that it is not imposed on nonresidents because it applies generally to the net income of all Arrakis citizens. Treas. Reg. § 1.903-1(a). A tax would be considered not generally applied if it were exclusive to a certain industry or type of income. *Id.* Therefore, the RAFT tax meets the first prong of the substitution requirements as the Arrakis Tax is generally applied.

Second, the RAFT must be applied in-lieu of the Arrakis Tax, as a substitution for the generally imposed income tax and not in addition to the generally imposed tax. Treas. Reg. § 1.903-1(b)(1). The RAFT operates as a tax imposed in substitution for, and not in addition to the generally imposed Arrakis Tax because the profits of foreign corporations are exempt from the Arrakis Tax as the foreign corporation is a nonresident of Arrakis. R. at ¶ 4. Therefore, the profits of a foreign corporation operating machinery in Arrakis cannot be subject to both the Arrakis Tax and the RAFT. Example 1 in the Regulations states that where a country has a tax on net income generally imposed except for nonresidents and where the nonresidents are subject to a separate distinct tax, the tax on the nonresident satisfies the substitution requirement and is an in-lieu of tax under Section 903. Treas. Reg. § 1.903-1(b), Ex. 1.

Therefore, the RAFT is a creditable tax under Section 903 because it is a valid tax under the Regulations, there exists a generally imposed tax in Arrakis, and the RAFT is in substitution of, not in addition to, the general Arrakis Tax.

II. The IRS Improperly Denied Royal Harkonnen's Claimed Foreign Tax Credit For a Tax Paid to IFIL When it Held That The Payment Did Not Qualify as a "Tax"

To be granted a foreign tax credit under Section 901[3], a payment made to a foreign country must first be found as a "tax." Treas. Reg. § 1.901-2(a)(1)(i) (2013). Here, the IRS denied foreign tax credits to Royal Harkonnen for its

[3] Section 901 allows a credit for the amount of . . . "income tax" paid to any foreign country. 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. Treas. Reg. § 1.901-2(a)(1) (2013).

payment to IFIL because it refused to acknowledge that the payment qualified as a tax.[4] R. at ¶ 43.

In order to be a tax, a levy must (1) be from a foreign country with the authority to levy taxes, and (2) be a compulsory payment. Treas. Reg. § 1.901-2(a)(2)(i). Here, the IRS found that IFIL was not a foreign country with the authority to levy taxes because it was not a valid taxing entity. R. at ¶ 43. Further, the IRS found that the payment to IFIL was not compulsory because Royal Harkonnen failed to exhaust all of its available remedies to reduce its tax burden. R. at ¶ 43. The IRS erred when making this determination because IFIL is a foreign country with the authority to levy taxes, and the payment was compulsory. Therefore, the IRS improperly denied Royal Harkonnen's claimed foreign tax credits for taxes paid to IFIL, and the Fourteenth Circuit's decision should be reversed.

A. IFIL is a country with the authority to levy a tax

The threshold issue in determining the creditability of foreign tax credits is whether the foreign country had the authority to levy the tax. Treas. Reg. § 1.901-2(a)(2)(i); *Burnet v. Chi. Portrait Co.,* 285 U.S. 1, 10 (1932). Under Section 901, "foreign country" means any foreign state. Treas. Reg. § 1.901-2(g)(2). For tax credit purposes, the international status of the foreign government doesn't matter to the Court as long as the entity had the authority to tax because the burden on the

[4] The IRS never assessed the predominant character of the tax because it held that the payment did not meet the threshold requirement of being a "tax." Since the IRS failed to assess the creditability of foreign tax credits for taxes paid to IFIL, the issue of creditability is not ripe for review.

corporation is the same regardless of the entity's status. *Burnet*, 285 U.S. at 10, 12. In determining whether a foreign state has the requisite authority to levy the tax, the Court makes two considerations: (1) whether the taxing entity is a foreign country, and (2) whether the country had taxing authority. *Id.* at 20.

