[JOINT COMMITTEE PRINT]

EXPLANATION OF FOREIGN TAX CREDIT RULES APPLICABLE TO PETROLEUM INCOME AND DESCRIPTION OF ADMINISTRATION PROPOSAL

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INTRODUCTION

This pamphlet has been prepared by the staff of the Joint Committee on Taxation for the Ways and Means Committee hearings on the Administration's proposal regarding the foreign tax credit allowed for foreign taxes paid on petroleum income. The public hearings are scheduled for June 19 and 25–26, 1979.

The pamphlet first provides a summary of present law and the Administration proposal. This is followed by a detailed discussion of the foreign tax credit rules applicable to all foreign income (oil and nonoil) and next by a discussion of the special foreign tax credit rules relating to petroleum income, including background on the development of present law and Treasury rulings and regulations. The fourth part of the pamphlet describes the Administration's proposal regarding foreign tax credits for petroleum income.

A description and analysis of other proposals, including Member's proposals, will be prepared by the staff prior to committee consideration of the Administration proposal.

I. SUMMARY

A. Present Law Rules

U.S. taxpayers are allowed a credit against their U.S. tax liability for foreign income taxes paid. However, the credit is limited to insure that it offsets U.S. tax only on the taxpayer's foreign source income, and that it does not offset U.S. tax on U.S. source income.

Special rules have been enacted in recent years which apply to foreign tax credits claimed by oil companies. These special oil tax credit rules were adopted largely because of the difficulty in determining whether payments made to foreign governments on oil income are in substance as well as in form creditable income taxes or whether they are, instead, noncreditable payments such as royalties or severance taxes. Generally, these special rules limit the credit which may be claimed for foreign taxes on oil and gas extraction income only to 46 percent of the taxpayer's overall foreign extraction income. However, a special exception allows the oil companies to ignore losses from any country for purposes of computing this limitation and in effect allows those losses to be used to reduce U.S. tax on other foreign oil-related income, such as shipping or refining income.

B. Administration Proposal

The Administration proposal would eliminate the special per-country loss rule in computing the 46-percent limitation on an overall basis. It would also require the taxpayer to apply the 46-percent limit on a country-by-country basis if that resulted in a lower credit. These changes would limit the extent to which U.S. tax liability on income from low tax countries or foreign oil-related income which is subject to relatively low rates of foreign tax (e.g., foreign shipping and refining income) can be offset by excess oil extraction taxes from high tax countries, or by extraction losses in other foreign countries. In those circumstances where an offset does occur, the resulting U.S. tax benefit will be recaptured in future years.

The proposal will generally be effective for taxable years beginning after 1978. However, under the proposal, foreign extraction losses which were incurred in 1975 (when the special rules limiting the credit for extraction taxes became effective) through 1978 will be subject to the new per-country recapture rules and will be recaptured against foreign extraction income in 1979 and later years.

A more detailed explanation of the Administration proposal, with examples, appears in Part IV.

II. FOREIGN TAX CREDIT RULES APPLICABLE TO ALL FOREIGN INCOME (OIL AND NONOIL)

A. In General

The foreign tax credit was enacted to prevent U.S. taxpayers from being taxed twice on their foreign income—once by the foreign country where the income is earned and again by the United States as part of the taxpayer's worldwide income. The foreign tax credit is intended to allow U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country. Foreign tax credits may not be used to offset U.S. tax on domestic income.

This foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which any income is earned) has the first right to tax the income arising from activities in that country, even though the activities are conducted by corporations or individuals resident in other countries. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from these activities, but recognizes the obligation to insure that double taxation does not result. Some countries avoid double taxation by exempting foreign source income from tax altogether. However, most countries, including the United States, avoid double taxation through a foreign tax credit system, providing a dollar-for-dollar credit against home country tax liability for income taxes paid to a foreign country.

The credit is available only with respect to foreign income, war profits, or excess profits taxes (for ease of reference, referred to generally as foreign income taxes). Other taxes paid by the taxpayer are generally not creditable but are treated only as deductible expenses. Thus, to be creditable, a foreign tax must be the substantial equivalent of income tax in the United States sense, regardless of how the tax is denominated by the foreign government which imposes it. *Biddle* v. *Commissioner*, 302 U.S. 573 (1938). Moreover, in order to be considered an income tax, the foreign tax must be directed at the taxpayer's net gain. *Bank of America Nat'l T. & S. Ass'n* v. *United States*, 459 F.2d 513 (Ct. Cl. 1972). In that case, a credit was denied for certain foreign taxes on the gross income of a bank because the taxes would have applied even if the bank had a loss after deduction of its expenses from its gross income. Since the taxpayer could not show that the risk of such a loss was minimal, the tax was not considered to be an income tax in the United States sense.

Under present IRS ruling policy,[1] in order for a foreign tax to qualify for the U.S. foreign tax credit, it must be imposed on the net gain of the taxpayer (determined by allowing the deduction of the generally significant expenses incurred in the production of that income), it must be imposed only on income that is realized, and it must be imposed on the receipt of income rather than some other transaction. The proposed regulations issued by the Treasury on June 15, 1979 elaborate on these rules. These regulations are described within at Part III.A.3.

A credit is also provided, however, for a tax paid in lieu of a foreign income tax which is otherwise generally imposed (sec. 903).

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[1] *See, e.g.*, Rev. Rul, 78–61, 1978–1 C.B. 221; Rev. Rul. 78–62, 1978–1, C.B. 226; Rev. Rul. 78–63, 1978–1 C.B. 228.

B. Foreign Tax Credit Limitation (Sec. 904)

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. source income. Accordingly, the computation of the foreign tax credit contains a limitation to insure that the credit only offsets the U.S. tax on the taxpayer's foreign income. The limitation operates by prorating the taxpayer's total U.S. tax liability before tax credits ("pre-credit U.S. tax") between his U.S. and foreign source taxable income.[2] Therefore, the limitation is determined by using a simple ratio of foreign source taxable income divided by total taxable income. The resulting fraction is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. taxes paid on the foreign income and, thus, the upper limit on the foreign tax credit.

The following example illustrates the computation of the foreign tax credit limitation. Assume that the U.S. taxpayer has foreign source taxable income of $300 and U.S. source taxable income of $200 for total taxable income of $500. Assume further that the pre-credit U.S. tax on the $500 is $230 (i.e., a 46-percent rate). Since 60 percent ($300/$500) of the taxpayer's total worldwide taxable income is from foreign sources, his foreign tax credit is limited to $138, or 60 percent of his $230 pre-credit U.S. tax. Thus, a taxpayer with foreign taxes paid in excess of $138 will only be allowed a foreign tax credit of $138 (the excess taxes paid may be carried to other years) and if the taxpayer has paid less than $138 in foreign taxes he will have a foreign tax credit equal to the amount of the taxes paid.

Historically, the foreign tax credit limitation has been determined based upon either the taxpayer's total foreign income or his foreign income from each separate country, or both. These are known as the overall limitation and the per-country limitation, respectively. Currently, the foreign tax credit limitation can only be computed under the overall method. However, the per-country method has been elective or mandatory at various times in the past.

