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## Proposed Changes in Federal Income Tax Credits for Foreign Oil and Gas Payments

by John L. Kramer\*

### I. INTRODUCTION

**S**ECTION 901(a) OF the Internal Revenue Code<sup>1</sup> permits a taxpayer to claim a tax credit for income, war profits, and excess profits taxes paid or accrued to foreign countries or United States possessions. Payments made to a foreign government in the form of a royalty, or a separate charge for a service or a benefit, can only be claimed as a deduction in determining the taxpayer's taxable income.<sup>2</sup> The foreign tax credit permits a U.S. taxpayer to pay a net U.S. tax liability on his overseas activities equal to the difference between his gross U.S. tax liability on the foreign-source income and the amount of his foreign tax payments claimed as a credit.<sup>3</sup> Thus, a U.S. taxpayer's tax liability on his foreign-source income is limited to the higher of his effective U.S. tax rate or his effective foreign tax rate for all countries in which activities are conducted. A taxpayer who must claim a foreign tax payment as a deduction receives a benefit equal only to the amount of the deduction times the taxpayer's marginal tax rate.<sup>4</sup> Thus, the cost of conducting overseas activities is increased when a taxpayer is prevented from claiming a credit for a foreign "tax" payment.

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<sup>1</sup> I.R.C. § 901(a).

<sup>2</sup> I.R.C. § 164(a)(3). See Rev. Rul. 76-215, 1976-1 C.B. 194. The term "taxpayer" includes U.S. citizens, resident aliens, nonresident aliens, partnerships, trusts, and corporations. I.R.C. §§ 901(b)-(c), 7701(a)(3)-(4). However, because this article concerns itself primarily with oil and gas companies, the discussion that is presented utilizes the foreign tax credit rules as they are applied to corporations. The term "oil companies" will be used throughout the article to refer to firms engaging in both oil and gas production and exploration activities.

<sup>3</sup> See I.R.C. § 904(a).

<sup>4</sup> See I.R.C. § 164(a)(3). A taxpayer may desire to claim the foreign taxes as a deduction when, for example, he has incurred an overall foreign loss and thus cannot currently claim any of the taxes as a credit and does not anticipate being able to claim a credit for these taxes in another year within the seven year carryback or carryover period of Code § 904(c). If the overall foreign loss produces a net operating loss, these taxes can be carried back or forward as prescribed by Code § 172.

There are three primary restrictions which serve to deny a taxpayer foreign tax credit benefits for foreign "tax" payments. First, not all "tax" payments made to a foreign government are eligible to be credited. Only income, war profits, and those excess profits taxes which are substantially equivalent to U.S. income taxes can be claimed as a credit.<sup>5</sup> Payments made to a foreign government that do not represent a tax, or that fail to meet the U.S. standard for an income tax, may only be claimed as a deduction.<sup>6</sup> Second, the section 904 foreign tax credit limitation rules restrict a taxpayer's credit for foreign taxes to the portion of his U.S. tax liability that is attributable to his foreign-source income.<sup>7</sup> Foreign tax payments in excess of this limitation may be carried back or forward for use in other taxable years only if the taxpayer's foreign tax payments in the carryback or carryover year are less than that year's foreign tax credit limitation.<sup>8</sup> Third, section 907(a) restricts the creditability of foreign income taxes paid or accrued on foreign oil and gas extraction income<sup>9</sup> to forty-six percent of the corporate taxpayer's foreign oil and gas extraction income.<sup>10</sup> A limited amount of foreign taxes in excess of this limitation can be carried back or forward.<sup>11</sup> Any foreign taxes paid or accrued on foreign oil and gas extraction income that are not currently creditable, or that cannot be carried back or over, cannot be claimed as a deduction.<sup>12</sup> Moreover, they cannot be used to offset the taxpayer's U.S. tax liability on other foreign source income.<sup>13</sup>

The availability of a credit for tax payments made to oil and gas producing and exporting countries has been the subject of considerable review since the 1973 oil embargo. As outlined in the next section of this paper, a number of changes have been made to the foreign tax credit rules since 1973. These changes restrict the ability of oil companies to use payments made to foreign governments as tax credits.<sup>14</sup> These changes have apparently resulted in the substantial deflation of the total sum of

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<sup>5</sup> *Biddle v. Commissioner*, 302 U.S. 573 (1938). See discussion in text accompanying note 68 *infra*.

<sup>6</sup> I.R.C. §§ 162(a), 164(a)(3). See Rev. Rul. 76-215, 1976-1 C.B. 194, relating to the deductibility of Indonesian oil and gas production sharing payments that were held not to qualify as a creditable tax.

<sup>7</sup> I.R.C. § 904(a). A special foreign tax credit limitation provision is contained in § 907(b) requiring a separate limitation to be computed for the taxpayer's foreign oil-related income as defined by § 907(c)(2). Foreign oil and gas extraction income is defined in I.R.C. § 907(c)(1).

<sup>8</sup> I.R.C. § 904(c). Foreign taxes paid or accrued on the foreign oil-related income in excess of this separate limitation can only be carried back or over to reduce the U.S. taxes due on such income in earlier or later taxable years and are not permitted to offset the U.S. taxes due on other foreign source income.

<sup>9</sup> Foreign oil and gas extraction income is defined in I.R.C. § 907(c)(1).

<sup>10</sup> I.R.C. §§ 907(a), 11(b).

<sup>11</sup> I.R.C. § 907(f).

<sup>12</sup> I.R.C. § 907(a), (f)(1). See CONF. REPT. 94-120, 94th Cong., 1st Sess. 69 (1975).

<sup>13</sup> I.R.C. § 907(b).

<sup>14</sup> See discussion in text accompanying notes 50-59 *infra*.

payments by American corporations to oil producing and exporting countries which are eligible to be claimed as a foreign tax credit on 1979 income tax returns.<sup>15</sup> Even the deflated sum is estimated to be as large as \$24.8 billion.<sup>16</sup>

Three recent events may further restrict the availability of the foreign tax credit to the oil companies. These events represent responses to the taxing systems in the petroleum producing and exporting countries, and to the increase in the level of the royalty and tax payments being made to these nations.<sup>17</sup> First, as a result of a four-year review of outstanding promulgations relating to the operation of the foreign tax credit, the Internal Revenue Service (IRS) recently issued a series of revenue rulings relating to the creditability of selected foreign taxes.<sup>18</sup> In these rulings, as well as in a series of private letter rulings,<sup>19</sup> the IRS applied a

<sup>15</sup> *Proposed Amendments to the Foreign Tax Credit Limitation For Oil and Gas Extraction Taxes: Hearings Before the House Comm. on Ways and Means, 96th Cong., 1st Sess. 60 (1979)* (statement of Jack F. Bennett) [hereinafter cited as *1979 Hearings*].

<sup>16</sup> *Id.*

<sup>17</sup> See STAFF OF JOINT COMM. ON TAXATION, 96TH CONG., 1ST SESS., EXPLANATION OF FOREIGN TAX CREDIT RULES APPLICABLE TO PETROLEUM INCOME 15 (Comm. Print 1979) which indicates that: "These special extraction tax limitations are designed to deal with both the problem of determining what portion of a payment to a foreign government constitutes a creditable income tax and what portion is serving the function of a royalty, and also the problem of excess extraction taxes being used against other income."

<sup>18</sup> The published rulings and the taxes involved include: Rev Ruls. 78-61, 1978-1 C.B. 221 (Ontario Mining Tax Act); 78-62, 1978-1 C.B. 226 (French tax on non-domiciliaries, Haitian tax, Cuban sugar tax, Mexican tax of the Ley del Impuesto sobre la Renta); 78-63, 1978-1 C.B. 228 (Libyan Petroleum Law No. 25 and two Saudi Arabian Royal Decrees); 78-222, 1978-1 C.B. 232 (Indonesian oil and gas production sharing contracts); 78-233, 1978-1 C.B. 236 (State of Mexico tax on interest); 78-234, 1978-1 C.B. 237 (Tanzanian withholding tax); 78-235, 1978-1 C.B. 238 (Mexico City taxes on interest income); 78-258, 1978-1 C.B. 239 (Brazilian income taxes on interest); 78-410, 1978-2 C.B. 347 (Indonesian production sharing contracts); 78-424, 1978-2 C.B. 197 (United Kingdom Petroleum Revenue tax); 79-93, 1979-1 C.B. 243 (Libyan Petroleum Law No. 25); 79-140, 1979-1 C.B. 238 (Bahrain Income Tax); 79-240, 1979-32 I.R.B. 8 (state, federal, and local Mexican taxes on interest income); 79-291, 1979-39 I.R.B. 18 (Italian social security taxes); and 80-94, 1980-14 I.R.B. 10 (German social security taxes).