Here, IFIL is a sovereign state and thus a "foreign country," and it has the authority to tax Royal Harkonnen because sovereign states possess a presumed right to tax. The IRS erred when it held that IFIL was not a proper taxing authority and when it refused to acknowledge Royal Harkonnen's tax payments to IFIL as taxes.

1. IFIL is a sovereign state and therefore a "foreign country"

IFIL is a "foreign country" under Section 901 because it is a sovereign foreign state. In determining if an entity is a sovereign state, courts require that the entity (1) have a defined territory, (2) have a permanent population, (3) be under the control of its own government, and (4) engage in or have the capacity to engage in formal relations with other entities. *Klinghoffer v. S.N.C. Achille Lauro Ed Altri-Gestione Motonave Achille Lauro in Amministrazione Straordinaria*, 937 F.2d 44, 47 (2d Cir. 1991); *Knox v. Palestine Liberation Org.*, 306 F. Supp. 2d 424, 434 (S.D.N.Y. 2004); Restatement (Third) of Foreign Relations Law § 201 (1987).

Here, IFIL's defined territory and people are concentrated within a portion of the Sietch Dunes known as the "Badlands." R. at ¶ 29. An entity may satisfy the territorial requirement even if its boundaries are not entirely settled. Restatement (Third) of Foreign Relations Law § 201 cmt. b (1987). Also, IFIL has a permanent population. IFIL believed its leader Jessica Mohiam was the rightful heir of the historic Sietch Throne (R. at ¶ 24), so it can reasonably be inferred that IFIL includes individuals within the Sietch bloodline. A person need only pledge its membership to IFIL in order to vote as part of its population. R. at ¶ 27. Further, IFIL is under the control of its own government. To satisfy the governmental requirement, a state only needs to have some authority exercising governmental functions that can represent the entity in international relations. Restatement (Third) of Foreign Relations Law § 201, cmt. d (1987). Here, IFIL has its own government which is lead by its elected leader Jessica Mohiam, who has received unanimous electorate votes in every election since the inception of IFIL. R. at ¶ 24, 27. Lastly, IFIL has engaged in formal relations with other entities. For example, Mohiam directly represented IFIL in the First Annual Caladan Oil Field Conference alongside the leaders of the Republic of Arrakis, the Sietch State, and Royal Harkonnen. R. at ¶ 35. The validity of the authority of Mohiam or IFIL to engage in relations with the other entities was never questioned.

Furthermore, whether an entity satisfies the requirements to be a sovereign state is also determined by other states when they decide whether to treat that entity as a sovereign state. Restatement (Third) of Foreign Relations Law § 201, cmt. h (1987). Here, the neighboring countries Al Dhanab and Anbus, along with France and Russia, all chose to recognize the independence and legitimacy of IFIL as a sovereign state within the Sietch Dunes region. R. at ¶ 28. The President of the United States similarly treated IFIL as a sovereign state when he issued

Executive Order 14012, which directly recognized IFIL as a “sovereign friend of the United States, whom [the United States] would like to establish trade relations with.” R. at ¶ 34. The Executive Order did not refer to relations with IFIL through the connection of any other government, but treated it as an entirely separate entity. Also, the Holy Royal Court of Arrakis stated that it “recognizes IFIL as a part of Sietch.” R. at ¶ 32. The statement shows that IFIL is recognized separately from the Sietch State but within or as a part of the Sietch Dunes.

2. IFIL has the authority to levy the tax as a presumed right of a sovereign state

IFIL has the authority to levy its tax since the power to tax is a presumed right of a sovereign state. The authority to tax is generally acknowledged as a sovereign power. *Tex. Learning Tech. Grp. v. Comm'r*, 958 F.2d 122, 124 (5th Cir. 1992). The connection between sovereign states and their power to tax is presumed to the extent that it has generally not required explanation. Diane Ring, *What's at Stake in the Sovereignty Debate?: Int'l Tax and the Nation-State*, 49:1 Va. J. Int'l L. 155, 198 (2008).

