113256

BY THE COMPTROLLER GENERAL

Report To The Congress

OF THE UNITED STATES

The Foreign Tax Credit And U.S. Energy Policy

The foreign tax credit is not an effective tool for shaping U.S. energy policy. GAO reached this conclusion after examining whether the tax credit hinders, promotes, or does not affect the goals of reducing U.S. oil imports and diversifying the sources of imported oil.

Eliminating or severely curtailing the foreign tax credit would increase the effective rate of taxation on U.S. oil companies operating abroad, and thereby may reduce the competitive stance of U.S. companies' foreign operations. It could possibly reduce exploration and development efforts somewhat.

However, the magnitude of these potential effects does not appear to be great enough to substantially reduce the ability of U.S. companies to operate abroad or to fundamentally change the locus of oil company activity overseas. Therefore, any change in the foreign tax credit should be based on tax rather than energy policy objectives.

UNITED STATES GENERAL ACCOUNTING OFFICE

113256

EMD-80-86
SEPTEMBER 10, 1980

For sale by:

Superintendent of Documents
U.S. Government Printing Office
Washington, D.C. 20402

Telephone (202) 783-3238

Members of Congress; heads of Federal, State, and local government agencies; members of the press; and libraries can obtain GAO documents from:

U.S. General Accounting Office
Document Handling and Information
Services Facility
P.O. Box 6015
Gaithersburg, Md. 20760

Telephone (202) 275-6241

COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-199972

To the President of the Senate and the
Speaker of the House of Representatives

This report discusses the impact of the foreign tax credit provisions of the Internal Revenue Code on the U.S. oil industry and the implications for U.S. energy policy. The report also discusses the potential effects on oil industry operations and on energy policy of proposed changes to the current law. We conducted this study to determine whether the credit hinders, promotes, or is neutral with regard to achieving U.S. energy goals and if it is possible or advisable to use the credit as a tool of energy policy.

We are sending copies of this report to the Director, Office of Management and Budget, and to the Secretaries of the Treasury and Energy.

Elmer B. Staats
Comptroller General
of the United States

COMPTROLLER GENERAL'S REPORT TO THE CONGRESS

THE FOREIGN TAX CREDIT AND U.S. ENERGY POLICY

D I G E S T

The foreign tax credit allows U.S. corporations to credit a portion of their foreign income taxes paid abroad against their U.S. income tax liability on this income. The oil and gas industry claims the greatest portion of the total foreign tax credit--roughly 75 percent.

To counter perceived inequities in the tax treatment of U.S. oil companies, Congress has made several changes to the credit which have progressively restricted its use by the industry. Several new proposals further restricting the the oil industry's use of foreign tax credits have lately been under consideration by the Congress and the administration.

Claims regarding the importance of the credit to the oil industry imply that any future severe limitations to the use of these credits by the industry might prove detrimental to its financial and competitive positions, and, were this to happen, it might adversely affect U.S. energy goals.

GAO attempted to determine

--whether the foreign tax credit as it currently works hinders, promotes, or is neutral with regard to achieving the goals of reducing U.S. oil imports and diversifying the sources of imported oil.

--what alterations to the credit might be required to make tax law more consistent with the attainment of these energy goals, and

--if it is possible or advisable to use the credit as a tool of U.S. energy policy.

In conducting this study, GAO focused on the implications of various alternatives to the

Tear Sheet. Upon removal, the report cover date should be noted hereon.

present foreign tax credit for energy policy. The options considered in this report are

--the present tax credit system,

--elimination of the credit,

--elimination of both the credit and tax deferral benefits,

--further restrictions on the use of the credit by oil firms as proposed by the Department of the Treasury and the Internal Revenue Service, and

--use of the tax credit to achieve energy policy objectives by varying the amount of credit allowed among different countries.

GAO found that the foreign tax credit benefits the oil industry by lowering its U.S. tax burden as against the alternative of claiming foreign taxes as a deduction. In theory, a credit is worth approximately double the value of a deduction. In fact, however, the credit is worth considerably less than this amount because of special limitations and the inability of many firms to use excess credits. The gap between the value of credits and deductions is less when income is earned in a foreign country with high tax rates, as are found in the most important members of the Organization of Petroleum Exporting Countries (OPEC). (See pp. 9 to 18.)

The oil industry uses the largest portion of all foreign tax credits. Since 1974, the amount of credit claimed by the industry amounted to approximately $15-$17 billion per year or 75 percent of the amount claimed by all industries. The value of the credit to the oil industry, measured in terms of increased tax liability if foreign taxes were deducted instead, averaged about $1.6-1.9 billion per year from 1975-1977. Treasury's estimate for 1979 is $2.3 billion.

If the credit had not been available for 1976 (the latest year for which detailed data are available), it is estimated by the Treasury that eight large U.S. multi-national oil companies would have accounted for roughly 70 percent of the increased tax burden for the entire industry. It is evident that a relatively small number of firms claim a very large portion of the total credit claimed by the industry. While 80 firms claimed a credit in tax year 1976 totaling $17.2 billion, 5 of these firms had claims amounting to $14.8 billion, or 86 percent of the total. (See pp. 20 to 24.)

Eliminating or further restricting the credit could result in a significant financial loss to the industry and could possibly have an adverse impact on the industry's ability to invest. Using 1976 data for 12 major oil companies claiming 95.2 percent of the total oil industry credit for that year the $1.6 billion increased 1976 tax burden without the credit would represent 16.8 percent of the net income of the group. Elimination of the credit would increase these companies' U.S. tax liability by 43.7 percent over the U.S. tax actually paid. (See pp. 24 and 25.)

This increased tax liability, however, might be offset by other industry actions, for example by passing additional taxes through to consumers, or by altering the corporate form of exploration and development activity. In addition, any loss in investment capability would affect not only foreign oil activities, but also could apply to energy and non-energy investments alike.

The impact of further restrictions on the credit on individual firms would very much depend on the size and nature of the firm's operations and on the particular foreign tax rates to which a firm's foreign income is subjected. (See pp. 25 and 26.)

The foreign tax credit has had little impact on exploration and development activities. Further restrictions on use of the credit by the oil industry would reduce the profitability of foreign ventures, but it is unlikely to have widespread influence on decisions regarding industry exploration and production operations.

Taxes are only one component of overall cost and, in GAO's opinion, are rarely a deciding factor in foreign investment decisions. Far more important are variables such as geologic promise, political stability, and philosophy of the host government. Elimination of the credit could reduce the rate of development of oil fields abroad which are marginally profitable even with the credit. It might also stimulate domestic production activity, but this is unlikely since U.S. geologic considerations would remain the same. (See pp. 27 and 28.)

In order to test the effects of further restrictions on the credit, GAO collected data on exploration, leasing, wildcatting and development activities of foreign and American companies operating abroad. GAO examined whether the restrictions on the credit imposed in 1976 affected how aggressively the U.S. firms searched for oil or whether they damaged the competitive position of the U.S. companies. GAO found no significant changes in either case. While this evidence does not imply that restricting the credit had no effect, it does indicate that any effects were so small that they made no appreciable difference to the trends in either exploratory activity or competitiveness. (See p. 30.)

GAO also concluded that the foreign tax credit does not subsidize overseas activity at the expense of domestic activities. The relatively high tax rates in most countries on oil production and the limitations on the credit make foreign activity more expensive than domestic activity from a tax standpoint. (See pp. 33 to 37.)

GAO's analysis indicates that if the credit is eliminated and the deferral provision remains, it is likely that many U.S. companies will change from branch to subsidiary operations. Therefore, deferral would have to be eliminated along with the credit to increase tax revenue.

There is a possibility that discarding both the credit and deferral would induce some U.S. oil companies to reincorporate abroad. GAO believes this is unlikely, however, since the capital gains tax penalty involved would far outweigh any potential advantage U.S. oil companies might derive from foreign re-incorporation. (See pp. 28 and 29.)

CONCLUSIONS

GAO's research indicates that should the tax credit be severely altered, it would increase the effective rate of taxation on U.S. oil companies operating abroad, and thereby may reduce the competitive stance of these companies vis-a-vis foreign operations. It could possibly reduce exploration and development efforts to some extent.

In GAO's opinion, however, while the possibility of these effects must be acknowledged, their magnitude does not appear to be sufficient to substantially reduce the ability of U.S. companies to operate abroad nor to fundamentally change the locus of oil company activity overseas.

Most evidence on the impact of altering the credit points to a negative but marginal effect on such factors as industry profits, competitive standing, and foreign exploration and development activity. Thus, it is doubtful that U.S. energy policy would be either enhanced or hindered in any fundamental way by changes to the foreign tax credit. The credit was neither intended to be used for such purposes, nor is it evident that it is well suited as an energy policy instrument. The tax policy objectives should be given higher priority considerations.

RECOMMENDATIONS TO THE CONGRESS

GAO recommends that:

- The merits of the foreign tax credit be considered primarily on the basis of achieving tax policy objectives.

- If it is determined that tax policy objectives warrant retaining the credit for the oil industry, only then should consideration be given to selective application of the credit to encourage exploration and production activities in non-OPEC areas. While it is not clear that selective application of the credit would be effective in diversifying U.S. oil sources from the Persian Gulf area, it would at least be consistent with this objective.

AGENCY COMMENTS

The Departments of Energy and Treasury reviewed a draft of GAO's report. The Department of Energy declined to comment, but the Department of the Treasury suggested clarifying language on some of the technical and legal aspects of the foreign tax credit. The Treasury also provided recent revisions of their estimates of the revenue impact on repealing the credit, which were incorporated into the report.

Contents

ABBREVIATIONS

GAO	General Accounting Office
IRS	Internal Revenue Service
OPEC	Organization of Petroleum Exporting Countries
Aramco	Arabian-American Oil Company

CHAPTER 1

INTRODUCTION

Foreign income tax payments by U.S. corporations have been creditable against their domestic tax liabilities since 1918. The specifics of the foreign tax credit* provisions of the U.S. tax code have been altered several times since then. In most cases, these changes have been designed to harmonize U.S. tax treatment of domestic and foreign-source income. Recent alterations have been made in response to perceived inequities in the tax treatment of income earned by U.S. oil companies abroad.

The purpose of the present study is to determine whether the foreign tax credit, as it currently operates, hinders, promotes, or is neutral with regard to achieving the U.S. energy goals of reducing oil imports and diversifying the sources of imported oil. The study also aims to determine how various alternatives to the present credit would affect the attainment of these energy goals and if it is possible or advisable to use the credit as a tool of U.S. energy policy.

SCOPE AND METHODOLOGY

The present study is relatively narrow in scope. It focuses only on the energy implications of the present foreign tax credit and its alternatives. No attempt is made to assess the propriety of crediting foreign income taxes against a corporation's U.S. tax liabilities from the standpoint of U.S. tax policy. Nor does this report address whether the credit provides for equal tax treatment for U.S. corporations regardless of industry or source of income. This study also does not deal with the question of whether levies paid by U.S. oil companies abroad are in reality income taxes or should be considered royalties. The main focus of this report is the implications of the foreign tax credit for U.S. energy policy.

---

*The term "credit" as used in this report refers to the option to subtract the amount of income taxes paid by U.S. firms to foreign governments (subject to the specific limitations discussed in this report) from U.S. taxes due on this same income. The alternative is to treat these taxes as normal business deductions whereby foreign income taxes paid are subtracted from the firm's foreign income net of other expenses and the U.S. tax is charged on the remaining amount. The value of the deduction depends on the relative level of U.S. and foreign tax rates but is less than the credit.

