

## SYMPOSIUM

### MULTINATIONAL CORPORATIONS AND THE ENERGY CRISIS

*Foreign Governmental Control of  
Multinational Corporations Marketing  
in the United States*

*American Tax Credits and Foreign  
Taxes and Royalties*

*Expropriation, Threats of Expropriation  
and Developmental Policy*

## IMPLICATIONS OF CURRENT HOUSE OF REPRESENTATIVES ACTION TO AMEND THE FOREIGN TAX CREDIT AS APPLIED TO FOREIGN SOURCE PETROLEUM INCOME

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### INTRODUCTION

The tax treatment of foreign-source income of U.S. oil companies is under a multi-faceted attack which arises largely from a number of serious misconceptions. For example, critics of present tax policy argue erroneously that it:

1. *Encourages American companies to explore abroad rather than at home and hence is contrary to the national interest.*

Actually, U.S. tax treatment of foreign petroleum exploration and production closely parallels domestic taxation. A notable exception is that percentage depletion is valueless in many foreign cases because the foreign tax is higher than the U.S. tax would be without depletion. Furthermore, the investment credit on tangible personal property is largely inapplicable to foreign operations. In no case does an operator pay a lower total tax (domestic plus foreign) than he would pay on a similar operation in the United States.

Some critics who understand that foreign and domestic tax treatments are parallel are now contending that foreign petroleum tax treatment should be deliberately amended—in the name of the national interest—to make foreign exploration less attractive. Their goal is to bring American explorers home to search for secure domestic supplies. In fact, one cannot encourage domestic exploration by making foreign exploration *less* attractive. Domestic exploration must be made *more* attractive. It is no more than a half truth to say that American companies have gone abroad because foreign exploration has been more profitable than domestic. Oil is sought wherever a geologically attractive prospect is available and an economically adequate return seems feasible (after adjustment for political risk).

Exploration declined in the United States after the mid 1950's because: (a) there was excess oil producing capacity; (b) many of the most attractive prospects were held off the market by the Government (*e.g.*, the Atlantic offshore); (c) environmental objections blocked promising developments (*e.g.*, the Alaskan North Slope); and (d) crude oil and

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natural gas price ceilings cast an economic cloud over the industry.

2. *Gives international companies a competitive advantage over domestic competitors by enabling them to apply unused foreign tax credits against their tax liabilities on domestic source income.*

This allegation is simply false. Unused foreign tax credits cannot be used to reduce tax on U.S.-source income because the amount of foreign tax which can be credited is limited to the amount of U.S. tax which would be due on the foreign operation if it were conducted in the United States. A foreign loss may be deductible from U.S. income, but unused foreign tax credits do not reduce taxes on domestic-source income.

3. *Permits U.S. petroleum taxpayers to escape U.S. tax by enabling them to credit royalties and/or to transfer unused credits to shelter income from low-tax foreign countries or industries which would otherwise be taxable to the United States.*

It is on these two points that I wish to concentrate today, since recent actions of the Committee on Ways and Means are designed to "correct" them.

#### *I. PRODUCING COUNTRY INCOME TAXES ALLEGEDLY ARE EITHER ROYALTIES OR EXCISE TAXES, IN WHOLE OR IN PART*

In Saudi Arabia, Aramco's concessionary arrangements provide that the government is to receive a basic royalty equal to four gold shillings per ton (plus another five cents per barrel for offshore production). Converted at \$35 an ounce, this basic royalty of four gold shillings was \$.22 for light Arabian oil of 34° no gravity. Most of the concessions in other producing countries generally provide that the royalty be  $\frac{1}{8}$  of the market value of oil, on which posted prices were based until the late 1950's.

