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Taxation of International Petroleum Exploration and Production Activities

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TAXATION OF INTERNATIONAL PETROLEUM EXPLORATION AND PRODUCTION ACTIVITIES*

Frank M. Burke, Jr.†

TABLE OF CONTENTS

I.	INTRODUCTION	526
II.	UNITED STATES FEDERAL INCOME TAX	
	CONSIDERATIONS	528
A.	<i>General</i>	528
B.	<i>Intangible Drilling and Development Costs</i>	529
C.	<i>Depletion and Depreciation</i>	530
D.	<i>Geological and Geophysical Costs</i>	530
E.	<i>Foreign Tax Credit</i>	532
	1. Economic Interest	532
	2. Types of Foreign Tax Credits	533
	3. Tax vs. Royalty	535
	4. Definition of Income Tax	536
	5. Paid or Accrued	539
	6. Dual Capacity Taxpayer	539
	7. "In Lieu Of"	541
	8. Tax Treaties	542
	9. Reductions and Limitations	542
	a. <i>Section 901(e)</i>	542
	b. <i>Section 907(a)</i>	543
	c. <i>Section 907(b)</i>	545
	d. <i>Section 904</i>	546
	10. Alternative Minimum Tax Limitation	548
	11. Taxable Income and Source of Income	548
	12. Recapture of Overall Foreign Losses	549

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13. Carrybacks and Carryforwards	550
F. <i>Taxation of Foreign Subsidiary</i>	550
G. <i>Transfers of Property to Foreign Entity</i>	552
III. FOREIGN TAX CONSIDERATIONS	554
A. <i>General</i>	554
B. <i>Nature of Payments to Foreign Government</i>	555
C. <i>Identifying All Foreign Taxes</i>	556
D. <i>Type of Entity</i>	557
E. <i>Computing Foreign Taxable Income</i>	557
F. <i>Withholding Taxes</i>	561
IV. FORMS OF ORGANIZATION	562
A. <i>General</i>	562
B. <i>Direct Ownership</i>	562
C. <i>Domestic Subsidiary</i>	563
D. <i>Partnership or Limited Liability Company</i>	563
E. <i>Foreign Subsidiary</i>	565
V. OBSERVATIONS	566
VI. CONCLUSION	567

I. INTRODUCTION

For many years, operating in the international environment has been an integral part of the operations of large petroleum companies. These companies obviously have the capability to analyze geological prospects, but more importantly, in relation to international operations, each company has well established procedures for analyzing international political and economic factors, including tax considerations, in potential areas of exploration. Many independents have been quite successful in on-shore and off-shore exploration in the United States, but have not previously felt the need to risk capital in foreign areas in order to continue in the petroleum business. However, as the potential for significant new petroleum discoveries in the United States declines, many U.S. independents are, for the first time, seriously considering international exploration as an alternate business strategy. In order for a petroleum company to continue as a going concern, it must engage in continuous exploration for, and development of, petroleum reserves. Proven petroleum reserves constitute the working stock of a petroleum company which must be drawn upon continuously for its ongoing revenues. Unless reserves are replaced through continuous exploration and development, a petroleum company becomes a liquidating, rather than a

going, concern. Many U.S. independent petroleum companies are finding that the United States simply does not presently provide them with the needed exploration opportunities. Further, because of the non-competitiveness of the federal income tax system as it relates to petroleum exploration, it is not economically feasible to explore in marginal areas of the United States which have not been adequately explored in the past. Hence, U.S. independent petroleum companies heretofore uninterested in international exploration may be forced to explore internationally if they are to continue as going concerns.¹

The advisor who deals with U.S. petroleum companies entering international petroleum exploration for the first time must be more than a tax specialist. Often the advisor is in a position to greatly influence the environment under which a client will operate because foreign law is often quite vague and flexible. The advisor must be prepared to deal with inaccessible accurate information and with foreign legal research materials that are seldom up to U.S. standards. Negotiations and operations in the international arena are unlike the traditional U.S. petroleum business. Accordingly, the advisor must be (1) adept in negotiation, (2) politically astute, (3) sensitive to cultural and political issues of the host country, and (4) skilled as a diplomat. The advisor and the client must realize that, in many countries, negotiation of a petroleum exploration arrangement² is locally perceived as an integral part of the future of the

1. For a general discussion of overall business aspects of petroleum operations outside the United States, see FRANK M. BURKE, JR. & RICHARD D. DOLE, *BUSINESS ASPECTS OF PETROLEUM EXPLORATION IN NON-TRADITIONAL AREAS* (1991).

2. Petroleum exploration arrangements may be in the form of a service contract, a production sharing contract, a concession agreement, or a joint venture. Under a service contract, title to the petroleum remains in the host country (or one of its agencies), and the petroleum company does not earn any direct interest in petroleum reserves. The company earns its profit by being paid a fee for its services and is generally considered to be a contractor for the host country. Under the typical service contract, the petroleum company bears the risk of exploration, and funds expended for exploration are recovered only from production.

A production sharing contract is an arrangement under which the host country and the petroleum company share in production in accordance with the percentages stated in the contract. The petroleum company normally provides all funds for exploration and operations and is typically entitled to recover its cost from a portion of production.

Under a concession agreement, the petroleum company has direct ownership of the petroleum produced. The host country is entitled to a portion of production as a royalty and is entitled to levy taxes on the taxable or net income generated from the sale of the balance of production. A concession arrangement is the oldest form of international exploration agreement, but is not used much today.

The joint venture arrangement, which is becoming more common, is an arrangement between the petroleum company and the host country (or one of its agencies) in which the host country (or the agency) participates directly as an owner in the project. Obviously, many variations of all of the foregoing forms have been adopted by various countries and petroleum companies. See BURKE & DOLE, *supra* note 1, at 16-17.

national economy of the host country, not merely as a leasing transaction between a landowner and a petroleum company.

The advisor must be prepared to deal with government representatives who may not be knowledgeable in petroleum industry matters and who are administering, in many instances, host country law not designed to deal with petroleum issues. These circumstances will be particularly prevalent in oil importing developing countries (OIDCs) which have not yet enjoyed significant petroleum exploration and which do not have reserve potential which is attractive to multi-national companies. However, independents may find OIDCs to be a fruitful area of exploration and production over the next ten to twenty years. As soon as OIDCs recognize that the U.S. independents have the potential to become the explorationists and operators of their petroleum industries and they take appropriate steps to encourage exploration, significantly increased international activity by U.S. independents will occur.

The subject of international petroleum exploration and production is broad and complicated. International petroleum operations generate many problems under the United States federal income tax law (U.S. income tax law) because of the complicated provisions applying to foreign operations. In addition, a wide range of problems result from the interaction between the law in the host country and U.S. law. Furthermore, issues such as exchange control, repatriation, and the environment will need detailed consideration during the negotiation process.

This paper will focus on (1) U.S. income tax issues involved in international exploration and production operations, and (2) the general tax areas to be considered when analyzing the law of a foreign country. The myriad of other legal, accounting, and economic issues which may be involved are beyond the scope of this paper.

II. UNITED STATES FEDERAL INCOME TAX CONSIDERATIONS

A. *General*

Historically, the U.S. income tax system has allowed petroleum companies certain deductions and other incentives to encourage capital formation.³ The intangible drilling and development costs (IDC) deduction and the percentage depletion deduction have been available to the

3. For a detailed discussion of United States federal income tax rules relating to foreign petroleum operations, see generally FRANK M. BURKE, JR. & ROBERT W. BOWHAY, *INCOME TAXATION OF NATURAL RESOURCES* §§ 29.01-29.37 (1985) (updated for current developments as C.W. RUSSELL, *INCOME TAXATION OF NATURAL RESOURCES* §§ 23.01-23.30 (1991)); ALEXANDER J.

industry in varying degrees for many years.⁴ However, apparently because of congressional concern regarding the outflow of capital for international exploration, the availability of both of these incentives has been significantly modified or eliminated for international petroleum activities. Because of the unique nature of most foreign exploration arrangements, the issues regarding geological and geophysical (G&G) costs must be thoroughly analyzed based upon the specific facts of the situation being considered. Also, the historical concept of economic interest assumes significant importance in the U.S. income taxation of international petroleum operations, particularly with respect to the foreign tax credit. The foreign tax credit rules must be thoroughly understood because application of these very complicated rules can dramatically change the economics of a proposed international petroleum operation.

In addition to reviewing the U.S. income tax law relating to petroleum operations outside the United States, the advisor must also determine if the United States has a tax treaty with the foreign country under consideration. The foreign tax credit, withholding tax rates, and other U.S. calculations may be affected by a treaty with a potential host country.

B. *Intangible Drilling and Development Costs*

For petroleum operations in the United States, any taxpayer who owns the operating rights in a petroleum property and incurs intangible drilling and development costs (IDC) may elect to expense or to capitalize the costs in the year such costs are first paid or incurred by the taxpayer.⁵ However, IDC incurred after December 31, 1986, outside the United States must be recovered either over a ten year period, using straight line amortization, or, at the election of the taxpayer, as part of the cost depletion basis of property.⁶ It should be carefully noted that this rule does not apply to dry hole costs which are deductible at the time paid or incurred.⁷

BRUEN ET AL., *FEDERAL INCOME TAXATION ON OIL & GAS* §§ 12.01-12.09 (1989); ERNST & YOUNG'S *OIL & GAS FEDERAL INCOME TAXATION* 31-1 to 31-11 (James L. Houghton et al. eds., 1991); E.C. Lashbrooke, Jr., *Taxation of Foreign Oil and Gas Income: A Primer*, 31 *OIL & GAS TAX Q.* 762 (1983).

4. I.R.C. § 263(c), (i) (1988) (concerning deductibility of IDC); *id.* §§ 613, 613A (1988) (concerning allowance for percentage depletion).

5. *Id.* § 263(c); Treas. Reg. § 1.612-4 (1965).

6. See I.R.C. § 263(i).

7. See *id.* (last sentence).

C. Depletion and Depreciation

While percentage depletion continues to be available for domestic petroleum production on a limited basis, percentage depletion for foreign oil and gas production was repealed effective January 1, 1975.⁸ Cost depletion, however, remains available for domestic and foreign petroleum production.⁹

The cost of depreciable property placed in service after December 31, 1986, used predominately outside the United States, must be recovered by means of the alternative depreciation system, rather than the accelerated cost recovery system.¹⁰ As a general rule, personal property must be depreciated using the straight line method (without regard to salvage value), the half-year convention, and a recovery period equal to the class life of the property, or twelve years if the property has no class life.¹¹ Real property must be depreciated over a forty year period using the mid-month convention.¹²

D. Geological and Geophysical Costs

Under U.S. income tax principles, G&G costs,¹³ such as surveys, preparation of maps, and analysis of data to determine the feasibility of exploring a particular tract, must be allocated to the "project area" over which exploration is to be conducted and apportioned among any areas of interest selected for a more detailed survey. The cost of a detailed survey on an area of interest is allocated to that area of interest. Costs allocated to a particular area of interest may be deducted as a loss if that area is abandoned or is deemed unworthy of further development. On the other hand, if an area is explored, costs allocated to that area must be capitalized and recovered through depletion.¹⁴

8. I.R.C. § 613A(a), (e)(3). For purposes of percentage depletion, the United States includes the 49 states, the District of Columbia, U.S. possessions, and underwater areas adjacent to the territorial waters of the United States over which the United States has exclusive rights, under international law, to exploration and production of oil and gas. *See id.* § 638 (1988).