In conducting this study, General Accounting Office staff interviewed executives of U.S. oil companies, academics, and State and Federal officials to obtain their views concerning the potential impact on oil industry operations of various changes in the foreign tax credit provisions. GAO analysts and expert consultants analyzed the information obtained in these interviews in conjunction with financial and operations data supplied by the oil industry, Internal Revenue Service (IRS) tax profiles, and other data. The Treasury Department supplied the estimates of the initial financial effects specific changes in the foreign tax credit would have on the oil industry.

Despite extensive review of the role of foreign tax credits in determining the financial standing and influencing the behavior of U.S. oil companies in the past--and the potential effects of future changes--the final assessment of these effects depends greatly on professional judgement. From the available data it is not possible to determine with certainty what impact future tax changes will have on oil company investment decisions. There are many factors which interact to determine industry behavior; the foreign tax credit is only one of these factors. Consequently, our conclusions represent a considered judgement based on a review and analysis of the data relevant to assessing the implications of the foreign tax credit for U.S. energy policy.

CHAPTER 2

THE FOREIGN TAX CREDIT: LEGISLATIVE HISTORY, PRESENT LAW, AND PROPOSED ALTERNATIVES

LEGISLATIVE HISTORY

The 1913 Federal income tax law contained a provision allowing U.S. corporations to treat all foreign taxes paid as business expenses and, therefore, to deduct them from gross receipts when determining income subject to U.S. taxation. The Revenue Act of 1918 changed this, permitting corporations to credit taxes paid abroad on foreign income against their U.S. tax liability on this income. While a few countries had allowed credits for taxes paid to their colonies prior to 1918, the United States was the first country to apply the foreign tax credit on a worldwide basis to avoid double taxation of foreign income.

According to some tax experts, the foreign tax credit was designed (1) to eliminate taxation of the same income by both U.S. and foreign governments, and (2) to achieve an equitable division of tax revenues between the home and host governments. The credit, by eliminating "double taxation," acted somewhat to encourage overseas commerce and investment, and to discourage U.S. corporations with activities abroad from reincorporating in a foreign country to avoid an oppressive combined tax burden.

In the 1950s, however, some contend that the foreign tax credit was employed as a means of transferring financial assistance to Saudi Arabia. Under the advice of the Treasury Department, the Saudis imposed an income tax on the Arabian-American Oil Company (Aramco)--which was then entirely U.S. owned--with the consent and cooperation of Aramco, and the U.S. Government. Thus, a portion of the income taxes formerly paid by Aramco to the United States was transferred to the Saudi Treasury.

Since its inception, the credit has been altered several times. In 1921, the overall credit limitation was first adopted to prevent credits for foreign taxes from offsetting taxes on domestic income. The per-country limitation (calculation of the limit on a country-by-country basis) was introduced in 1932. Credits were limited to the lesser of the two methods. In 1954, the overall limitation was repealed. It was reintroduced in 1960, and the taxpayer was permitted to choose between applying the per-country or the overall limitation.

The most notable--and the most recent--changes have been directed toward limiting the amount of credit allowed for taxes paid by U.S. oil companies abroad. In 1975 and 1976, the Congress legislated changes to the credit which limited the use of credits from oil and gas extraction activities against taxes on other income, and introduced additional restrictions. As will be discussed later, further restrictions on the credit for oil firms have recently been under congressional consideration.

PRESENT LAW

Under present tax law, the United States taxes domestic corporations on their worldwide income. U.S. corporations are permitted a foreign tax credit which helps them avoid international double-taxation--taxation of the same foreign source income by both the foreign host government and the U.S. government. Generally, the credit is available in two basic circumstances:

--A U.S. firm operating through a branch abroad may claim a direct credit for a portion of the income, war profits, or excess profits taxes paid to a foreign government on income derived in that country (sec. 901, Internal Revenue Code). The direct credit also applies to investment income.

--A U.S. firm which operates abroad through a foreign subsidiary may claim an "indirect" credit for income taxes paid abroad by the subsidiary when profits are remitted to the parent. The U.S. parent's credit is limited to the portion of its share of the total income which is actually repatriated. The parent receives a credit for the portion of taxes "deemed" paid by it on its share of total income which is actually remitted to the parent (sec. 902, Internal Revenue Code). The parent may also credit foreign income taxes on the dividends and other income it receives from the subsidiary.

The Internal Revenue Code sets out certain rules to determine what amount of foreign income taxes paid abroad by a U.S. company are creditable against its U.S. tax liability. The most important of these rules are contained in seven key provisions. Three of these provisions apply generally to all U.S. corporations earning income abroad and paying foreign taxes, regardless of the particular industry. These include provisions governing:

--Limitations on the amount of credit available (sec. 904(a)).

--The "carryover" of excess taxes paid (sec. 904(c)).

--The "recapture" of foreign losses (sec. 904(f)).

The remaining four provisions apply specifically to U.S. companies which earn income from foreign oil and gas activities and pay foreign taxes on this income. These include provisions relating to:

--Limitations on the amount of creditable extraction taxes (sec. 907(a)).

--Limitations on the amount of creditable oil-related taxes (sec. 907(b)).

--The "carryover" of disallowed oil extraction credits (sec. 907(f)).

--The "per country extraction loss rule" (sec. 907(c)).

All U.S. corporations operating abroad are permitted to credit income taxes paid to foreign governments on income earned abroad against the U.S. income tax liability on that same income. These credits may be used only against U.S. taxes on foreign income; they may not be used to offset the tax liability on a corporation's domestic income. To prevent this, the code designates a limitation on the amount of credit that can be claimed.

The limitation designated in section 904(a) of the Code (46 percent of foreign income in most cases) is designed to ensure that the credit offsets only the U.S. tax on foreign income by setting an upper limit on the amount of credits claimed. Generally, this limitation prevents the crediting of foreign taxes paid which are in excess of the U.S. taxes due on the same income (currently 46 percent). Currently, the credit limit must be calculated on an "overall" basis.

Under the overall method, the Internal Revenue Code requires that a firm aggregate its income and losses from all foreign sources in calculating the credit. This allows a corporation to "average" its foreign taxes paid to high tax rate countries with taxes paid to low tax rate countries.

The overall limitation is:

$$\frac{\text{Foreign source income}}{\text{Worldwide income}} \times \text{U.S. pre-credit tax (at 46 percent)}$$

This limit equals the U.S. statutory tax rate times the foreign source income. This is generally the upper limit for creditable taxes. However, if this limit exceeds the actual foreign tax paid, the allowable credit would be the lesser of the two amounts.

Initially, taxpayers were permitted to use either the overall method or the per-country method in calculating the credit limitation. The difference between the two methods is that the overall method requires that the limit be calculated for taxes paid to <u>all</u> foreign countries together and the per-country method requires that the limit be calculated separately for taxes paid to each foreign country individually.* In 1975, the law was changed requiring firms engaged in foreign oil and gas operations to compute the limitation only on an overall basis. Currently, all taxpayers are required to use the overall method.

The code also permits the taxpayer to "carry over" taxes paid above the limitation for a specific number of years, subject to certain limitations. In addition, the "recapture" provisions of the code allow the United States to recoup tax benefits derived from the deduction of losses in previous years before a further benefit is given through the credit. The recapture provision requires that in cases where foreign losses reduce U.S. tax on domestic income, a

---

*Use of the overall method of computing the credit is usually of most benefit to the corporation which earns income in a foreign country with a high tax rate and in a country with a low tax rate, relative to the U.S. rate. The taxpayer can thus average income and offset U.S. taxes due on the low-tax income. This method will hurt a corporation which has substantial losses in some countries that offset income from other foreign countries. These losses decrease the amount of foreign income and thus, lower the credit limitations.

Use of the per-country method of computing the limitation benefits the corporation which has a loss in one foreign country and income from another. The loss thus cannot reduce the credit limitation for taxes paid to the country in which income arose. This method is of least benefit to a corporation with income from both a high- and a low-tax country. Taxes in excess of the limit paid to the high-tax country cannot offset tax on low-tax country income and these excess credits are lost.

portion of the foreign income subsequently earned abroad be treated as income from domestic sources and taxed accordingly.*

In addition to these general provisions of the foreign tax credit under section 904 which apply to all U.S. corporations, the code contains special provisions which apply only to income from foreign oil and gas activities. Section 907 of the Code, relating to foreign tax credits allowable for foreign oil and gas income,** was added in recent years with the specific intention of limiting the use of excess credits which are generated from oil and gas extraction income to offset a corporation's U.S. tax liability on other foreign income, including both oil-related and non-oil foreign income.

---

*Under the "carryover" provision, the excess taxes carried over are creditable only to the extent that the sum of the foreign taxes actually paid in these other years and the excess taxes deemed paid in those years do not exceed the limitation for those years.

The recapture provision comes into play in a situation where a company's foreign losses exceed its foreign income in a particular year. In such an instance, the excess loss may be deducted from U.S.-source income and thus reduce the U.S. tax on domestic income. If at a later time, the company earns income from abroad on which it would normally receive a credit, the company could receive the tax benefit of reducing taxable U.S.-source income in the loss year and also receive a credit benefit in the next year in which foreign income is earned. To correct this situation, the recapture provision requires that in cases where foreign losses reduce U.S. tax on domestic income, a portion of the foreign income subsequently earned abroad be treated as domestic income and taxed accordingly. The amount of this foreign income which can be treated as U.S. domestic income in a single year is limited to the lesser of the amount of the prior foreign loss, or 50 percent or greater of the foreign taxable income for the current year. Therefore, the amount subject to recapture does not exceed 50 percent of the taxpayers foreign income for the recapture year unless the taxpayer wishes that a higher percentage be so treated.

**For purposes of sec. 907, "foreign oil and gas extraction income" is foreign taxable income from the extraction of minerals from oil or gas wells and from the sale of extraction assets. "Foreign oil-related income" is defined as foreign taxable income from extraction activities, plus processing, transporting, and distribution, activities, etc.

Under current law, section 907 stipulates that amounts claimed by a U.S. corporation as income taxes paid on foreign oil and gas extraction income are creditable up to an amount equal to total foreign extraction income multiplied by the normal corporate tax rate or, at current rates, approximately 46 percent of this income.

This section also allows for a carryover of excess extraction taxes paid or "excess credits" beyond the limitation--equal to 2 percent of foreign extraction income--to the preceding 2 years and the succeeding 5 years, subject to certain limitations. This carryover provision differs from that specified in section 904 in that this applies strictly to extraction taxes, where the section 904 carryover applies to all other foreign income taxes. In addition, the amounts of credits permitted to be carried over are restricted to different limits.

Section 907 further states that a corporation must compute the overall foreign tax credit limitation, as specified in section 904, separately for foreign oil-related income and for all other taxable income. Therefore, foreign taxes paid on foreign oil-related income cannot be used to offset U.S. taxes on other income. In calculating the oil-related overall limitation, the extraction tax limitation discussed earlier must be taken into account.

The Code also contains a "per country extraction loss rule" which provides that a net loss in a particular country on extraction activities is not subtracted when computing foreign oil extraction income for that year but is subtracted when computing oil-related income for that year (section 907 (c)(4)). This increases the amount of extraction taxes that a corporation can credit because, by not subtracting the loss, total extraction income is higher; therefore, allowable credits are higher. This is obviously of benefit to firms engaged in extraction activities which have losses from drilling activities and foreign oil-related income (e.g., from refining or shipping) which is taxed at lower rates.

(It should be noted that sec. 901(f) also applies to oil and gas extraction income. This section denies the credit for taxes on oil income when the company has no economic interest in the oil and when the transaction is at a price different from the fair market value.)