In 1950, Saudi Arabia also levied an income tax after observing that Venezuela and many other countries were imposing income taxes on profits of the companies operating in their jurisdictions. Saudi Arabia levied a 20 percent income tax and also an additional income tax of 50 percent with the 20 percent income tax and the above royalties being credits against the 50 percent additional income tax. In other words, the sum of the royalties, the 20 percent income tax, and the additional income tax were to equal 50 percent of the profits before royalties and taxes. Since the income tax and the additional income tax were measured by, and levied on, income in the same manner that the U.S. tax law levies a tax on income, the new taxes were accepted by the U.S. Treasury as a creditable income tax. That treatment by the Treasury was no different from its treatment of income taxes in other foreign

countries—such as Canada, the United Kingdom, France, and Australia—where American companies produce oil.

Accordingly, since 1950, Aramco has paid both taxes based on its income and a royalty to the Saudi Arabian government. Yet for a quarter of a century, critics of the oil industry have persistently claimed that the whole arrangement in 1950 was an effort to convert a royalty into a tax. They make this contention even though the basic royalty was continued and is still paid in addition to the tax. In fact, the royalty is higher today. In addition to the basic royalty discussed above, Aramco is required to make a supplemental royalty payment so that the total royalty payments are never less than  $\frac{1}{8}$  of the posted price, even though the posted price has usually exceeded market price since the late 1950's. The argument that the entire payment is a royalty is without merit because it implicitly denies a sovereign government the right to levy an income tax in addition to a royalty on oil production in its jurisdiction.

A foreign government deals with the oil industry in two capacities: (a) as the owner of natural resources in place; and (b) as a sovereign taxing power. The foreign government collects a royalty as the owner of the natural resources; and it levies an income tax on the profits in its capacity as the taxing sovereign. Each payment is separate, and each is made for different reasons. In recognition of this distinction, a U.S. tax deduction is allowed for the royalty; and a U.S. tax credit is allowed for the income tax to the extent that the United States would tax the same income. Thus, a tax credit is *not* allowed for oil royalties paid to foreign governments. This system of payments is used in Canada, the United Kingdom, Australia, Venezuela, and the Persian Gulf. It parallels payments to the U.S. Government on its own oil lands. The U.S. Government collects a royalty as the landowner and levies an income tax on the profits as the taxing sovereign. There is no reason to treat payments to foreign governments differently.

A variant of the royalty argument states that the income tax is actually an excise tax. By definition, an income tax varies with changes in profits and hence, with changes in market price or cost. However, under the posted price system as we have known it for the past 15 years or so, posted price has exceeded market price; and at a given level of posted price, the income of a company based on posted prices has not changed even though income based on market prices has varied with fluctuations in market price. Thus, some critics assert that the tax is actually a specific excise tax of so many dollars per barrel. This contention is highly questionable.

In the first place, the tax usually applies to the difference between the posted price (or the market price if that happens to be higher than post) and actual costs before income tax. Consequently, when costs change, the per barrel tax changes accordingly. Moreover, since costs

vary among companies and fields, the tax is not the same on different companies or on oil from different fields. Do excise taxes differ among companies when the companies' costs differ? That is a characteristic of income taxes, not of excise taxes. Some might contend that this defense is de minimis because actual cost is only a small fraction of posted price. But even that is not necessarily true outside of the Middle East.

More importantly, the argument has two further flaws.

#### A. *A Point of Law*

The crude is sometimes exported from the countries at the posted prices in order to meet concessionary requirements. These requirements are a condition of retaining the concession and are not a part of the tax law. Thus, no other price could legally be used as the sales price of a company subject to the concessionary requirements—regardless of what the tax rate may be under the tax law. In such a case, the company *has* realized income based on posted price; and this is the actual income of that company as the term "income" is generally understood in commercial and business affairs or in its use in the sixteenth amendment of the United States Constitution and the U.S. tax laws. Thus, any tax based on posted price is an income tax for that company and should be recognized as an income tax for U.S. foreign tax credit purposes. It is our view that where the taxes are based on the actual income of a company subject to those tax laws, the tax payments are an income tax even though that income may be inflated because the company is required to export oil at the posted prices.