9. *Id.* § 613.

10. *Id.* § 168(g)(1)(A), (g)(2) (1988). Section 168(g)(4) requires that rules similar to the rules under I.R.C. § 48(a)(2) (relating to investment credit) be applied in determining whether property is used predominantly outside the United States. *See id.* § 48(a)(2)(B)(vi), (x) (1988).

11. *See id.* § 168(g)(2).

12. *See id.*

13. *See generally* Frank M. Burke, Jr., *Geological and Geophysical Costs: The Confusion Continues*, 4 THE NAT. RESOURCES TAX REV. 169 (1991).

14. In 1950, the Internal Revenue Service issued I.T. 4006, 1950-1 C.B. 48, setting its position regarding G&G costs. I.T. 4006 was superseded by Rev. Rul. 77-188, 1977-1 C.B. 76, which substantially adopted the positions taken in I.T. 4006. Rev. Rul. 83-105, 1983-2 C.B. 51, was issued to explain the application of Rev. Rul. 77-188.

In many foreign countries, an exploration arrangement area will cover a significant amount of acreage, and exploration will normally take several years. The arrangements normally provide for periodic relinquishment of portions of the acreage originally granted. Under the U.S. rules regarding G&G costs, it appears that no deduction is allowable for the costs attributable to the acreage relinquished, and that accumulated costs become the cost basis of the portions retained.¹⁵ The advisor to a petroleum company should attempt to acquire separate tracts or to negotiate separate treatment of acreage to avoid this problem. Other concerns may preclude negotiating an arrangement which allows various parts of the acreage acquired to be treated as separate properties under section 614 of the Internal Revenue Code. However, if practical, the advisor should consider acquiring separate tracts from the host country in such a way as to create separate properties for U.S. income tax purposes. If separate properties are established, then as various tracts are relinquished, it may be possible to claim a deductible loss for the costs allocated to the relinquished tracts. On the other hand, if the overall concession or contract acreage is considered to be one property, the relinquishment of a tract will be considered a mere shrinkage in value of the total property and no deduction will be allowed.¹⁶

In a typical foreign country, the petroleum company undertakes exploration and development of a specific area under a well-defined program. Title to the minerals remains with the foreign government (or its agent). The company is obligated to provide funds and equipment for exploration and development and bears the risk of failure. Normally, the company has the right to share in oil and gas production or the proceeds from the sale thereof, and must look to income derived from production for a return of its capital investment. The arrangement is often for a fixed period of time. In such situations, the taxpayer should be deemed to have an economic interest in the property for U.S. income tax purposes.¹⁷ Even if a taxpayer's rights terminate before the end of the expected economic life of the project, an economic interest should be

15. But see *American Smelting & Ref. Co. Consol. v. United States*, 423 F.2d 277, 287-89 (Ct. Cl. 1970) in which the court accepted an argument for allocating costs between areas of interest, as well as areas of disinterest, to allow partial write-offs of G&G when acreage is relinquished. The Internal Revenue Service announced in Rev. Rul. 77-187, 1977-1 C.B. 50, that it would not follow the *American Smelting* decision.

16. See generally Frank M. Burke, Jr., *Worthless Oil and Gas Properties: The Two-Step Analysis Revisited*, 3 THE NAT. RESOURCES TAX REV. 343 (1990). For a recent case dealing with partial worthlessness, see *Phillips Petroleum Co. & Affiliated Subsidiaries*, 1991 T.C.M. (Macmillan) 257.

17. Rev. Rul. 73-470, 1973-2 C.B. 88.

present if the taxpayer is obligated to bear all exploration and production risks and must look solely to production to recoup its investment.

E. *Foreign Tax Credit*

The United States maintains general jurisdiction to tax the worldwide income of its citizens and of entities organized in the United States.¹⁸ Income derived outside the United States may also be subject to taxation by the country in which it is earned. Hence, it is possible for U.S. taxpayers to be taxed twice on the same income unless a credit is allowed against U.S. income tax for foreign income taxes paid. The potential for double taxation is mitigated for U.S. taxpayers by means of the foreign tax credit mechanism. The general effect of the foreign tax credit is that a U.S. taxpayer is subject to an aggregate income tax equal to the higher of the domestic or the foreign tax on the relevant income. The theory is that the foreign tax credit prevents the aggregate income tax liability of a U.S. taxpayer, regardless of source, from being less than that which would have been payable if the income had been earned wholly within the United States.

A U.S. taxpayer may treat foreign taxes as a deduction,¹⁹ or as a credit.²⁰ It is generally more favorable to treat foreign tax as a credit. Nevertheless, a U.S. petroleum company engaging in foreign exploration and production must carefully consider the proper election based on the facts and circumstances involved. The election to claim a deduction or credit is made on an annual basis, and the election may be changed at any time prior to the expiration of the period for making a claim for refund for the tax year.²¹ The period for making a claim for refund is ten years.²²

1. *Economic Interest*

A U.S. taxpayer must possess an "economic interest" in property for U.S. income tax purposes in order for certain foreign tax payments to be

18. The Sixteenth Amendment of the United States Constitution grants the United States worldwide taxing jurisdiction over U. S. citizens and entities. U.S. CONST. amend. XVI.

19. I.R.C. § 164(a)(3) (1988).

20. *Id.* §§ 33, 901(a) (1988).

21. *Id.* § 901(a).

22. *Id.* § 6511(d)(3) (1988). While Rev. Rul. 63-248, 1963-2 C.B. 623, takes the position that the ten-year period is available only for taxpayers who originally claimed a credit to adjust the amount of the credit, the courts have held that the ten-year period is available to make the election to claim the credit. See *Hart v. United States*, 585 F.2d 1025, 1028, 1035 (Ct. Cl. 1978); *United States v. Woodmansee*, 578 F.2d 1302, 1304 (9th Cir. 1978).

creditable foreign taxes²³ and for the depletion allowance.²⁴ The regulations define the term as follows: "An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place . . . and secures, by any form of legal relationship, income derived from the extraction of the mineral . . . to which he must look for return of his capital."²⁵ Essentially, an economic interest is present when a taxpayer has an interest in property which diminishes as the mineral is extracted and the taxpayer shares directly in the economic benefit (and risk) of the minerals.²⁶ An interest in petroleum in place can be present if a taxpayer has the right to share in the petroleum produced²⁷ even though, under local law, legal title to the petroleum is in the name of another person.²⁸

2. Types Of Foreign Tax Credits

The manner in which U.S. tax is imposed on the earnings of a foreign petroleum operation depends on how legal ownership of the activity is structured. If the operation is conducted in the form of a branch, the annual income or loss of the branch is taxable in the United States on a current basis to the U.S. taxpayer. On the other hand, the earnings of a foreign subsidiary of a U.S. taxpayer are generally not subject to U.S. tax until they are repatriated as interest, dividends, or in another form. In either case, the issue is how the U.S. taxpayer can obtain a foreign tax credit for the host country income taxes paid.

Under U.S. income tax law, the foreign tax credit takes two forms: (1) the direct foreign tax credit,²⁹ and (2) the deemed paid foreign tax credit.³⁰ The direct foreign tax credit is a credit for foreign taxes paid or accrued by the U.S. taxpayer on its income.³¹ These taxes include those imposed on earnings of a branch, as well as withholding taxes imposed

23. See *infra* note 40 and accompanying text (regarding rules for parent corporations to deduct payments made by foreign subsidiaries).

24. *Anderson v. Helvering*, 310 U.S. 404 (1940); *Palmer v. Bender*, 287 U.S. 551, 557-58 (1933).

25. Treas. Reg. § 1.611-1(b)(1) (as amended in 1973).

26. See *Commissioner v. Southwest Exploration, Inc.*, 350 U.S. 308, 312-14 (1956).

27. For example, a taxpayer may have a contractual, rather than a real property, interest in production. The Belle Isle Contract Units which are traded in the over-the-counter market are an example of a contractual interest in natural resource production which constitutes an economic interest for United States federal income tax purposes.

28. *Thomas v. Perkins*, 301 U.S. 655, 659 (1937).

29. See I.R.C. § 901.

30. *Id.* § 902 (1988).

31. *Id.* § 901(b).

on interest, dividends, royalties, and similar types of income.³² The deemed paid foreign tax credit is a credit for foreign taxes paid or accrued on the income of a foreign subsidiary of a U.S. taxpayer. This credit becomes available upon a distribution by a foreign subsidiary of its earnings. It can only be claimed by corporate (not individual) shareholders which own at least ten percent of the foreign subsidiary.³³

The deemed paid foreign tax credit is based on the taxes paid or accrued on the distributed portion of the foreign corporation's earnings. The amount of credit available is computed by multiplying the ratio of the amount of the dividend to the foreign subsidiary's undistributed earnings and profits by the total foreign taxes paid or accrued with respect to the undistributed earnings and profits.³⁴ Undistributed earnings and profits for this purpose are the pool of undistributed earnings and profits (determined under U.S. tax accounting principles) of the foreign corporation accumulated in tax years beginning after December 31, 1986, through the end of the tax year in which the dividend is distributed.³⁵ The pool of taxes included in the formula is the amount of foreign taxes paid or accrued during the same time period.³⁶ The pool of taxes is reduced by taxes deemed paid with respect to dividends distributed in earlier years³⁷ and includes any income taxes deemed paid by the foreign corporation with respect to a dividend received from a second-tier corporation in which it owns at least a ten percent voting interest.³⁸ The foreign taxes flowing from a second-tier or third-tier corporation to a first-tier corporation may also include taxes imposed on the earnings of a third-tier corporation deemed paid by the second-tier corporation.³⁹ In order for foreign taxes paid by second and third-tier subsidiaries to ultimately be creditable by a U.S. parent corporation, the U.S. corporation's indirect interest in those subsidiaries must be at least five percent.⁴⁰ No credit is allowed for foreign taxes attributable to a corporation owned below the third-tier. For this reason, U.S. corporations generally seek to maintain ownership of foreign operations within three tiers.

32. *See id.* § 903 (1988); *cf.* Treas. Reg. § 1.901-2(b) (1983) (regarding taxes which are in the nature of withholding taxes on gross income).

33. I.R.C. § 902(a).

34. *See id.*

35. *Id.* § 902(c)(1).

36. *Id.* § 902(c)(2).

37. *Id.*

38. Treas. Reg. § 1.902-1(c)(2) (as amended in 1979).

39. *Id.* § 1.902-1(d)(2).

40. I.R.C. § 902(b)(3).

3. Tax vs. Royalty

In the normal situation, a foreign country enters into an exploration arrangement for minerals owned by the country. As a consequence, petroleum companies make substantial payments to the foreign government which may be bonuses, rentals, royalties, income taxes, or other types of taxes or payments. It is necessary to categorize payments by their true nature. Payments categorized as taxes must be further classified either as income taxes or as other taxes, such as excise, customs, or ad valorem taxes.