1. Overall limitation

Under the overall method, the taxpayer combines the income and losses from all his foreign operations and allocates the pre-credit U.S. tax based upon this amount. Therefore, if, as in the example above, 60 percent of the taxpayer's taxable income is from all foreign sources combined, then his foreign tax credit is limited to 60 percent of his pre-credit U.S. tax.

The overall limitation is generally advantageous to the taxpayer when he has income subject to a high tax (as compared to the U.S. rate) in one foreign country and income subject to a low or zero tax in another country. The use of the overall method allows the taxpayer

[2] The pre-credit U.S. tax is the U.S. tax before all credits, that is, before the investment tax credit and other credits as well as the foreign tax credit.

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to use the foreign taxes imposed by the high-tax country to offset the U.S. tax imposed on the foreign income in the low or zero tax country.

The taxpayer will generally find the overall method a disadvantage when he has substantial net losses from some foreign countries that offset his income from other foreign countries, particularly high tax countries. This is because the losses reduce the amount of the foreign source income to which the pre-credit U.S. tax may be allocated and therefore they reduce the amount of the foreign tax credit limitation.

2. Per-country limitation

Under the per-country method, the taxpayer is required to determine his foreign tax credit on a country-by-country basis. Thus, the taxpayer is allowed to take a foreign tax credit for taxes paid to any particular foreign country only to the extent that the taxes paid to that country do not exceed the limitation separately determined for that country. In other words, under the per-country limitation taxes paid to any foreign country can only be used as credits against the portion of the total pre-credit U.S. tax which is allocable to income from sources within that country.

The method of computing the per-country limitation is to divide the taxable income from sources within each foreign country by the taxpayer's total taxable income and multiply the resulting fraction by the pre-credit U.S. tax. Thus, if, in the example above, $100, or 20 percent, of the taxpayer's total worldwide taxable income of $500 were from sources within a particular foreign country, the taxpayer's foreign tax credit limitation for taxes paid to that country would be equal to 20 percent of his pre-credit U.S. tax. The taxpayer's total foreign tax credit for the year would be equal to the sum of his foreign tax credits allowed for each country.

The per-country limitation is advantageous to the taxpayer when he has income in one country and a loss in another country. Use of the per-country method prevents the loss from the second country from reducing the foreign tax credit limitation for taxes paid to the first country.

The per-country method is a disadvantage where the taxpayer has income from both a high-tax country and a low-tax country. In such circumstances, it is possible for the taxpayer to have paid foreign taxes in excess of his limitation in the high-tax country, thus getting no credit for those excess taxes, while having a limitation for the low-tax country in excess of the foreign taxes paid to that country. Since, under the per-country limitation, foreign taxes paid in one country cannot be used to increase the foreign tax credit allowed for another country, the taxpayer loses potential foreign tax credits for this year.

3. Examples

All countries with income

The overall and per-country limitations may further be illustrated by the following examples. Assume that a taxpayer has taxable income from U.S. sources of $200 and taxable income of $100 from each of foreign countries A, B, and C. Further assume that his U.S. tax before the foreign tax credit is $230 on total worldwide taxable income of $500 (that is, he is taxed at a 46-percent U.S. rate) and he pays foreign taxes of $75 to A, $30 to B, and no taxes to C. He has no excess foreign tax credit carryovers or carrybacks from other years. His limitations would be as follows:

	Per-country limitation				Overall limitation
	A	B	C	Total	(A, B, C)
(1) Foreign income	100	100	100	300	300
(2) Foreign tax	75	30	0	105	105
(3) FTC limitation	46	46	46	NA	138
(4) Credit allowed (lesser of (2) or (3))	46	30	0	76	105
(5) Excess credits ((2) − (4))	29	0	0	29	0

The taxpayer's per-country limitation is equal to $46 for each of countries A, B, and C. In country A the foreign tax credit is limited to the $46 limitation (the excess credits may be carried to other years subject to the limitation for those years). Since the foreign taxes paid, if any, in countries B and C do not exceed their respective limitations, the foreign tax credit for each country is limited to the taxes paid, if any, to that country, or $30 for B and zero for C. The taxpayer's total foreign tax credits for the year under the per-country method equals the sum of the foreign tax credits allowable for each country, or $76.

It should be noted that under the per-country limitation, the taxpayer could not use the $29 excess credits from country A to offset either the remaining $16 of U.S. tax on the income from country B (after the allowance of a $30 foreign tax credit for taxes paid to B) or the $46 U.S. tax on the income from country C.

The taxpayer's overall limitation in this example is $138. However, since he only paid foreign taxes of $105, he is permitted to claim a foreign tax credit under the overall method for the full amount of the foreign taxes paid.

Losses in some countries and income in others

Now assume the same facts as above, except that the taxpayer has a tax loss of $100 from Country C. Assume that his effective pre-credit U.S. tax rate remains at 46 percent—that is, his U.S. tax before reduction by the foreign tax credit is $138 on $300 of total worldwide taxable income ($200 from U.S. sources plus $100 net from foreign sources). His foreign tax credit limitations would be determined as follows:

	Per-country limitation				Overall limitation
	A	B	C	Total	(A, B, C)
(1) Foreign income	100	100	(100)	100	100
(2) Foreign tax	75	30	0	105	105
(3) FTC limitation	46	46	0	NA	46
(4) Credit allowed (lesser of (2) or (3))	46	30	0	76	46
(5) Excess credits (2)—(4))	29	0	0	29	59

Under the per-country limitation, the taxpayer could claim a foreign tax credit of $76 against his pre-credit U.S. tax of $138, leaving a net U.S. tax liability of $62. In effect, the per-country limitation allows the taxpayer to offset the loss in country C against his U.S. taxable income (thereby reducing his pre-credit U.S. tax), while disregarding the loss when calculating his credit from each of countries

A and B. In contrast, the overall limitation would only be $46, leaving a net after-credit U.S. tax liability of $92, because the $100 loss from country C would offset income from countries A and B in determining the amount of U.S. tax the credit could offset.

4. Carryovers

If the taxpayer is unable to use all his foreign tax credits in a year because of the foreign tax credit limitation, he is allowed to carry the excess credits over to other years and may claim them as foreign tax credits to the extent that the foreign taxes actually paid in the carryover year or years are less than his foreign tax credit limitation. The carryover rules provide that the excess credits are first to be carried back to the second preceding year. To the extent they cannot be used in that year, they may be carried to the first preceding year. The process is then repeated for the first through fifth years following the current taxable year. If the taxpayer cannot use credits in any of the seven carryover years, their benefit is lost.

In the second example in the preceding section, the taxpayer had $59 of excess credits under the overall limitation. Assuming that that is the limitation which applied to him, and that that taxable year was 1978, he could carry the excess credits back to 1976, the second preceding taxable year. If in 1976 he had claimed foreign tax credits of $105 and had a foreign tax credit limitation of $138, he could claim an additional foreign tax credit for that year of $33 (the excess of $138 over $105). He would then have a carryback of the $26 ($59 minus $33) of excess credits to 1977. To the extent he could not use them in that year, he would have a carryover available for the five years succeeding the current year, 1979 through 1983, in order.