DIRECT VERSUS INDIRECT CREDIT

As noted earlier, there are two basic types of foreign tax credits: the "direct" credit and the "indirect" or derivative credit. The direct credit applies to U.S. firms operating through branch offices abroad. The indirect credit applies to U.S. corporations operating abroad through foreign subsidiaries. We deal specifically with the direct credit in this report. This is not because the indirect credit is less important. In fact, many companies, especially in the oil industry, operate through foreign subsidiaries and, therefore, claim an indirect credit for taxes "deemed" paid on their share of repatriated earnings. We address the direct credit specifically because it is a simpler version of the same process. We have determined that the financial effect of both forms of credit on the U.S. firm--whether operating through a branch or subsidiary--is basically the same. By focusing on the direct credit, we eliminate unnecessary confusion in our description of the functioning and effects of the credit.

COMPUTING THE CREDIT: A GENERAL OVERVIEW

A tax credit is subtracted from taxes due, while a tax deduction is subtracted from gross receipts when computing the total income to be taxed. Taxpayers have the option to credit or deduct their foreign income taxes. Generally, it is more advantageous to use credits. In theory, for income from countries where the income tax is the same as the U.S. corporate tax rate of 46 percent, the after-tax income of a firm claiming a credit is approximately double that which would result from a deduction.* Table 1 illustrates the value of a credit versus a deduction for foreign income taxes paid, assuming $100 of foreign-source income (before tax) and a foreign tax rate of 46 percent.

The firm in the example, by using the credit option, has a greater total after-tax income than it would if it were to claim foreign taxes as a deduction. In addition, by using the credit this firm is just as well off financially having earned its income abroad as it would be if it had earned this income domestically.

---

* When the foreign tax rate exceeds the U.S. tax rate, however, the difference between a credit and a deduction narrows.

TABLE 1

Optional Methods of Claiming Foreign Income Taxes Paid in Computing U.S. Taxes Due

Foreign income taxes claimed as a deduction		Foreign income taxes claimed as a credit
100.00	Foreign source income	100.00
46.00	Foreign income taxes paid	46.00
54.00	U.S. taxable income	100.00
24.84	U.S. taxes due (46%)	46.00
-	Foreign tax credit	46.00
24.84	Total U.S. taxes paid	0.00
70.84	Total taxes paid (foreign and U.S.)	46.00
70.8%	Effective tax rate	46%
29.16	Total after-tax income	54.00

The impact of the credit on the total tax liability of U.S. corporations, and consequently on their after-tax income, will differ according to the foreign host government's tax rates. Model tax calculations, demonstrating the differing effects of the foreign tax credit on a hypothetical firm operating under one of three alternative foreign tax rates, are shown in table 2. Again, these are simplified examples and are intended to be illustrative.

TABLE 2

Total Taxes Due Under Alternative Foreign Tax Rates

	A Foreign tax rate comparable to U.S. rate (46%)	B Low foreign tax rate (35%)	C High foreign tax rate (85%)
(1) Foreign income	200.00	200.00	200.00
(2) Foreign tax paid	92.00	70.00	170.00
(3) U.S. income tax due on foreign income before credits	92.00	92.00	92.00
(4) Credit limitation (Sec. 904)	92.00	92.00	92.00
(5) Excess of U.S. tax due over foreign tax paid (3-2)	0	22.00	-
(6) Excess credits (2-4)	-	-	78.00
(7) U.S. tax due on foreign income after credits (4-2)	0	22.00	0
(8) Total taxes (foreign and U.S.) paid on foreign income (2+7)	92.00	92.00	170.00

Example A in table 2 shows foreign-source income taxed at a rate equivalent to that of the United States. The tax due the United States on foreign income is zero. The firm pays taxes first to the country in which the income was earned, and, due to the credit, owes no U.S. tax on foreign income. This firm pays the same total taxes as its domestic counterpart whose income is solely from domestic activity.

Example B, in which the foreign tax rate is lower than that of the United States illustrates that the United States retains the right to claim the difference between the foreign tax paid and the U.S. tax due on the foreign income of $22, resulting in a total tax bill on foreign income of $92.

Example C illustrates how the maximum credit limitation acts to limit the use of credits when a foreign country has a tax rate above that of the United States. Only $92 in credits is allowed. No tax is owed to the United States on the foreign source income. The firm has, however, paid $170 in taxes to the foreign host government. The $78 above the limit is "excess" credits which can be carried forward or backward to be used in other years.

As has been noted, the amount of excess credits which can be carried over is subject to certain limitations. In some cases, the amount of excess credits generated may exceed these limits. This is most common in the case where a firm operates solely or predominantly in high-tax areas as do certain firms involved in foreign oil and gas extraction activities.*

It is important to note that under present law, excess credits are neither creditable nor deductible against U.S. tax liabilities. Thus to the extent that they are generated, they reduce the advantage of crediting foreign tax payments in relation to deducting them. This is illustrated in table 3.

---

*Tax rates on oil extraction income in some OPEC countries are in the 80-90 percent range.

TABLE 3

Comparing Foreign Tax Credits And Deductions
With Differing Volumes Of Excess Credits

	(A)			(B)		
	Credit		Deduction	Credit		Deduction
Foreign income	100.00		100.00	100.00		100.00
Foreign tax rate	50%		50%	90%		90%
Foreign income taxes paid	50.00		50.00	90.00		90.00
U.S. taxable income	100.00		50.00	100.00		10.00
U.S. tax due (46%)	46.00		23.00	46.00		4.60
Foreign tax credit	46.00		-	46.00		-
U.S. tax paid	0		23.00	0		4.60
Excess credits	4.00		-	44.00		-
Total taxes paid (foreign/U.S.)	50.00		73.00	90.00		94.60
Difference		23.00			4.60	

The table shows how the value of credits approaches the value of deductions under high foreign tax rates. To the firm facing the 50-percent foreign tax rate (A), the credit is worth $23 more than the deduction option. To the firm facing the 90-percent foreign tax rate (B), the credit option is worth only $4.60 more than simply using foreign tax payments as a business deduction.

COMPUTING THE DIRECT FOREIGN TAX CREDIT FOR OIL AND GAS INCOME

A simplified computation of the direct foreign tax credit for a U.S. oil company is shown in table 4.

TABLE 4

Direct Foreign Tax Credit for A U.S. Oil Company (note a)

	A	B	C	D	Total
Net foreign income	$200	(-$50)	$200	$100	$450
Foreign tax rate	(80%)	(80%)	(30%)	(30%)	-
Foreign tax paid	160	0	60	30	250
U.S. tax rate	(46%)	(46%)	(46%)	(46%)	(46%)
U.S. tax due (before credits)	[------69-----]		92	46	207
907 extraction limitation (46% of extraction income) (note b)	[------92-----]		-	-	92
904 Limitation (overall limitation)	[----------161----------]			46	207
Allowable foreign tax credits (note c)	[--------d/152----------]			e/30	182
U.S. tax due (after credits)	[------------9----------]			16	25

a/A = Country in which extraction income earned.
B = Country in which extraction loss incurred.
C = Country in which refining income earned.
D = Country in which non-oil income earned.

b/Extraction losses need not be subtracted in calculating sec. 907 limitation.

c/Lesser of sec. 907 limitation plus foreign oil-related taxes paid or sec. 904 limit for oil-related income.

d/Extraction tax limitation (907 limitation) plus foreign oil-related taxes paid (92+60=152)

e/For non-oil income, allowable credit is lesser of foreign tax paid or sec. 904 overall limitation.

The company portrayed in the table has operations in four different countries. We assume that the company has extraction activities in country A from which it earns $200 in income. The company also has extraction operations in country B, but in this particular year, it incurred a loss of $50. Country C is the source of the company's refining income of $200. An additional $100 of non-oil income is earned in country D for a total of $450 of net income from foreign sources. We further assume that the foreign tax rates on extraction income in countries A and B are 80 percent, the rates on the refining income in country C and the non-oil income in country D are 30 percent, and the statutory U.S. corporate rate is 46 percent on income from all activities.

Present law (sec. 907) requires that non-oil income be separated from oil-related income and that a separate overall limitation (sec. 904) be calculated for each type of income. Therefore, in table 4, a separate overall limitation must be computed for income from country D. This limitation amounts to $46. However, total allowable credits on income taxes paid to country D amount to $30 (the foreign tax paid), since this is less than the U.S. tax liability of $46 on this same income. The company thus owes the United States $16 in taxes on its non-oil income.

The oil-related income must now be considered separately. The Internal Revenue Code requires that the company's extraction income be aggregated to calculate the limitation on the amount of foreign extraction taxes that can be credited. The per-country extraction loss rule, as previously noted, allows the company to aggregate its extraction income without taking the extraction losses into account. In other words, for purposes of calculating the section 907 limitation, extraction income from countries A and B is $200. The limitation is thus $92, or 46 percent of $200. Therefore, the allowable extraction tax credit is $92 which is less than the actual foreign tax paid on this income. (Note that without the per-country loss rule, the allowable extraction tax credit would be only $69, or 46 percent of $200 minus $50.)

The next step is to add extraction and "downstream" income from A, B, and C to obtain total oil-related income of $350. (Note that in calculating the overall limitation for oil-related income, the extraction loss of $50 from country B is taken into account). The section 904 overall limitation is then computed as previously described. This limitation on oil-related income taxes available for credit amounts to $161, which is 46 percent of $350, or the tentative U.S. tax on this income. The $161, is not, however, the total allowable foreign tax credit for oil-related income.

The section 907 extraction limitation prevents the use of more than $92 in extraction credits on total oil-related income. In the example in table 4, the total allowable foreign tax credit is $152. This is the sum of the allowable extraction credits ($92) and the foreign tax paid on refining income in country C ($60). Since this sum ($152) is less than the overall limitation on oil-related income ($161), it is the amount that takes precedence and is the upper limit of creditable taxes on oil-related income. This amount is also less than the tentative U.S. tax on total oil-related income ($161). Consequently, there is a residual U.S. income tax liability of $9 on this income. U.S. tax is due regardless of the fact that the total foreign tax paid on oil-related income is $220 and, thus, greater than the pre-credit U.S. tax liability of $161. This is the result of the section 907 limitation which prevents the use of "excess" extraction credits against taxes due on downstream activities.

If we make the same comparison made in table 1 of the benefits of the credit option versus the deduction, the same general conclusion is reached for oil and gas income: in theory, the credit is worth more to the oil industry, even with the special restrictions, than is the deduction. This is demonstrated in table 5.

TABLE 5

Optional Methods of Claiming Foreign Income Taxes Paid on Oil and Gas Income In Computing U.S. Taxes Due

Foreign income taxes claimed as a deduction				Foreign income taxes claimed as a credit		
Extraction	Refining	Total		Extraction	Refining	Total
$200	$50	$250	Net foreign source income	$200	$50	$250
80%	40%	--	Foreign income tax rate	80%	40%	--
160	20	180	Foreign income tax paid	160	20	180
40	30	70	U.S. taxable income	200	50	250
18.40	13.80	32.20	U.S. taxes due (46%) (before credits)	92	23	115
--	--	--	Extraction limitation	92	--	--
--	--	--	Overall limitation	[------115------]		--
--	--	--	Foreign tax credit (92 + 20)	[------112------]		--
18.40	13.80	32.20	Total U.S. taxes paid	[--------3-------]		3
178.40	33.80	212.20	Total taxes paid (foreign plus U.S.)	160 (3)	20	183
89%	68%	85%	Effective tax rate	[-------73%------]		73%
21.60	16.20	37.80	Total after-tax income	[-------67-------]		67

In the example, with the credit, total after-tax income is $67 compared to $37.80 using the deduction option. In this example, the deduction imposes an effective tax rate of 85 percent on the firm and a 67-percent effective rate using the credit.