Identifying income taxes may be difficult because income taxes levied by foreign countries often differ from the U.S. income tax in various respects. The differences include calculating gross income by using posted prices for petroleum which do not necessarily reflect fair market value, allowing or disallowing deductions in a manner inconsistent with U.S. income tax law, and treating events other than actual sale of the petroleum (such as production or processing) as being tantamount to realization. The advisor must remember that the foreign government's primary interest is capturing as large a share of profits from the arrangement as possible and has little interest in clarifying the nature of payments it receives.

For many years, the Internal Revenue Service consistently ruled that payments to host countries in connection with petroleum concession and contractual arrangements were eligible for the U.S. foreign tax credit.⁴¹ Because of increasing concern that many payments were concealed royalties rather than foreign tax payments, Congress, in 1975, enacted section 901(f) in an attempt to distinguish between a royalty paid to a host country and a tax paid to the host country.⁴² Section 901(f) provides that any amount paid or accrued to a foreign country in connection with the purchase and sale of oil or gas extracted in that country is not considered a tax eligible for the foreign tax credit if (1) the taxpayer has no economic interest in the oil and gas, and (2) either the purchase or sale is made at a price other than fair market value.⁴³ Section 901(f)

41. See, e.g., Rev. Rul. 68-552, 1968-2 C.B. 306, revoked by Rev. Rul. 78-63, 1978-1 C.B. 228 (regarding Libya); Rev. Rul. 55-296, 1955-1 C.B. 386, revoked by Rev. Rul. 78-63, 1978-1 C.B. 228 (regarding Saudi Arabia). Rev. Rul. 78-63 itself was revoked by Rev. Rul. 84-172, 1984-2 C.B. 315.

42. Rev. Rul. 80-223, 1980-2 C.B. 217, holds that enactment of §§ 901(f) and 907 superseded inconsistent provisions in income tax treaties.

43. The Tax Court has considered the applicability of I.R.C. § 901(f) on two occasions. In *Gulf Oil Corp. v. Commissioner*, 86 T.C. 115 (1986), *aff'd*, 914 F.2d 396 (3d Cir. 1990), the court held that I.R.C. § 901(f) did not apply to taxes paid to Iran because the taxpayer had the requisite economic interest. *Id.* at 136. However, the Internal Revenue Service will not follow the holding of

applies to disallow treatment as a foreign tax credit before the limitations discussed below are applied. The disallowed payment should be deductible as a tax under section 164(a).⁴⁴

In 1976, the Internal Revenue Service revoked several of its prior rulings treating payments to certain countries as "creditable taxes" and held that a variety of payments made to foreign governments were not eligible for the credit.⁴⁵ In October 1983, final regulations on the subject became effective for taxable years beginning after November 14, 1983.⁴⁶

4. Definition of Income Tax

Under the present regulations, a foreign levy is a creditable tax for U.S. income tax purposes only if it is a tax and its predominant character is that of an income tax in the U.S. sense.⁴⁷ A foreign levy is a tax if it is a compulsory payment pursuant to the foreign country's taxing authority.⁴⁸ If a payment is for a specific economic benefit, the payment is not a creditable tax.⁴⁹ Further, a levy is not treated as a tax to the extent that the tax is used by the foreign country to provide a subsidy to the taxpayer or a related party, and the amount of the subsidy is determined by reference to the amount of the levy.⁵⁰ If a compulsory payment relates to both a levy of taxes and an exchange for a specific economic benefit, the levy may be divided between the two amounts.⁵¹ A taxpayer subject to such a levy is a "dual capacity taxpayer."⁵² As discussed below,⁵³ a dual capacity taxpayer is allowed a credit for only the tax portion of the levy.

If a foreign tax is likely to reach "net gain" in the normal situations in which it applies, then the predominant character of the tax is that of an income tax in the U.S. sense.⁵⁴ A foreign tax is likely to reach net gain if, based upon its predominant character, the tax meets the three

this case. Tech. Adv. Mem. 88-12-002 (November 30, 1987). In *Gulf Oil Corp. v. Commissioner*, 86 T.C. 937 (1986), *aff'd in part, rev'd in part*, 914 F.2d 396 (3d Cir. 1990), the court held that I.R.C. § 901(f) applied to taxes paid to Kuwait since the taxpayer did not have an economic interest and the taxpayer presented no evidence to prove that certain pre-discount prices were equal to fair market value. Hence, no credit was allowed for the taxes paid Kuwait. *Id.* at 960. The court stated that the taxes paid to Kuwait qualified for deduction under I.R.C. § 164(a). *See id.* at 962.

44. *See Gulf Oil*, 86 T.C. at 962.

45. *See supra* note 41.

46. Treas. Reg. § 1.901-2(h)(1).

47. *Id.* § 1.901-2(a)(1).

48. *Id.* § 1.901-2(a)(2)(i); *see also id.* § 1.901-2(d) (regarding separate levies).

49. *Id.* § 1.901-2(a)(2)(i).

50. I.R.C. § 901(i).

51. Treas. Reg. § 1.901-2(a)(2)(i).

52. *Id.* § 1.901-2(a)(2)(ii); *see infra* notes 73-85 and accompanying text.

53. *See infra* notes 73-85 and accompanying text.

54. Treas. Reg. § 1.901-2(b).

following tests: the realization test, the gross receipts test, and the net income test.⁵⁵ Since each test is based on the "predominant character" of the tax, absolute compliance with each test is not required for a tax to meet the net gain requirement.

A tax meets the realization test if it is imposed on or after an event deemed to result in realization of income for U.S. income tax purposes. A tax imposed prior to realization may also meet the realization test if the result is to recapture a deduction, credit, or other allowance previously claimed by the taxpayer. Also, a tax imposed prior to realization will meet the realization test if it is based upon (1) the difference in values of an asset at the beginning and end of a period, or (2) the physical transfer, processing, or export of readily marketable property (such as crude oil or natural gas), provided that the income is not taxed again at a later time (unless credit or other relief is provided for the first tax paid).⁵⁶ A tax imposed on a deemed distribution will meet the realization requirement if it is imposed with respect to amounts meeting the realization requirement in the hands of the person that, under applicable foreign law, is deemed to make the distribution. This special rule is applicable if no other tax is imposed upon actual distribution, or, if a second tax is imposed, credit or comparable relief is provided for the first tax paid.⁵⁷

To meet the gross receipts requirement, a foreign tax must be predominantly calculated on either "gross receipts, or gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value."⁵⁸ For example, a tax which assumes the gross receipts of a headquarters company to be equal to 110% of the business expenses incurred by the company will meet the gross receipts test so long as it can be established that the formula is likely to produce hypothetical gross receipts not greater than the fair market value of arm's length receipts from similar transactions with affiliates.⁵⁹ On the other hand, the gross receipts test is not met by tax on petroleum production where the gross receipts are deemed to be 105% of the fair market value of the petroleum produced since the computation is designed to produce an amount greater than fair market value.⁶⁰ Such a tax may, however, qualify as a tax "in lieu of" an income tax under section 903.⁶¹

55. *Id.*

56. *Id.* § 1.901-2(b)(2)(i).

57. *Id.* § 1.901-2(b)(2)(ii).

58. *Id.* § 1.901-2(b)(3)(i).

59. *Id.* § 1.901-2(b)(3)(ii) Ex. 1.

60. *Id.* Ex. 3.

61. *Id.* For a discussion of "in lieu of" taxes, see *infra* notes 86-90 and accompanying text.

A foreign tax will meet the net income requirement if the tax is predominantly computed by reducing gross receipts to permit (1) recovery of significant costs and expenses (including major capital expenditures) that are attributable or allocable to the gross receipts, or (2) recovery of significant costs and expenses computed under a method likely to produce an amount that approximates, or is greater than, recovery of the costs and expenses.⁶² A deferred recovery of significant costs in computing the foreign tax will not cause the tax to fail the net income test unless the deferral is an effective denial of recovery of such costs.⁶³

In order to meet the net income test, the regulations require that losses incurred in one activity in a trade or business be allowed to offset income earned by the same taxpayer in another activity in the same trade or business. Income and losses from different trades or businesses need not be consolidated. Further, income and losses from the same trade or business do not necessarily have to be allowed in the same taxable period unless the result of allowance in different periods is an effective denial of an offset of the losses against the income. If losses are permitted to offset profits from the same trade or business in an appropriate manner, the fact that the foreign law does not permit a carryover of losses incurred in one period to offset income incurred in a different period is immaterial. Income and losses of related persons do not have to be consolidated unless the foreign law requires separate entities to carry on separate activities in the same trade or business. If so, the net income requirement is applied as if the separate activities were carried on by a single entity.⁶⁴ The regulations indicate that separate foreign exploration contract areas are separate activities in the oil and gas exploration business and that production, marketing, and refining of petroleum are separate trades or businesses for purposes of the net income test.⁶⁵

A foreign tax on gross receipts or income does not normally satisfy the net income requirement. However, the net income test is met for a tax on gross receipts where (1) costs and expenses generally will not be high enough to offset gross receipts or income, and (2) the amount of tax paid with respect to gross receipts or income will not cause the taxpayer to have a net loss. Stated differently, a tax on gross receipts or income can satisfy the net income requirement only when a business subject to

62. Treas. Reg. § 1.901-2(b)(4)(i).

63. *See id.*

64. *Id.* § 1.901-2(b)(4)(ii).

65. *See id.*

the tax will virtually never incur a loss (after taking into account payment of the tax).⁶⁶ While the creditability of withholding tax on gross amounts, such as royalties, is not dealt with under section 901, such taxes should qualify as taxes "in lieu of" income taxes creditable under section 903 provided the substitution requirement of section 903 is met.⁶⁷

5. Paid or Accrued

After a tax is determined to be creditable, the credit is allowed under sections 901 and 903 only for amounts paid or accrued to a foreign government.⁶⁸ A qualifying tax is not treated as paid or accrued if:

1. There is a reasonable likelihood that the amount will be refunded;⁶⁹
2. The amount paid is used, directly or indirectly, to subsidize the taxpayer;⁷⁰
3. The amount is replaced by other payments to the foreign country;⁷¹
- or
4. Payment of the amount is not compulsory.⁷²

The regulations deal with each of the foregoing points in some detail and should be carefully reviewed.

6. Dual Capacity Taxpayer

As indicated above, unless a tax treaty provides to the contrary,⁷³ a foreign levy is not creditable under section 901 if the levy is deemed to be direct or indirect⁷⁴ compensation paid to the foreign country for a specific economic benefit.⁷⁵ A specific economic benefit is a benefit which is not made available on substantially the same terms to virtually all persons subject to the income tax law imposed by the country, or if no general income tax law is imposed by the country, the economic benefit is not made available to the general public.⁷⁶ If the levy on a dual capacity taxpayer is not separate from the levy applicable to other persons, then no part of the levy will be considered paid in exchange for a specific

66. *Id.* § 1.901-2(b)(4)(i).

67. *See id.* § 1.903-1(b)(1) (1983).

68. *Id.* § 1.901-2(e)(1), (g)(1).

69. *Id.* § 1.901-2(e)(2).

70. *Id.* § 1.901-2(e)(3).

71. *See id.* § 1.901-2(e)(4).

72. *Id.* § 1.901-2(e)(5).

73. *See id.* § 1.901-2A(b)(2) (1983).