<sup>19</sup> Thirty-one private letter rulings since Jan. 1, 1978 deal with the creditability of a foreign tax levy:

*Private Letter Ruling #*

- 7940695 Art. 318 of Tax Law for Dept. of the Federal District of Mexico (Mexico City)
- 7946085 Art. 257 I, 259, 266 Ley de Hacienda del Estado de Mexico
- 7946071 Art. 257 I, 259, 266 Ley de Hacienda del Estado de Mexico
- 7946032 Art. 257 I, 259, 266 Ley de Hacienda del Estado de Mexico
- 7944081 Sec. 903 equivalency— no specific tax mentioned
- 7939114 Sec. 903 equivalency— no specific tax mentioned
- 7931006 Sec. 903 equivalency— no specific tax mentioned
- 7926028 Canadian Province of British Columbia — tax on income from mining
- 7921007 Puerto Rican taxes

number of existing case law principles to deny future credits for a number of previously creditable foreign taxes. Second, the IRS recently issued proposed amendments to Treasury Regulations sections 901 and 903 relating to the requirements for a foreign tax levy to be a creditable income tax.<sup>20</sup> Part of these proposed regulations characterize as a royalty or a tax the single payments which oil companies make to foreign governments that retain the rights to the natural resources in the ground.<sup>21</sup> Finally, the current administration has proposed additional restrictions on the foreign tax credit for the oil companies.<sup>22</sup> The Administration's proposal is multi-purpose: it restricts the foreign tax credit for taxes accruing on extraction income to offsetting only the U.S. tax liability on such income, prevents "per-country" losses from generating extra foreign tax credits, requires U.S. tax benefits resulting from extraction losses in a country to be recaptured when extraction gains are realized in later years in that country, and repeals the special foreign tax credit rules relating to foreign oil-related income other than extraction income.<sup>23</sup>

This article examines the foreign tax credit concept and how the rules limiting the creditability of "tax" payments made by the oil compa-

7921004	Indonesian Corp. Tax Ordinance & Dividend Tax
7918004	Indonesian Corp. Tax Ordinance & Dividend Tax
7905118	Indonesian Corp. Tax Ordinance & Dividend Tax
7904014	Libyan Taxes (r/r 78-63) — available as FTC carryover and carryback
7851024	Polish Peoples Republic taxes
7843007	Canadian Province of British Columbia — tax on income from logging
7840061	Indonesian Corp. Tax Ordinance & Dividend Tax
7838105	Indonesian Corp. Tax Ordinance & Dividend Tax
7838064	Virgin Islands Taxes
7827063	Brazilian withholding tax on interest income — retroactive application
7837045	Brazilian withholding tax on interest income — retroactive application
7837044	Venezuelan withholding tax on discounted drafts
7835105	Indonesian Corp. Tax Ordinance & Dividend Tax
7834075	Indonesian Corp. Tax Ordinance & Dividend Tax
7827005	§ 903
7825006	Canadian Province of British Columbia — tax on income from mining
7825003	§ 903
7822001	Swiss National Defense Tax
7820053	Brazilian withholding tax on interest income
7820014	Brazilian withholding tax on interest income
7819010	Brazilian withholding tax on interest income
7817059	Brazilian withholding tax on interest income

<sup>20</sup> 44 Fed. Reg. 36,071 (1979) at 36071-77.

<sup>21</sup> Prop. Treas. Reg. §§ 1.901-2, 903-1 (June 20, 1979).

<sup>22</sup> 1979 Hearings, *supra* note 15, at 1-24 (statements of W. Michael Blumenthal and Donald C. Lubick).

<sup>23</sup> *Technical Explanation of Administration's Proposal to Change the Limitation on the Foreign Tax Credit for Oil and Gas Extraction Taxes*, June 11, 1979, reprinted in DAILY TAX REP. (BNA) at J-1 (June 12, 1979).

nies has been shaped by the tax structure of the oil and gas producing and exporting countries. Particular emphasis is placed on the recent revenue rulings dealing with the creditability of the foreign taxes of Libya, Saudi Arabia, and Bahrain and the issuance of proposed Treasury Regulations on the general creditability of foreign tax payments. Finally, the article suggests the responses to be expected from the oil producing and exporting countries, the U.S. government, and the oil companies regarding these recent promulgations.

## II. HISTORY OF THE FOREIGN TAX CREDIT

The foreign tax credit was enacted in 1918 to provide taxpayers operating abroad with relief from the burden of double taxation of foreign source income.<sup>24</sup> The Revenue Act of 1918 permitted citizens, residents, resident aliens, and domestic corporations a credit for income and excess profits taxes paid to foreign countries and U.S. possessions.<sup>25</sup> Prior to the 1918 Act, a taxpayer could only claim foreign income taxes as a deduction in computing taxable income.<sup>26</sup>

The general concept of a foreign tax credit rests upon the fact that the United States taxes its citizens, residents, and domestic corporations on their worldwide income. To mitigate the effects of the double taxation of foreign source income in both the United States and the country in which it is earned, taxing authorities have adopted the foreign tax credit as the basic means for reducing the worldwide tax liability on such income to the higher of the effective U.S. tax rate or the effective foreign tax rate.<sup>27</sup> The principle of allowing a credit for foreign taxes is illustrated by the following statement:

The basic concept of a tax credit system is that the country in which the business is carried on has the first right to tax the income from it even though the activity is carried on by a foreigner. The foreigner's home country also taxes the income, but only to the extent the home tax does not duplicate the tax of the country where the income is earned. The duplication is eliminated by the foreign tax credit.<sup>28</sup>

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<sup>24</sup> Revenue Act of 1918, Pub. L. No. 65-254, §§ 222(a), 238(a), 40 Stat. 1057 (1919).

<sup>25</sup> *Id.*

<sup>26</sup> See Revenue Act of 1913, Pub. L. No. 63-16, §§ II(B), II(G)(b), 38 Stat. 114; Revenue Act of 1916, Pub. L. No. 64-271, § 5(a)(3), 39 Stat. 756.

<sup>27</sup> The term "effective" U.S. or foreign tax rate is used in place of average or statutory tax rate because some of the taxpayer's non-U.S. source income may be subject to tax under the laws of the U.S. or the foreign country, but not both countries. See Rev. Rul. 74-310, 1974-2 C.B. 205.

<sup>28</sup> *The Administration's Emergency Windfall Profits Tax: Hearings Before the House Comm. on Ways and Means, 93rd Cong. 2d Sess. 145 (Feb. 4, 1974) (statement of George P. Schultz).*

The foreign tax credit is but one method to eliminate double taxation. The United States also employs a number of other means to prevent double taxation including: an exemption or exclusion of foreign source income from taxation,<sup>29</sup> a system of bilateral tax treaties whereby income is exempted from taxation or taxed at a reduced tax rate by the United States or its treaty partner,<sup>30</sup> and a special tax credit which eliminates the U.S. tax burden with respect to certain non-U.S. source income items.<sup>31</sup>

The United States also included an indirect foreign tax credit as part of the original 1918 Act provisions.<sup>32</sup> The indirect credit rules have permitted a domestic corporation to claim a tax credit for a proportionate part of a foreign subsidiary's foreign taxes. The proportionate part was based on the relationship of the dividends paid to total profits.<sup>33</sup> The 1918 rules permitted the indirect credit to be claimed only when the domestic corporation owned more than half of the foreign subsidiary's shares.<sup>34</sup> These rules have been changed a number of times since that date extending the indirect credit to second-tier and third-tier foreign subsidiary corporations and reducing the minimum stock ownership levels.<sup>35</sup>

The Revenue Act of 1921 introduced the concept of a foreign tax credit limitation by providing that taxes paid or accrued to a foreign country may be credited only against the portion of the taxpayer's U.S. tax liability that is attributable to the taxable income earned within the foreign country.<sup>36</sup> This "per-country" method remained the only alternative for computing the foreign tax credit limitation until 1960, when an alternative "overall" limitation method was enacted that could be elected by the taxpayer.<sup>37</sup> This overall method permitted a taxpayer to average the effective tax rates of all foreign countries in which activities were conducted, and offset the "unused foreign taxes" paid in one country against the "unused limitation" accruing in another country.<sup>38</sup>

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<sup>29</sup> I.R.C. §§ 911(a), 933(a).