#### B. *A Point of Economics and Sovereignty*

What if the tax were levied on the difference between realized market price and cost without a posted price computation? How could it be considered anything other than an income tax on the profits of the firm? Any other position would implicitly question the right of a producing country to levy an income tax. But the United States can surely not deny the right of a sovereign foreign government to tax corporate profits. Entirely apart from considerations of local law, at least that part of the tax attributable to the difference between realized price and cost must be an income tax. As Mr. Stanford Ross recently told the Church Subcommittee:

Oil companies as well as manufacturing and other multinational companies should expect to pay some reasonable amount of income taxes to host or source countries, and, in fairness, only a part of what is paid to Middle Eastern countries could equitably be treated as a royalty.<sup>1</sup>

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1. Statement of Stanford G. Ross, *Hearings Before the Subcomm. on Multinational Corporations of the Senate Comm. on Foreign Relations*, 93d Cong., 2d Sess., pt. 4, at 126 (1973).

At least part of the payment to governments must be a tax. And we believe that the tax on the difference between market price and cost is clearly an income tax. One may argue that the law should be amended so that the remaining tax which is attributable to the difference between posted price and market price is a non-creditable tax; but the tax on the difference between market price and cost is an income tax which should be creditable.

An equitable way to resolve this controversy over income tax *versus* royalty *versus* excise tax could be simply to disallow as an income tax creditable for U.S. tax purposes the tax on the difference between posted price and market price, as the staff of the Joint Committee on Internal Revenue Taxation has recently suggested. (This would parallel the treatment of foreign percentage depletion, which is effectively disallowed for the purpose of computing transferable credits.)

One final note on this matter. Some circles in the producing countries have recently contended that the oil companies should be held to a constant after-tax profit per barrel of sales. This would imply back-calculating the posted price from the difference between market price and cost to give a company the stipulated profit. If such a system is adopted, the posted price must change when market price changes. Thus, the tax would clearly be a function of market price because the tax would follow from posted price which, in turn, would change with market price. Another way to look at it is to consider the extra tax a sort of 100 percent excess profits tax. If market price were to rise, posted price would be recalculated to capture the entire increase for the producing government—that differs only in the marginal rate (100% *versus* 85%) from the U.S. Korean War excess profits tax.

## II. TRANSFERRING UNUSED CREDITS SHELTERS INCOME WHICH WOULD OTHERWISE BE TAXABLE TO THE UNITED STATES

The U.S. tax potentially due on income from the producing countries is usually less than the foreign tax, leaving the taxpayer with unused credits. Taxpayers electing the overall limitation on the foreign tax credit can use these unused credits from the producing countries if they operate in other countries which have tax rates lower than the U.S. rate. Thus, the overall limitation method is criticized because it allegedly shelters income earned by American firms in low-tax countries or industries abroad from home taxation. The unused credits from a high-tax country can be used to offset the difference between the tax rate in the low-tax foreign country and the tax rate at home. A moment's careful reflection will show, we believe, that this claim is largely invalid.

For the criticism to be valid, a basic condition must prevail:

*Only American companies must be willing to make the investment in the low-tax country or industry.*

This is most unlikely in view of the economic growth of Europe and Japan over the past twenty years. Imposing a U.S. tax on American companies does not mean that active foreign-owned competitors—now including the Japanese and the oil producing countries, as well as the Europeans—will be taxed by *their* home governments. *Market forces* require parallel tax treatment of American foreign investment if the American producer is to remain competitive with foreign-owned companies.

Our principal foreign-owned competitors are domiciled in the Netherlands, the United Kingdom, and France. The Netherlands and France do not tax foreign-source income, and the United Kingdom permits an averaging of foreign losses and profits similar to the U.S. overall limitation method. Disallowance of the transferral of unused credits from high-tax countries in the integrated chain of operations to cover low-tax countries would leave us at a serious competitive disadvantage relative to companies domiciled in countries which either do not tax foreign-source income at all, or tax it on some sort of global basis which aggregates all foreign profits, losses, and taxes. Thus, one cannot really say that the transfer of unused credits shelters income which would otherwise be subject to U.S. tax. On the contrary, without the transfer, there would very likely be no U.S. company operating in the low-tax environment.