74. *See id.* § 1.901-2(a)(2)(ii)(E) (regarding when a taxpayer is considered to indirectly receive an economic benefit).

75. *Id.* § 1.901-2(a)(2)(ii)(A).

76. *Id.* § 1.901-2(a)(2)(ii)(B).

economic benefit. On the other hand, if the application of a foreign levy is different for the dual capacity taxpayer, either by its terms or in practice, from the levy applicable to other persons, it will be considered a separate levy.⁷⁷ Taxpayers engaged in petroleum activities under an arrangement with a foreign country which owns or controls the petroleum in the ground are dealing with the country both as a taxpayer and as a person exploiting the petroleum resources of that country. Consequently, the dual capacity taxpayer rule may impact persons engaged in petroleum exploration and production.⁷⁸ If a petroleum company makes payments to a foreign country as bonuses, royalties or other amounts for the right to explore and develop petroleum and is required to pay the same income tax as all other taxpayers in that country, then the income tax should be creditable for U.S. income tax purposes. If the tax is subsequently increased with respect to petroleum companies only, it is arguable that the increased payment, although not applicable to all taxpayers in the host country, is not being paid for a specific economic benefit since the original payment presumably created that benefit in a prior year and represented adequate compensation for such benefit when paid.

Dual capacity taxpayers can use one of two techniques to establish the portion of a levy which is a tax: (1) the facts and circumstances test, or (2) the elective safe-harbor test.⁷⁹ If a U.S. tax treaty with the foreign country provides for the levy to be treated as a creditable tax, the treaty can be relied upon to claim credit for the tax regardless of whether the credit would be allowed in the absence of a treaty.⁸⁰ While little guidance is given regarding the method of applying the facts and circumstances technique for petroleum companies, it appears that the above example regarding a subsequent increase in tax on petroleum companies is a situation in which the technique could be utilized to sustain the argument that the additional payment resulting from the increased tax on petroleum companies was not paid in exchange for a specific economic benefit.

A dual capacity taxpayer can elect to use the safe harbor technique,

77. *Id.* § 1.901-2A(a)(1).

78. *See id.* § 1.901-2(a)(2)(ii)(B) (defining a concession to extract government owned petroleum as a specific economic benefit); *see also id.* § 1.901-2A(a)(2) Ex. 1, 2 (regarding taxpayers engaged in mineral exploitation in a foreign country).

79. *Id.* § 1.901-2A(c).

80. *Id.* § 1.901-2A(b)(2).

which is based on a formula designed to approximate the amount of income tax the taxpayer would have paid if it was not a dual capacity taxpayer and if the amount treated as paid in return for the specific economic benefit had been deductible in determining the foreign income tax liability.⁸¹ In making the calculation, costs and expenses and the amount actually paid under the qualifying levy are subtracted from gross receipts. The resulting amount is multiplied by a percentage using the general income tax rate (TR in the formula) as follows:

$$\frac{TR}{1-TR}$$

If the host country imposes no general tax, the regulations provide that the highest U.S. corporate rate (presently thirty-four percent) is used.⁸² The safe harbor method may be elected for use with respect to one or more of the countries in which a taxpayer is doing business. Once made, the election is effective for the taxable year in which it was made and for all subsequent taxable years.⁸³ The election can be revoked only with consent of the Commissioner of Internal Revenue.⁸⁴ The taxpayer may, in a later taxable year, elect to use the safe harbor method for additional countries.⁸⁵

7. "In Lieu Of"

Under section 903, the foreign tax credit is also allowed for taxes paid in lieu of income, war profits, or excess profits taxes. In order to qualify under section 903, a foreign levy must be a tax under section 901 and must meet a substitution requirement provided in the regulations under section 903.⁸⁶ The foreign country's purpose for the tax is immaterial, as is whether the tax base bears any relationship to realized net income. The tax base may be gross income, gross receipts or sales, or the number of units produced or exported.⁸⁷ The tax must be in substitution for, and not in addition to, a generally imposed income tax.⁸⁸ Since withholding taxes on gross amounts received by non-residents are in lieu of an income tax on such amounts, such taxes are normally creditable as in lieu of section 901 taxes.

81. *Id.* § 1.901-2A(e).

82. *Id.* § 1.901-2A(e)(5).

83. *Id.* § 1.901-2A(d)(1).

84. *Id.* § 1.901-2A(d)(4).

85. *Id.* § 1.901-2A(d)(1).

86. *Id.* § 1.903-1(a).

87. *Id.*

88. *Id.* § 1.903-1(b)(1).

A foreign tax which is contingent upon the availability of a credit against tax due to another country is not in substitution for an income tax, but rather is considered to be a "soak-up" tax.⁸⁹ A tax otherwise creditable is considered to be a "soak-up" tax to the extent of the lesser of (1) the amount of tax resulting from the availability of a credit in another country, or (2) the excess of the foreign tax paid over the foreign tax due by the taxpayer under the generally imposed income tax of the foreign country.⁹⁰

8. Tax Treaties

If the United States has a tax treaty with the host country which treats a specific levy by the host country as an income tax for U.S. foreign tax credit purposes, then payments by a taxpayer entitled to the benefits of the treaty are not considered paid for a specific economic benefit except to the extent the treaty so provides.⁹¹ The taxpayer must claim the credit pursuant to the treaty. If a taxpayer does not claim the credit pursuant to a treaty, but rather claims the credit under section 901 or section 903, then the rules regarding dual capacity taxpayers discussed above would apply to the levy.⁹² A taxpayer might claim the credit under section 901 or section 903, rather than under the treaty, to avoid a limitation in the treaty.

9. Reductions and Limitations

a. Section 901(e)

Section 901(e) is designed to reduce the amount of otherwise creditable foreign taxes for the natural resources industry. Under this section, the amount of foreign tax paid or accrued with respect to mineral income in each foreign country is reduced by the amount by which the foreign tax or a hypothetical U.S. tax, whichever is smaller, exceeds the actual U.S. tax on the foreign mineral income.⁹³ The hypothetical U.S. tax is

89. *Id.* § 1.903-1(b)(2).

90. *Id.*

91. *Id.* § 1.901-2A(b)(2).

92. *See id.*

93. *See* I.R.C. § 901(e)(1); *see also* Treas. Reg. § 1.901-3(c)(2)(i) (as amended in 1977) (providing that the disallowed amount may not be deemed paid or accrued under I.R.C. § 904(d) in any other taxable year). The regulations also provide that to the extent the *reduced* amount of tax allowed under I.R.C. § 901(e) exceeds the I.R.C. § 904 limitations in the year paid or accrued, the excess may be carried back or forward under the normal foreign tax rules and not again be subject to the I.R.C. § 901(e) reduction in the year to which carried. The question as to whether the disallowed amount can be deducted as a tax under I.R.C. § 164 or as a business expense under I.R.C. § 162 remains unanswered.

the U.S. tax on mineral income from a particular foreign country determined with a deduction for cost depletion, rather than for percentage depletion.⁹⁴ Since percentage depletion for foreign petroleum production was repealed in 1975, the reduction under section 901(e) should no longer apply to foreign taxes paid with respect to income from foreign petroleum operations. However, the reduction will continue to apply to foreign taxes paid on solid mineral income for which U.S. percentage depletion is available.⁹⁵

b. Section 907(a)

Section 907(a) provides a reduction of otherwise creditable foreign taxes paid or accrued by a taxpayer engaged in foreign petroleum exploration and production. Under this provision, the amount of "foreign oil and gas extraction taxes" otherwise creditable in a taxable year will be reduced, in the case of a corporation, to an amount equal to the product of the highest U.S. corporate tax and the taxpayer's foreign oil and gas extraction income (FOGEI) for the taxable year.⁹⁶ For non-corporate taxpayers, the reduction is computed by multiplying the taxable year's FOGEI by a fraction, the numerator of which is the taxpayers' pre-credit U.S. income tax and the denominator of which is the taxpayers' entire U.S. federal taxable income.⁹⁷ Hence, non-corporate taxpayers utilize the average federal income tax rate before foreign tax credit in making the calculation. The section 907(a) limitation can be significant.

FOGEI is defined as taxable income derived outside the United States and its possessions from the production of oil and gas, or from the exchange of assets used by the taxpayer in the trade or business of oil and gas production.⁹⁸ Foreign oil extraction losses are deducted to determine FOGEI.⁹⁹ In addition, certain dividends and interest from foreign corporations and partnership and trust distributable income (to the extent attributable to the payor's FOGEI) are includable in a taxpayer's

94. See I.R.C. § 901(e)(1).

95. Since I.R.C. § 901(e) has not been amended to exclude oil and gas income from mineral income, a taxpayer having both income from minerals subject to percentage depletion and oil and gas income not subject to percentage depletion, and a different foreign tax rate for the mineral income than for the oil and gas income, could have a larger disallowance of foreign tax under I.R.C. § 901(e) than the disallowance if only the mineral income subject to percentage depletion was treated as mineral income under § 901(e). Accordingly, I.R.C. § 901(e) should be amended to delete oil and gas income from the definition of mineral income under I.R.C. § 901(e).

96. See I.R.C. § 907(a)(2)(A) (1988).

97. *Id.* § 907(a)(2)(B).

98. *Id.* § 907(c)(1).

99. Treas. Reg. § 1.907(c)-1(c)(1) (1991).

FOGEI.¹⁰⁰ The regulations provide that FOGEI also includes interest on working capital and foreign exchange gain or loss.¹⁰¹ Additionally, FOGEI may include income derived from providing services directly related to the extraction of oil and gas.¹⁰² The regulations specifically state that income from insurance, accounting, or managerial services is generally excluded from directly related services income.¹⁰³ A taxpayer may have FOGEI under other circumstances if the income is directly attributable to extraction of oil and gas.¹⁰⁴ An example of such other circumstances is compensation for services which is dependent on the volume or value of oil and gas extracted. Hence, under a service contract type arrangement for oil and gas exploration and production, the income received, if based upon the volume or value of oil and gas extracted, could be FOGEI, even though the taxpayer has no economic interest in the project.¹⁰⁵

If oil and gas is disposed of, or is acquired other than from a foreign government, at a posted price (or other pricing arrangement) which differs from the fair market value thereof, the foreign oil and gas extraction income from such transactions must be calculated utilizing the fair market value of oil and gas, not the artificial price.¹⁰⁶ The regulations also require that gross income from extraction be determined by reference to the fair market value of the oil and gas in the immediate vicinity of the well.¹⁰⁷ Obviously, serious problems can arise under an exploration arrangement where a posted price, or other hypothetical price, is used to calculate the foreign tax or other payments to the foreign government. A significant amount of foreign tax can be disallowed as a credit under section 907(a) if care is not taken to consider the impact of pricing provisions under the foreign tax law and/or exploration arrangement. Gross income from oil and gas extraction activities must be reduced by allocable expenses determined pursuant to the regulations under section 861 to arrive at oil and gas extraction income for purposes of section 907(a).¹⁰⁸

After FOGEI is calculated, a taxpayer must determine the amount of taxes paid to each foreign country during the year with respect to such

100. I.R.C. § 907(c)(3).

101. Treas. Reg. § 1.907(c)-1(f)(3), (4).

102. *Id.* § 1.907(c)-1(g)(2).