The foreign tax credit and its special oil and gas limitations have different effects under various foreign tax rates. These variations are similar to those illustrated in general terms in table 2. While the special restrictions add complicating factors, the outcomes are similar, demonstrating the influence of differential host-country tax rates on the value of the credit. A more technical discussion is contained in appendix I.

ADMINISTRATION PROPOSALS TO CHANGE THE CREDIT

The administration proposed that a substantial further revision be made to the limitation on the foreign tax credit allowed for foreign oil and gas extraction income in June 1979. The main features of the administration's proposal included:

--The credit for taxes on foreign oil and gas extraction income would be restricted to the lesser of the extraction limitation computed on an overall or a per-country basis.

--The "per-country extraction loss rule" contained in present law would be disallowed in computing the overall limitation on extraction taxes. Instead, all foreign extraction losses and income would be taken into account in this calculation.

--Foreign extraction losses must be recaptured on a per-country basis against extraction income arising in a particular country in future years.

--The present 2-percent limitation on excess extraction credits that can be carried over to other years would be eliminated.

--The present requirement that a separate overall limitation be calculated for foreign oil-related income and for non-oil income would be eliminated. The limitation would thus be calculated on all non-extractive foreign income combined.

These proposed alterations to the current foreign tax credit law would further restrict the use of the credit by the oil industry. The provisions would prevent excess extraction tax credits or losses resulting from the per-country loss extraction rule from offsetting U.S. tax on non-extraction foreign oil related income earned in low-tax areas. The proposal would also restrict the use of excess extraction taxes from one country as credits against U.S. taxes on extraction income from another country with a lower tax rate. The administration's plan would further require recapture of losses on a percountry basis rather than an overall basis as is now the case.

In addition to these legislative proposals, the Internal Revenue Service has recently proposed clarifying what characteristics a foreign tax must have in order to be deemed creditable against U.S. taxes. The proposed IRS regulations set out criteria which would be used to determine whether a certain tax is a creditable income tax or a royalty, which is deductible.

To be considered a creditable income tax, the foreign tax:

--Must not be merely a payment for an economic benefit such as the right to extract oil. (The tax may not be higher than that levied by the country on other businesses, or, if no tax is levied on other businesses, the tax on oil income may not exceed the U.S. rate.)

--Must be based on realized net income from actual sales rather than on posted prices.

The intent of the proposed regulations is to clarify which taxes are eligible for the credit and to ensure that those taxes currently being claimed are legally creditable.

OTHER OPTIONS

In addition to the administration's proposals, other alternatives considered in this study are:

--Elimination of the credit altogether, or more specifically, elimination of the foreign tax credit for foreign taxes paid by the U.S. oil industry. This is an extreme case in which oil companies would be allowed to deduct foreign taxes paid as a business expense in calculating their U.S. tax liability but could not credit these sums.

--Elimination of both the credit and tax deferral provisions.

--Use of the tax credit to achieve energy policy objectives by varying the amount of the credit allowed among different countries.

HOW MUCH MONEY IS AT STAKE?

The oil and gas industry is the largest user of the foreign tax credit. This is illustrated in table 6, which shows that oil and gas firms accounted for about $17.2 billion, or approximately 75 percent of foreign tax credits claimed in 1976.* This is because U.S. oil firms generate substantial foreign source income. This income is subject to foreign taxes which are far in excess of those levied on non-oil activities. Consequently many oil firms can consistently claim the maximum credit. Firms in other industries having less foreign income and lower foreign taxes often cannot.

One way to assess how valuable the credit is to the oil and gas industry is to examine the U.S. tax these firms would have paid in the absence of the credit. These figures appear in table 7.

*Figures used throughout this report are 1976 data because this is the latest year for which IRS has detailed information.

TABLE 6

Corporate Income Taxes, Foreign Tax Credits, and Oil Company Foreign Tax Credits Claimed for Selected Tax Years (note a)
(in billions of dollars)

	1965	1970	1973	1974	1975	1976
Corporate income taxes due from all firms (after credits)	27.3	27.9	39.1	41.2	39.3	49.2
Foreign tax credit claimed by all firms	2.6	4.5	9.6	20.6	19.9	23.5
Foreign tax credit claimed by U.S. oil firms	1.0	1.8	5.2	15.5	15.1	17.2
Percentage of total credit claimed by oil firms	38.5	40.0	54.2	75.2	75.9	73.2

a/Tax years are frequently fiscal years. Hence the 1976 tax year, for example, would include not only tax returns for firms with tax years beginning January 1, 1976, and ending December 31, 1976, (calendar year returns), but also July 1, 1976, to June 30, 1977 (fiscal year), returns.

Source: IRS and Office of International Tax Affairs, Department of the Treasury.

TABLE 7

Estimates of Increased U.S. Tax Liability If Foreign Oil Taxes Deducted Instead of Credited, Selected Years (note a) ($ billions)

Year	Total increased liability
1962	.4
1964	.4
1966	.4
1968	.4
1970	.6
1971	.6
1972	.5
1973	1.1
1974 b/	2.7
1975 b/	1.7
1976 b/	1.6
1979 c/	2.3

a/The calculations provided by the Treasury Department on the revenue effects of elimination of the credit were based on several assumptions. These figures illustrate the difference in tax liability of the oil industry if the foreign taxes were deducted rather than credited, providing no other factors change. To compute these figures, Treasury assumed that corporations would not defer payment of taxes by retaining earnings abroad. It was further assumed that no change in corporate structure would occur to avoid payment of taxes. In other words, because of these restrictive assumptions, these estimates are possible maximum amounts of increased tax liability which may, in fact, be lower if other factors are considered. The figures up to 1976 are based on company data; and the 1979 figure is an estimate. The Treasury Department arrived at these estimates by taking the total amount of foreign income taxes paid abroad by the oil industry and calculating them as deductions, i.e., subtracted income taxes paid abroad as expenses when calculating taxable income for U.S. purposes. The figures in table 7 are the difference between the deduction calculation and the actual U.S. tax liability for each year after credits.

b/Preliminary.
c/Estimate.

Source: Office of the Secretary of the Treasury
Office of Tax Analysis

This table gives an indication of the credit's value to the oil industry by demonstrating the additional tax burden incurred each year if the industry could not take advantage of the foreign tax credit. The Treasury estimate for 1976 shows that, without the credit, the oil industry would have paid an additional $1.6 billion in taxes over what it paid with the credit. Of this $1.6 billion, eight large U.S. multinational oil companies (with sales of $7 billion or more, and foreign source taxable income of $500 million or more) accounted for $1.1 billion, or roughly 70 percent of the total. These eight companies accounted for over 90 percent of the credit claimed by petroleum companies in 1976, according to the Treasury. The Treasury projection for 1979 indicates that, without the credit, the oil industry as a whole would owe an additional $2.3 billion in taxes over what it would normally pay with the credit. It should be noted that, in comparing tables 6 and 7, the increased tax liability is considerably less for each year than is the amount of credit claimed for that year. This is because the taxes credited in table 6 do not have to be paid to the U.S. Treasury; they can be deducted, lowering the tax liability considerably. In addition, the figures in table 6 do not take into account the excess credits lost above the credit limitations.

Additional Treasury estimates indicate that if the Department's proposals to retain the credit but restrict its use are adopted, oil industry taxes would rise by about $514 million in 1979 and would increase in subsequent years. The Treasury provided no estimates as to the distribution of these additional tax liabilities among individual firms in the industry.

Neither Treasury nor the Internal Revenue Service have provided estimates on the revenue impact of the proposed IRS regulations. However, several experts we interviewed believed that such alterations would declare the foreign taxes paid by oil companies abroad, which are presently credited, to be mostly non-creditable. This would essentially deny the credit to the oil industry, and raise oil industry taxes about the same amount as predicted by Treasury for elimination of the credit. This is based on the debatable assumption that the host countries do not alter their tax systems to fit with the IRS regulations.

HOW SIGNIFICANT IS THE TAX CREDIT TO THE OIL INDUSTRY?

Referring back to table 6, the Treasury data show that the oil and gas industry claimed most of the foreign tax credit. Their proportion grew steadily from 38.5 percent in 1965 to 75.9 percent in 1975 and dropped only slightly to 73.2 percent in 1976.

In 1976, approximately 80 oil and gas firms filed with the IRS, claiming the $17.2-billion foreign tax credit for the industry that year. Table 8, based on information made available to us by the Internal Revenue Service, shows the number of firms in the oil industry and the amounts claimed by various groups of these firms for that year. Out of the 80 firms claiming the total oil industry credit, 25 of these claimed 97.3 percent of the industry total and 71.2 percent of the total for all U.S. firms. Of these 25 firms, five claimed 86 percent of the total credit claimed by the entire industry.

TABLE 8

Tax Credits Claimed by the Oil Industry in 1976

Number of oil firms claiming credit	Amount of foreign tax credit claimed ($ billion)	Percent of total credit claimed
80	17.20	100.0
25	16.72	97.3
10	16.13	93.8
5	14.79	86.0

Source: IRS.

These statistics demonstrate that a relatively small number of firms claim a very large portion of the foreign tax credit in the oil and gas industry, and in fact, of the total credit claimed by all U.S. firms.

We noted earlier the Treasury Department's estimate that the oil industry would have paid an additional $2.3 billion in taxes in 1979, if credits were not available. The Treasury also estimated that the administration's proposal to alter the credit would have meant an additional $514 million in taxes in 1979. We can assess how significant this additional tax burden is by comparing the additional taxes to industry financial data.

Table 9 gives a useful perspective of what the additional taxes would mean to the oil industry. For example, an additional tax burden of $1.6 billion in 1976 would have reduced the net income of twelve major U.S. oil companies with substantial foreign operations by 16.7 percent.

TABLE 9

Effects of $1.6-Billion Additional Tax on Key Aggregate Financial Data for 12 Major U.S. Oil Companies (note a) (1976)

Financial Data	Total ($ billion)	Percentage change
Net income	9.56	-16.7
Domestic income tax	3.66	+43.7
Foreign income tax	35.08	+ 4.6

a/These 12 companies claim 95 percent of the total tax credit claimed by the industry. The companies are listed in Appendix II.

Source: Department of Energy.

These figures indicate that eliminating the foreign tax credit could have an adverse impact on the industry. The administration's proposal would have proportionately less effect. The relevant data for our purposes are the figures for net income and income taxes. These figures give an indication of the amount of investment that can be undertaken by the industry out of profits and the taxes paid to these 12 firms. All three indicators are important determinants of the oil industry's ability to invest. The Departments of Energy and Treasury state that oil companies finance exploration ventures mainly from internal corporate funds. Therefore, the profit level is a major determinant of the oil companies' ability to invest and explore. According to this logic, falling profits impair the ability to finance exploration and development activities.

Net income gives an indication of internal funds available for future investment. Less profits means an adverse impact on the ability of the 12 large firms to invest. If investment were reduced, this is turn could have an impact on the industry's competitive position abroad. Therefore, a decline in profits caused by the increased taxation indicated in table 9 could hurt the oil industry's ability to make further investment.

While the potential damage is real, there are several complicating factors. First, the industry's position with respect to capital expenditures, dividends, and cash assets applies to any investments oil companies might make. In fact, recent U.S. oil company acquisitions of non-oil assets both domestically and overseas appear to indicate that a good deal of investment activity has little to do with foreign exploration and production. While this may be the result of low rates of return on foreign oil development, the large profits reported for overseas operations of U.S. oil firms indicate that this is probably not the case. Rather than a low rate of return on foreign production and exploration, investment opportunities abroad may be limited. Second, the increased tax burden on the oil industry suggested by the figures in table 9 presupposes that no changes are made in industry structure which reduce the impact of the tax changes. This is unrealistic, since the industry will devote considerable efforts to reduce at least some of the burden through changing the corporate form of foreign exploration and development activity. Finally, the impact will be reduced to the extent that additions to corporate taxes can be shifted forward to ultimate consumers, both at home and abroad.