5. Recapture

In a case where foreign losses exceed foreign income in a given year, the excess loss could reduce U.S. tax on domestic source income. In this case, if the taxpayer later receives income from abroad on which he obtains a foreign tax credit, the taxpayer will have received the tax benefit of reducing his U.S. income for the loss year while not paying a U.S. tax for the later profitable year. To reduce the advantage to these taxpayers, the foreign tax credit limitation was modified in 1975 and 1976 to require that in cases where a loss from foreign operations reduces U.S. tax on U.S. source income, the tax benefit derived from the deduction of these losses should, in effect, be recaptured by the United States when the company subsequently derives income from abroad.

In general, the recapture is accomplished by treating a portion of foreign income which is subsequently derived as income from domestic sources. Since the amount that is recaptured represents a loss which in the previous taxable year reduced the U.S. tax on income from U.S. sources, the recaptured amount is to be treated as income from sources within the United States.

In order to reduce the impact for any given year of the recapture of prior losses, a special rule limits the amount of foreign income which is to be treated as U.S. source income in the recapture year to the lesser of the amount of the prior foreign loss (to the extent that the loss has not been recaptured in prior taxable years) or 50 percent of the foreign taxable income for the current year, or such larger percent as the taxpayer may choose. Thus, in any taxable year the amount subject to recapture is not to exceed 50 percent of the taxpayer's foreign income for the year of recapture (before recharacterization) unless the taxpayer chooses to have a greater percentage of his foreign income so recharacterized.

For example, suppose that a taxpayer has foreign operations in only one country. In one year he has a $100 loss in that country and pays no foreign taxes. He also has $100 of U.S. source income, which is offset by the foreign loss, with the result that he pays no U.S. tax. The $100 foreign loss will have reduced his U.S. tax which he otherwise would have paid on his U.S. source income (assuming for purposes of illustration a 46-percent rate) by $46.

Suppose that in the following year he has $200 of income in the foreign country on which he pays a foreign tax of $92. Assume that he again has U.S. income source of $100. His pre-credit U.S. tax is $138 (46 percent of $300) and his foreign tax credit limitation is $92 ($138 multiplied by $200/$300). Thus, he would be entitled to credit the full $92 of foreign tax, reducing his U.S. tax by that amount. His total reduction in U.S. tax for the two years is $138 ($46 plus $92).

However, his net foreign income for the two years is only $100 ($200 minus $100) and thus, over the two-year period, his U.S. tax attributable to his foreign operations is really only $46. Had he incurred the loss in the same year as the income, his foreign tax credit limitation would only have been $46 (46 percent of $100). The $100 foreign loss would still have reduced his U.S. tax by $46, but he would only have been allowed a foreign tax credit of $46, rather than $92, on the net $100 of income.

The recapture rules treat $100 of the taxpayer's foreign income in the second year as U.S. source, reducing his foreign tax credit limitation from $92 to $46, and putting him in the same position as a taxpayer who incurred the loss and obtained the income in the same year.

C. Chronology of Major Changes

1913—The Federal income tax was adopted and imposed on the worldwide income of U.S. taxpayers. A deduction, but no credit was allowed for foreign income taxes.

1918—In order to alleviate the burden of double taxation, the foreign tax credit was adopted for foreign income taxes. There was no foreign tax credit limitation to prevent taxes imposed by one foreign country from being used as a foreign tax credit against U.S. tax on income from other foreign countries or against the U.S. tax on income from the United States.

1921—The foreign tax credit limitation was adopted in order to prevent credits for foreign taxes from being used as offsets against U.S. tax on U.S. source income. It was an overall limitation so that foreign taxes paid to one country could be allowed as credits against U.S. tax on income from other foreign countries.

1932—The per-country foreign tax credit limitation was adopted so that foreign taxes from one country could not be claimed as credits against U.S. tax on income from other foreign countries. Foreign tax credits were limited to the *lesser* of the overall or the per-country limitation.

1942—The provision allowing a credit for foreign taxes paid "in lieu of" foreign income taxes was adopted.

1954—The overall limitation was repealed because it might operate to discourage investment in countries where losses might be incurred. Under the overall limitation, losses in one foreign country are applied against income from other foreign countries, thereby reducing the foreign tax credit limitation. As a result, taxpayers who continually pay foreign taxes in excess of the allowable limitation derive no tax benefit from the losses. After 1954, foreign tax credits were subject only to the per-country limitation.

1960—The overall limitation was reintroduced, and the taxpayer could elect to use the overall limitation, rather than the per-country limitation. Once the overall limitation was elected, however, the taxpayer could not switch back to the per-country limitation without the consent of the IRS. This election was intended to accommodate differing types of foreign ventures. It was felt that a multinational company functioning as a single integrated business enterprise in a number of countries should be allowed to credit taxes imposed in one country in which it operated against income which under U.S. tax rules was treated as having its source in other foreign countries.

1975—The special limitations on credits for foreign oil and gas extraction taxes (discussed in Part III below) were adopted.

1976—The per-country limitation was repealed in order to prevent taxpayers with income in some countries and losses in others from using the losses to reduce their U.S. tax on their U.S. source income while at the same time using the foreign tax credit to offset their U.S. tax on their income from those countries in which they were operating at a profit. The 1976 Act required all taxpayers to use the overall limitation.

In addition, recapture provisions were adopted so that if a taxpayer sustained an overall foreign loss which was used against U.S. source income, the taxpayer's foreign source income in future years was reduced by the amount of that overall foreign loss (thus reducing his foreign tax credit limitation).

III. FOREIGN TAX CREDIT RULES APPLICABLE TO PETROLEUM INCOME

A. Royalty Versus Income Tax Issue (Sec. 901)

1. In general

In the case of taxes paid to a foreign government with respect to oil and gas extraction income, the normal foreign tax credit rules are subject to possible abuse because of the difficulty in determining whether the payment was a tax on the extraction income or a royalty on the oil and gas extracted (or some other deductible but not creditable payment such as a severance tax or a share of production—for ease of reference, generally referred to herein as royalties). In most foreign countries, the rights to the oil or gas extracted by the U.S. oil companies are owned by the foreign government. Consequently, the foreign government can collect its revenues from the oil or gas extraction operations either by charging a royalty on the oil and gas extracted or by imposing a tax on the extraction income. A U.S. taxpayer is benefited if the payment is an income tax on the extraction income because, as a foreign tax credit, the foreign tax reduces the taxpayer's U.S. tax liability for $1 for each dollar paid as a foreign tax (up to the foreign tax credit limitation), whereas a royalty would only reduce the taxpayer's U.S. tax liability by a maximum of 46 cents for each dollar of royalty paid.

When the U.S. oil companies began their operations in a number of the major oil exporting countries, they only paid a royalty since there was generally no applicable income tax in those countries. However, in large part because of the benefit to the oil companies of imposing a foreign income tax, as opposed to a royalty, those countries have adopted income taxes applicable to extraction income. Moreover, because of this relative advantage to the oil companies of paying income taxes rather than royalties, most oil-producing nations in the post-World War II era have tended to increase their revenues from oil extraction by increasing their taxes on U.S. oil companies. Even after the foreign oil tax rates had been increased to levels higher than the U.S. rate—with the result that additional increases would only produce excess credits unusable by the companies—foreign countries have tended to increase their take by increasing their effective tax rate (by, for example, increasing the posted price on which the tax is based) rather than by increasing the royalty rate. This approach was taken by the foreign countries in large part because the taxes could be increased unilaterally while increases in the royalty rate would require renegotiation of the contract. In any event, as the result of these increases in the effective tax rate, most oil-producing countries now impose taxes on oil income at effective rates as high as 80 percent or more, while the charges designated as royalties are imposed at relatively low rates (usually 20 percent or less) as compared to the taxes paid to those countries.