In our case, IFIL as a sovereign state had the presumed power to levy a tax. At the Annual Caladan Oil Field Conference, IFIL, the Republic of Arrakis, and the Sietch State discussed their respective income taxes upon Royal Harkonnen (R. at ¶ 35), and the competency of IFIL to levy the tax was never in question.

In addition, a tax levied pursuant to proper taxing authority must be imposed by the foreign government in its role as a revenue raiser and not in its role as a regulator. *Phillips Petrol. Co. v. Comm'r*, 104 T.C. 256, 295 (1995). In this case, IFIL neither imposed the tax to regulate how much oil Royal Harkonnen could produce from Unit #12, nor did it impose the tax to regulate any particular action of Royal Harkonnen. The IFIL tax on Royal Harkonnen's income at Unit #12 is functionally similar to the taxes demanded by Arrakis and the Sietch State because they are all taxes imposed to raise revenue for their respective entities.

Because IFIL is a foreign country with the authority to tax, the levy imposed by IFIL satisfied the first prong of a "tax," and the IRS erred when it held that IFIL was not a valid taxing entity.

3. The tax imposed by IFIL is not an impermissible tax

The tax paid to IFIL is not an impermissible tax because it does not violate the Arrakis Constitution or the Sietch Dunes Peace Treaty as the IRS and Fourteenth Circuit stated. R. at ¶ 39, 43. A treaty is not binding on third parties who are not parties to the treaty. *Vienna Convention on the Law of Treaties* art. 34, May 23, 1969, 1115 U.N.T.S. 331; Malgosia Fitzmaurice, *Third Parties and the Law of Treaties*, 6 Max Planck Y.B. United Nations Law 37, 38 (2002). This principle is recognized as fundamental to the international community, and its existence has never been questioned. Fitzmaurice, *supra,* at 38.

The IRS erred when it found that the payment of the tax imposed by IFIL violated the Peace Treaty because IFIL was never a party to the Peace Treaty. R. at ¶ 39. International law prohibits the imposition of the Peace Treaty upon IFIL. Fitzmaurice, *supra,* at 38. Only Arrakis, the Sietch State, Royal Harkonnen, and a U.S. Ambassador to Arrakis were present at the Arrakeen Peace Summit, and signatories to the Peace Treaty. R. at ¶ 16. Further, the Peace Treaty does not mention the word "tax" or suggest any form of taxing limitation upon any of the parties to it. The IRS was incorrect when it claimed that IFIL violated the Peace Treaty's limitation of a single tax within the Sietch State (R. at ¶ 43), because the Peace Treaty has no association with IFIL's ability to tax.

Additionally, the IFIL tax does not violate the Arrakis Constitution because it is a completely separate tax by a separate taxing authority from the Sietch State. The Regulations state, "a levy imposed by one taxing authority is always separate . . . from a levy imposed by another taxing authority." Treas. Reg. § 1.901-2(d)(1). The single tax limitation imposed upon the Sietch State by the Arrakis Constitution does not affect the ability of IFIL to tax Royal Harkonnen pursuant to its individual taxing authority. IFIL had proper taxing authority to levy the tax on Unit #12, regardless of any tax limitation placed upon the Sietch State because IFIL is a sovereign entity and considered a separate foreign country for tax credit purposes. Therefore, the IFIL tax should have been treated separately from the Sietch State tax.

Because IFIL was not subject to the Sietch Dunes Peace Treaty and its taxing power was not restricted under the Arrakis Constitution, its tax is not an impermissible second tax and this Court should reverse the Fourteenth Circuit's decision.