Our interviews revealed that the impact of the increased tax liability resulting from changes in the foreign tax credit would be greater on some firms than on others. Companies which operate predominantly or exclusively in high-tax areas now lose their excess credits and would experience a smaller tax increase. The ultimate effect of the increased tax burden on foreign operations would very much depend on how much each individual firm would pay relative to its financial resources. The increased tax burden could put some independent oil firms out of business, while some other independents and integrated firms would be affected only slightly.

The administration's proposal would also have differential effects. Again, however, the actual effects on each firm's operations cannot be predicted unless the increased tax burden on each firm is considered in relation to the particular financial situation of that individual firm.

CHAPTER 3

EFFECTS OF THE FOREIGN TAX CREDIT ON EXPLORATION AND PRODUCTION ACTIVITIES

A change in the creditability of foreign taxes may have an impact on the exploration and production decisions of U.S. firms operating overseas. Taxes are a component of overall cost and, hence, influence ultimate profitability. They are only one component, however, and our research indicates that tax considerations are a relatively minor factor in oil company foreign investment decisions. Far more important variables include geologic promise, and the political stability and philosophy of the host government. Modifying the foreign tax credit would influence the profitability of foreign ventures, but it is unlikely to have much influence on the industry's decisions on where to explore and produce.

WHAT WOULD ELIMINATING THE CREDIT DO TO PRODUCTION?

We found that completely eliminating the foreign tax credit could have several effects on oil production activities:

- --It could reduce development of those fields only marginally profitable even with the foreign tax credit. Without the credit, profitability of these fields would drop below acceptable levels. Those firms whose taxes increase greatly could well curtail foreign development substantially, depending on the particular financial situation of the individual firms involved.

- --It could stimulate domestic activity by making investment in foreign marginal fields less attractive. Most experts we interviewed, however, believe such stimulation would be unlikely. Oil investment opportunities in the United States are presently constrained by geological and environmental limitations, and there is no reason to believe that just because certain marginal foreign opportunities may become less attractive, U.S. investment opportunities will become more attractive.

--It could change the corporate structure through which most U.S. development now takes place abroad from a branch operation to a foreign subsidiary. Under the deferral provisions of the Internal Revenue Code, corporations normally pay no U.S. taxes on subsidiaries' foreign income until profits are repatriated to the U.S. parent. Turning branches into subsidiaries is, therefore, one way U.S. oil firms could avoid "double taxation" in the absence of the credit. This does not imply that companies creating foreign subsidiaries would escape U.S. taxation altogether. Rather, deferring tax payments would give companies flexibility to manage the increased tax burden as profits rise and fall.

WHAT IF DEFERRAL WERE ALSO ELIMINATED?

Since it would be relatively easy to turn branches into subsidiaries, some U.S. oil companies would probably do so to maintain profitable production activities and, at the same time, avoid the full increase in taxes if the credit were eliminated. Because of this, elimination of the credit must be accompanied by elimination of the deferral provisions for foreign subsidiary income to achieve the full impact. In that event the combined effect is tentatively estimated as $3.4 billion in added tax revenue in 1980 ($2 billion in 1976). Combining these changes would have several additional effects on U.S. oil company operations abroad:

--Marginally profitable foreign oil field development by U.S. companies would be curtailed to a greater degree than by simple elimination of the credit.

--Domestic investment by the U.S. companies may increase. Simply abolishing the credit alone would give firms the option of switching to subsidiary operations which may be more attractive than to U.S. investment. Abolishing deferral would remove this as a profitable alternative. No longer having the option of avoiding double taxation through subsidiaries, firms may see domestic oil development or other non-oil investments as more profitable, and thus more attractive.

--Industry officials told us that discarding the credit and deferral provisions would increase effective tax rates and may force oil companies to re-incorporate abroad as foreign firms to avoid the onerous tax burden. While effective tax rates would increase, we view a shift in corporate location as unlikely. Re-incorporation would require oil companies to evaluate their assets at market value and to pay capital gains taxes on all U.S. properties. Economists and even industry representatives indicated such a tax penalty would far outweigh any potential advantage U.S. oil companies might derive from foreign re-incorporation in most cases.

HOW WOULD THE ADMINISTRATION'S PROPOSAL AFFECT OIL PRODUCTION?

The administration's proposed modification of the foreign tax credit could have several possible effects on the foreign activities of U.S. oil companies:

--The proposed tax alterations increase the tax burden largely on oil-related income such as from refining and shipping, and could cause similar (if lesser) trends in the same direction as would elimination of the credit. We believe that this smaller tax increase is even less likely to curtail foreign development activity of major U.S. oil companies or to materially change operating locales.

--By limiting creditability of extraction taxes to either the "per country" or "overall" calculation method, whichever generates the greater tax revenue, the administration's proposal assures that companies operating in more than one country would have no reduction in their tax burden. Under this proposal, it is more likely that they would experience some increase in effective tax rates. Companies which operate solely in one country would be unaffected by this provision of the proposal should it be adopted.

--Some economists predict that the administration's proposals, in all probability, would result in greater development activity being carried out through foreign subsidiaries. This implies that less revenue will be forthcoming than the Treasury estimates.

--Our research and interviews indicate that it is unlikely that a significant change would occur in the speed of foreign field development, the operating locales, or procedures of U.S. oil companies abroad, as the result of adopting the administration's proposals.

While there is no direct way to tell just how much the administration's proposal will affect future oil exploration and other foreign investment decisions, looking at the recent past may provide some clues. We collected data on exploration, leasing, wildcatting, and development activity for large foreign and American companies operating abroad over the last 10 years. We then computed an "aggressiveness index" for each year to see if the changes which lowered the value of the foreign tax credit in 1976 caused a decline in the U.S. firms' efforts to find oil.* The assumption here is that tax increases in the recent past would have effects similar to tax increases which could take place in the near future.

We found no significant changes in the degree of aggressiveness in the companies' behavior before and after the changes. In fact, we found that the size of the firms, oil prices and the state of the economy influenced exploratory activity much more than net income of the petroleum industry.

Of course this does not mean that the 1976 changes had no effect. Rather, it means that whatever effects they had were so small that it made no appreciable difference in the trend in the companies' search for oil. This implies relatively minor changes in tax policy in the future may also have only small or insignificant effects.

HOW WOULD THE PROPOSED IRS REGULATIONS CHANGE THE STATUS QUO?

The proposed IRS regulations could have a severe impact on the foreign tax credit as it presently functions and as it would function under the administration's new legislative proposals if, as some believe, they would have the effect of making taxes paid to some OPEC countries non-creditable.

---

*See Appendix III for a description of the "aggressiveness index" and a list of the companies included in it.

The proposed regulations, as discussed previously, suggest certain criteria for determining if a foreign tax is actually an income tax, and is, therefore, creditable. Some OPEC countries tax the oil industry at relatively high rates, (80-90 percent as compared to 46 percent) and their taxes are not based on actual net income. Under these circumstances, the IRS regulations as proposed would appear to disqualify such taxes from being creditable. This, in turn, would make discussion of the Treasury proposal or any similar restrictive legislation academic for those countries unless they changed their taxes to meet IRS standards; the foreign tax credit would be, in essence, abolished for those oil extraction taxes. Treasury officials have commented to the Ways and Means Committee that interpreting the IRS regulations as disqualifying most OPEC taxes from being creditable is incorrect. The Indonesian income tax which U.S. oil firms pay has been determined by Treasury to be a creditable tax under current foreign tax credit regulations and this status will remain unaffected by the proposed IRS regulations. Other OPEC countries, such as Iraq, Iran, and others, merely sell oil to U.S. firms and, therefore, charge no income tax, and will be unaffected by the new regulations, according to the Treasury official. Moveover, in Treasury's view, the standards made explicit in the regulations are the standards that have prevailed implicitly all along.

On the other hand, those nations which supply the largest U.S. imports would be affected. Saudi Arabia Nigeria and Libya, who together supply nearly half of our crude oil imports, all have high taxes which probably would not be creditable under the proposed regulations. Furthermore, more than three-quarters of the total foreign tax credit claims originate in these countries. Clearly, the proposed regulations would, in the absence of changes in these nations' tax codes, come close to outright elimination of the credit.

If we assume that all OPEC countries would adjust to the regulations so that their income taxes meet the criteria set out by IRS for creditability, the Treasury's and other legislative proposals would still have an effect on the functioning of the credit, but to a diminished degree. If countries were to conform their taxes to the U.S. criteria, presumably their tax rates would decline considerably to a range comparable with U.S. tax rates. Revenue losses could be offset by simultaneously raising royalty payments.

Of course, the host countries may not change their tax codes to preserve the credit for the companies, especially if it means lowering their revenue. Under these circumstances it appears that the taxes paid by U.S. firms to countries such as Saudi Arabia, Libya, and Nigeria would no longer be creditable. In this case, any proposed legislative changes would lose much of their relevance, and the basis for these proposals would, for the most part, disappear.

HOW WOULD CHANGING THE CREDIT AFFECT SMALL AND LARGE OIL FIRMS?

The changes involved in the proposals clearly reduce the tax benefits of major U.S. oil companies while leaving small independent producers largely unaffected. For example, independents usually have limited foreign operations, and these are generally located in only a few countries. Consequently, calculating extraction credits on the basis of the lower of the "overall" or "per country" methodologies should not significantly change the tax rates currently experienced by most of them. Moreover, most small U.S. independent oil companies with operations abroad have few "oil-related" foreign activities such as offshore refineries or foreign-based tanker fleets.

HOW WILL CHANGING THE CREDIT AFFECT U.S. COMPANIES' COMPETITIVE POSITION?

Oil industry representatives maintain that U.S. oil companies would become less competitive with foreign firms if any significant changes to the foreign tax credit are made. It is clear that whatever the relative competitive position of U.S. companies at the moment, eliminating the foreign tax credit will raise the taxes paid by these firms and thereby lower present rates of return. There is substantial disagreement among economic experts, however, over U.S. firms' present competitive standing and how much an alteration in the foreign tax credit would change it.

Some analysts assert that U.S. companies are operating on the edge of a competitive precipice in their overseas operations even now. They argue that any further erosion in international standing will result in a significant reduction in the ability of U.S. oil firms to bid for promising new exploration and development tracts overseas and that this, in turn, would lead to a highly undesirable curtailment of "U.S. flag" presence abroad. According to these analysts, any increase in effective taxation caused by altering the foreign tax credit would not be in the best interest of U.S. foreign policy.

Others assert that, while particular companies may presently be experiencing competitive difficulties, U.S. companies are still the dominant force in international energy markets. In their view, if the proposed alterations in the foreign tax credit were to substantially raise the effective tax burden on U.S. firms, this would not change the competitive ranking of the U.S. oil industry overseas despite the increased tax payments. Moreover, most of the analysts who subscribe to this less alarming view of the competitive position of U.S. firms also feel that the proposed tax changes would have limited impact on effective tax rates in any case for the reasons outlined in chapter 2: changes in corporate structure, the ability to deduct now-useless excess credits, and the ability to shift additional taxes toward final consumers should reduce the influence of tax code alteration.