2. IRS Rulings on Foreign oil taxes (sec. 901)

Early rulings

In 1955 the IRS issued Revenue Ruling 55-296, 1955-1 C.B. 386, which held that the taxes imposed by Saudi Arabia were income taxes which qualified for the foreign tax credit. On the basis of this and subsequent rulings, foreign taxes paid on oil income were generally treated as qualifying for foreign tax credit.

Recent rulings

Beginning with Revenue Ruling 76-215, 1976-1 C.B. 194, which denied the foreign tax credit for amounts paid to Indonesia under production-sharing contracts, the IRS has issued a series of revenue rulings and other administrative determinations denying the foreign tax credit, on a prospective basis, for foreign "taxes" paid to various foreign countries on the grounds that those taxes do not constitute income taxes within the meaning of section 901 of the Internal Revenue Code and thus do not qualify for the credit. These rulings revoked the earlier IRS rulings which had allowed the foreign tax credit for the Saudi Arabian tax and the oil taxes of certain other countries. These rulings have generally been applicable only on a prospective basis (under the authority of sec. 7805(b)), treating taxes paid in prior years as qualifying for the credit.

Generally, in those recent rulings, the IRS indicated that it would consider a tax imposed on foreign mineral extraction income by a country that owns the mineral to be a creditable income tax if the following characteristics are present: (1) the foreign government also requires payment of an appropriate royalty commensurate with the value of the concession; (2) the taxpayer is precluded from discharging its income tax liability from property owned by the foreign government; (3) the amount of income tax is calculated and satisfied separately and independently of the amount of the royalties or other charges imposd by the foreign government; (4) the taxpayer, in computing the income subject to the foreign income tax, is allowed to deduct, without limitation, its significant expenses; (5) under the foreign law, the income tax is imposed on the receipt of income realized by the taxpayer; (6) the foreign taxable income from extractive operations is computed on the basis of the taxpayer's entire extractive operations within the foreign country; and (7) the net taxable income or losses from extractive operations are combined with income or losses from other activities which are subject to the tax.

3. Proposed regulations

In addition to the recent series of rulings dealing with particular foreign taxes and with various specific issues as to the creditability of those taxes, in 1978 the IRS and Treasury commenced a regulations project that is intended to clarify on a more comprehensive basis the requirements which the IRS and Treasury believe must be satisfied before a foreign tax can qualify for the U.S. foreign tax credit. The proposed regulations were issued June 15, 1979 and are generally effective for taxable years beginning after that date.

The rules set forth in the proposed regulations generally follow those which have been articulated in the recent rulings with respect to particular taxes. It can be expected that under the criteria contained in the proposed regulations, most foreign petroleum taxes presently imposed would not be considered to be income taxes qualifying for the foreign tax credit. It should be noted, however, that the regulations are only in proposed form and thus possibly might be changed in certain respects in response to public comments. It is also possible that the proposed regulations might be challenged in court by certain oil companies or other taxpayers who would be denied foreign tax credits by application of the regulations. Alternatively, foreign countries might restructure their taxes on petroleum income so that the taxes satisfy the criteria adopted in the regulations and thus qualify for the foreign tax credit. (This has already been done by Indonesia in response to the 1976 ruling disallowing the credits for amounts paid under production-sharing contracts; the restructured tax was held to qualify for the foreign tax credit in Rev. Rul. 78-222, 1978-24 I.R.B. 15.) Given these possible developments, the exact impact of the proposed regulations on the foreign tax credits claimed for foreign oil taxes will not be finally resolved for some time.

The proposed regulations generally provide with respect to all taxpayers that a payment to a foreign government is an income tax that can be credited against U.S. income tax liability only if the charge is computed on realized net income. In determining whether a tax is imposed on realized net income, the foreign income tax must be "substantially equivalent" to the U.S. income tax, but need not exactly parallel the U.S. tax.

The regulations further provide (interpreting sec. 903) that a special tax imposed "in lieu of" a foreign country's general income tax cannot be credited against U.S. tax liabilities unless the amount paid is comparable to the amount which would have been paid on the income involved had that country's general income tax applied.

The proposed regulations require foreign income taxes to be separate and indepndent from other charges imposed by the foreign government in order for the tax to qualify for the foreign tax credit. A foreign tax will not qualify for the credit unless the foreign government is "at risk" with respect to the income tax payment and the total amount of all payments collected from the taxpayer (i.e., the income tax plus any additional petroleum tax, any make-up payment, royalty, or other payment). Under this "at risk" rule, the foreign government's revenues from the tax must vary with the taxpayer's income without offsetting changes occurring in other payments by the taxpayer to the foreign government. For example, if a royalty or other similar payment increased as the amount of the tax fell, so that the foreign government received the same total revenues from the taxpayer regardless of the amount which was paid in the form of an income tax (for example, the amount of the "income tax" is credited against the royalty owed), the proposed regulations would not allow a credit for the amount paid in the form of an income tax, even where this basic tax is imposed by the foreign country on all income, not just extraction income. This type or arrangement is common in connection with foreign petroleum taxes and, consequently, this rule would treat as deductible royalties a substantial portion of the foreign petroleum taxes which have been claimed as foreign tax credits. This rule of the proposed regulations generally reflects existing IRS positions.

With respect to income from the extraction of oil and gas or other natural resources, the proposed regulations set forth three circumstances in which foreign taxes on that extraction income will be treated as creditable income taxes (provided the general test outlined above are satisfied):

(1) if the extraction income is taxed under the general income tax, the foreign country taxes extraction income in the same manner as other income;

(2) if extraction income is the only income which is subject to tax by that country, the tax rate does not exceed 46 percent (this 46-percent rate safe haven does not apply, however, if nonextraction income is also taxed by that country); or

(3) if extraction income is subject to a special tax imposed in lieu of the foreign country's general income tax, the amount paid on extraction income under the special tax is comparable to what would have been paid on that income if the country's general income tax had applied.

If the extraction tax does not satisfy one of these three tests, the proposed regulations presume that it is a royalty. This presumption can be rebutted only if the taxpayer demonstrates that, under its circumstances, the amount paid is not, in any part, compensation for the right to extract the oil or other natural resource in question. Because of the essentially factual nature of this question, the IRS will not issue advance rulings on the question of whether the facts in the taxpayer's situation are such that the presumption is rebutted, and thus the taxpayer will only be able to rebut the presumption on audit.