B. The tax payment to IFIL is compulsory

Royal Harkonnen's payment to IFIL is compulsory and thus meets the second and final requirement of a "tax." In addition to being a levy imposed by a foreign country with the authority to tax, a levy must also be a compulsory payment. Treas. Reg. § 1.901-2(a)(2)(i). A payment is compulsory if it is: (1) made under a reasonable interpretation of the foreign law, and (2) if the taxpayer exhausts all effective and practical remedies in an effort to reduce its foreign tax liability. *Id.* § 1.901-2(e)(5)(i). The reasonableness of Royal Harkonnen's interpretation of foreign law is not at issue in this case. However, the IRS did hold that Royal Harkonnen failed to "exhaust all of its remedies." R. at ¶ 39. It is unclear if the IRS actually assessed whether Royal Harkonnen's remedy was effective and practical because the IRS classified the payment as an unqualified tax under the erroneous notion that Royal Harkonnen had to exhaust every available remedy. R. at ¶ 39. The tax payment to IFIL is compulsory because Royal Harkonnen exhausted "all effective and practical remedies" trying to lower its tax burden as required by the Regulations. Therefore, the IRS erred when it required Royal Harkonnen to exhaust every available remedy and when it determined that the payment to IFIL was not compulsory and did not qualify as a "tax."

1. Royal Harkonnen's petition to The Holy Royal Court of Arrakis is an exhaustion of its effective and practical remedies

Royal Harkonnen's petition to the Holy Royal Court is an exhaustion of its effective and practical remedies. A remedy is effective and practical only if the cost thereof is reasonable in light of the amount at issue and the likelihood of success. Treas. Reg. § 1.901-2(e)(5)(i). In terms of defining what remedies are effective and practical, there has been little case law on how far a taxpayer must go to reduce its foreign tax liability. Carolyn M. DuPuy & D. Kevin Dolan, *The Creditability of Foreign Taxes: General Issues*, 901-2d Tax Mgmt. Port. (BNA) F-3 (2014). The question of what remedies must be pursued is a matter of judgment, but generally, the taxpayer should do what it can in order to reduce its foreign tax liability. *Id.* Exhaustion of every avenue of litigation is not necessary for a remedy to be effective and practical. *Int'l Bus. Machines Corp. v. United States*, 38 Fed. Cl. 661, 675 (1997). In our case, Royal Harkonnen exhausted its effective and practical remedies when it sought advice from the Holy Royal Court, which is the highest court in Arrakis. R. at ¶ 4, n.6, 32.

An initial good faith effort to challenge a tax without further pursuit of pointless alternative remedies constitutes an exhaustion of effective and practical remedies. *Schering Corp. v. Comm'r*, 69 T.C. 579, 602 (1978). In *Schering*, the United States Tax Court determined that a corporation exhausted all of its effective and practical remedies when it asked foreign tax authorities about its tax liability and was told that it had to pay the tax. *Id.* The court arrived at this conclusion even though the corporation did not seek judicial review or competent authority relief under the applicable foreign treaty. *Id.* at 602-603. The taxpayer was not required to seek the other remedies since the effort would have been futile. *Id.* at 602.

In this case, Royal Harkonnen made a good faith effort to challenge the tax demanded by IFIL when it petitioned the Holy Royal Court for a determination on IFIL's ability to levy a tax. R. at ¶ 32. Not only is the Holy Royal Court the highest court in Arrakis, but it is also the court that handles all tax disputes in Arrakis. R. at ¶ 31. Further, the IRS claimed that Royal Harkonnen should have petitioned the Sietch Council for a determination on IFIL's status. R. at ¶ 43. However, the Sietch Council handles only judicial functions of the Sietch State, and is subject to the overall control of Arrakis. R. at ¶ 17. Royal Harkonnen should neither be penalized for obtaining judicial advice from the highest authority court nor should it have to waste its time and assets seeking resolution from an entity that does not handle the relevant tax issues. Like the court in *Schering* did not require the corporation to pointlessly try to reduce its tax burden from multiple sources, this Court should not require Royal Harkonnen to exhaust futile remedies suggested by the IRS either.