<sup>30</sup> See, e.g., *Treasury Department's Model Income Tax Treaty of May 17, 1977*, 1 TAX TREATIES (CCH) 11,153 [hereinafter cited as *Model Income Tax Treaty*].

<sup>31</sup> I.R.C. § 936(a).

<sup>32</sup> Revenue Act of 1918, Pub. L. No. 65-254, § 240(c), 40 Stat. 1057 (1919).

<sup>33</sup> I.R.C. § 902(a).

<sup>34</sup> Revenue Act of 1918, Pub. L. No. 65-254, § 240(c), 40 Stat. 1057 (1919).

<sup>35</sup> I.R.C. § 902(a). Similar indirect foreign tax credit rules are found in I.R.C. § 960 and Treas. Reg. § 1.1248-1(d) for dividend income realized from investments in Controlled Foreign Corporations (§§ 951, 1248) and in Treas. Reg. § 1.902-1(a)(2) for Domestic International Sales Corporations (§ 995).

<sup>36</sup> Revenue Act of 1921, Pub. L. No. 67-98, §§ 222(a)(5), 238(a), 42 Stat. 227.

<sup>37</sup> Foreign Tax Credit: Overall Limitation Pub. L. No. 86-780, § 1, 74 Stat. 1010 (1960).

<sup>38</sup> The term "unused foreign taxes" means the excess of the foreign taxes paid or accrued in a country over the portion of the taxpayer's U.S. tax liability attributable to that country. The term "unused limitation" means the excess of the portion of the taxpayer's

The Revenue Act of 1942 extended the concept of creditable income taxes to include taxes paid "in lieu of a tax upon income, war-profits or excess-profits . . ." to any foreign country or U.S. possession.<sup>39</sup> Such taxes ordinarily were not eligible to be credited under the section 901 tax credit rules. The "in lieu of" rules permit a credit to be claimed by a U.S. taxpayer for taxes paid on a class or type of income under the special taxing laws of a foreign country instead of the country's general income tax laws.<sup>40</sup>

During the sixty or so years since its initial enactment, the foreign tax credit has become a regular part of the bilateral tax treaties into which the United States has entered. A number of the tax treaties which the United States has entered into include a provision detailing those foreign taxes which are considered to be income taxes, and therefore eligible to be claimed as a foreign tax credit.<sup>41</sup> Where the foreign country also utilizes the foreign tax credit as a means of avoiding double taxation, a corresponding provision also indicates the U.S. taxes which are to be considered creditable taxes under the foreign taxing system.<sup>42</sup>

In many Middle Eastern countries, the government owns the land from which the oil is extracted. A single payment which represents both a royalty payment and an income tax payment is made by the oil companies to the government. Whether these oil-related outlays represent an "income tax" or a "royalty" has been the subject of considerable debate for more than two decades. The debate began when the IRS held in Revenue Ruling 55-296<sup>43</sup> that amounts received by Saudi Arabia under the "general" income tax laws and "additional" income tax laws from companies engaged in the production of petroleum and other hydrocarbons would be treated as a creditable tax. Similar published and unpublished rulings followed relating to taxes levied by other foreign jurisdictions.<sup>44</sup> The enactment of the Code section 901(e) as part of the Tax Reform Act of 1969 marked the first of a number of special foreign tax credit provisions designed to resolve the uncertainty surrounding the combined royalty and collection of income tax payments by a number of the oil pro-

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U.S. tax liability attributable to a country over the income taxes paid or accrued in that country. *Id.* § 1.

<sup>39</sup> Revenue Act of 1942, Pub. L. No. 77-753, § 158(f), 56 Stat. 858 (adding former I.R.C. § 131(h) now I.R.C. § 903).

<sup>40</sup> I.R.C. § 903.

<sup>41</sup> See, e.g., *Model Income Tax Treaty*, *supra* note 30, art. 23.

<sup>42</sup> See, e.g., *id.* Not all foreign countries utilize a foreign tax credit to eliminate the double taxation. Countries, such as the Netherlands, France, and Belgium, exempt from local taxation the foreign income of its residents.

<sup>43</sup> Rev. Rul. 55-296, 1955-1 C.B. 386.

<sup>44</sup> See Rev. Rul. 68-552, 1968-2 C.B. 306 (Libyan Petroleum Law No. 25).



ducing and exporting nations.<sup>45</sup> Section 901(e) was enacted as a Conference Committee compromise which provided that a foreign tax credit would not be permitted for foreign taxes imposed on foreign mineral income to the extent that such taxes were attributable to the percentage depletion allowance granted by the United States.<sup>46</sup> Excess foreign taxes attributable to the percentage depletion allowance on foreign mineral income also would not be permitted to reduce the U.S. tax liability on other foreign income.<sup>47</sup>

This departure from a common set of foreign tax credit provisions for all foreign industries became more prevalent during the 1970's as a result of the differences in the taxing systems of both the United States and the oil producing and exporting nations.<sup>48</sup> These departures from neutrality in the foreign tax credit laws have largely resulted from the ever-increasing level of payments being collected by the oil producing and exporting nations, the inability of the U.S. taxing authorities to define the charges levied by these nations as being either royalty or tax payments, and the political pressures to reduce the incentives offered for the exploration, production, and use of foreign oil.<sup>49</sup>

Six special credit provisions applying to the oil companies were enacted in the Tax Reduction Act of 1975:<sup>50</sup>

- (1) section 907(a) places a special limitation on the amount of the foreign income taxes paid or accrued on a taxpayer's foreign oil and gas extraction income that are eligible to be claimed as a foreign tax credit under section 901;<sup>51</sup>
- (2) section 901(f) prevents a foreign tax credit from being claimed with respect to taxes paid or accrued to a foreign country on a sale of oil or gas when (a) the oil or gas was extracted in the country levying the tax, (b) the taxpayer retained no economic interest in the oil or gas, and (c) the purchase or sale transaction occurred at a price different from the fair market value for the oil and gas;<sup>52</sup>
- (3) section 907(b) requires a separate foreign tax credit limitation for foreign oil-related income, thus preventing the use of foreign taxes paid on oil-related income in excess of this limitation from reducing the oil

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<sup>45</sup> 26 U.S.C. § 901(e) (1969) (enacted as Tax Reform Act of 1969, Pub. L. No. 91-172, § 506(a), 83 Stat. 497, 634).

<sup>46</sup> CONF. REPT. 91-782, 91st Cong., 2d Sess. 315 (1969), reprinted in [1969] U.S. CODE CONG. & AD. NEWS 2392, 2430-31.

<sup>47</sup> *Id.*

<sup>48</sup> Conf. Rept. 93-1028, 93d Cong., 2d Sess. 51 (1974); Conf. Rept. 93-1502, 93d Cong., 2d Sess. 63 (1974).

<sup>49</sup> *Id.*

<sup>50</sup> Tax Reduction Act of 1975, Pub. L. No. 94-12, § 601(a), 89 Stat. 26, 54 [hereinafter cited as Tax Reduction Act].

<sup>51</sup> *Id.*

<sup>52</sup> *Id.* § 601(b) at 58.

company's U.S. tax liability on other types of foreign income;<sup>53</sup>

(4) the per-country method of computing the foreign tax credit limitation was repealed for the separate foreign oil-related income limitation;<sup>54</sup>

(5) section 907(f) requires a foreign oil-related loss to be recaptured by reducing the applicable foreign tax credit limitation for foreign oil-related income in future taxable years;<sup>55</sup> and

(6) section 907(c)(4) places foreign source income in categories that permit an oil and gas exploration loss in a country to be deducted only from foreign oil-related income, and not from the taxpayer's other foreign source income.<sup>56</sup>

Each of these changes represented an attempt to remedy an alleged deficiency in the foreign tax credit rules as applied to oil and gas production and exploration activities.<sup>57</sup> These changes were the result of a Conference Committee compromise<sup>58</sup> which replaced a Senate proposal that would have repealed the foreign tax credit on all foreign oil-related income and would have permitted the taxes accruing on such income to be claimed only as a deduction.<sup>59</sup> In addition, the Senate proposal would have taxed the foreign oil-related income at a flat twenty-four percent rate.<sup>60</sup>

Further modifications to the foreign tax credit provisions were enacted as part of the Tax Reform Act of 1976 and<sup>61</sup> the Revenue Act of 1978.<sup>62</sup> These changes were largely directed at taxpayers other than the oil companies, since most of the special provisions affecting the oil companies had been enacted in 1975. These two acts, however, did contain some

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<sup>53</sup> *Id.* § 601(a) at 54.