B. Statutory Limitations on Extraction Tax Credits (sec. 907)

1. Reasons for limitations

Congress recognized the great difficulty in ascertaining whether a payment labeled as an income tax was, in fact, an income tax or a royalty (or other deductible but not creditable payment such as an excise tax) and concluded that this difficulty led to a distortion of the foreign tax credit mechanism in the oil and gas area. This problem was compounded by the fact that foreign oil-producing countries frequently impose these oil taxes at extremely high rates—presently averaging roughly 80 to 90 percent—and consequently the companies would ordinarily have substantial excess tax credits to use against U.S. tax on other foreign income. Congress also was aware that even if the Code were amended to provide a revised and more detailed definition of a creditable tax for foreign oil taxes, the foreign oil-producing countries could, and would, restructure their taxes so they qualified for the foreign tax credit as revised.

Consequently, the Code (sec. 907) has been amended in recent years to place additional limitations on the use of excess credits arising from oil and gas production to offset U.S. tax on other foreign source income. 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. The section 907 limitations do so by specifying that the payment to the foreign government will be treated as a creditable income tax only to the extent that it is imposed at a rate which does not exceed the maximum U.S. corporate tax rate.

In making these changes, Congress has made it clear that it was taking no position on the question of whether the amounts designated by the foreign countries as income taxes and claimed by the oil companies as foreign tax credits in fact constituted creditable income taxes as required by section 901 of the Code.

2. Chronology of major developments

Tax Reform Act of 1969

A provision (not enacted) of the House-passed verison of the 1969 Act would have imposed a mandatory per-country limitation on foreign taxes on mineral income (including oil and gas income). This provision was designed to prevent the use of excess credits from foreign mineral income against U.S. tax on nonmineral income from the same country or income from any other foreign country. In addition, the House bill provided for recapture of foreign mineral losses on a per-country basis. These provisions, were deleted by the Senate and from the final legislation on the grounds that the questions involved needed further study but with the understanding that Treasury would make comprehensive recommendations to Congress in the near future with respect to credits for foreign mineral taxes.

The 1969 Act did contain one provision dealing with the foreign tax credit for foreign petroleum income, however. It provided that excess foreign tax credits resulting from the percentage depletion allowance could not be used against other foreign income.

1974 Treasury proposal

Pursuant to its commitment made in connection with the 1969 Act, the Treasury in 1974 made recommendations to revise the rules relating to foreign tax credits on foreign oil and gas income. Treasury proposed that the credit for foreign taxes on oil and gas income in all cases be subject to a per-country limitation, with the foreign taxes which exceeded this limitation being treated as deductible royalties. In addition, Treasury proposed that the intangible drilling costs and other start-up losses which often arisen in connection with the exploration and development of oil and gas deposits in new areas of operation be subject to recapture against extraction income generated in those countries, in later years. This was intended to eliminate the situation which permitted the current deduction of the exploration and development losses against U.S. source income, reducing U.S. tax liability, and then permitted the foreign country to claim the full income taxes on the profits when production commenced, with the U.S. tax being offset by the foreign tax credit.

1974 Ways and Means Committee energy bill (not enacted)

This bill, the Energy Tax and Individual Relief Act of 1974, reported by the Ways and Means Committee but not considered by the House, provided in part that foreign tax credits on foreign oil and gas extraction income could not exceed 52.8 percent of that income (48 percent, the applicable U.S. corporate rate at that time, plus an additional 10 percent of that 48 percent). For purposes of this extraction limitation, the extraction income would generally be computed, and the limitation applied, on an overall basis. However, where a company's extraction operations in one or more countries resulted in losses for U.S. tax purposes in any year, those losses would not have been taken into account in computing its overall extraction income limitation the "per-country extraction loss rule").

Excess credits for foreign taxes imposed on extraction income could be used against foreign oil-related income—basically, income directly or indirectly derived from the extraction, refining, distribution, or shipping of oil or gas. The normal foreign tax credit limitation would have been imposed separately with respect to foreign oil related income and all other income. The bill would have repealed the election to use the per-country limitation, requiring use of the overall limitation, and required recapture of overall foreign loses for all taxpayers. (As explained in the following sections, essentially these same rules were enacted in 1975 and further modified in 1976 and 1978 to reduce the extraction limitation to the present 46-percent corporate rate.)

The reason articulated for repealing the election to use the per-country limitation for oil companies was that the use of the per-country limitation often permitted oil companies to obtain what in effect was a double tax benefit. Multinational oil companies typically have substantial profits in some countries but substantial exploration and development losses in others. Since the per-country limitation is computed separately for each foreign country, the credits allowed for the high foreign taxes paid to those foreign countries where the companies were in the production stage and then operating at a profit were not reduced by the losses sustained by the companies in other foreign countries where they were in the exploration and development stage. In addition, when the operations in the loss country reached the production phase and became profitable, a credit would be allowable for the taxes paid in that country which would offset the U.S. tax otherwise due on that income. In other words, a U.S. taxpayer who had losses from a foreign country and who used the per-country limitation received one tax benefit in the years when the losses arose (by using the losses to reduce U.S. tax on U.S. income) and received a second tax benefit in later years when income was derived from that foreign country (in that no U.S. tax was imposed on that income to the extent of the foreign taxes paid that country—usually sufficient to offset all U.S. tax).

This was the same problem that the 1974 Treasury proposals were directed at, but whereas the Treasury proposals would have, in effect, required those exploration and development losses to be applied against future extraction income from the same country, the House energy bill would have first applied them (as does present law) against the taxpayer's other foreign oil related income in the year of the loss.

Tax Reduction Act of 1975

During its consideration of the 1975 Act, the Senate adopted a floor amendment which would have denied the credit for foreign taxes on oil and gas income—allowing those taxes as deductions only—but providing that that income was to be subject to U.S. tax at a 24-percent rather than a 48-percent rate. In addition, the Senate adopted a floor amendment that would have eliminated the deferral of U.S. tax on all income (oil and nonoil) earned by foreign subsidiaries of U.S. companies. The House-passed bill contained no provisions deaing with extraction tax credits.

The conference report did not follow the Senate bill but instead generally followed the provisions that were contained in the 1974 Ways and Means energy bill—the principal difference was that the provisions enacted in 1975 limited the credit for foreign taxes on foreign oil and gas income to 50 (rather than 52.8) percent of that extraction income. The Act provided that per-country losses would not be taken into account in computing the extraction limitation (but would still be available to offset the taxpayer's foreign oil related income). The option to use the per-country limitation was eliminated with respect to foreign oil and gas income; the oil companies were required to use the overall limitation and recapture was provided for overall foreign oil related losses.

The 1975 Act also provided that no foreign tax credit is allowable for payments to a foreign country in connection with the purchase and sale of oil or gas where the taxpayer has no economic interest in the oil or gas and either the purchase or the sale is at a price which differs from the fair market price of the oil or gas, i.e., a posted price. This provision was intended to deny any foreign tax credit to oil companies with respect to oil or gas which is owned by the foreign government (e.g., oil which is described as nonequity oil or buyback oil) where payments for the purchase of the oil owned by the foreign country are disguised in part as the payment of a tax.

In addition, the 1975 Act provided that foreign shipping income, including oil shipping income (which comprises approximately 90 percent of the foreign source income from U.S.-controlled shipping), is to be treated as subpart F income currently subject to U.S. tax (i.e., deferral on that income was terminated). This subpart F treatment does not apply, however, to the extent that the shipping income is reinvested in shipping assets (which, for this purpose, include certain self-propelled drilling rigs).

Tax Reform Act of 1976.