In order to shed some light on the question of competitiveness, we compared the trends in the aggressiveness index for foreign and U.S.-based oil companies for the pre-and post-1976 periods. Here again, we found no significant break in the trend of foreign to U.S. activity abroad. Both types of companies have been progressively less aggressive over the entire 1969-78 period, with the large U.S. companies' activities falling at about twice the rate of foreign company activity. In the 1976-78 period, however, the U.S. companies' exploratory activities declined only slightly faster than the foreign companies'. As in the case of U.S. companies' exploratory activity alone, this result implies that changing the foreign tax credit would have relatively little effect on U.S. companies' competitive position.

IS THE TAX CREDIT A SUBSIDY FOR FOREIGN OIL DEVELOPMENT?

Many assert that present tax law encourages foreign oil and gas development over domestic endeavors of similar potential because foreign taxes are creditable, while State and local taxes in the United States are deductible only. This does not appear to be the case. The reasons for this are due to the high tax rates prevailing in many producing countries, the limits on the credit, and the loss of excess credits in many cases.

Under the present tax code, firms can elect to either deduct foreign income taxes in their entirety as a cost of doing business abroad and pay U.S. taxes on the remaining net income, or they can choose to credit a limited portion of foreign income taxes paid against U.S. taxes. It is better for firms to elect the credit since overall effective tax rates will be lower. This is illustrated as follows:

	Credit	Deduction
Total income (all foreign)	200.00	200.00
Foreign tax rate	46%	46%
U.S. Federal tax rate	46%	46%
Foreign tax collection	92.00	92.00
Federal tax collection	00.00	49.68
Total tax collection	92.00	141.68
Effective tax rate	46%	70.8%

If both foreign and federal tax rates are 46 percent, electing the credit means reducing the overall effective tax rate from 70.8 percent using a deduction, to a rate of 46 percent using a credit.

However, in the case of oil firms with foreign production, the difference between deductions and credits is not this large. Present tax law states that if the credit is used, foreign taxes in excess of the statutory U.S. tax rate may not be credited or deducted. As such they are foreign tax payments for which no Federal allowances are made. This reduces the advantage of the credit over the deduction, especially at high foreign tax rates.

The second reason that the foreign tax credit provision does not result in bias toward foreign operations vis-a-vis domestic ones of similar potential is simply the relative differences in tax rates between regions of the United States and most foreign host governments. Typically, foreign tax rates are vastly greater than those in U.S. regions. State and local taxes are rarely higher than 10 to 15 percent. Foreign tax rates on oil operations run as high as 80 or 90 percent. At these rates the credit is still advantageous but the ultimate foreign tax burden is substantially above the U.S. burden. This is illustrated by the example below, where the ability to credit results in a reduction in effective tax rate from 92 to 85 percent for a firm generating extraction income abroad (case A). This is a "subsidy" in the sense that crediting does reduce effective tax burdens by about 7.5 percent. The fact remains, however, that even with the credit, the tax burden abroad on extraction income is still much higher than the tax burden faced by a firm operating in the United States (case B), even at a 20-percent State tax level.

Case A--Foreign Operations

	Credit	Deduction
Total income (all foreign)	200.00	200.00
Foreign tax rate	85%	85%
U.S. Federal tax rate	46%	46%
Foreign tax collection	170.00	170.00
Federal tax collection	00.00	13.80
Total tax collection	170.00	183.80
Effective tax rate	85%	92%

Case B--U.S. Operations

	Deduction Only
Total income (all domestic)	200.00
State tax rate	20%
U.S. Federal tax rate	46%
State tax collection	40.00
Federal tax collection	73.60
Total tax collection	113.60
Effective tax rate	56.8%

Low State corporate tax rates and high foreign tax rates are usually the case. For example, Texas has no corporate income tax; Louisiana's is 8 percent; California's is 9.6 percent; and Oklahoma's is 4 percent. (See app. IV.) The United States' three largest crude oil suppliers--Saudi Arabia, Nigeria and Libya--have tax rates of 85, 85 and 65 percent, respectively.*

While there is no bias in favor of overseas operations at the present time, the credit will become relatively more important in the future as:

--The amount of non-creditable, non-deductible foreign tax payments declines (i.e., as "excess" credits are eliminated), and

--The amount of State and local taxes paid increases.

---

*Libya's actual tax rate is greater than 65 percent in combination with other surtaxes. This is also true for Nigeria, where actual taxes are more than 85 percent. (U.S. Congress, House of Representatives, Foreign Tax Credits for Oil and Gas Extraction Taxes, Hearings before the House Ways and Means Committee, Washington, D.C. 1979,: p. 70.)

Many economists expect both these events to occur in the near future.

The total tax bill of oil companies operating abroad will decline over the next few years. Foreign holdings are being nationalized, and oil companies will no longer receive the "rent" that accrues to those who own scarce oil resources. As a result, they will no longer be earning large profits which foreign governments now tax away through high rates. What income remains will likely be generated through providing services--activities whose profit margins are slim and which are taxed at lower rates. Thus, not only will the absolute size of foreign earnings decline, rates will drop commensurate with the fall in pre-tax profitability of oil company operations.

The foreign tax credit will become relatively more important as State and local taxes on U.S. firms rise. As mentioned earlier, the effective tax burden of deductions is almost always higher than that of credits. Consequently, as State and local taxes--which can only be deducted--rise, firms will find foreign operations relatively more attractive from a tax standpoint than they were in the past, all other factors being equal.

Typically, business taxes at the State level are relatively low, reflecting an awareness on the part of State finance officials that States are relatively interchangeable as business locations within any given region. It is a simple matter for firms domiciled in one State to move. As a result, "competition" among States for business activity is keen and "profit margins"--average tax rates--correspondingly small. (See app. II.)

Oil production is geographically specific, however, and relatively insensitive to State tax policy. Thus, competitive checks on tax levels normally present among States seeking manufacturing industries are absent. However, tax rates for the oil and gas industry have been held to levels of other industries according to a general fairness doctrine.

Before 1973, there were few reasons for higher taxes on extractive industries in general, or the energy industry in particular. Since then the perception that the energy industry is unique has grown, and both the State and Federal Governments have revised their taxing policies. Alaska now has several taxes specific to the energy sector and an effective tax rate on oil production in excess of 25 percent in some instances. Louisiana is currently suing the Federal Government over the right to impose a "first use" tax on gas produced offshore and piped through the State. The Governor of California has recently called for a State "windfall profits" tax on energy companies domiciled there, and a citizens group is proposing an initiative for the 1980 ballot to accomplish the same purpose if the legislature fails to enact it.

These efforts may be just the beginning of State efforts to increase energy taxation. Moreover, the pressure for State and local energy taxation may also increase as decontrol heightens consumer discontent over windfall gains. Both the trend toward reduced U.S. ownership of resource bases abroad and increased State and local taxes at home will increase the attraction of foreign as opposed to domestic operations should present law remain unchanged.

SHOULD WE AWARD THE FOREIGN TAX CREDIT SELECTIVELY?

The foreign tax credit has been criticized in the belief that it subsidizes foreign exploration vis-a-vis domestic endeavors, and also for not being in concert with the energy policy objective of diversifying sources of supply because it is available to operators in any foreign country. Many analysts have called for using the foreign tax credit as a "tool" of energy policy awarding it selectively to encourage diversification of U.S. supplies.

Differential creditability is one option to encourage oil exploration and production in non-traditional producing areas. This would entail setting limits on the creditability of foreign taxes in areas already well known for their production potential that are lower than those that are set in areas of less geologic promise. Another option is to deny the foreign tax credit to some producing areas (OPEC countries, for instance), while maintaining it as presently structured in others.

Tailoring the credit on a country-by-country basis is a further refinement of this option. This would involve taking the credit out of the Internal Revenue Code and including it in bilateral tax treaties between the United States and selected foreign countries, as is now the case with the United Kingdom's Petroleum Revenue Tax.

The major advantage all these options have over the present system is the introduction of some Government energy policy review before foreign tax payments are deemed creditable. Prior to "awarding" the tax credit abroad, the U.S.

Government would be able to evaluate the prospective host country's geological base and its political and economic climate, and make some assessment as to the necessity of the credit for U.S. energy objectives or competitive purposes. There are ample precedents for such an approach. For example, most-favored-nation status under the General Agreement on Tariffs and Trade is currently granted by the United States only after a review of its compatibility with U.S. foreign policy objectives.

It should be kept in mind, however, that regardless of how the credit is granted--universally or selectively--with the hope of encouraging oil exploration and development, it can only achieve so much in this regard. No amount of creditability will make a blatantly unprofitable venture profitable. By the same token, foreign tax credits will certainly make a profitable venture more attractive. Consequently, the foreign tax credit has the ability to help in inducing investment in the gray area between these extremes. In marginal cases, where investment is not being undertaken because the expected rate of return is not quite high enough to make it attractive, foreign tax credits can make a difference. But it is only in these instances that the foreign tax credit will prove useful as a tool of energy policy.

There are, of course, drawbacks as well as benefits to any selective credit approach. In particular, the decisionmaking process may prove cumbersome and arbitrary. Questions which would have to be settled before implementing a selective foreign tax credit policy include the following:

--Who will decide which countries are granted the foreign tax credit?

--What will be the level to which foreign taxes are creditable?

--What factors will determine eligibility for foreign tax creditability (i.e., what weights will be attached to energy potential, economic factors, political conditions, and foreign tax structure)?

--What will be the reaction of countries denied tax creditability or those whose taxes qualify at relatively low levels?

Such manipulations of the foreign tax credit to encourage diversification of foreign oil sources may not be necessary, however. Current data indicate that U.S.

oil companies' foreign exploration is already highly concentrated outside the Middle East. A considerable portion is also in non-OPEC countries. This apparent trend is being studied further in our ongoing review on the potential for diversifying sources of U.S. imported oil.

HOW MUCH WOULD ELIMINATING THE CREDIT RAISE U.S. OIL PRICES?

Increased taxes on the U.S. oil industry resulting from altering the foreign tax credit could be absorbed by the oil industry, the host country, the consumer, or some combination of the three. However, it is highly unlikely that host countries who are major producers would be willing to assume the burden of the increased tax bill for the industry by lowering the amount of revenue they demand from the companies. These nations have sufficient economic leverage to maintain existing revenues. Oil consumers, both the companies and their customers, will probably absorb most if not all of the additional cost. While little information is available on which of these participants will bear the brunt of cost increases, standard corporate tax theory predicts that it will be the consumer. Assuming that all costs were passed on to the consumer, the Treasury Department estimated the potential increase in gasoline prices resulting from a denial of the foreign tax credit for Saudi Arabian and Libyan taxes, based upon mid-1977 oil costs and U.S. import levels, at about one-tenth of 1 cent per gallon.

CHAPTER 4

IMPLICATIONS OF THE FOREIGN TAX CREDIT FOR ENERGY POLICY

FINDINGS

With regard to the foreign tax credit's impact on oil industry revenues, we have found that:

--Foreign tax payments for all taxpayers have been creditable against U.S. tax liabilities since 1918. The tax credit for the oil industry, however, assumed the nature of a foreign aid program in the 1950s with the knowledge and consent of the U.S. Government.

--In theory, a credit is worth double the value of a deduction, but this is not actually the case for the oil industry due to the extraction and overall limitations and the inability of many firms to use the excess credits. The credit is worth less relative to deductions in high tax countries such as some OPEC countries. The value of the credit would be further reduced under the administration's proposals.

--From a tax standpoint alone, companies are better off operating in the United States than in countries with high tax rates, such as many OPEC countries, even with the credit.

--The oil and gas industry makes by far the largest use of the credit. Since 1974 the amount claimed by the oil and gas industry amounted to about $15-$17 billion per year, or about three-fourths of the amount claimed by all industries. The reason for this is that oil and gas firms generate substantial foreign earnings on which foreign tax rates are far in excess of those levied on non-oil activities.