103. *Id.* § 1.907(c)-1(g)(2)(iv).

104. *Id.* § 1.907(c)-1(b)(3).

105. *See id.* § 1.907(c)-1(g)(2)(i)(B).

106. I.R.C. § 907(d); Treas. Reg. § 1.907(d)-1(a)(i) (1991).

107. *See* Treas. Reg. § 1.907(d)-1(c)(5).

108. *See id.* § 1.861-8(f)(1)(vi)(D).

income. The regulations under section 907 provide detailed rules for the calculation of the appropriate amount of foreign tax to be attributed to foreign oil and gas extraction income in each country.¹⁰⁹ Taxes not considered creditable under section 907(a) in the year paid or accrued may be carried back two years and forward five years as creditable foreign income tax, subject to the section 907(a) and section 904 limitations in the carryback or carryforward year.¹¹⁰

c. Section 907(b)

Before applying the general limitations set forth in section 904, an additional limitation must be applied to foreign taxes paid or accrued on foreign oil related income. Foreign oil related income is defined as taxable income derived from sources outside the United States and its possessions from:

1. The processing, transportation, distribution, or selling of oil and gas or their primary products;¹¹¹
2. The disposition of assets used in the foregoing activities;¹¹²
3. The performance of any other related services;¹¹³
4. Interest on working capital and foreign exchange gain or loss;¹¹⁴
5. Dividends (including section 1248 dividends), interest and partnership income to the extent attributable to foreign oil and gas related activities;¹¹⁵ and
6. Other income which the facts and circumstances demonstrate are in substance attributable to processing, transporting, distributing, or selling oil and gas or their primary products.¹¹⁶

Under section 907(b), creditable taxes on foreign oil related income do not include amounts paid or accrued after December 31, 1982, to the extent that the United States Treasury Department determines that the foreign law imposing the tax is structured, or in fact operates, to result in an amount of tax imposed with respect to foreign oil related income that is materially greater, over a reasonable period of time, than the amount imposed on income that is not foreign oil related income or foreign oil and gas extraction income.¹¹⁷ Absent this rule, a foreign country could

109. *Id.* § 1.907(c)-3(a) (1991).

110. *Id.* § 1.907(f)-1 (1991).

111. I.R.C. § 907(c)(2)(A)-(C).

112. *Id.* § 907(c)(2)(D).

113. *Id.* § 907(c)(2)(E).

114. Treas. Reg. § 1.907(c)-1(f)(3), (4).

115. *Id.* § 1.907(c)-2 (1991).

116. *Id.* § 1.907(c)-1(f)(6).

117. I.R.C. § 907(b).

maximize the creditability of its taxes in the United States by taxing extraction income at the maximum rate used in the section 907(a) calculations and by increasing the tax on foreign oil related income. The amount of foreign tax not creditable under section 907(b) is treated as a deductible business expense under the foreign law.¹¹⁸

d. Section 904

For taxable years beginning before 1987, one aggregate limitation on the amount of foreign tax credit available was generally determined on an "overall" basis in which net income and net losses from all foreign sources were used to calculate the limitation. Under the overall limitation, the foreign tax credit could not exceed the portion of U.S. tax determined by multiplying the before-credit U.S. tax by a fraction, the numerator of which is the taxpayer's foreign taxable income and the denominator of which is the taxpayer's worldwide taxable income. For taxable years beginning after 1987, however, separate foreign tax credit limitation calculations are required for several categories of foreign source income.¹¹⁹

Under the current approach, categories of income, referred to as "baskets," are established in situations where the potential exists for taxpayers to average foreign tax rates imposed on the same kind of income by various foreign countries. Under the basket approach, a taxpayer separately calculates the foreign tax credit limitation for each category of income specified in the Code.¹²⁰ Although exceedingly complicated, as a general matter, a taxpayer first computes a tentative U.S. tax on worldwide income and then calculates foreign source taxable income for each of the applicable baskets. The limitation for each specific basket is then calculated. The foreign tax credit allowed is the sum of the credits available for the various baskets. Baskets requiring separate computations include (1) passive income,¹²¹ (2) high withholding tax interest,¹²² (3) financial services income,¹²³ (4) shipping income,¹²⁴ (5) dividends from

118. *Id.*

119. *Id.* § 904(d) (1988).

120. *Id.* § 904(d)(1).

121. *Id.* § 904(d)(1)(A).

122. *Id.* § 904(d)(1)(B).

123. *Id.* § 904(d)(1)(C).

124. *Id.* § 904(d)(1)(D).

non-controlled section 902 corporations,¹²⁵ (6) dividends from a Domestic International Sales Corporation (DISC) or a former DISC,¹²⁶ (7) foreign trade income,¹²⁷ (8) certain distributions from a Foreign Sales Corporation (FSC) or a former FSC,¹²⁸ and (9) all other income.¹²⁹

In applying the basket concept, "look-through" rules must be applied under which actual and constructive dividends of a Controlled Foreign Corporation (CFC) are characterized according to the nature of the income of the CFC.¹³⁰ A CFC is a foreign corporation in which more than fifty percent of the voting power or value is owned by U.S. shareholders.¹³¹ The effect of the look-through rules is to treat income distributed by a CFC as if it had been earned by a foreign branch of the U.S. taxpayer. The U.S. taxpayer identifies the basket categories of income represented by actual and constructive dividends from a CFC in the same manner as the various items of income were characterized in the hands of the CFC.¹³² Complex rules govern the application of the look-through concept to Subpart F inclusions by a U.S. taxpayer.¹³³

If a taxpayer has a loss in one of its baskets, the loss is first allocated to foreign income in other baskets and then to U.S. income. Accordingly, foreign losses offset U.S. income only to the extent that aggregate foreign losses exceed foreign income.¹³⁴ The allocation of a loss in a particular basket is made proportionately to the other baskets on the basis of their respective shares of foreign income.¹³⁵ In cases where a foreign loss in one basket offsets income in another basket, income in subsequent years in the loss basket is recharacterized as income in the second basket.¹³⁶ If losses in a basket offset income in more than one other basket, subsequent income in the loss category is recharacterized as income in the other baskets on a proportionate basis.¹³⁷ Foreign income tax attributable to a basket is not recharacterized.¹³⁸ A loss from U.S. sources which does not exceed the total taxable income of the various baskets is

125. *Id.* § 904(d)(1)(E).

126. *Id.* § 904(d)(1)(F).

127. *Id.* § 904(d)(1)(G).

128. *Id.* § 904(d)(1)(H).

129. *Id.* § 904(d)(1)(I).

130. *See id.* § 904(d)(3).

131. *Id.* § 957(a) (1988).

132. *See id.* § 904(d)(3)(D).

133. *Id.* § 904(d)(3)(B).

134. *Id.* § 904(f)(5)(A).

135. *Id.* § 904(f)(5)(B); *see also* I.R.S. Notice 89-3, 1989-1 C.B. 623.

136. I.R.C. § 904(f)(5)(C).

137. *Id.*

138. *Id.*

allocated among the baskets proportionately.¹³⁹

While petroleum royalties could be categorized in the passive income basket and certain foreign oil and gas related income might be categorized as passive income or in some other income category, any amount of foreign oil and gas related income not so categorized would be includable in the other income basket. Foreign oil and gas extraction income is specifically excluded from the passive income category¹⁴⁰ and is included in the other income basket in computing the taxpayer's overall foreign tax credit limitation.

10. Alternative Minimum Tax Limitation

Many U.S. petroleum companies are subject to the Alternative Minimum Tax (AMT) provisions.¹⁴¹ The AMT applies in situations where, due to a taxpayer's ability to benefit from tax incentives in the U.S. income tax law, traditionally calculated taxable income significantly understates "economic" income. The AMT imposes additional constraints on the use of foreign tax credits. First, a separate AMT foreign tax credit limitation must be computed equal to the product of the applicable AMT rate and net foreign source income (determined under AMT principles).¹⁴² Second, foreign tax credits cannot be used to offset more than ninety percent of a taxpayer's AMT liability.¹⁴³

11. Taxable Income and Source of Income

As is readily apparent from the foregoing discussion, the various limitations imposed on the creditability of foreign taxes require a taxpayer to carefully determine foreign source taxable income, as well as determine the amount of such income which is foreign oil and gas extraction income and foreign oil related income. In addition, the income attributable to the various baskets must be ascertained. In determining the taxable income for foreign tax credit purposes, U.S. income tax rules are applied.¹⁴⁴ United States rules may differ dramatically from the rules of the foreign country imposing the tax. In the case of oil and gas operations, many differences occur because of the varying treatments accorded

139. *Id.* § 904(f)(5)(D).

140. *Id.* § 904(d)(2)(A)(iii)(IV).

141. *See id.* §§ 55-59 (1988).

142. *See id.* § 59(a)(1).

143. *See id.* § 59(a)(2).

144. *See* Temp. Treas. Reg. §§ 1.861-8T (as amended in 1990); 1.861-9T (as amended in 1989); 1.861-10T (1988); 1.861-11T (1988); 1.861-12T (1988); 1.861-13T (1989); 1.861-14T (1988).

IDC, G&G costs, depreciation, depletion, and other items. The source of income is also determined according to U.S. income tax rules. Sections 861 through 863 provide specific rules for determining the source of dividends, interest, royalties, rents, personal service compensation, gains on dispositions of real or personal property, and other items. Section 865 provides rules for sourcing income from the sale of personal property in taxable years beginning after 1986. Temporary regulations provide rules for allocating expenses, losses, and other deductions in calculating taxable income from specific sources and activities.¹⁴⁵

In general, income from petroleum production and from the sale of petroleum products, within or without the country of production, constitutes gross income from sources within the country of production.¹⁴⁶ If the circumstances of production and sale appear to require an allocation, the Internal Revenue Service may apportion income between the country of production and another country.¹⁴⁷ In addition, the Internal Revenue Service can make other allocations or apportionments, if it deems such allocations or apportionments necessary to more clearly reflect the proper income source.¹⁴⁸

12. Recapture of Overall Foreign Losses

For a taxpayer sustaining an overall foreign loss for any year, foreign source income in subsequent years is treated as U.S. source income to the extent of the lesser of (1) fifty percent (or such larger percentage as the taxpayer may elect) of the foreign income for the subsequent year, or (2) the amount of unused foreign losses from prior years.¹⁴⁹ If a taxpayer sustains an overall foreign loss and has not yet fully recaptured the loss, gain (but not loss) will be recognized on an otherwise tax-free disposition of property (including a gift) used predominantly outside the United States in a trade or business which constitutes a material factor in the realization of income.¹⁵⁰ All non-recognition provisions are overridden by this rule.¹⁵¹ The amount of gain recognized is the lesser of the amount which would have been recognized in a sale at fair market value or any overall foreign loss not previously recaptured.¹⁵²

145. *Id.*

146. *See* Treas. Reg. §§ 1.863-1(b)(1) (as amended in 1988), 1.863-6. (1975)

147. *Id.* § 1.863-1(b)(1).

148. *Id.* § 1.863-1(b)(2).

149. I.R.C. § 904(f)(1).

150. *See id.* § 904(f)(3).

151. *Id.* § 904(f)(3)(A)(i).