In contrast, a corporation does not exhaust all effective and practical remedies when it completely fails to challenge a second tax on income that has already been subject to a separate foreign tax. *Procter & Gamble Co. v. United States*, No. 1:08-CV-00608, 2010 WL 2925099, at *7 (S.D. Ohio July 6, 2010) (holding that the failure to challenge both taxes under their respective authorities is a failure to exhaust all effective and practical remedies.) Here, Royal Harkonnen did not need to challenge its taxes with separate foreign authorities as the corporation in *Procter & Gamble* was required to do because the Holy Royal Court, as the highest court in Arrakis, had the authority to provide a single controlling answer on any and all of Royal Harkonnen's taxes. R. at ¶ 4, n.6. By petitioning for advice from the Holy Royal Court, Royal Harkonnen exhausted the most effective and practical remedy available to it in its attempt to reduce its tax burden to IFIL. The Treasury Regulations do not require more than that.

2. Royal Harkonnen is not required to exhaust every available remedy

The Regulations state that in order for a tax to be compulsory the taxpayer must exhaust all *effective and practical* remedies to reduce the taxpayer's liability for foreign taxes. Treas. Reg. § 1.901-2(e)(5)(i) (emphasis added). The IRS erred when it required Royal Harkonnen to exhaust "all of its remedies," which in essence, required it to exhaust every possible available remedy.

Here, Royal Harkonnen was not required to petition the Sietch Council for further determination of the IFIL tax, as suggested by the IRS (R. at ¶ 43), because requiring Royal Harkonnen to seek additional remedy after it already petitioned the Holy Royal Court for the same determination would require the exhaustion of every available avenue of judicial review. The United States Court of Federal Claims in 1997 discredited this very requirement when it expressed that if the IRS believes a taxpayer must exhaust all of its litigation remedies in order to obtain a foreign tax credit, then the IRS should have sought an amendment to the final Regulations. *Int'l Bus. Machines Corp.*, 38 Fed. Cl. at 675. The drafters of the Regulations could have specified that a taxpayer must exhaust *all available* *remedies* if that was the intent of the provision, but chose not to limit the focus of the statute in that way.

The IRS's proposed requirement of exhausting every available remedy will result in impractical and unintended requirements upon domestic corporations operating abroad. As stated by Judge Layton in his dissent from the Fourteenth Circuit, "requiring a taxpayer to seek relief from every possible competent court is not practical, cost efficient, or warranted." *Royal Harkonnen Oil Co. v. United States*, No. 15-1701 2, 21 (14th Cir. 2014).

Royal Harkonnen's payment to IFIL was a compulsory payment because Royal Harkonnen sought all effective and practical remedies attempting to reduce its tax liability to IFIL. The IRS erred when it required Royal Harkonnen to exhaust every available remedy and therefore erred when it refused to acknowledge the payment to IFIL as a compulsory payment.

CONCLUSION

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

Respectfully submitted,

Team 80
Attorneys for the Petitioner

APPENDIX

26 U.S.C § 901

(a) 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.

26 U.S.C. § 903

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.

Treas. Reg. § 1.901-2

(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.

* * * *

(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—

(A) Upon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the Internal Revenue Code;

(B) Upon the occurrence of an event prior to a realization event (a "prerealization event") provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer; or

(C) Upon the occurrence of a prerealization event, other than one described in paragraph (b)(2)(i)(B) of this section, but only if the foreign country does not, upon the occurrence of a later event (other than a distribution or a deemed distribution of the income), impose tax ("second tax") with respect to the income on which tax is imposed by reason of such prerealization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such a second tax for tax paid on the occurrence of the prerealization event) and—

(*1*) The imposition of the tax upon such prerealization event is based on the difference in the values of property at the beginning and end of a period; or

(*2*) The prerealization event is the physical transfer, processing, or export of readily marketable property (as defined in paragraph (b)(2)(iii) of this section).

A foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even if it is also imposed in some situations upon the occurrence of events not described in this paragraph (b)(2)(i). For example, a foreign tax that, judged on the basis of its predominant character, is imposed upon the occurrence of events described in this paragraph (b)(2)(i) satisfies the realization requirement even though the base of that tax also includes imputed rental income from a personal residence used by the owner and receipt of stock dividends of a type described in section 305(a) of the Internal Revenue Code. As provided in paragraph (a)(1) of this section, a tax either is or is not an income tax, in its entirety, for all persons subject to the tax; therefore, a foreign tax described in the immediately preceding sentence satisfies the realization requirement even though some persons subject to the tax will on some occasions not be subject to the tax except with respect to such imputed rental income and such stock dividends. However, a foreign tax based only or predominantly on such imputed rental income or only or predominantly on receipt of such stock dividends does not satisfy the realization requirement.