<sup>54</sup> *Id.* The repeal was part of the addition of Code § 907(b) which was effective for taxable years ending after December 31, 1975. The per-country tax credit limitation was also replaced for other taxpayers as part of the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1031(a), 90 Stat. 1520.

<sup>55</sup> Tax Reduction Act, *supra* note 50, § 601(a) at 54. A similar loss recapture provision was enacted for other taxpayers in the Tax Reform Act of 1976, Pub. L. No. 94-455 § 1032(a), 90 Stat. 1624.

<sup>56</sup> Tax Reduction Act, *supra* note 50, § 601(a) at 54.

<sup>57</sup> See CONF. REPT. 93-1028, 93d Cong., 2d Sess. 50-61 (1974); Conf. Rept. 93-1502, 93d Cong., 2d Sess. 60-70 (1974).

<sup>58</sup> CONF. REPT. 94-120, 94th Cong., 1st Sess. 60 (1975), reprinted in 1975-1 C.B. 630. This compromise position had been proposed earlier in the unenacted Energy Tax and Individual Relief Bill of 1974 to remedy the distortion of the foreign tax credit mechanism in the oil and gas area. See H.R. 17488, 93d Cong., 2d Sess., § 122 (1974). The apparent distortion for petroleum companies occurs as a result of the difficulty of ascertaining whether a single payment made to a foreign government that retains the rights to the natural resources in the ground constitutes, in fact, a tax payment or a royalty.

<sup>59</sup> CONF. REPT. 94-120, 94th Cong., 1st Sess. 60 (1975), reprinted in 1975-1 C.B. 630.

<sup>60</sup> *Id.*

<sup>61</sup> Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 1031-1035, 1051, 1061, 90 Stat. 1520.

<sup>62</sup> Revenue Act of 1978, Pub. L. No. 95-600, §§ 403, 421, 701, 92 Stat. 2763.

minor revisions to the 1975 changes.<sup>63</sup>

### III. REVENUE RULINGS ON CREDITABLE MIDDLE EASTERN TAXES

The IRS has published three revenue rulings directly relating to the creditability of taxes levied upon oil companies by the Middle Eastern countries.<sup>64</sup> These rulings, along with Revenue Ruling 78-61,<sup>65</sup> delineate the criteria which the Service employs to determine whether a foreign tax levy is creditable. Particular attention will be given to the IRS's position in Revenue Ruling 78-61, and the application of this position with respect to taxes levied by Libya, Saudi Arabia, and Bahrain.

#### A. General Requirements

Revenue Ruling 78-61 indicates that two requirements must be satisfied to permit a foreign tax levy to be claimed as a credit under section 901. First, the foreign country's levy must be an indivisible tax on a single base.<sup>66</sup> Second, the indivisible tax must qualify as a section 901(b) income tax.<sup>67</sup> This second requirement does not mean that the foreign tax laws must be identical to the U.S. tax laws, only that the foreign levy be "the substantial equivalent of the income tax in the United States sense."<sup>68</sup> Whether an indivisible foreign tax levy is a substantially equivalent income tax is determined not by the effect of the tax on a particular taxpayer or transaction, but rather by the general impact of the tax on the entire class of taxpayers.<sup>69</sup>

The principal determinants of whether a foreign tax levy qualifies as a section 901(b) income tax are:

- (1) the foreign tax base must be income according to a standard substantially equivalent to the U.S. criteria employed for determining what constitutes realized income;<sup>70</sup>
- (2) the purpose of the income tax must be to tax a net gain and the structure of the tax must be such that it will almost always fall on a net

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<sup>63</sup> See, e.g., Tax Reform Act of 1976, Pub. L. No. 94-455, §§ 1031-35, 1051, 1052, 90 Stat. 1520 and the Revenue Act of 1978, Pub. L. No. 95-600, §§ 301(b)(14), 701(q)(2), and 701(u)(2)-(8), 92 Stat. 2763.

<sup>64</sup> Rev. Rul. 78-63, 1978-1 C.B. 228 (Libyan and Saudi Arabian Taxes) *amplified in* Rev. Rul. 79-93, 1979-11 I.R.B. 11 (Libyan taxes); and Rev. Rul. 79-140, 1979-1 C.B. 238 (Bahrain taxes).

<sup>65</sup> Rev. Rul. 78-61, 1978-1 C.B. 221.

<sup>66</sup> *Id.* at 223.

<sup>67</sup> *Id.*

<sup>68</sup> *Id.* See, e.g., *Schering Corp. v. Comm'r*, 69 T.C. 579, 592 (1978).

<sup>69</sup> *Id.* Rev. Rul. 78-61, 1978-1 C.B. 221, 223.

<sup>70</sup> *Id.*

gain;<sup>71</sup> and

(3) the tax must be levied solely upon the receipt of income by the taxpayer and not levied on transactions, sales, privileges, or franchises.<sup>72</sup>

Any foreign levy failing to met these standards may still be creditable as a tax levied in lieu of an income tax under section 903 provided that the foreign country also imposes a general income tax upon its taxpayers.<sup>73</sup>

Revenue Ruling 78-61 indicates that the standards which define a creditable foreign income tax have evolved through case law. In applying the case law standards for the realization of income, the IRS requires no more than that a substantially equivalent degree of realization be present in the foreign taxing system.<sup>74</sup> This requirement would apparently preclude the establishment of a single standard of realization as being appropriate for all foreign taxing systems since the U.S. income tax laws do use a number of realization standards. However, the use of the U.S. standard apparently precludes the claiming of a credit for a tax that is based on constructive realization or deemed realization of income, even though the U.S. tax laws do apply such a standard to certain levies.<sup>75</sup>

In applying the second standard that the foreign levy must fall on net gain, the IRS does not require that the foreign taxing laws use net income as the tax base.<sup>76</sup> However, for a gross income levy to be creditable, it must be imposed upon forms of income the associated expenses of which ordinarily will not produce a net loss, and therefore will not violate the net gain concept.<sup>77</sup> Creditable gross income taxes may be levied only upon gross dividends, interest, and royalties.<sup>78</sup> A tax levied upon gross trade or business income ordinarily does not fall within the "net gain" concept.<sup>79</sup> This exception to the creditability of taxes levied upon gross income occurs because the expenses incurred in producing trade or business income are usually large enough to provide a reasonable probability

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<sup>71</sup> *Id.* at 223-24.

<sup>72</sup> *Id.* at 224.

<sup>73</sup> *Id.* at 226.

<sup>74</sup> *Id.* at 223. The realization concept apparently prevents a creditable tax from being based upon the production, utilization, shipment, or exporting of a resource, or an artificial sale of a resource at a posted price that may be mandated by the government.

<sup>75</sup> *Id.* See also text surrounding note 123 *infra*.

<sup>76</sup> Rev. Ruls. 73-106, 1973-1 C.B. 343; 78-61, 1978-1 C.B. 221 at 224.

<sup>77</sup> Bank of America Nat'l Trust and Savings Ass'n v. United States, 459 F.2d 513 (Ct. Cl. 1972). The Court of Claims considered a tax to fall upon a "net gain" when a taxpayer would not generally be required to pay the tax when he had no "net gain."

<sup>78</sup> Rev. Ruls. 78-61, 1978-1 C.B. 221, 224; 73-106, 1973-1 C.B. 343; Bank of America Nat'l Trust & Sav. Ass'n v. United States, 459 F.2d 513 (Ct. Cl. 1972); Allstate Ins. Co. v. United States, 419 F.2d 409 (Ct. Cl. 1969).