Of particular importance in this connection is our international tanker fleet. World shipping is characterized by tax incentives—to be blunt, by virtual exemption from tax. If American oil companies are taxed on their foreign shipping income, the shipping component of the delivered cost of their refined products would be higher than that incurred by their foreign competitors. Thus, American companies could no longer afford to build tankers for international service rather than charter them from foreign companies. This cannot be in the national interest.

In his Trade Message on April 10, 1973, the President said:

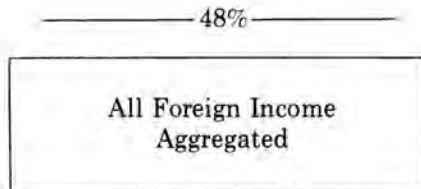
... our system for taxing the foreign profits of American business . . . permits American-controlled business in foreign countries to operate under the same tax burdens which apply to its foreign competitors in that country. I believe that system is fundamentally sound. We should not penalize American business by placing it at a disadvantage with respect to its foreign competitors.

This view is economically sound. Any other treatment would jeopardize the competitive survival of American oil companies abroad. We cannot accept that as being in the national interest.

### III. THE NEW ENERGY TAXATION BILL

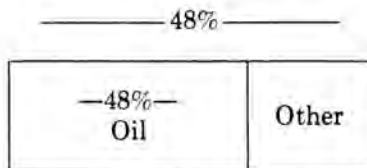
I should like to close by discussing what the Committee on Ways and Means proposes to do about the royalty-excite and transferral issues in its new "Oil and Gas Energy Tax Act of 1974." After much deliberation and many suggestions the Committee has come up with a rather simple change. First, all oil companies would be put on the overall basis. Today, the overall basis lumps together all foreign income and taxes and permits a maximum U.S. credit of 48 percent of foreign source income—assuming, of course, that that much total income tax has been paid somewhere abroad:

DIAGRAM A



Second, Ways and Means would fracture our foreign business into "oil" and "other:"

DIAGRAM B



A second 48 percent credit limit would be applied to oil-related income. This is discriminatory treatment of oil income (no other business is so treated). Its effect is to prevent the transfer of credits from oil-related income to non-oil income. We were surprised to find that interest on our loans to our petroleum affiliates is not considered oil income.

Third, a second fracturing would isolate income from the extractive stage of the oil business and limit the creditable tax to 10 percent more than the statutory rate (or 52.8 percent) applied to income based on market price, not posted price:



## DIAGRAM C

————— 48% —————	
—48%— Oil	Other
Extractive —52.8%—	

Unused credits from extraction could only be applied to oil income, not to other.

This treatment is doubly discriminatory in comparison with other industries:

1. It disallows part of the foreign tax, even in countries where companies are required by law to sell at the posted price.
2. It substitutes a 52.8 percent tax rate for the rate actually imposed by the foreign country.

As indicated earlier, we can understand an argument for disallowing that part of the tax attributable to the difference between market price and posted price. But why disallow part of the foreign tax actually paid? Even if there were no posted price computation, this provision would substitute the U.S. rate plus 10 percent for the foreign rate; that is also treatment not accorded any other industry.

The Administration has proposed using the U.S. rate of 48 percent as the limit on extractive income. That proposal lost in the Committee by only one vote with two members not voting.

Encouragingly, both the Committee and the Administration versions accept the view that part of the producing tax is, in fact, an income tax. That is certainly far preferable to contending that the whole tax is a royalty or excise tax.

Discouragingly, however, both versions sharply restrict the amount of transferable credit from oil production. The Committee version restricts credit to 4.8 percent of income based on market price (52.8-48). The Administration version would restrict to zero. Our foreign competitors face no such restrictions from their home governments.