152. *Id.*

Under prior law, foreign oil related losses were subject to recapture only against foreign oil related income in subsequent years.¹⁵³ Current law allows oil related losses to be recaptured against foreign non-oil related income and foreign non-oil related losses may be recaptured against foreign oil related income.¹⁵⁴

A special recapture rule is provided for losses from extraction activities. If an overall foreign oil and gas extraction loss is incurred in a year and reduces foreign source non-oil income, the loss must be recaptured in later years by reclassifying future foreign oil and gas extraction income as foreign non-oil income.¹⁵⁵ Since a portion of future foreign oil and gas extraction income will not be so categorized, the section 907(a) limitation on the creditability of foreign taxes on foreign oil and gas extraction income will be lower and, as a result, creditable foreign oil and gas extraction taxes will be lower.

13. Carrybacks and Carryforwards

Because of the changes which have occurred over the past several years in the method of computing the foreign tax credit limitation, significant complications can arise with respect to carrybacks and carryforwards of foreign tax credits. Generally, unused foreign tax credit can be carried back two years and carried forward five years.¹⁵⁶ As previously indicated, foreign oil and gas extraction income tax credits are again subject to application of the section 907(a) limitation in the tax year to which carried.¹⁵⁷

F. *Taxation of Foreign Subsidiary*

Prior to 1983, petroleum refining, processing, transportation (other than shipping), and other petroleum related activities conducted through a foreign corporation were not subject to U.S. tax until income was repatriated to the U.S. shareholders through dividend distributions. Under current law, however, certain foreign oil related income of a Controlled Foreign Corporation (CFC) is subject to current U.S. taxation.

153. *Id.* § 904(f)(4), amended by Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, 448 (codified as amended at I.R.C. § 904(f)(1), (2)).

154. *Id.* § 904(f)(1), (2).

155. *Id.* § 907(c)(4). The purpose of this rule is to determine the amount of foreign oil and gas extraction income under I.R.C. § 907(a). Hence, the rule operates independently of I.R.C. § 904(f) dealing with overall foreign losses. Treas. Reg. § 1.907(c)-1(c)(1).

156. I.R.C. § 904(c).

157. *Id.* § 907(f).

A CFC is a foreign corporation, more than fifty percent of the voting power or value of the stock of which is owned directly, indirectly or through attribution by U.S. shareholders on any day during the tax year of the foreign corporation.¹⁵⁸ A U.S. shareholder is a U.S. person who owns directly, indirectly, or through attribution ten percent or more of the total combined voting power of all classes of voting stock of the foreign corporation.¹⁵⁹

Subpart F of the Code provides detailed rules requiring U.S. shareholders to currently include in income their pro rata share of a CFC's Subpart F income even though no actual dividend is paid.¹⁶⁰ Of the five categories of Subpart F income currently taxed to U.S. shareholders, the only category usually relevant to petroleum companies is "foreign base company income." Foreign base company income includes foreign personal holding company income and foreign base company sales, services, shipping, and oil related income.¹⁶¹ Foreign base company oil related income is essentially foreign oil related income as defined for foreign tax credit purposes.¹⁶² All foreign oil related income as defined in section 907(c)(2) and (3) is foreign base company oil related income except in the situations described in the following paragraph.

Since income earned by a corporation in its country of organization is not normally classified as foreign base company income; foreign oil related income is not classified as foreign base company income if it is derived from sources within a foreign country in connection with (1) oil or gas extracted from a well located in such foreign country, or (2) oil or gas, or a primary product of oil or gas, sold by the foreign corporation or a related party for use within such foreign country.¹⁶³ Income otherwise constituting foreign base company oil related income will not be treated as such unless it is earned by a corporation that is a large oil producer for the tax year. A corporation is a large oil producer if during the taxable year, or the preceding taxable year, the average daily production of foreign crude oil and natural gas of its related group equals or exceeds 1,000 barrels, computed under rules set forth in section 613A except that only oil and gas produced from wells outside the United States is taken into

158. *Id.* § 957(a).

159. *See id.* § 951(b) (1988).

160. *See id.* §§ 951-964 (1988).

161. *Id.* § 954(a) (1988).

162. *See id.* § 954(g).

163. *Id.* § 954(g)(1)(A), (B).

account.¹⁶⁴ If income qualifies as foreign base company oil related income, and in another category of foreign base company income, the income will be classified as foreign base company oil related income.¹⁶⁵

Under certain circumstances, income that otherwise would be foreign base company income may be recharacterized. Prior to 1987, section 954(b)(4) provided a "formed or availed of" test which allowed a foreign corporation, or its shareholders, to establish that neither the creation of the corporation, nor the transaction generating a particular type of income, had as one of its significant purposes a substantial reduction of income taxes so as to exclude the item in question from foreign base company income. For years beginning after 1986, however, a more objective test was enacted. Under that test, if an item of income is subject to an effective foreign tax that is greater than ninety percent of the maximum U.S. corporate rate, such income will not be considered foreign base company income.¹⁶⁶ However, this exception does not apply to foreign base company oil related income.¹⁶⁷ Accordingly, an item which would not be classified as foreign base company income under the old "formed or availed of" test may now be classified as foreign base company oil related income if it has the required characteristics.

Petroleum companies should carefully review the foreign personal holding company rules to determine if the rules are applicable to a proposed foreign activity.¹⁶⁸ If a corporation is classified as a foreign personal holding company, each U.S. shareholder is required to include its pro rata share of foreign personal holding income of the corporation in its gross income each year, regardless of whether the income is actually distributed.¹⁶⁹ Income from petroleum working interests is not classified as foreign personal holding income, but petroleum royalties will be so classified.¹⁷⁰

G. *Transfers of Property to Foreign Entity*

If property other than cash is transferred to a foreign corporation, and the fair market value of the property exceeds the transferor's adjusted tax basis, taxable gain may be recognized by the transferor under

164. *Id.* § 954(g)(2).

165. *See id.* § 954(b)(8); § 954(a).

166. *See id.* § 954(b)(4).

167. *Id.* (last sentence).

168. *Id.* §§ 551-558 (1988).

169. *Id.* § 551(a), (b).

170. *See id.* § 553(a).

section 367, or an excise tax may be imposed under section 1491. In general, section 367 provides that unless a statutory exception applies, a foreign corporation will not be treated as a corporation when it receives property from a U.S. person as part of a transaction in which gain would not ordinarily be recognized.¹⁷¹ The result of a foreign corporation not being treated as a corporation is that the non-recognition rules do not apply and the transfer may be taxable to the transferor.¹⁷² For example, if a foreign working interest explored by a U.S. entity is transferred to a foreign corporation after the property is proven, the transfer may result in the realization of taxable gain by the U.S. entity under section 367.

For transfers or exchanges after 1984, certain exceptions apply to the applicability of section 367.¹⁷³ For example, transfers of appreciated property for use in an active trade or business are not subject to section 367 with certain exceptions.¹⁷⁴ The active trade or business exception does not apply to transfers of inventory and a number of other categories of property.¹⁷⁵ Further, the regulations under section 367 require recapture of depreciation, IDC, and depletion on the transfer of property to a foreign corporation if such recapture would have been required on the sale of the property at its fair market value.¹⁷⁶ Transfers of royalty interests are not treated as transfers of property for use in an active trade or business.¹⁷⁷ Transfers of working interests and other oil and gas interests may or may not be treated as transfers for use in the active conduct of a trade or business, depending upon the facts and circumstances.¹⁷⁸ The temporary regulations under section 367, however, provide a limited safe harbor for transfers of working interests if the requirements of the regulations are met.¹⁷⁹

Because of the section 367 rule recognizing gain on some transfers, careful consideration should be given to the option of using a foreign corporation at the outset of exploration, rather than planning to transfer proven properties to such a corporation at a later date. Obviously, the facts and circumstances of each particular case will dictate whether or

171. *See id.* § 367(a)(1) (1988).

172. *Id.*

173. *See id.* § 367(a)(3)-(5).

174. *Id.* § 367(a)(3)(A).

175. *Id.* § 367(a)(3)(B).

176. *See* Temp. Treas. Reg. § 1.367(a)-4T(b)(1) (1986).

177. *Id.* § 1.367(a)-4T(e)(4).

178. *See id.* § 1.367(a)-2T (1986).

179. *Id.* § 1.367(a)-4T(e)(1)-(3).

not use of a foreign corporation at any point during the ownership of a petroleum property is appropriate.

An excise tax may be imposed under section 1491 if a U.S. person transfers appreciated property to a foreign partnership, estate, trust, or corporation either as paid-in surplus or as a contribution to capital. The tax is equal to thirty-five percent of the excess of the fair market value of the property over the sum of the adjusted tax basis of the property and any gain recognized by the transferor.¹⁸⁰ Section 1491 does not apply if the transfer is (1) described in section 367, (2) not described in section 367 but the taxpayer elects, before the transfer, to apply principles similar to those of section 367, or (3) one for which an election has been made under section 1057 to treat the transaction as a taxable sale or exchange.¹⁸¹

Since sharing arrangements, joint ventures, and partnerships are common in the petroleum industry, the risk of a tax under section 1491 may be present in many foreign exploration arrangements. The tax under section 1491 cannot be avoided by simply electing to be excluded from the provision of Subchapter K of the Code since that election does not affect the classification of an arrangement as a partnership for purposes of section 1491.¹⁸² Hence, the possibility of a section 1491 tax must be carefully considered in every foreign exploration arrangement.

III. FOREIGN TAX CONSIDERATIONS

A. General

A careful review of the tax law of the potential host country and of other aspects of the host country law relevant to petroleum activity is an essential part of the overall economic evaluation of a proposed transaction.¹⁸³ The advisor must expect many factors peculiar to a foreign petroleum operation as contrasted to a domestic operation. For example, in almost every foreign country, the foreign government regards the interest in subsoil as the property of the state and an economic interest in petroleum in place is obtainable only by an exploration arrangement, which is normally of limited duration. In some foreign countries, it is

180. I.R.C. § 1491 (1988).

181. *Id.* § 1492 (1988).

182. Olin Bryant, 46 T.C. 848, 863 (1966), *aff'd*, 399 F.2d 800 (5th Cir. 1968); Rev. Rul. 65-118, 1965-1 C.B. 30.

183. Since the discussion in this section is intended to provide the advisor with a general overview of problems frequently encountered in foreign petroleum tax systems, no attempt has been made to focus on the law of any particular country.

even difficult to ascertain which governmental body or agency actually has the authority to deal with the natural resources of the country. Frequently, the basic terms of the concession or contract are set forth in model clauses described by the country's petroleum statute, or rules interpreting the statute. Some countries, grant almost unlimited discretion in designing petroleum arrangements to a governmental agency.

Another problem which permeates both application of the foreign tax law, as well as application of the U.S. foreign tax credit rules,¹⁸⁴ is that many countries lack a representative market or field price for petroleum and the price is determined by extrapolation or by artificial government prices which bear little resemblance to fair market value. These artificial prices are used to calculate taxes, royalties and perhaps other levies. In addition, foreign tax laws are often obscure in their applicability to petroleum operations and may be subject to modification in the concession or contractual agreement itself. Further, while perhaps not directly impacting tax planning, the convertibility of foreign currency, the applicable exchange rate and the ability to repatriate earnings of the host country are all important considerations with which the advisor must be thoroughly familiar.