<sup>79</sup> Rev. Ruls. 78-61, 1978-1 C.B. 221; 74-435, 1974-2 C.B. 204; Keasbey & Mattison Co. v. Rothensies, 133 F.2d 894 (3d Cir. 1943).

of exceeding gross income and cause the tax to be imposed even when the taxpayer has no net gain. Thus, a non-creditable tax generally results where the foreign tax laws do not permit the deduction of the "generally significant expenses" incurred in producing trade or business income.<sup>80</sup>

The third requirement that the foreign levy be a tax on the receipt of income and not on transactions precludes the crediting of a tax which is an excise or transactions tax, or a tax which is paid in order to obtain a franchise or privilege, such as for the exploitation of natural resources.<sup>81</sup> Some tax laws may contain both income tax and excise tax elements. When this occurs, the IRS has indicated that the characterization of the tax is usually based upon the predominant characteristics of the tax.<sup>82</sup>

### B. *Middle Eastern Taxes*

The Libyan surtax on petroleum income was found not to be substantially equivalent to taxes complying with U.S. definitions of an income tax for two reasons.<sup>83</sup> First, the Libyan surtax was found to be based upon a foreign oil concessionaire's gross receipts<sup>84</sup> from extracted crude oil.<sup>85</sup> These gross receipts were not permitted to be less than the product of the number of barrels of crude oil exported, multiplied by the applicable "posted price" for the type of crude oil exported, less certain marketing allowances.<sup>86</sup> As such, the income that served as the tax base may not have been realized by the oil concessionaire from a sales transaction.<sup>87</sup>

The Libyan surtax also failed to qualify as an income tax because the Libyan government's posted price for the crude oil generally exceeded its market value.<sup>88</sup> The use of a posted price for the oil in determining the taxing base assured the Libyan government a specified revenue amount even though the market value of the oil may have declined. Because the Libyan posted prices generally exceeded the sale price for the oil, the foreign oil concessionaire's nominal income and foreign tax liabilities generally exceeded the amount that would have been due had the tax liability

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<sup>80</sup> Rev. Rul. 78-61, 1978-1 C.B. 221, 224.

<sup>81</sup> *Id.*

<sup>82</sup> *Id.*

<sup>83</sup> Rev. Rul 78-63, 1978-1 C.B. 228 (ruling relates to Libyan Petroleum Law No. 25 of 1955, art. 14(1)(a)). The IRS did not review the creditability of the Libyan "Company Tax" Law No. 64 of 1978, pt. II, arts. 1 and 93-104.

<sup>84</sup> Even though the Service in Revenue Ruling 78-63 refers to the tax as being based upon "gross receipts" certain deductions were permitted to be claimed in arriving at "profits" under the Libyan law.

<sup>85</sup> Rev. Rul 78-63, 1978-1 C.B. 228, 230.

<sup>86</sup> *Id.*

<sup>87</sup> *Id.*

<sup>88</sup> *Id.*

been based upon realized net income. Thus, because a portion of these levies were paid upon artificial and fictitious income, the IRS held that no portion of these levies conformed with the U.S. standards for an income tax.<sup>89</sup> The IRS did not accept the use of a "posted price" pricing system even though some oil concessionaires sold the Libyan oil to their purchasing affiliates at the posted price and received full payment of the amount due in return.<sup>90</sup> Where a sales transaction occurs at the posted price due to state control, the tax base on which the levy is made is contrived.<sup>91</sup> Furthermore, the surtax does not tax realized income when the minimum surtax is triggered by the exportation of oil which has not been sold.<sup>92</sup>

The Saudi Arabian income tax<sup>93</sup> and additional income tax<sup>94</sup> both failed to conform to the U.S. concept of an income tax because of the use of the posted price mechanism.<sup>95</sup> The two taxes were found to be based upon a U.S. concept of income realization because a U.S. company engaged in producing oil and gas in Saudi Arabia must sell in Saudi Arabia all oil that is destined for export.<sup>96</sup>

Approximately one year after the Libyan and Saudi Arabian levies were determined to be non-income taxes, the Bahrain Income Tax<sup>97</sup> was found to fail to conform to the U.S. concept of an income tax.<sup>98</sup> The tax failed because the income derived from the production and refining of the oil that served as the tax base was determined by reference to a posted price, that of a barrel of Saudi Arabian crude oil which was found to be in excess of the actual price paid by unrelated purchasers for the oil.<sup>99</sup> Thus, for reasons similar to those that denied the creditability of the Saudi Arabian tax in Revenue Ruling 78-63, the Bahrain income tax was deter-

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<sup>89</sup> *Id.* A question could be raised as to whether an "all or nothing" test should be utilized in determining whether a tax is creditable. A tax levy is usually considered to be partially creditable only when the tax is computed on two or more separate tax bases. See Rev. Rul. 78-61, 1978-1 C.B. 221 and Lanman & Kemp — Barclay & Co. of Colombia, 26 T.C. 582 (1956).

<sup>90</sup> *Id.*

<sup>91</sup> *Id.*

<sup>92</sup> *Id.* The minimum surtax amounts to the posted-price value of all barrels of oil exported. *Id.*

<sup>93</sup> See Rev. Rul. 78-63, 1978-1 C.B. 228, 231-32 (relating to Royal Decree 17/2/28/3321, ch. II (Nov. 4, 1950)).

<sup>94</sup> See Rev. Rul. 78-63, 1978-1 C.B. 228, 231-32 (relating to Royal Decree 17/2/28/7634 (Dec. 27, 1950)).

<sup>95</sup> Rev. Rul. 78-63, 1978-1 C.B. 228, 231-32.

<sup>96</sup> *Id.* at 231.

<sup>97</sup> See Rev. Rul. 79-140, 1979-1 C.B. 238 (relating to Bahrain Income Tax Decree No. 80/1955 as amended by Decree No. 11 (Finance) 1966, and Decree No. 1/1977).

<sup>98</sup> *Id.*

<sup>99</sup> *Id.* at 17.

mined to be a non-income tax.<sup>100</sup>

None of these taxes were found to constitute a tax levied "in lieu of an income tax" under section 903.<sup>101</sup> The Libyan tax was found to be levied in addition to the general Libyan income tax. The Saudi Arabian and Bahrain income taxes were found not to be levied "in lieu of taxes" because each of the countries failed to have a "generally imposed income tax."<sup>102</sup>

#### IV. PROPOSED TREASURY REGULATIONS

Proposed Treasury Regulation section 1.901-2 defines three terms: "tax," "income tax," and "taxes paid or accrued."<sup>103</sup> Each of these three terms is examined below along with the new rules for determining whether a tax is paid "in lieu of a general income tax" and therefore eligible to be claimed as a credit under Code section 903.

##### A. Definition of a Tax

A "tax" is defined as a payment of a compulsory charge that does not represent compensation for a specific benefit.<sup>104</sup> A payment is compulsory only when made pursuant to a legal liability to a foreign government or to a third party whereby the payment acts to reduce the legal liability to the foreign government.<sup>105</sup> A payment is noncompulsory to the extent that it exceeds the taxpayer's legal liability, except when all effective and practical remedies have been exhausted in seeking a reduction in the amount of the liability.<sup>106</sup>

The proposed regulations differentiate user charges from tax payments by stating that "payment of a charge by a person is presumed to be compensation for a specific benefit if the government provides to that person ("user") an economic benefit not provided to persons that do not

<sup>100</sup> *Id.*

<sup>101</sup> *Id.*

<sup>102</sup> *Id.*

<sup>103</sup> Prop. Treas. Reg. § 1.901-2 (June 20, 1979).

<sup>104</sup> Prop. Treas. Reg. § 1.901-2(a)(1) (June 20, 1979).

<sup>105</sup> *Id.* § 1.901-2(a)(2)(i) and (v). Such a third party payment is discussed in Rev. Rul. 76-215, 1976-1 C.B. 194 (relating to production sharing payments made to a corporation wholly-owned by the Indonesian government by a U.S. taxpayer).