--Since 1974 the value of the credit to the oil and gas industry relative to a deduction has averaged about $1.7 billion per year. The estimate for 1979 is $2.3 billion.

--If the credit had not been available for 1976, eight large U.S. multinational oil companies would have accounted for roughly 70 percent of the increased tax burden for the entire industry.

--If the administration's legislative proposals are adopted, the value of the credit would be reduced by about $500 million in 1979. The decreased value would grow steadily to about $900 million by 1985.

--While Treasury has not so stated, many feel that the IRS regulations proposed in June 1979 would result in the taxes paid to most OPEC countries not being creditable. This would mean the loss of most of the value of the credit to the industry. There is the possibility that the countries might adjust their tax systems to comply with the new regulations. These changes would probably include lower tax rates for the producing companies. Presumably, they would maintain income levels from the companies through higher charges elsewhere, such as royalties.

--A relatively small number of firms claim a very large portion of the total credit claimed by the oil and gas industry. While a total of 80 oil and gas firms claimed a credit in tax year 1976 totaling $17.2 billion, 5 of these firms had claims totaling $14.8 billion, or 86 percent of the total.

--Elimination or further restrictions of the credit could result in a significant financial loss to the industry and could have an adverse effect on the industry's ability to invest. Using 1976 data for 12 major oil companies with substantial foreign operations, for example, the $1.6-billion value of the credit represents 16.8 percent of net income to the group. Elimination of the credit would increase the domestic tax burden of these companies by 43.7 percent.

--This would be a maximum impact, however, which would be affected by other considerations. It is unrealistic to assume that the industry could not reduce at least some of the burden by passing through additional tax costs to ultimate consumers and by altering the corporate form of foreign exploration and development activity. In addition, any loss in investment capability would not affect only foreign oil activities. It could apply to energy and non-energy investments as well.

--The impact of elimination of the credit would be spread among individual firms differently. Companies affected the least would be companies with operations only in countries with high tax rates, which therefore have excess credits that cannot be used. Aramco is an example of this.

With regard to the effects of the foreign tax credit on exploration and development activities, we have found that:

--Modifying the credit as proposed would reduce the profitability of foreign ventures, but it is unlikely to have widespread influence on decisions regarding the locus of exploration and production. Taxes are only one component of overall cost and are rarely a deciding factor in foreign investment decisions. Far more important are variables such as geologic promise, political stability, and philosophy of the host government.

--Elimination of the credit could reduce the rate of development of oil fields abroad which are just marginally profitable even with the credit. It could also stimulate domestic production activity, but this is unlikely since geologic considerations would remain the same.

--If the credit is eliminated and the deferral provision remains, it is likely that many companies will re-establish overseas branches as subsidiaries to defer U.S. taxes. Elimination of deferral must accompany the elimination of the foreign tax credit if the revenue increases estimated by the Treasury are to be realized.

--There is a possibility that elimination of the credit and deferral would stimulate companies to re-incorporate abroad. This is unlikely, however, since the capital gains tax penalty involved would outweigh any potential advantage U.S. oil companies might derive from foreign re-incorporation.

--Implementation of the administration's proposals would have effects similar to those resulting from elimination, only to a lesser degree. Furthermore, they would primarily increase the tax on non-extraction income which can now be sheltered by drilling losses. Past alterations in the credit have had little apparent effect on U.S. companies' search for oil abroad. There is no clear differential impact of the changes on integrated versus independent producers.

--There is disagreement among economists whether the proposed changes to the credit would change the competitive ranking of U.S. firms versus foreign ones. However, past changes in the credit do not seem to have seriously affected U.S. companies' competitive status.

--The credit does not subsidize overseas activity at the expense of domestic. This is due to the high tax rates prevailing in most producing countries, the limitations on the credit, and the loss of excess credits in many cases.

--The value of the credit will become relatively more important in the future, however, as excess credits are eliminated and State and local tax rates are increased in the United States.

--The credit could be used selectively to attempt to stimulate activity in the non-producing areas. But this could only work on the margin, and defining, implementing, and administering such a program would be difficult.

--If the proposed IRS regulations are implemented, and OPEC countries change their tax system accordingly, one effect would be to reduce the amount of foreign taxes paid, and therefore the excess credits that are currently lost. If the countries do not change their tax systems, the taxes paid to many countries would probably not be creditable.

--If the cost of eliminating the tax credit were passed on totally to the consumers, it would not be large--probably a fraction of a cent per gallon.

CONCLUSIONS

Our research indicates that should the foreign tax credit be eliminated in favor of a deduction, or altered along the lines of the administration's proposals, it would increase the effective rate of taxation on U.S. oil companies operating abroad, thereby reducing the competitive stance of these companies vis-a-vis foreign operations. It could also reduce to some extent oil and gas exploration and development efforts overseas.

In our opinion, however, while the theoretical possibility of these effects must be acknowledged, they do not appear to be sufficient to substantially reduce the ability of U.S. companies to operate abroad nor to significantly change the locus of oil company activity overseas.

Because most evidence on the impact of altering the tax credit points to a negative but marginal effect on such factors as industry profits, competitive standing vis-a-vis foreign firms, and foreign exploration and development activity, it is doubtful that U.S. energy policy would be either enhanced or hindered in any fundamental way by the proposed changes to the foreign tax credit or even by discarding it altogether. In view of this finding and unless more conclusive evidence is presented, we believe that any decisions affecting the credit should be based primarily on tax policy considerations rather than on energy policy objectives.

If the Government determines that the credit should remain available to the oil industry for tax policy reasons, we believe consideration should be given to tailoring it to provide a greater incentive to explore and develop non-OPEC areas. While it is not clear that selective application of the credit would be effective in diversifying U.S. oil sources from the Persian Gulf area, it would at least be consistent with this objective.

RECOMMENDATIONS TO THE CONGRESS

We recommend that:

--The merits of the foreign tax credit be considered primarily on the basis of achieving tax policy objectives. Since the energy impact of changing the credit is small, the credit should not be manipulated for energy policy reasons only. The credit was neither intended to be used for such purposes, nor is it evident that it is an effective energy policy instrument.

--If tax policy objectives warrant retaining the credit for the oil industry, the Congress should consider selective application of the credit to encourage exploration and production activities in non-OPEC areas.

AGENCY COMMENTS

We submitted a draft of our report to the Departments of Energy and the Treasury for their comments. The Department of Energy declined to comment. The Treasury Department's comments were predominantly technical in nature. (see app. V) The Treasury suggested clarifying language on some of the legal aspects of certain foreign tax credit provisions and provided recent revisions of their estimates of the revenue impact of repealing the credit. These revisions have been incorporated into the report.

The Treasury Department also questioned our statement that the elimination of the foreign tax credit would have a negative but marginal effect on industry profits, competitive standing and foreign exploration and development activity. The Treasury commented that "if the credit and deferral were repealed, the drop in after-tax profits of the oil companies foreign oil operations would be nearly 50 percent, too high to be referred to as 'marginal'." While that may be true for foreign oil operations, the maximum effect on the oil industries' total net profit would be more in the range of 16-17 percent, as explained on pp. 23-26. Furthermore, this would be the maximum theoretical impact under the most extreme case, i.e., total elimination of the credit plus the deferral provision. Few have proposed such a drastic change. If it were implemented, however, we believe it is reasonable to assume the impact would be reduced through changes in tax laws by the producing countries, passing a good deal of the costs to the ultimate consumer, or other means.

COMPARING CALCULATIONS OF THE CREDIT FOR OIL AND GAS ACTIVITIES UNDER ALTERNATIVE FOREIGN TAX RATES

The first example in the table on page 47, example A, demonstrates the effects of the credit on total taxes and income from oil activities under foreign tax rates comparable with U.S. rates. The combined foreign and U.S. tax rates amount to 46 percent, the rate that would be charged if the income were earned in the United States. Total after-tax income from foreign extraction and refining operations is $135. The special restrictions on creditability of extraction taxes does not limit their use in this example.

Case B, where the foreign tax rate on extraction income is less than that in the United States, results in the same effective tax rate and after-tax income as in case A. Because the foreign tax rate on extraction income is below the U.S. rate, the extraction limitation does not limit the use of credits. However, because only $60 in foreign taxes was paid on this income, the firm must pay the difference between this sum and the U.S. tax liability, or $32. The difference between this case and case A is that the $32 goes to the U.S. Treasury rather than to the foreign treasury.

Example C illustrates a case in which a foreign government charges an 80-percent tax rate on extraction income--far in excess of the U.S. rate--and a rate comparable to the U.S. rate on refining income. In this case, the extraction tax restrictions limit the amount of creditable extraction taxes. While the firm pays no U.S. tax, the foreign tax is larger, resulting in a greater effective tax burden of 73 percent and lower after-tax income than that in the previous two cases. In addition, $68 in taxes above the extraction limitation cannot be credited and, except for the 2-percent carryover allowance, are lost.

It should be noted that these examples are greatly simplified for purposes of illustration. The possible various combinations of foreign extraction and refining income taxes are numerous and will have varying effects. They do not fully illustrate how the extraction limitation restricts the use of credits against total oil-related income or how the overall oil-related income limitation may take precedence over the extraction limitation. Nor do the examples take losses into account. The cases presented do, however, serve to demonstrate that varying foreign tax rates do affect after-tax income on oil extraction and refining activities.

TABLE I-1

Total Taxes Due and After-tax Income for Oil and Gas Activities Under Alternative Foreign Tax Rates

	A			B			C		
	Extraction	Refining	Total	Extraction	Refining	Total	Extraction	Refining	Total
Net foreign source income	200	50	250	200	50	250	200	50	250
Foreign income tax rate	46%	46%	-	30%	46%	-	80%	46%	-
Foreign tax paid	92	23	115	60	23	83	160	23	183
U.S. taxable income	200	50	250	200	50	250	200	50	250
U.S. taxes due (46%) (before credits)	92	23	115	92	23	115	92	23	115
Extraction limitation	92	-	92	92	-	92	92	-	92
Overall limitation	[--------115------]		115	[------115----]		115	[----115------]		115
Foreign tax credit	[-------115------]		115	[------115----]		115	[----115------]		115
Total U.S. taxes paid	[---------0-----]		0	32	0	32	[------0------]		0
Total Taxes Paid	92	23	115	92	23	115	160	23	183
Effective Tax Rate	46%	46%	46%	46%	46%	46%	80%	46%	73%
Total After-Tax income	108	27	135	108	27	135	40	27	67

TWELVE MAJOR U.S. OIL COMPANIES

INCLUDED IN TABLE 9

Arabian-American Oil Company
Exxon Corporation
Mobil Corporation
Texaco Incorporated
Standard Oil of California
Standard Oil Company of Indiana
Atlantic Richfield Company
Continental Oil Company
Phillips Petroleum Company
Union Oil Company of California
Getty Oil Company
Occidental Petroleum Corporation

OVERSEAS EXPLORATION AND DEVELOPMENT ACTIVITY

Many factors affect the extent of oil exploration and development activities abroad by U.S. companies. These include the net income of oil firms, taxation, oil prices, overall energy demand, and general economic activitiy. We found wide differences in company and independent views of the importance of the various factors, and our own review of this issue suffered to some extent from a paucity of reliable statistical data. Consequently the figures and conclusions below should be considered approximate rather than definitive.

Tables III-1 and III-2 present trends in the development activities of large foreign and domestic-based U.S. petroleum production companies. These figures illustrate that overall performance of both foreign and domestic-based large oil companies over the 10-year period beginning in 1969 was roughly equal. Foreign firms' development drilling and well completions declined less; U.S. firms declined less in terms of overall production; and both groups exhibited deteriorating performance later in the decade.