B. *Nature of Payments to Foreign Government*

The basic economic objective of the petroleum business is to develop valuable reserves that can be recovered at a profit to the petroleum company and the owner of the minerals. Hence, the division of economic rewards between the petroleum company and the potential host country (the owner of the minerals) is of prime importance and must be the focal point of negotiations.¹⁸⁵ Most host countries are merely concerned about receiving their share of the rewards as a total percentage of the profits derived from exploration and production. The host country is normally not concerned about the categorization of the payments it receives. However, the characterization of payments made to a foreign country is vitally important to the petroleum company.

Since only foreign income taxes may be credited against U.S. taxes on foreign income, it is important that payments made to a foreign country be classified as income taxes to the extent possible. Because the host country is generally not concerned with the categorization of payments it receives, payments which have the economic effect of a tax may not be

184. See I.R.C. § 901(f).

185. See generally BURKE & DOLE, *supra* note 1, at 20-38.

labeled as such and thus may not be creditable against U.S. income tax. Thus, the imposition of a foreign tax with no offsetting credit has the effect of double taxation. In order to avoid a problem with creditability of foreign tax payments, the documents implementing the petroleum arrangement should clearly reflect the nature of all payments being made to the host country. Presumably, a royalty based upon units of production or percentage of volume of production will be included as a clearly defined part of the payments. Further, the application of the local income tax law to the results of operations under the concession or contract should be clearly specified in the agreement itself, or at least be clearly referenced to well defined income tax legislation. Lastly, the division of the remaining profits among the parties should be defined in the agreement.

C. *Identifying All Foreign Taxes*

There are a number of types of foreign taxes which are imposed on petroleum operations. The advisor must be thoroughly familiar with all forms of taxation used by the host country so that the total economic impact of such taxes can be assessed.¹⁸⁶ Taxes may take the form of income taxes, excess profits taxes, patrimony or capital taxes, surface taxes based upon land area or land use, production taxes, stamp taxes, value added taxes, transportation taxes, and other types of taxes. Special pricing provisions and/or artificial rates of exchange may also represent indirect forms of taxation.

In a number of countries, the normal customs duty rate is reduced to a nominal amount with respect to imports of certain goods, including equipment. Such reductions in customs duty rates may be part of the tax statute, or may be negotiated as part of the concession or contractual arrangement. In other countries, however, significant customs duties can apply. Some countries will allow reductions in customs duty rates if it can be established that the imported equipment cannot be obtained locally or will be re-exported at some future time.

In many countries, the entire tax regime applicable to foreign operated petroleum operations is largely a subject of negotiation. In such countries, favorable tax rates, or perhaps even permanent or semi-permanent tax holidays, can be obtained. Further, special deductions for capital recovery and other similar provisions may be available.

186. See generally BURKE & DOLE, *supra* note 1, at 48-50.

D. *Type of Entity*

In a number of foreign countries, concessions or licenses are granted only to persons who are incorporated under the laws of that country. Accordingly, because in many cases it is desirable to carry on foreign exploration and production by a U.S. taxpayer as a branch, special arrangements may be necessary to vest the economic interest in the foreign property in a U.S. taxpayer even though the formal exploration arrangement is with a foreign entity. Normally this approach is accomplished, as has been done in the United Kingdom, by means of an operating agreement between the foreign entity holding the license and a U.S. affiliate, whereby the exploration and production activities are carried out for the licensee by the U.S. taxpayer. The Internal Revenue Service has ruled that this method of conducting business creates an economic interest in the U.S. taxpayer acting as operator.¹⁸⁷

As discussed in detail below,¹⁸⁸ the form of organization used should be thoroughly analyzed by the advisor to be sure that maximum advantage can be obtained for U.S. income tax purposes, while at the same time providing all necessary legal safeguards for the U.S. company.

E. *Computing Foreign Taxable Income*

Issues which commonly create complications in evaluating the host country income tax law include the calculation of gross income and of net or taxable income.¹⁸⁹ In certain countries, a tax treaty with the United States will exist which specifically governs the treatment of certain items resulting from operations in the host country. In the absence of specific provisions in the host country's income tax law or in a treaty, the concession or contractual agreement may be used to define the boundaries of host country income taxation, including special treatment of certain items of income and expense.

It is important that either the host country's income tax law or the arrangement governing the petroleum operation provide how gross income from the sale of petroleum produced in the country will be calculated. If crude oil is sold in the open market at prevailing market prices, no difficulty should arise in the calculation. If the petroleum is sold to an affiliate at a price different than the market price, the normal rule is that, for host country income tax purposes, the price that would have been

187. Rev. Rul. 68-551, 1968-2 C.B. 261.

188. See *infra* notes 190-203 and accompanying text.

189. See generally BURKE & DOLE, *supra* note 1, at 20-33.

received in the free market, if higher, will be used in determining gross income.

If petroleum or products derived therefrom are sold between related entities which are residents of separate countries, it is important to understand the transfer pricing practices of the host country. The taxing authorities in most countries are empowered to examine transfer pricing issues. While legislation governing transfer prices is often vague, an arm's length standard is normally applied. As a result, transactions between related parties should be taxed as if they had been negotiated at arm's length. Transfer pricing issues can arise at several points in foreign petroleum operations including prices at which capital equipment is transferred to the petroleum operation, prices at which units of petroleum (or refined products, if refining takes place locally) are sold to a related party, the amount of royalties which are charged by a parent corporation in consideration for the use of technology and other intangibles, fees charged by the parent for management and other services, and the rate of interest charged on loans from affiliates.

If the host country taxing authorities take the position that a local entity is engaged in transactions with a related party which are not priced at arm's length, the authorities will normally seek to adjust the income of the entity to what it would be under an arm's length standard. There may also be a constructive dividend resulting from the adjustment in which case withholding tax could be imposed. Pricing controversies with tax authorities can best be avoided through development of a well-documented, consistently applied approach to establishing inter company prices.

If an adjustment is made to income in one country, the result can be double taxation if an offsetting adjustment is not also made to the income of the other country involved in the associated transaction. The taxing authorities in the country where the other party is resident are generally under no obligation to allow such an adjustment. However, if there is a tax treaty in effect between the two countries, it may provide for discussions between tax authorities in those countries which may result in an allowance of an offsetting (or partially offsetting) adjustment.

As previously discussed, in many countries, the free market price for petroleum is replaced by an artificial "posted" price, even if the petroleum is sold in the open market. Because of potential foreign tax credit problems in the United States, a petroleum company should endeavor to

have the fair market price used to calculate gross income for host country income tax purposes, and for all other purposes under the concession or contractual agreement. Obviously, petroleum companies may find themselves suffering from an economic disadvantage, as well as a U.S. tax disadvantage, if the manner of determining the "posted price" does not approximate the price that would be realized in the open market.

After issues relating to the calculation of gross income have been addressed, attention must be given to the deductions to be allowed in the calculation of net income subject to host country income taxation. Tax systems around the world vary dramatically in determining deductions that will be allowed in computing local taxable or net income, particularly for petroleum operations.

Of primary importance to petroleum companies is the ability to recover capital before paying significant amounts of host country income tax. The most desirable mechanism is to allow full cost recovery against revenues realized from production in the host country. To the extent immediate expensing of all costs is not available, appropriate allowances for depletion, depreciation, and amortization must be provided. The more liberal the allowances, the more attractive the income tax regime will be for petroleum companies.

Expenses which must be taken into account, either in the immediate expensing mechanism or through the depletion, depreciation and amortization allowances, include those incurred during the evaluation and negotiation period. Costs incurred outside the potential host country during negotiations are generally serious points of contention. It is desirable, from the perspectives of both parties to deal with these expenses as part of the contractual arrangement, if the law itself does not cover this point. If such costs are not allowed as part of an immediate expensing mechanism, they should be subject to amortization over a reasonable period.

Some countries seriously seeking foreign exploration capital have allowed bonus deductions, either in the form of a deduction similar to the U.S. percentage depletion deduction based on gross income, or by allowing more than one hundred percent recovery for certain categories of expenditure. In some countries, such special deductions may be subject to specific negotiation. The advisor must ascertain whether or not the possibility of such special deductions is present.

Another area which may create difficulty in negotiations is the deductibility of costs incurred in dealing with companies affiliated with the

oil company. Most countries permit the deduction of home office management and other costs incurred outside the host country if the activities directly relate to the petroleum operation. The advisor should ascertain how specific the relationship must be in order to deduct these costs. Must the relationship be clear and direct or is there flexibility allowing for allocation of expenses which cannot be identified as specifically related to an activity in a specific location? Countries differ in the extent to which expenses must be specifically identified. A thorough and well-documented approach to identifying home office expenses is prudent given the possible reduction in foreign tax burden which it can produce.

During the life of most petroleum exploration and production ventures outside the United States, the use of debt is considered. Use of debt from outside the host country in petroleum exploration projects has given rise to a number of controversies. In the past, this type of debt has been utilized to avoid foreign exchange problems and the treatment of repatriated funds as taxable dividends. Some host countries have, historically, disallowed deductions for all interest payments made outside the host country, or at least interest payments made to affiliates outside the host country.

If "thin capitalization" rules exist in the host country, that country may take the position that debt owed to a related party is actually equity. When thin capitalization rules are applied, the interest payment will not be deductible because it will be recharacterized as a dividend for tax purposes. The result of this recharacterization is that the interest deduction is denied and withholding tax determined at the rate applicable to dividends (normally higher) rather than interest is applied to the payments. The income tax systems of many countries do not contain thin capitalization rules, although there is growing sensitivity to this issue.

In evaluating a possible investment in petroleum exploration, a petroleum company should carefully review the history of the income tax system in the potential host country. A general observation is that some foreign countries have used their income tax systems during the life of a project to increase the share of economic benefit accruing to the country by increasing the tax rate or changing the calculation of taxable income. It is important to a petroleum company that some stability exist in the potential host country income tax system so that the company can calculate, with some degree of accuracy, its expected return of capital and economic profit potential over the long period of time that will be involved in the exploration, development, and production process. Also,

petroleum companies will find a host country with an income tax system that is sensitive to petroleum market conditions attractive. The United Kingdom petroleum tax system has historically been such a system.

Some countries do not allow consolidation of petroleum exploration and production activities with other operations of the taxpayer in that country for income tax purposes. Other countries do not allow the operations of one field to be consolidated with operations of other fields in the same country. Obviously, these types of features in an income tax law could be disadvantageous to a petroleum company in computing taxable income in the host country and for U.S. foreign tax credit purposes.

Another feature of a potential host country's income tax system which can be of importance is whether or not losses can be carried backward or forward to offset taxable income in other years. Most countries permit some type of carryforward for a specified number of years. Fewer countries allow a carryback. In some countries, a carryforward is permanent, but limitations such as allowing the loss carryforward to offset only income generated by the same petroleum concession or contract may be present.