<sup>106</sup> Prop. Treas. Reg. § 1.901-2(a)(2)(ii). This position is consistent with a series of earlier Revenue Rulings dealing with this question. These rulings include Rev. Rul. 72-370, 1972-2 C.B. 437 (foreign taxes not owed to a foreign government following a § 482 allocation of income were not creditable under § 901) and 76-508, 1976-2 C.B. 225 (a domestic corporation that was allocated income from a foreign subsidiary was required to reduce its deemed paid tax credit by the amount of foreign taxes which were not due to the foreign government following the adjustment and for which an adjustment of the tax liability was not requested).

pay the charge."<sup>107</sup> This presumption is rebuttable by the user provided that he can clearly demonstrate that no part of the charge represents compensation for an economic benefit.<sup>108</sup>

The term "economic benefit" is defined as including, but not being limited to, "a good, service, right to use or extract resources, patents or other property which the foreign government owns or controls, or discharge of contractual obligation or a liability for interest or penalties."<sup>109</sup> Specifically included as an economic benefit is the "right or privilege to use or extract resources, patents or other property which the government owns or controls."<sup>110</sup> However, an economic benefit does not include the right or privilege to engage in a particular line of business, or to engage in business in a particular form, unless such rights are granted only to a limited number of persons.<sup>111</sup>

There are two situations when a user's payment of a charge is not compensation for a specific benefit.<sup>112</sup> The first occurs when the user is subject to a charge levied by a foreign government that is not an income tax and where the amount of this substitute charge is comparable to the amount that would have been paid under the country's general income tax laws.<sup>113</sup> Three requirements are necessary to satisfy this presumption:

- (1) The charge must be based upon the user's realized net income;
- (2) a tax is imposed on a substantial amount of realized net income derived by persons *other than* users; and
- (3) users generally are subject neither to higher rates, nor to provisions that significantly increase the amount of the charge paid by users over the amount that would be paid by the users if they were subject to the country's income tax laws that are applicable to nonusers.<sup>114</sup>

Alternatively, the user's payment of a charge imposed by a foreign government is considered to be exempt from the specific benefit rule if:

- (1) The foreign country does not impose a tax on a substantial amount of income earned by nonusers;
- (2) the charge is computed on the basis of realized net income; and
- (3) the rate of charge does not exceed forty-six percent.<sup>115</sup>

Under this second exception, a charge equalling forty-six percent of a tax-

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<sup>107</sup> Prop. Treas. Reg. § 1.901-2(a)(3)(i) (June 20, 1979).

<sup>108</sup> *Id.*

<sup>109</sup> *Id.* § 1.901-2(a)(3)(iii)(A).

<sup>110</sup> *Id.*

<sup>111</sup> *Id.*

<sup>112</sup> *Id.* § 1.901-2(a)(3)(ii)(A).

<sup>113</sup> *Id.*

<sup>114</sup> *Id.*

<sup>115</sup> *Id.* § 1.901-2(a)(3)(ii)(B).



payer's realized net income would be fully creditable as a tax under section 901.<sup>116</sup> When the charge is levied at a rate exceeding the forty-six percent rate, as would be the case with most oil producing and exporting countries, apparently none of the charge would be eligible to be credited. A treatment so different for such a small rate differential appears to be unwarranted, and a revision ought to be considered to make only the amount of the charge in excess of the forty-six percent rate represent a non-tax ("user") charge.

### B. *Definition of an Income Tax*

The proposed regulations establish two requirements for a foreign tax to become an income tax.<sup>117</sup> An income tax must be computed on the basis of *realized net income*, and not be related to the availability of a credit for the tax against the tax liability to another country.<sup>118</sup> This second restriction prevents a foreign country from levying a tax against only residents of certain nations that utilize a credit mechanism for foreign taxes to mitigate the effects of double taxation, or from entering into a separate agreement with individual taxpayers to levy a tax against their income only to the extent that the tax payment is creditable under their home country tax laws.

A taxpayer's income must be the tax base for a creditable tax.<sup>119</sup> This requirement prevents wealth, accumulated profits, the value of capital or property, or other non-income amounts from being used as a tax base.<sup>120</sup> The foreign country's income tax also must be imposed at the time of realization of income.<sup>121</sup> Because the U.S. tax laws impose a number of different times for realization of income, the proposed regulations state that a tax satisfies the realization requirement when:

- (1) the event giving rise to the legal liability to pay the tax: (a) results normally in the realization of income by taxpayers under Subtitle A of the Internal Revenue Code; (b) occurs subsequent to an event described in (1)(a); or (c) is the export from the foreign country of an inventory-type item *and* the tax is computed on the basis of the property's fair market value at the time of export;<sup>122</sup> or
- (2) The tax is based on the taxpayer's proportionate share of the income realized by the entity such as a corporation, trust, or estate which

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<sup>116</sup> *Id.*

<sup>117</sup> *Id.* § 1.901-2(b)(1).

<sup>118</sup> *Id.*

<sup>119</sup> *Id.* § 1.901-2(b)(2).

<sup>120</sup> *Id.*

<sup>121</sup> *Id.* § 1.901-2(b)(3)(i).

<sup>122</sup> *Id.*

the taxpayer controls, or in which the taxpayer has an interest.<sup>123</sup> The export tax exception, situation (1)(c) *supra*, fails to produce an income tax if the foreign government also imposes a charge upon the realization of income at the time the export property is shipped outside the country.<sup>124</sup>

A creditable tax must be based upon net income.<sup>125</sup> This requirement necessitates that the tax be computed in a manner permitting a taxpayer a "reasonable opportunity" to recover the significant expenses and capital expenditures incurred in deriving the gross receipts.<sup>126</sup> The principal considerations in determining whether an expense or capital expenditure is significant is whether: (1) the disallowance of the recovery of the item in question would significantly increase the taxpayer's taxable income in the U.S. sense; and (2) the disallowed items are otherwise significant with respect to the type of activities being conducted by the taxpayer.<sup>127</sup> A foreign country is permitted to establish reasonable limitations on the recovery of capital expenditures and expenses in the determination of the foreign income tax liability.<sup>128</sup> A limitation is not considered to be reasonable where it negates the taxpayer's recovery of a significant expense or capital expenditure.<sup>129</sup>

The foreign tax may be creditable when levied upon gross income.<sup>130</sup> To have a creditable gross income tax, the U.S. taxpayer must not be engaged in the conduct of commerce within the foreign country.<sup>131</sup> Income is considered to be derived from the conduct of commerce within a foreign country when it is generated by *assets used in or held for use* in the conduct of commerce in the foreign country, or if activities of commerce in the foreign country were a material factor in the realization of the income.<sup>132</sup>

The determination of whether a levy is an income tax requires the

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<sup>123</sup> *Id.*

<sup>124</sup> *Id.* § 1.901-2(b)(3)(i)(C). Thus a charge levied on the basis of a posted price and the number of barrels of crude oil exported, as was the case with the Libyan tax, would fail to be a creditable tax. See Prop. Treas. Reg. § 1.901-2(d), ex. (3) (June 20, 1979).

<sup>125</sup> Prop. Treas. Reg. § 1.901-2(b)(4)(i) (June 20, 1979).

<sup>126</sup> *Id.*

<sup>127</sup> *Id.* §§ 1.901-2(b)(4)(ii).

<sup>128</sup> *Id.* §§ 1.901-2(b)(4)

<sup>129</sup> *Id.* §§ 1.901-2(b)(4)(ii), 2(d), exs. (5)-(7). The Libyan tax failed to permit a deduction for interest, expenses incurred in organizing and initiating Libyan petroleum operations prior to receiving a government concession, and certain fees and rents paid to the government. Rev. Rul. 78-63, 1978-1 C.B. 228, 229. Whether these disallowed items would be significant under the Proposed Regulations is not specified.

<sup>130</sup> Prop. Treas. Reg. § 1.901-2(b)(4)(iii) (June 20, 1979).

<sup>131</sup> *Id.* Conduct of commerce is based upon the Code Section 864 standards for the engaging in the conduct of a U.S. trade or business.

<sup>132</sup> *Id.*

application of the requirements of a tax *and* the requirements of an income tax to each of the foreign government's separate charges.<sup>133</sup> The characterization of each separate levy as an income or non-income tax generally applies to all persons subject to the charge unless the levy is limited to a specific class of taxpayer or modified by a contractual agreement.<sup>134</sup> The IRS has indicated that because of the factual nature of such a determination, it will not issue advance rulings on the question of whether a particular payment is a tax in cases where the royalty-tax issue is not covered by one of the aforementioned three exceptions.<sup>135</sup>

### C. Taxes Paid or Accrued

Section 901(a) permits a foreign tax credit to be claimed for taxes that are paid or accrued during a taxable year.<sup>136</sup> Formerly, a tax was considered to accrue when the "final events that fix the fact and amount of the taxpayer's income, deduction, or credit must occur during the year in which the income, deduction, or credit is reflected."<sup>137</sup> Under the new regulations, a tax is considered to have been paid or accrued "only to the extent that the total amount of all payments of any kind made by a person to a foreign government exceeds the amount for which the person would have been liable if the person were not liable for any income tax."<sup>138</sup>

This addition prevents a taxpayer from being able to claim a foreign tax credit in a situation where the foreign income taxes merely offset the payment of a royalty or a non-income tax type of levy, and the government is guaranteed a certain dollar amount in income tax or other types of payments.<sup>139</sup> Similarly a foreign tax credit is denied where a royalty or other form of non-creditable payment that varies inversely with the amount of the income tax payment is used by the foreign country.<sup>140</sup> The IRS has indicated that:

Foreign income taxes will be creditable under the proposed regulations

<sup>133</sup> *Id.* Prop. Treas. Reg. § 1.901-2(c)(2) (June 20, 1979).