During its consideration of the 1976 Act, the Senate adopted a floor amendment which would have reduced the limitation on the credit applicable to foreign oil and gas extraction income to 48 percent computed on a per-country rather than on an overall basis (and thus excess oil tax credits from one country could not offset U.S. tax on income from other countries). In addition, the Senate amendment would have expressly enabled the Treasury to deny the credit for oil and gas taxes imposed by any foreign country whenever those taxes exceeded that country's generally applicable tax rate on other income or where the country did not impose a generally applicable tax on other income.

The conference report did not follow the Senate amendment but instead reduced the overall limitation on foreign oil and gas extraction taxes to 48 percent of foreign extraction income. The 48-percent limit was reduced to 46 percent when the 1978 Act reduced the U.S. corporate rate to that level.

3. Explanation of present law (sec. 907)

Under the special section 907 extraction tax limitations which have been added to the Code in recent years, amounts claimed as taxes paid on foreign oil and gas extraction income of a U.S. company only qualify as creditable taxes (if they otherwise so qualify) to the extent they do not exceed 46 percent (which equals the highest corporate tax rate) of such extraction income.[3] Foreign taxes paid in excess of that amount are, in general, neither creditable nor deductible. However, a foreign tax credit carryover is allowed for excess extraction taxes paid to the extent of 2 percent of foreign oil extraction income.

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[3] For purposes of this limitation, "foreign oil and gas extraction income" is the foreign source taxable income derived by the taxpayer from extraction (by the taxpayer or any other person) of minerals from oil and gas wells or from the sale of extraction assets. Income from extraction includes the purchase and sale of crude oil by the taxpayer in cases where the taxpayer is not performing the extraction operations. Also it includes cases where the taxpayer is performing extraction services within the country for the government of that country (whether or not the taxpayer may purchase the oil from that government).

Present law also provides that a taxpayer is to compute the foreign tax credit limitation separately for his foreign oil-related income.[4] Thus, foreign taxes paid on the taxpayer's foreign oil-related income may not offset his U.S. tax on his other income and vice versa.

The taxpayer's extraction income is generally the sum total of the taxpayer's income and loss from foreign extraction operations. However, if the extraction activities and sales of the extraction assets in any country result in a net loss for any year, the loss from that country is not taken into account in the computation of the foreign oil extraction income for the year (the special "per-country extraction loss rule"). This benefits the taxpayer because his oil and gas extraction tax limitation is greater by 46 percent of the nonincluded loss. This increases the amount of oil and gas extraction taxes that the taxpayer can treat as a creditable tax. (It should be noted, however, that the per-country extraction loss is included in computing the taxpayer's overall foreign tax credit limitation for foreign oil-related income for the year.)

Another way of describing the impact of this per-country loss rule is that it allows a company to use against any low-taxed foreign refining or shipping income excess oil tax credits from its net foreign extraction income from all foreign countries (that is, its net income taking into account all income and losses from its extraction activities in all foreign countries). To illustrate, if a company's extraction activities generated $300 income in country A and a $100 loss in country B, it would have net income of $200 from those foreign extraction activities on which it would pay $92 of U.S. tax (at a 46-percent rate) before the foreign tax credit. However, because the $100 loss would not be taken into account in computing the 46-percent extraction limitation under present law, the company would be entitled to claim oil tax credits of $138 (46 percent of $300)—using $92 in credits against the U.S. tax on the net extraction income and the $46 excess credits against other income. It should be noted, however, that the $46 of extraction tax credits being used against the tax on other income are generated only as a result of the per-country loss.

This special per-country extraction loss rule is designed to encourage the exploration for and development of new oil reserves in countries where the companies do not presently have significant production (countries which generally are not OPEC members). During the period in which a company undertakes exploration and development activities in a new area in which it is not already producing oil income,

[4] The term "foreign oil-related income" includes the income derived from sources outside the United States and its possessions from the extraction (by the taxpayer or any other person) of minerals from oil or gas wells, the processing of these minerals into their primary products, and the transportation, distribution, and sale of these minerals or primary products. The term also includes income from the sale or exchange of assets used in these activities. Finally, the term includes certain other income indirectly derived from these activities: in general, dividends (including deemed dividends under subpart F) and interest from foreign corporations in which the taxpayer has a 10-precent stock interest, foreign source dividends from a U.S. corporation, and the taxpayer's distributive share of the income of partnerships, to the extent the dividends, interest, or distributive share is attributable to foreign oil-related income of the intermediate corporation or partnership.

the company will ordinarily incur substantial tax losses (in part because of the election to deduct intangible drilling costs). Most oil companies pay foreign oil taxes at an overall rate substantially higher than their aggregate U.S. tax on their net income from foreign extraction activities. Without this special per-country extraction loss rule, any expenses incurred by a company in exploring for and developing new oil and gas deposits would reduce the company's net extraction income and thus would reduce its allowable credits. In order to preserve the incentive for such exploration and development of new deposits, this special per-country extraction loss rule was adopted to permit the companies to use these losses, which can be substantial, against shipping income or other relatively low-taxed foreign oil-related income. (It should be noted, however, that in the past several years a number of oil companies have sustained losses on their shipping operations because of a worldwide excess of tanker capacity.)

Another argument advanced for the special loss rule is that, if the limitation on extraction taxes is intended to make sure that the credit for extraction taxes paid to a country does not exceed the U.S. tax paid on extraction income from that country, then losses from other countries should not be taken into account. This rationale, however, highlights the fact that the limitation of present law, since it is computed on an overall basis, rather than a per-country basis, does not actually operate to limit the credit for extraction taxes paid to a country to the amount of U.S. tax which would have been imposed on that income.

4. Illustration of special limitations on oil taxes

The application of the section 907 foreign extraction tax limitation and the section 904 limitation on foreign oil related income are illustrated in the following two examples. The first example illustrates the situation where the section 904 limitation is the controlling limitation. The second example illustrates the situation where the foreign extraction tax limitation is the controlling limitation.

Example 1

Assume an oil company's foreign income and foreign taxes were those set forth in the table below:

	Extraction country			Shipping and refining	Total	Limitation
	A	B	C			
Income (loss)	$200	$200	($100)	$50	$350	----
Foreign tax	170	60	0	5	235	----
Foreign oil and gas extraction income	200	200	0		400	[1] $184
Foreign oil related income	200	200	(100)	50	350	[2] 161

[1] Sec. 907(a) extraction tax limitation.
[2] Sec. 904 limitation on foreign oil related income.

The amount of extraction taxes which the company can claim as credits for the current year are limited to $184 by the section 907 extraction tax limitation. This is 46 percent of the sum of the $200 of extraction income from country A plus the $200 of extraction income from country B. (Pursuant to the special per-country extraction loss rule, the $100 extraction loss from country C is not taken into account.) However, the company's separate overall section 904 foreign tax credit limitation on foreign oil related income of $350 ($200 each from countries A and B plus $50 of shipping and refining income, less the $100 extraction loss from country C) is only $161, assuming an effective pre-credit U.S. rate of 46 percent. Accordingly, the total credit the company can claim against its total foreign oil-related income is limited to $161, its precredit U.S. tax on that income.[5]

In this situation, therefore, the special section 907 extraction limitation (here $184) does not restrict the credits allowed the taxpayer. In fact, the only effect (if any) which various special limitations for oil credits would have is that they would prevent the $28 excess credits on oil related income (the excess of the $184 of extraction taxes plus $5 in shipping and refining taxes over the $161 of allowable credits) from being used against low-taxed foreign income of the company which is not derived from oil related activities—generally a relatively small amount.