F. *Withholding Taxes*

A withholding tax is typically imposed on dividends, interests, rents, royalties, and fees paid to non-residents, such as the home office of a U.S. petroleum company. Rates of withholding on such payments are generally in the range of twenty to thirty percent, subject to reduction under applicable treaties. Withholding tax rates may vary, however, depending upon the nature of the payment. Careful note should be made of applicable withholding tax rates so that proposed transactions can be structured to minimize the withholding tax burden. For example, under many tax treaties, the rate of withholding on interest is reduced more than the rate on withholding of dividends. Also, royalties paid for the use of intangibles are generally subject to withholding, while fees for management and technical services generally are not. In most cases, payments for goods are generally not subject to withholding, but the transfer price may include an implicit royalty. The United States has not negotiated tax treaties with most countries in Latin America and Africa. As a result, withholding tax on remittances from operations in those areas are often high in order to discourage repatriation of profits.

Another important consideration is whether withholding tax is imposed by a potential host country on remittances of branch profits. Most

countries do not impose a tax on such remittances thereby creating an incentive for operations to be structured in branch, rather than subsidiary, form. However, some countries impose a tax on branch operations to conform the treatment of branches and subsidiaries. The form of organization issue includes a number of legal and other considerations in addition to the withholding tax issue.

IV. FORMS OF ORGANIZATION

A. *General*¹⁹⁰

The form of entity chosen for operations in a foreign country may, to a large degree, be governed by the need for protection from legal liability. In other instances, the form of organization may be governed by local or contractual requirements. Additionally, the rules of taxation in the petroleum company's own country and in the potential host country may be a deciding factor. A U.S. petroleum company must seriously consider the various organizational alternatives available for a particular foreign petroleum project, taking into account the possible tax benefits in the United States, the need for protection from legal liability in the potential host country, requirements of that country's law with respect to ownership of exploration rights or concessions in the potential host country, the tax law of the potential host country, and any treaties that may exist.

B. *Direct Ownership*

A U.S. petroleum company, which itself may be a corporation, partnership or proprietorship under laws of the United States, generally may operate in a foreign country through a domestic branch. Operations in this form result in income and deductions being treated as incurred directly by the U.S. entity.

Because of legal liability constraints, the branch form of organization may not be desirable since it could expose the other assets of the petroleum company to liabilities resulting from its exploration and production activities in the potential host country. The tax benefits available in the United States, particularly because of the inability to immediately deduct IDC, may not justify incurring such legal risk.

190. See generally BURKE & DOLE, *supra* note 1, at 39-44.

C. *Domestic Subsidiary*

If it is desirable to have the foreign activities treated as incurred by a domestic taxpayer, a U.S. petroleum company could organize a domestic subsidiary in the United States that would operate in the potential host country. If the U.S. petroleum company is a corporation, the new domestic subsidiary could be included in the consolidated U.S. income tax return of the parent company and its other affiliates. The new domestic subsidiary must meet the requirements for inclusion in a consolidated group.¹⁹¹ If the companies are consolidated for U.S. income tax purposes, losses incurred from the subsidiary, including dry hole costs and abandonment losses, could be offset against the taxable income of the parent or other members of the consolidated group.

D. *Partnership or Limited Liability Company*

A U.S. petroleum company forming a consortium to operate in a potential host country, either with other petroleum companies or with local partners, may use a partnership as its form of organization. As a general rule, if the form of organization utilized is treated as a partnership for U.S. income tax purposes, the entity will be a conduit allowing taxable income or loss to flow through to the partners for U.S. income tax purposes. The partnership may be either a general partnership or a limited partnership. In addition, a limited liability company may be used. This option is now available under the laws of several states in the United States and is treated as a partnership for U.S. income tax purposes. The limited liability company has the advantage of providing limited liability to all parties, while at the same time allowing flow through of taxable income or loss to the individual owners of the limited liability company.

Whenever utilizing a general partnership, a limited partnership or a limited liability company, a U.S. petroleum company must be sure that the organization is not classified as an association taxable as a corporation for U.S. income tax purposes.¹⁹² Normally, for U.S. income tax purposes, partnerships formed under state statutes that generally conform to the Uniform Partnership Act or the Uniform Limited Partnership Act

191. See I.R.C. §§ 1501, 1504(a), (b) (1988).

192. See *id.* § 7701(a)(3) (1988); Treas. Reg. § 301.7701-2 (as amended in 1983).

will not be treated as associations,¹⁹³ but careful attention must be given to the relevant characteristics of the organization to be sure that the problem is avoided. By the same token, a limited liability company can be formed under a state limited liability company statute, similar to the Wyoming Limited Liability Company Act, and should not be treated as an association if proper attention is given to the documents creating the entity.¹⁹⁴ If an entity is treated as an association taxable as a corporation for U.S. income tax purposes, it becomes a separate taxable entity independent of its owners and is subject to taxation in the United States as a corporation. Hence, the conduit treatment accorded to taxable income or loss of an entity treated as a partnership for U.S. income tax purposes is lost.

In some cases, a foreign entity utilized to conduct operations in a foreign country will be treated as a partnership for U.S. income tax purposes. In determining if a foreign entity is an association taxable as a corporation or a partnership for U.S. income tax purposes, the U.S. rules are applied.¹⁹⁵ These rules outline certain legal characteristics of the entity which determine its status as an association or as a partnership. However, the laws of the country in which the entity is formed govern the legal relationships among the owners, and with third parties, and are applied in determining the critical legal characteristics of the organization.¹⁹⁶ If there is a requirement that exploration and development be carried on only by organizations formed under the laws of the host country, an analysis of the host country's laws as they relate to the particular form of business organization being used is important to determine the U.S. income tax classification of the entity.

A number of foreign entities have been recognized by the Internal Revenue Service as partnerships for U.S. income tax purposes, despite the fact that the entity is treated as a separate legal person under the laws of the foreign country in which the entity is formed. For example, Brazilian and Panamanian limitadas, which resemble a U.S. limited liability

193. See Treas. Reg. § 301.7701-2; see also Rev. Proc. 89-12, 1989-1 C.B. 798 (regarding circumstances under which the I.R.S. will consider a ruling request relating to the classification of an organization as a partnership).

194. Rev. Rul. 88-76, 1988-2 C.B. 360; see also Frank M. Burke, Jr. & John S. Sessions, *The Wyoming Limited Liability Company: An Alternative to Sub S and Limited Partnerships?*, 54 J. TAX'N 232 (1981).

195. Treas. Reg. § 301.7701-1(b) (as amended in 1977).

196. *Id.* § 301.7701-1(c).

company, have been held to be partnerships for U.S. income tax purposes.¹⁹⁷ Also, a United Kingdom unlimited liability company has been treated as a partnership for U.S. income tax purposes.¹⁹⁸ In any case, where a foreign entity is used, careful attention must be given by U.S. taxpayers to the classification of the entities for U.S. income tax purposes.

E. *Foreign Subsidiary*

If a foreign subsidiary is formed by a U.S. petroleum company under the laws of the host country or another foreign country for purposes of conducting exploration and production activities in the host country, the U.S. income tax rules regarding ownership of such an entity by a U.S. taxpayer must be considered.¹⁹⁹ As previously discussed, a U.S. taxpayer is not normally taxed currently on a foreign corporation's activities and the losses of such corporations cannot be deducted for U.S. income tax purposes. If the foreign corporation is a CFC, unfavorable U.S. tax consequences may result. However, most foreign petroleum exploration and production income will not cause a foreign corporation to be a CFC. Further, if a partially owned foreign subsidiary which is not a CFC is utilized, consideration must be given to the availability of the U.S. foreign tax credit for foreign income taxes paid by such subsidiary.²⁰⁰

One area of caution, which has been previously discussed,²⁰¹ is where a U.S. taxpayer commences foreign exploration in non-corporate form and subsequently elects to transfer the assets associated with such effort to a foreign corporation. Attention must be given to the rules of sections 367 and 1491 to be sure that no adverse U.S. tax consequences will result from the subsequent transfer of assets to the corporation.

In some cases, it may be desirable to use a foreign corporation to hold title to a foreign exploration and production arrangement, if title cannot be held directly. The use of title holding corporations is common for the United Kingdom North Sea licenses. Since the laws of the United

197. The author received favorable private rulings for clients classifying these types of entities as partnerships for U.S. income tax purposes prior to the time private rulings became public information.

198. Rev. Rul. 88-8, 1988-1 C.B. 403.

199. See *supra* notes 158-70 and accompanying text.

200. See *supra* notes 32-40 and accompanying text.

201. See *supra* notes 171-82 and accompanying text.

Kingdom restrict the grant of a mineral interest to locally organized entities, title is taken by a nominee United Kingdom corporation. The nominee then farms out the property to the actual operator. The actual operator furnishes all funds for exploration, development, and other activities under the license obligation. The actual operator effectively assumes all of the obligations of the nominee corporation and complies with all requirements for the United Kingdom government. The actual operator receives all of the production from successful operations and must look solely to production to recover its investment. The Internal Revenue Service recognizes the actual operator as a true owner of the license in such a situation.²⁰² The United Kingdom requires that the actual operator agrees that it will be managed from within the United Kingdom, thereby becoming a United Kingdom resident for United Kingdom tax purposes, or that it will operate through a branch which is taxable in the United Kingdom.

Because of the significant operations of U.S. petroleum companies in Canada and the possibility that Mexico may, at some point in the future, again allow foreign companies to explore for and develop petroleum resources in that country, a U.S. petroleum company operating in these countries should be aware that a special rule applies to a foreign corporation organized under the laws of Canada or Mexico. If the corporation is maintained solely to comply with the laws of those countries as to title and operation of the property, and if it is owned by a U.S. corporation that elects to have such foreign subsidiary treated as a domestic corporation, then it will be treated as a domestic corporation for U.S. income tax purposes.²⁰³ The importance of this provision is that the U.S. petroleum company can include the foreign corporation as a member of its U.S. consolidated income tax return group, thereby allowing inclusion of the taxable income or loss of the foreign subsidiary in the consolidated return of the U.S. parent corporation.

V. OBSERVATIONS

It is readily apparent from the foregoing discussion of U.S. tax considerations and foreign tax considerations that petroleum exploration and production outside the United States is an exceedingly complicated area. While increasingly significant amounts of capital are being directed

202. Rev. Rul. 68-551, 1968-2 C.B. 261.

203. I.R.C. § 1504(d).

toward foreign petroleum activities by U.S. petroleum companies, including more independent petroleum companies, the U.S. income tax law does nothing to encourage such investment. Nevertheless, it appears that foreign investment by petroleum companies in larger and larger amounts is inevitable.

Perhaps Congress should again carefully review the entire foreign exploration and production area to determine if, since petroleum exploration capital is going to be transported outside the United States in any event, it would be appropriate for the U.S. income tax law to encourage investment of such capital in the Western Hemisphere, rather than in more remote and less secure areas of the world. By encouraging concentration of foreign exploration in this hemisphere, at least by independent petroleum companies, more accessible reserves might be developed for the United States.

VI. CONCLUSION

Hopefully, as trade agreements continue to be considered with countries in the Western Hemisphere, including Mexico (as Mexico considers again allowing petroleum exploration by foreign companies), liberalization of the U.S. income tax rules regarding petroleum investments in those areas will occur. Until that time, U.S. petroleum companies will continue to seek the best geologic prospects in areas offering acceptable economic arrangements, whether those areas be in the Western Hemisphere or in other parts of the world. Advisors for petroleum companies entering international petroleum exploration will find advising clients in this area to be a challenging and interesting endeavor.