<sup>134</sup> *Id.*

<sup>135</sup> Treasury Department News Release B-1662 (June 15, 1979) reprinted in STAND. FED. TAX REP. (CCH) ¶ 6672.

<sup>136</sup> I.R.C. § 901(a).

<sup>137</sup> R. VON THULEN RHOADES AND E. STEINBERG, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS § 5.03 [5] (1978).

<sup>138</sup> Prop. Treas. Reg. § 1.901-2(e)(1) (June 20, 1979).

<sup>139</sup> *Id.* § 1.901-2(e)(3)(i). The Libyan surtax, *supra* notes 83-92 and accompanying text, was structured in this manner. The Libyan surtax was required only if the total annual amount of fees, rents, income taxes, and other direct taxes (except certain royalties) fell short of sixty-five percent of the oil concessionaire's profits from all its Libyan petroleum concessions.

<sup>140</sup> *Id.*

only if the foreign government is willing to be at risk with respect to income tax liability and with respect to all amounts collected from the taxpayer. Since the basic nature of an income tax is that the government's revenues decline as profits decline, the government must forego payment when taxpayers have no income tax liability.<sup>141</sup>

Thus, in a situation where offsetting foreign taxes exist,<sup>142</sup> only the excess, if any, of the amount of the income tax charge over the amount of the other charges levied is considered to be income tax paid or accrued.

Similarly, the amount of income tax paid or accrued is limited when the income tax charge and one or more non-income tax charges such as royalties are simultaneously determined so that their sum cannot be less than a third amount.<sup>143</sup> Such third amount might be a percentage of the gross value of petroleum production, but not an income tax. In such a case, the amount of the income tax paid or accrued represents the excess of the income tax charge over the third amount.<sup>144</sup>

#### D. *Definition of Taxes in Lieu of Income Taxes*

A charge is considered to be a tax "in lieu of an income tax" if:

- (1) The charge is defined as a tax;
- (2) The income of persons required to pay the "in lieu of" charge would, in the absence of a specific provision exempting such income, be subject to a general income tax<sup>145</sup> under the laws of the foreign country;
- (3) The foreign tax law produces an "in lieu of" charge that is not significantly greater than the amount of tax that would otherwise be due had the income been taxed under the country's general income tax law; and
- (4) The liability for the "in lieu of" charge is not related to the availability of a credit reducing the taxpayer's tax liability to another country in the amount of such a charge.<sup>146</sup>

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<sup>141</sup> Treasury Department News Release B-1662 (June 15, 1979) reprinted in *STAND. FED. TAX REP.* (CCH) ¶ 6672.

<sup>142</sup> *Id.* § 1.901-2(e)(3). Offsetting foreign taxes can exist when: (1) an income tax is reduced by a charge that is not an income tax, (2) a charge that is not an income tax can be reduced by an income tax, or (3) the total amount of payment to a foreign government is the greater of the amount of an income tax or the amount of a charge that is not an income tax.

<sup>143</sup> Prop. Treas. Reg. §§ 1.901-2(e)(4)(i), 1.901-2(e)(4)(ii), ex. (1) (June 20, 1979).

<sup>144</sup> *Id.* § 1.901-2(e)(4) (June 20, 1979).

<sup>145</sup> A general income tax is defined by Proposed Treasury Regulation § 1.903-1(c) (1979) as "an income tax or a series of separate income taxes (within the meaning of § 1.901-2 of the Proposed Regulations) which are imposed on substantially all significant business, investment, and personal services income arising within the country." Examples of a general income tax are contained in Proposed Treasury Regulation § 1.903-1(e), exs. (1) and (2).

<sup>146</sup> Prop. Treas. Reg. § 1.903-1 (a) (1979). The rules for application of the tax are contained in § 1.903-1(d) of the Proposed Regulations.

The definition of a tax found in section 1.901-2(a)(3)(i) of the Proposed Regulations that was outlined earlier is applied in the section 903 Proposed Treasury Regulations to determine if the requirement that the charge be capable of being characterized as a tax has been satisfied.<sup>147</sup> However, payment of a user charge is not considered to be made for a specific benefit if requirements (2) and (3) above are satisfied *and* similarly situated users generally pay similar charges for the economic benefits derived regardless of whether they come under the general income tax law or the "in lieu of" tax law.<sup>148</sup> Thus, the "in lieu of" tax rate may not be markedly different from the tax rate applied under the general income tax laws. The amount of the "in lieu of" tax that a taxpayer has paid or accrued is determined according to the section 1.901-2(e) Proposed Regulation rules.<sup>149</sup>

The failure of a country's general income tax law to qualify as an "income tax" under the section 901 definition of a tax can have serious ramifications for an "in lieu of" tax coming under section 903. In such a situation, the "in lieu of" tax fails to satisfy the third requirement of the proposed section 903 regulations<sup>150</sup> because the charges that are paid under the alternative taxing system cannot be considered to be levied in lieu of an income tax.

#### V. POSSIBLE REACTIONS TO THE PROPOSED REGULATIONS

The Proposed Treasury Regulations appear to represent a continuation of the Treasury Department's recent policy towards denying a foreign tax credit for the "tax" payments made to the Middle Eastern oil producing and exporting nations. The Saudi Arabian government has apparently revised its tax system to base the taxes paid upon realized sales prices, rather than posted prices, with an additional payment made to the government in order to provide the same level of revenues that were available under the posted price system.<sup>151</sup> The payments made by the U.S. oil companies to the Saudi Arabian government will likely remain non-creditable taxes because the total payment being made does not depend upon the taxpayer's realized net income. Apparently only the oil tax levies, made by the Indonesian government will still qualify as an income

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<sup>147</sup> Prop. Treas. Reg. § 1.903-1(a)(1)(1979).

<sup>148</sup> *Id.*

<sup>149</sup> *Id.* § 1.903-1(b). This rule prevents a "surtax" applied against only the oil companies (such as that levied by Libya) from qualifying under the § 903 credit provision.

<sup>150</sup> Prop. Treas. Reg. § 1.903-1(e), ex. (3) (1979).

<sup>151</sup> *The Decline of the Dollar: Hearings before the Subcomm. on Foreign Economic Policy of the Senate Comm. on Foreign Relations, 95th Cong., 2d Sess. (Feb. 22, 1978) (statement of Jay W. Glassman) reprinted in DAILY TAX REP. (BNA) at J-17 (Feb. 22, 1978).*

tax under the new regulations.<sup>152</sup> A number of possible reactions are available to this current state of affairs by the Middle Eastern oil producing and exporting countries, the United States government, and the oil companies. A brief summary of these possible reactions are indicated below.

The initial reaction by the oil producing and exporting nations could be a restructuring of their tax systems to conform their levies to the U.S. concept of an income tax. A wholesale change providing an income tax system that would be a "mirror image" of the U.S. system would be extremely unlikely. Changes of a lesser magnitude might be possible, such as dropping the posted price system or delaying the levy of the tax until the oil company realizes the income. However, this action alone probably would not produce a creditable tax because these payments would still be characterized as a payment for an economic benefit, the right to use or extract resources, under section 1.901-2(a)(3)(iii)(A) of the new Regulations. Any change in the foreign tax system, such as abandoning the posted price system, would likely result in a reduction in the foreign government's "tax" revenues. Probably a renegotiation of the basic operating agreement between the oil companies, and the foreign government would need to occur. This agreement would involve both parties incurring costs. The foreign government may not perceive the foreign tax credit as being a major problem requiring government involvement and may prefer that the United States oil companies resolve the problem directly with the U.S. government.<sup>153</sup>

Actions by the U.S. taxing authorities prior to 1978 to determine the portion of the "combined" tax and royalty payments made to the oil producing and exporting nations have been primarily aimed at placing an upper limit on the amount of the oil companies' payments to the foreign governments that is creditable.<sup>154</sup> These actions have tended to erode the neutrality that existed in the application of the foreign tax credit provisions between the various U.S. industries operating overseas. The appropriateness of this non-neutral treatment, solely because of the differences that exist between the more sophisticated U.S. taxing system and the less sophisticated taxing systems generally found in the oil producing and ex-

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<sup>152</sup> The Indonesian tax is already creditable under Rev. Rul. 78-410, 1978-2 C.B. 347.