Example 2

The effect of the extraction tax limitation of section 907 can be illustrated by increasing "shipping and refining income" in the above example to $150 so that it exceeds, rather than being less than, the loss in country C.

	Extraction country A	Extraction country B	Extraction country C	Shipping and refining	Total	Limitation
Income (loss)	$200	$200	($100)	$150	$450	----
Foreign tax	170	60	0	5	235	----
Foreign oil and gas extraction income	200	200	0		400	[1] $184
Foreign oil related income	200	200	(100)	150	450	[2] 207

[1] Sec. 907(a) extraction tax limitation.
[2] Sec. 904 limitation on foreign oil related income.

Under the extraction tax limitation of section 907, the taxpayer is allowed to claim $184 of its foreign extraction taxes as creditable taxes. (This is computed in exactly the same manner as in the previous example—46 percent of the $200 each from countries A and B, but not taking into account the $100 loss from country C.) The $184 is then added to the $5 of foreign taxes paid on other foreign oil related income to arrive at the total foreign taxes ($189) which are available to be credited against the U.S. tax on foreign oil related income.

The section 904 limitation is again computed separately on the basis of foreign oil related income. Assuming a 46 percent pre-credit U.S.

[5] Without the special per-country extraction loss rule, the section 907 extraction tax limitation would be $138 (46 percent of $300), so that the total credit against foreign oil related income would be $143 (the $138 extraction taxes plus the $5 of shipping and refining taxes). Therefore, allowable foreign tax credits for the year are increased by $18 as the result of the special loss rule ($161 less $143).

tax rate, the limitation is $207 (46% × $450). Since the $189 of foreign taxes available for credit after application of the foreign extraction tax limitation is less than the section 904 limitation of $207, only $189 may be claimed as a foreign tax credit. The taxpayer is required to pay on the foreign oil related income, after the foreign tax credit, U.S. tax of $18 ($207 minus $189). In this situation it is the section 907 extraction tax limitation rather than the separate section 904 limitation which restricts the allowable credit.[6]

[6] Without the special per-country extraction loss rule, the section 907 extraction tax limitation would be $138 (46 percent of $300), so that the total credit against foreign oil related income would be $143 (the $138 extraction taxes plus the $5 of shipping and refining taxes). Therefore, allowable foreign tax credits for the year are increased by $46 as the result of the special loss rule ($189 less $143).

IV. ADMINISTRATION PROPOSAL REGARDING FOREIGN TAX CREDITS RELATING TO PETROLEUM INCOME

A. Description of Proposal

The Administration has proposed that a substantial revision be made to the limitations on the foreign tax credits allowed for taxes on foreign oil and gas extraction income. Under the proposal, the credit for foreign extraction taxes would be limited to the lesser of a limitation on foreign extraction income (1) computed on an overall basis, or (2) computed on a per-country basis. In addition, in computing the overall limitation on extraction taxes, the special per-country loss rule of present law (sec. 907(c)(4)) would not be used; that limitation would be computed with respect to the company's net foreign extraction income (i.e., all foreign extraction losses as well as all foreign extraction income would be taken into account).

This proposed revision of the extraction limitations has two objectives. First, it is intended to prevent excess extraction tax credits or extraction losses, which arise as a result of the special per-country loss rule from offsetting the U.S. tax on low-taxed nonextraction foreign oil-related income (e.g., foreign shipping or refining income). Its second objective is to prevent the use of credits for excess extraction taxes from one country (i.e., the amount by which foreign taxes on extraction income from that country exceed the U.S. tax on that income) against the U.S. tax on low tax extraction income from another country. Although, as indicated in the discussion of present law in Part III, almost all foreign countries impose amounts designated as taxes at rates in excess of the U.S. rate, extraction income from certain foreign countries might be subject to foreign tax at a lower rate than the U.S. effective rate of tax on that income for several reasons. For example, differences between the U.S. and foreign tax systems as to the time that amounts received by a company are recognized as income might cause the U.S. tax to be higher in some years than the foreign tax. Alternatively, amounts designated as income taxes by certain of the foreign countries in which the company operated might be held not to be in substance income taxes for U.S. tax purposes, and thus they would not qualify for the foreign tax credit.

In addition, the Administration proposal would require the recapture of foreign extraction losses on a per-country basis against extraction income generated in that country in later years. That is, the income would, to the extent necessary to recapture the tax benefit generated by the loss, be treated as from U.S. sources, and thus foreign taxes on it would not be creditable. This prevents the taxpayer from using the loss to reduce U.S. tax on other foreign extraction income in one year and then paying no U.S. tax on the income from the loss country in the later year because of the foreign tax credit. (See section 5 of Part II (B) of this pamphlet for a more detailed discussion of the concept of recapture.)

The Administration proposal would also make certain related changes to the limitations on extraction tax credits. It would eliminate the present requirement that the overall foreign tax credit limitation be separately computed with respect to foreign oil-related income and all other income, requiring instead that the limitation be imposed on an overall basis with respect to all non-extractive foreign income of the taxpayer—oil and nonoil. The present 2-percentage point limitation on carrybacks and carryovers of excess extraction taxes could be eliminated. Under the proposal, excess extraction taxes would be carried back 2 years and forward 5 years under the normal credit carryover rules, but they would be subject to the revised extraction tax limitation for the year to which the taxes were carried. The proposal would require that, in the case of an affiliated group of corporations, the limitation be computed on a consolidated basis whether or not the group filed a consolidated return. Finally, the Administration has indicated that it may propose certain as yet unspecified amendments to the definition of extraction income for purposes of computing the limitation.

The Administration proposal would generally be effective for taxable years beginning after 1978. However, foreign extraction losses incurred from 1975 (when the special rules limiting the credit for extraction taxes became effective) through 1978 will be recaptured on a per-country basis against foreign extraction income from the country of the loss for 1979 and later years. The amount of loss incurred from 1975 through 1978 which is later recaptured, however, will not exceed 50 percent of the foreign extraction income for the year or years of recapture.

Example

The computation of the foreign tax credit under the Administration's proposal can be illustrated in the following examples:

Example 1

Assume an oil company's foreign oil extraction income and foreign extraction taxes were those set forth in the table below (the same facts as in Example 1 above illustrating present law):

	Extraction Country			
	A	B	C	Total
Income	$200	$200	($100)	$300
Foreign tax	170	60	0	230
Credits on per country basis	92	[1] 60	0	152
Credits on overall basis				*138*

[1] The per-country limitation for country B would be $92 (46 percent of $200), but the credits allowed would be limited to the $60 of taxes paid to country B.