The 1976 to 1978 interval is of particular interest. During this period, the provisions of the U.S. foreign tax credit were tightened considerably, yet large U.S. firms clearly outperformed their foreign counterparts in all measures of development activity. While this does not prove that the changes in the foreign tax credit had no influence on development behavior of U.S. firms abroad, it does seem reasonable to conclude that the foreign tax credit affected the competitive position of major producers marginally, if at all.

If the 1975-76 changes in the foreign tax credit did have any impact at the margin, the most likely indicators it would affect are those which pertain to exploration activity. Simple indexes of exploration variables appear in table III-3 for both large foreign and domestic-based oil companies, along with a composite index of industry "aggressiveness" in exploration activity, which reflects to a degree the relative costs associated with exploration techniques. 1/ Compound annual average growth rates in these measures are presented in Table III-4.

These figures indicate that overall aggressiveness in exploratory activity of foreign and domestic firms has fallen off since 1969. Growth rates in all components of the measure are negative for both groups, with a larger deterioration across all measures experienced by U.S. firms. Differences in the decline of aggregate aggressiveness between U.S. and foreign-based firms are slight, however, over the 1976 to 1978 period, the years potentially affected by foreign tax credit changes.

Moreover, an Ordinary Least Squares regression procedure, employed to explain the variance in the overall U.S. agressiveness measure, failed to find real net income of U.S. oil companies a significant determinant of exploration activity. More powerful and significant explanatory

---

1/Based on discussions with industry analysts, seismic crew months were assumed to be approximately half as expensive as leasing acreage or drilling wildcat wells. Reducing the weight of this variable by one-half and aggregating across indexes of exploration activity provided an index of exploration "aggressiveness"--a composite measure of how active U.S. and foreign oil companies have been in exploration abroad. Specifically, the index takes the following form for each year in the series:

$$AI_i = \frac{\left[\frac{NA_i}{NA\ 1969}\right] + (.5)\left[\frac{SCM_i}{SCM\ 1969}\right]\left[\frac{WW_i}{WW\ 1969}\right]}{[2.5]}$$

Where: AI = Aggressiveness value for year (i).

NA = Net acreage.

SCM = Seismic crew months.

WW = Wildcat wells completed.

2.5 = Value of numerator in 1969.

variables were proxies for such factors as world oil prices, general economic activity, and oil demand. The results of these calculations appear in Table III-5.

TABLE III-1

Indices of Overseas Development Activity 1/
Large U.S. 2/ and Foreign-Based 3/ Oil Companies

	Development feet drilled		Development wells drilled		Production	
Year	U.S.	Foreign	U.S.	Foreign	U.S.	Foreign
1969	1.000	1.000	1.000	1.000	1.000	1.000
1970	0.733	1.342	0.788	1.454	1.089	1.068
1971	0.599	1.107	0.786	1.153	1.174	1.228
1972	0.754	1.136	0.813	1.095	1.272	1.194
1973	0.920	1.439	0.987	1.409	1.172	1.125
1974	0.976	1.284	1.083	1.204	0.839	0.823
1975	0.567	0.998	0.681	1.048	0.713	0.771
1976	0.504	1.207	0.513	1.026	0.712	0.724
1977	0.576	0.765	0.688	1.005	0.743	0.754
1978	0.527	0.791	0.659	1.083	0.789	0.701

1/Figures derived from information in: Company Acreage and Activity Statistics, years 1969-1978, Petroconsultants, Ltd.

2/U.S. firms include: Gulf, Texaco, Occidental, Amoco, and Mobil.

3/Foreign firms include: AGIP, BP, CFP, and Shell.

TABLE III-2

Development Activities of Large U.S. And Foreign-based Oil Companies 1/

From		Compound average annual growth in: Development Feet	Development Wells	Petroleum Production
1969-1978				
	Foreign	- 2.6	+ .9	- 3.9
	Domestic	- 6.9	- 4.5	- 2.6
1969-1973				
	Foreign	+ 9.5	+ 9.0	+ 3.0
	Domestic	- 2.1	- .3	+ 4.0
1974-1978				
	Foreign	- 11.4	- 2.6	- 3.9
	Domestic	- 14.3	- 11.7	- 1.5
1976-1978				
	Foreign	- 19.0	+ 2.7	- 1.6
	Domestic	+ 2.3	+ 13.3	+ 5.3

1/Source: See table III-1.

TABLE III-3

Indices of Overseas Activity of Large U.S. and Foreign-based Oil Companies 1/

	Net acreage contracted		Seismic crew months of exploration		Wildcat wells drilled		Aggressiveness index 2/	
	U.S.	Foreign	U.S.	Foreign	U.S.	Foreign	U.S.	Foreign
Year								
1969	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
1970	1.420	0.947	1.043	1.799	0.840	1.106	1.113	1.181
1971	1.597	1.302	0.888	1.572	0.982	0.901	1.209	1.196
1972	1.297	1.178	1.382	1.142	0.906	0.966	1.158	1.086
1973	1.313	1.071	1.195	0.761	0.667	0.985	1.031	.975
1974	1.083	1.041	1.004	1.339	0.761	0.766	.938	.991
1975	0.741	0.806	0.966	0.851	0.958	0.890	.873	.349
1976	0.705	0.758	0.537	0.660	0.827	0.741	.720	.935
1977	0.492	0.548	0.574	0.759	0.737	0.551	.606	.591
1978	0.473	0.564	0.589	0.863	0.626	0.895	.557	.756

1/See table III-1

2/See footnote 1, p. 50.

TABLE III-4

Exploratory Activities of Large
U.S. and Foreign-based Oil Companies 1/

From	Net acreage	Seismic crew months	Wildcat wells drilled	Aggressiveness Index
	Compound average annual growth in:			
1969-1978				
U.S.	- 8.0	- 5.7	- 5.1	- 6.3
Foreign	- 6.2	- 1.6	- 1.2	- 3.1
1969-1973				
U.S.	+ 7.0	+ 4.6	- 9.6	+ .8
Foreign	+ 1.7	- 6.6	- .4	- .6
1974-1978				
U.S.	- 18.7	- 12.5	- 4.8	- 12.2
Foreign	- 14.2	- 10.4	+ 4.0	- 6.5
1976-1978				
U.S.	- 18.1	+ 4.7	-13.0	- 12.0
Foreign	- 13.7	+ 14.3	+ 9.9	- 10.1

1/Source: See table III-3.

TABLE III-5

Ordinary Least Squares Regression Analysis
Of Aggregate Aggressiveness Index for
Large U.S.-based Oil Companies

1. With real net income in the calculation; 1/

$$AI = \underset{(3.14)}{1.54} + \underset{(3.55)}{.922}\ PP + \underset{(1.75)}{.027}\ OP + \underset{(.5)}{.106}\ RNI - \underset{(6.0)}{1.6}\ GNP$$

9 observations; $\bar{R}^2 = .97$; D.W. = 2.09; S.E.R = 0.38

2. Without real net income in the calculation; 1/

$$AI = \underset{(6.7)}{1.74} + \underset{(4.07)}{.862}\ PP + \underset{(2.06)}{.031}\ OP - \underset{(6.92)}{1.59}\ GNP$$

9 observations; $\bar{R}^2 = .97$; D.W. - 2.15; S.E.R. = .035

Where AI = Aggregate index of exploration aggressiveness

PP = Aggregate index petroleum production of exploring firms

OP = World oil price index (Arabian Light)

RNI = Aggregate real income index of U.S. petroleum industry

GNP = Index of U.S. real GNP

Figures in parentheses are "t" statistics

1/Both equations suffer to some extent from multicollinearity (close relationships among the independent variables). This problems makes comparing the results among independent variables (PP, OP, RNI, GNP) misleading. To see the extent of this problem we estimated the influence of yearly changes in each independent variable on aggressiveness. This estimate generally agreed with the original estimate, real net income being insignificant in both cases. A third case, using net income for only those firms included in our data base, gave similar results. These results are not reproduced here but are available from GAO.

 APPENDIX III

Table V (cont.)

1.
$$AI - AI_{(N-1)} = \underset{(1.41)}{.048} + \underset{(3.59)}{.83}\ PP - PP_{(N-1)} + \underset{(1.20)}{.01}\ OP - OP_{(N-1)}$$

$$- \underset{(-3.54)}{2.31}\ GNP - GNP_{(N-1)}$$

8 Observations; $\bar{R}$ = .66; D.W. = 2.22; S.E.R. = .04

2.
$$AI - AI_{(N-1)} = \underset{(1.14)}{.06} + \underset{(3.13)}{.82}\ PP - PP_{(N-1)} - \underset{(-.32)}{.07} RN1 - RN1_{(N-1)} + \underset{(1.07)}{.01}\ OP - OP_{(N-1)}$$

$$- \underset{(-2.45)}{2.55}\ GNP - GNP_{(N-1)}$$

8 Observations; $\bar{R}$ = .56; D.W. = 2.11; S.E.R. = .04

APPENDIX IV

RANGE OF STATE CORPORATE INCOME TAX RATES FOR BUSINESS CORPORATIONS *
(As of Jan. 1, 1980)

State	Tax rate (percent)
Alabama	5
Alaska	5.4
Arizona	
$0-6,000	2.5
Over 6000	10.5
Arkansas	
over $25,000	6
California	9.6
Colorado	5
Connecticut	10
Delaware	8.7
Florida	5
Georgia	6
Hawaii	
$0-25,000	5.85
Over 25,000	6.44
Idaho	6.5
Illinois	4
Indiana	6
Iowa	
$0-25,000	6
Over $10,000	10
Kansas	4.5
Kentucky	
$0-25,000	3
Over 25,000	6
Louisiana	
$0-25,000	4
Over 200,000	8
Maine	
$0-25,000	5
Over 25,000	7
Maryland	7
Maaaschusetts	9.50
Michigan	2.35
Minnesota	12
Mississippi	
$0-5,000	3
Over 5,000	4
Missouri	5
Montana	6.75
Nebraska	
$0-25,000	4
Over 25,000	4.4
New Hampshire	8
New Jersey	7.5
New Mexico	5
New York	10
North Carolina	6
North Dakota	
$0-3,000	3
Over 25,000	8.5
Ohio	
$0-25,000	4
Over 25,000	8
Oklahoma	4
Oregon	6
Pennsylvania	9.5
Rhode Island	8
South Carolina	6
Tennessee	6
Utah	4
Vermont	
$0-10,000	5
Over 250,000	7.5
Virginia	6
West Virginia	6
Wisconsin	
$0-1,000	2.3
Over 6,000	7.9
District of Columbia	9.9

*Washington, Texas, South Dakota, Wyoming, and Nevada have no corporate income tax.

Source: The Book of the States, p. 336.

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

JUL 25 1980

Dear Mr. Anderson:

Secretary Miller has asked me to thank you for sending for our review the draft GAO report, "The Foreign Tax Credit and U.S. Energy Policy." We appreciate being given the opportunity to comment.

Our general observation is that the report is a well-balanced discussion of the issue. We have some specific comments, primarily on technical points, which, in the interest of expediting the editing of the report, we have given directly to Mr. Vincent Price of the Energy and Minerals staff.

Sincerely,

Donald C. Lubick

Mr. William J. Anderson
Director, General Government Division
United States General Accounting Office
Washington, D.C. 20548

AN EQUAL OPPORTUNITY EMPLOYER

UNITED STATES
GENERAL ACCOUNTING OFFICE
WASHINGTON, D.C. 20548

OFFICIAL BUSINESS
PENALTY FOR PRIVATE USE,$300

POSTAGE AND FEES PAID
U. S. GENERAL ACCOUNTING OFFICE

U.S.MAIL

THIRD CLASS