<sup>153</sup> Many of the oil producing nations no longer face this problem following nationalization of the oil properties. The foreign governments will obtain their revenues from the sale of crude oil to the oil companies instead of through royalty and tax payments.

<sup>154</sup> See I.R.C. § 907(a), (f). Section 907(a) restricts the creditable tax payments made with respect to oil and gas extraction income to the amount of the taxpayer's oil and gas extraction income for the taxable year multiplied by the highest marginal rate of the tax under section 11(b). Section 907(f) restricts the carryback or carryover of taxes paid in excess of this limitation, and prevents the taxpayer from deducting taxes that exceed the limit and are unable to be carried back or forward.

porting nations, is a question that is beyond the scope of this paper.<sup>155</sup>

A number of courses of action are available to the United States government, including:

- (1) eliminate the foreign tax credit for all industries;<sup>156</sup>
- (2) eliminate the foreign tax credit for all foreign oil and gas extraction income;
- (3) reduce the section 907(a) limitation for creditable taxes accruing on foreign oil and gas extraction income to below the current forty-six percent rate;
- (4) permit a foreign tax credit to be claimed on foreign oil and gas extraction income equal to the greater of the United States tax rate or the general income tax rate, whichever is higher;
- (5) label a given percentage of the foreign government charge as a royalty payment and permit the remainder of the charge to be labeled as a creditable income tax;<sup>157</sup>
- (6) levy a minimum tax on the foreign oil and gas extraction income upon which the taxpayer claims a foreign tax credit;<sup>158</sup>
- (7) further revise the application of the foreign tax credit to the oil companies to prevent the use of foreign taxes accruing on foreign oil and gas extraction income to reduce the U.S. tax liability on other forms of foreign source income.

Each of the above steps will require some form of legislative action. Instead, the IRS could make revisions to the proposed section 901 regulations to make the provisions regarding the creditability of a foreign tax better reflect the initial legislative intent<sup>159</sup> of mitigating the problem of double taxation that existed at the time the foreign tax credit was enacted. An alternative to revising the proposed section 901 regulations would be to modify the proposed section 903 regulations to permit an "in lieu of" tax to include part or all of the payments made to the oil produc-

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<sup>155</sup> See Schmidt, *Operation of the Foreign Tax in the Petroleum Industry: A 'Dry Hole'?*, 15 VA. J. INT'L L. 421, 436 (1978) and Note, *The Foreign Tax Credit and Treatment of Payments by the Petroleum Industry to Foreign Governments*, 91 HARV. L. REV. 844, 849 (1978).

<sup>156</sup> This position runs counter to the current Treasury Department position as outlined in: 1979 *Hearings*, *supra* note 15, at 9 (statement of W. Michael Blumenthal). The effects of such a change on the U.S. economy can be seen in C.F. BERGSTEN, T. HORST, AND T. MORAN, *AMERICAN MULTINATIONALS AND THE AMERICAN INTERESTS* 165-212 (1978).

<sup>157</sup> According to one commentator, enactment of this proposal appears unlikely in view of the need to deem between 85 and 90 percent of the payment a royalty before the excess credits are eliminated. See 1979 *Hearings*, *supra* note 15, at 42 (statement of Jack F. Bennett). At present, generally only 15 to 25 percent of such payments are labeled a royalty by the oil producing nations. *Id.* at 40. See also Rev. Rul. 78-63, 1978-1 C.B. 228, 229, 231.

<sup>158</sup> CONF. REPT. 94-120, *supra* note 34, at 69.

<sup>159</sup> E. OWENS, *THE FOREIGN TAX CREDIT: A STUDY OF THE CREDIT FOR FOREIGN TAXES UNDER U.S. INCOME TAX LAW* (1961).

ing and exporting nations. The "in lieu of" tax rate would no longer need to approximate the rate of the general income tax. The current disallowance of the "in lieu of" tax credit where either the foreign tax fails to qualify as an income tax or where no general income tax exists could be eliminated. It appears unlikely that the IRS will initiate a substantial change to either of these regulations in a way that would permit a credit for payments made to the oil producing and exporting nations.

Each of the above recommendations involves a change in the foreign tax credit as it is applied to all oil producing and exporting nations. A method also exists for effecting these changes on a country-by-country basis. Because many U.S. tax treaties contain a section that delineates the taxes of the treaty partner that are considered creditable foreign income taxes,<sup>160</sup> the United States could negotiate treaty arrangements regarding creditability of the taxes of each of the countries in question. Such a change could permit different arrangements to be developed with each of the oil producing and exporting nations. However, the change would be difficult and time consuming to accomplish because the United States currently does not have a tax treaty with most oil producing nations.

A number of possible reactions are likely by the oil companies, depending upon the severity of the increased tax costs. First, the oil companies could challenge the Proposed Regulations in the courts. Since a number of commentators have questioned the validity of the IRS rulings, some prospects apparently exist for having the Regulations overturned once they are enacted.<sup>161</sup> Alternatively, the oil companies might turn their efforts to activities other than oil exploration that are more profitable. This reduction in overseas activities could result in increased activities by non-U.S. firms. A perhaps more drastic action could be the U.S. oil companies relinquishing their U.S. incorporation to avoid the increased tax burdens. Should the U.S. tax burdens become too great, these firms might find it more profitable to exempt their foreign source income from U.S. taxation by becoming a citizen of another nation of the world.<sup>162</sup>

Each of these alternatives carries with it a number of ramifications other than a change in the total tax revenues collected by the United States government. These changes may mean greater reliance upon for-

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<sup>160</sup> See, e.g., *Model Income Tax Treaty*, *supra* note 30, art. 23.

<sup>161</sup> See Report of the Foreign Tax Credit Subcommittee, Committee on Foreign Activities of United States Taxpayers, ABA Taxation Section, *The Creditability of Foreign Income Taxes: A Critical Analysis of Revenue Rulings 78-61, 78-62, and 78-63*, 32 TAX LAW. 33 (1978), and *Tax Division Comments on Foreign Tax Credit Regs. Project*, 10 TAX ADVISER 103 (1979).

<sup>162</sup> See J. Kramer and G. Hufbauer, *Higher U.S. Taxation Could Prompt Changes in Multinational Corporate Structure*, 1 INT'L TAX J. 301 (1975).



eign oil produced by non-U.S. oil companies. The denial of the foreign tax credit does increase the relative attractiveness of the U.S. oil investment projects as opposed to foreign oil investment projects, but it does not guarantee that funds withdrawn from overseas oil activities will be used to increase domestic oil production at a time when U.S. consumers are facing high oil prices and when demand generally outstrips the oil output. Furthermore, the denial of the foreign tax credit will either increase the U.S. consumer's cost of petroleum products to the extent that the increased tax burden can be passed on to the consumer, or it will reduce the relative profitability of the shareholders' investments if the increased tax cannot be passed on. In either case, this increase can be viewed as a form of indirect tax increase levied upon the general public without any legislative action being taken.

## VI. CONCLUSION

Since the late 1960's the structure of the U.S. foreign tax credit has been changed a number of times. A number of these changes have originated as a result of the current taxing structure of the Middle Eastern oil producing and exporting nations that exacts a single payment from the U.S. oil companies representing a royalty charge and an income tax levy. The U.S. government now faces a crossroads in the generation of its foreign tax credit. Even though an ever increasing need for oil exists, the U.S. taxing authorities are attempting to administratively increase the U.S. tax burdens of the U.S. oil companies by issuing a series of Revenue Rulings and a new set of proposed regulations denying a foreign tax credit for a number of formerly creditable taxes.<sup>163</sup> A change of this magnitude appears to be of the nature that requires a legislative reappraisal of the entire foreign tax credit system, including its purposes and its current operating rules. As part of this examination, reasonable guidelines should be given to the IRS as to the congressional intent regarding the creditability of the levies of the oil producing and exporting nations, taking into account the nature of the foreign taxing systems, the nature of the oil production and exploration process, and the impact of any changes on the U.S. economy. Once this is done, a long-term prospectus for foreign oil and gas investment activities can be determined.

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<sup>163</sup> See notes 18-19, *supra* and accompanying text.