Under the per-country method, credits for extraction taxes would be limited to $152; the $100 loss in country C does not reduce the extraction income in the other two countries. Under the overall method, the $100 loss in country C is taken into account which results in a $138 limitation on the credit for extraction taxes (46% × $300). The credit computed on the overall basis ($138) is less than the credit computed on the per-country basis ($152), and thus the taxpayer's credit for extraction taxes in this example would be the $138 determined by the overall method. Since the credits computed by the overall method are the same as the U.S. tax on the extraction income from the three countries, the extraction tax credits fully offset the U.S. tax on that income. (The U.S. tax liability on the $200 of extraction income from country B is $92, $32 in excess of the $60 in creditable taxes paid to country B, but that $32 is fully offset by the $100 loss in country C.)

Under the Administration's proposal, the foreign tax credit limitation for oil related income which is not extraction income (e.g., shipping and refining income) would be computed separately with other nonoil income and would no longer be affected by the taxpayer's extraction taxes or per-country extraction losses. Assuming the same facts as those contained in the examples illustrating present law (e.g., the taxpayer had $50 of shipping and refining income on which it paid $5 of foreign tax), the company would have a $23 limitation on the credit (assuming that it had no other income or losses from nonoil related activities), permitting it also to claim the $5 foreign tax on that income as a credit. Thus, its total foreign tax credit, in this example, would be $143 ($138 extraction taxes plus $5 shipping and refining taxes).

As compared to present law, therefore, the Administration's proposal as applied to these facts would reduce the company's foreign tax credits (and thus increase its after-credit U.S. tax) by $18. (Extraction tax credits would be limited to $143 under the Administration's proposal as compared to $151 under present law. (For the computation under present law, see Ex. 1 under *Illustration of special limitations on oil taxes.*))

Example 2

The applicatioin of the per-country limitation can be illustrated by increasing the extraction income in country C to $200 in the above example and assuming a foreign tax on that income of $150.

	Extraction Country			
	A	B	C	Total
Income	$200	$200	$200	$600
Foreign tax	170	60	150	380
Credits on per-country basis	92	[1] 60	92	*244*
Credits on overall basis				276

[1] The per-country limitation for country B would be $92 (45 percent of $200), but the credits allowed would be limited to the $60 of taxes paid to country B.

In this example, the credit which would be allowed under the per-country method is $244; the excess taxes paid to countries A and C cannot be used to offset the $32 U.S. tax on income from country B after the foreign tax credit for the $60 paid to country B. (The pre-credit U.S. tax on the $200 of income from country B is $92.) The overall method would allow $276 of extraction taxes to be claimed as credits. (Under the overall method, the excess credits from countries A and C would be available to offset the $32 of U.S. tax from country B remaining after the credits for the taxes paid to country B.) The credits computed on a per-country basis ($244) are less than the credits computed on an overall basis ($276), and thus the taxpayer's credit for extraction taxes in this example would be the $244 determined by the per-country method.

As in the case of the previous example, the foreign tax credit for non-extraction income, such as shipping and refining income, would be a completely separate calculation and would not be affected by the extraction taxes or extraction income or losses. Again, the $5 tax on foreign shipping and refining income would be allowed as a credit and the company's total foreign tax credit for the year would be $249 ($244 plus $5). Since its pre-credit U.S. tax on its total foreign income of $650 ($600 of extraction income and $50 of shipping and refining income) is $299, under the Administration's proposal the company would pay a net U.S. tax of $50 after a foreign tax credit of $249.

If the rules of present law were applied to this situation, the taxpayer's section 907 extraction tax limitation would be $276 (46 percent of $600 extraction income) and its section 904 limitation on foreign oil related income would be $299 (46 percent of $600 extraction income plus $50 of shipping and refining income). Accordingly, the company could claim a credit for the $276 extraction taxes available after application of the extraction limitation as well as the $5 of shipping and refining taxes, for a total foreign tax credit of $281. Since its pre-credit U.S. tax on this income would be $299, its net U.S. tax after the foreign tax credit would be $18 under present law. Consequently, the Administration's proposal as applied to these facts would reduce the company's foreign tax credit (and increase its net after-credit U.S. tax) by $32 ($50 as compared to $18).

Example 3 (Recapture)

The effect of the recapture provisions of the Administration's proposal may be illustrated by assuming that the facts set forth in Example 1 above show the results of one year of operations and the facts set forth in Example 2 show the results of the next year's operations for the same taxpayer. The first year extraction loss in country C produced a tax benefit of $32. This is because the $100 loss reduces the taxpayer's pre-credit U.S. tax on extraction income by $46, while reducing the foreign tax credit allowed against that income by $14. If there had been no loss, the taxpayer would have been allowed a credit of $152 under the per-country method, which in that case would have been the lower of the two limitations. (The overall limitation would have been $184 on $400 of extraction income.) However, because of the loss, the taxpayer is actually allowed a credit of $138 under the overall method—which, taking the loss into account, is lower than the $152 under the per-country method. Thus, the taxpayer has saved $32 ($46 minus $14) in net after-credit U.S. tax. Therefore, $70 of income from country C in year 2 will be recaptured—an amount sufficient to reduce the allowable credit by $32 (46 percent of $70 is approximately $32).

	Extraction Country			
	A	B	C	Total
Income	$200	$200	$200	$600
Loss recapture			(70)	N/A
Income after recapture	200	200	130	N/A
Foreign tax	170	60	150	380
Credits on per-country basis	92	[1] 60	60	212
Credits on overall basis				276

[1] The per-country limitation for country B would be $92 (46 percent of $200), but the credits allowed would be limited to the $60 of taxes paid to country B.

The taxpayer's foreign tax credit under the applicable per-country limitation is reduced by $32, to $212 from the $244 which would have been allowed, as in Example 2, without recapture. This is accomplished by reducing the extraction income from country C in year 2 by the roughly $70 needed to offset the $32 tax benefit obtained in year one. It puts the company in the same position as it would have been if the $100 loss from country C in year 1 and the $200 income from year 2 were both realized in the same year.

B. Revenue Effect of Proposal

The Administration estimates that its proposal would have the following revenue effect for 1979–85:

[In millions of dollars]

	1979	1980	1981	1982	1983	1984	1985
Change in calendar year liabilities	514	772	636	706	777	848	914
Change in fiscal year receipts	77	784	711	668	738	809	878

The revenue effects of the proposal were estimated by the Administration on the basis of data derived, for the most part, from 1976 tax returns and grossed-up for the effects of inflation. The estimates are based on the credits claimed by the oil companies on their tax returns—they do not take into account the probability that many of the extraction taxes claimed by the companies as credits on their returns would be disallowed under the recent rulings and the proposed regulations. They also do not take into account the significant changes that have been made since 1976 in the tax structures of several of the major oil producing countries or the manner in which companies operate in some of those countries. For example, in some countries the production interests of the companies have been nationalized and the companies only purchase oil produced by the foreign country or operate on a service basis and are no longer subject to tax at the rates previously imposed. As a working hypothesis for purposes of making the estimates, it has been assumed that in most instances the manner of operation of the companies and the foreign tax systems will be restructured so that the companies will continue to pay creditable taxes to most of these countries at levels at least as high as the pre-credit U.S. tax which would be imposed on the income from those countries. Finally, the estimates do not attempt to take into account the possible changes in dividend policy and corporate structure of foreign affiliates which the companies are likely to make in order to minimize the impact of the proposed new limitations on extraction tax credits.

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