* * * *

(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). Levies are not separate merely because different rates apply to different taxpayers. For example, a foreign levy identical to the tax imposed on U.S. citizens and resident alien individuals by section 1 of the Internal Revenue Code is a single levy notwithstanding the levy has graduated rates and applies different rate schedules to unmarried individuals, married individuals who file separate returns and married individuals who file joint returns. In general, levies are not separate merely because some provisions determining the base of the levy apply, by their terms or in practice, to some, but not all, persons subject to the levy. For example, a foreign levy identical to the tax imposed by section 11 of the Internal Revenue Code is a single levy even though some provisions apply by their terms to some but not all corporations subject to the section 11 tax (*e.g.,*section 465 is by its terms applicable to corporations described in sections 465(a)(1)(B) and 465(a)(1)(C), but not to other corporations), and even though some provisions apply in practice to some but not all corporations subject to the section 11 tax (*e.g.,*section 611 does not, in practice, apply to any corporation that does not have a qualifying interest in the type of property described in section 611(a)). However, where the base of a levy is different in kind, and not merely in degree, for different classes of persons subject to the levy, the levy is considered for purposes of sections 901 and 903 to impose separate levies for such classes of persons. For example, regardless of whether they are contained in a single or separate foreign statutes, a foreign levy identical to the tax imposed by section 871(b) of the Internal Revenue Code is a separate levy from a foreign levy identical to the tax imposed by section 1 of the Internal Revenue Code as it applies to persons other than those described in section 871(b), and foreign levies identical to the taxes imposed by sections 11, 541, 881, 882, 1491 and 3111 of the Internal Revenue Code are each separate levies, because the base of each of those levies differs in kind, and not merely in degree, from the base of each of the others. Accordingly, each such levy must be analyzed separately to determine whether it is an income tax within the meaning of paragraph (a)(1) of this section and whether it is a tax in lieu of an income tax within the meaning of paragraph (a) of § 1.903-1. Where foreign law imposes a levy that is the sum of two or more separately computed amounts, and each such amount is computed by reference to a separate base, separate levies are considered, for purposes of sections 901 and 903, to be imposed. A separate base may consist, for example, of a particular type of income or of an amount unrelated to income, *e.g.,* wages paid. Amounts are not separately computed if they are computed separately merely for purposes of a preliminary computation and are then combined as a single base. In the case of levies that apply to dual capacity taxpayers, see also § 1.901-2A(a).

* * * *

(e) *Amount of income tax that is creditable—*

* * * *

(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 ifthetaxpayer 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.

* * * *

(g) *Definitions.* For purposes of this section and §§ 1.901-2A and 1.903-1, the following definitions apply:

(1) The term *paid* means "paid or accrued"; the term *payment* means "payment or accrual"; and the term *paid by* means "paid or accrued by or on behalf of."

(2) The term *foreign country* means any foreign state, any possession of the United States, and any political subdivision of any foreign state or of any possession of the United States. The term "possession of the United States" includes Puerto Rico, the Virgin Islands, Guam, the Northern Mariana Islands and American Samoa.

Treas. Reg. § 1.903-1

(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.

(3) *Examples.* The provisions of this paragraph (b) may be illustrated by the following examples:

Example 1.

Country X has a tax on realized net income that is generally imposed except that nonresidents are not subject to that tax. Nonresidents are subject to a gross income tax on income from country X that is not attributable to a trade or business carried on in country X. The gross income tax imposed on nonresidents satisfies the substitution requirement set forth in this paragraph (b). See also examples 1 and 2 of § 1.901-2(b)(4)(iv).