Modifying the Dual Capacity Taxpayer Rules - Taxing Profits Twice.

The Foreign Tax Credit

The United States employs a universal or worldwide tax system. This means that our American worldwide companies are taxed here on their U.S. profits (just like domestic companies), taxed abroad on their foreign profits, and then taxed again when those foreign profits are brought back home. By contrast, virtually all foreign multinationals companies are taxed under a territorial system in which they pay taxes on their home country profits in their home country and on their foreign profits in the foreign country, but foreign profits are not taxed a second time when they are brought home. Thus, the double taxation of foreign profits is avoided.

American worldwide companies must have a level playing field to compete in overseas markets. U.S. tax policy recognizes that principle. Current rules allow a credit in the amount of income taxes paid to foreign governments when U.S. tax is calculated on that same foreign income. Thus, U.S. tax policy prevents the double taxation of foreign earnings so that American worldwide companies are not economically disadvantaged when trying to develop foreign opportunities. The United States allows a credit only for income taxes, and not for other payments like property taxes, severance taxes, communications fees, or mineral royalties.

What Is A Dual Capacity Taxpayer?

A dual capacity taxpayer is a multinational company that pays a levy to a foreign country and also receives a specific economic benefit from that foreign country. Nearly all dual capacity taxpayers are U.S. based oil and gas companies that have operations in foreign countries.

What Is The Proposal?

In its F/Y 2012 budget proposal, the Obama Administration proposes to limit the creditability of foreign taxes paid by dual capacity taxpayers. Although these payments are income taxes under the foreign country's existing statutes and regulations, the proposal would recast them as deductible expenses paid to the foreign government.

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Denying the credit would impose double taxation on dual capacity taxpayers and make them uncompetitive.

How Would The Proposal Work?

Assume Country X has a 35% income tax on oil and gas income, while separately applying a 10% income tax rate on other industries. Currently, a U.S. based oil and gas company and its foreign competitors have the same effective tax rate of 35% on their Country X income. This proposal would upset that balance by redefining most of the Country X income tax paid by the U.S. based company as a deductible business expense – subjecting it to residual U.S. tax. As a result, a U.S. based oil and gas company with Country X income would face a total effective tax rate in excess of 50% whereas its foreign competitors would still continue to pay only 35% on similar income.

Is There A Problem With Current Law?

- No. Final regulations, which are currently in effect, were adopted in 1983 after almost a decade of contentious legislative and administrative debate, discussion and compromise. The United States has an effective set of rules to determine whether a payment is an income tax or some other expense. (For more detail on the development of the dual capacity laws, please see the attachment.)
- The current rules already place the full burden of proof on the taxpayer, and they place an even higher burden on a dual capacity taxpayer to demonstrate that the payments claimed as income taxes meet all of the U.S. rules. If the taxpayer fails, it loses the ability to credit any of those taxes.

What Is The Impact Of The Proposal?

- Inability to Compete: This tax change would impact only U.S. based companies, subjecting them to double taxation and much higher taxes than their international competitors. The substantial cost from double taxation will make existing foreign operations uneconomic and reduce U.S. based companies' ability to bid on future foreign projects.

- U.S Jobs: Overseas operations of U.S. based oil and gas companies are supported by well paying U.S. jobs. If current operations and growth opportunities cannot continue, it will mean fewer employment positions for U.S. workers and supporting businesses.

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- Energy Security: At a time when European, Japanese, Chinese and other state-owned competitors are seeking petroleum reserves to secure energy for their own countries, this provision will make it easier for them - at the expense of U.S. based oil and natural gas companies. America's energy security is strengthened by having U.S. based oil and gas companies operating abroad. It makes no sense for U.S. tax laws to favor private and state-owned oil companies based abroad in this critical industry.

Attachment

History of Development of Dual Capacity Taxpayer Rules

- **1974** Treasury notes in Congressional testimony a concern over whether payments treated as creditable taxes are income taxes.
- **1975** Section 907 was enacted. The main reason for this provision was the fact that the oil companies paid little or no U.S. tax on their foreign source income due to the generation of excess foreign tax credits arising from high foreign taxes which were believed, in part, to be royalties.
- **1976** Rev. Rul. 76-215 concluded that amounts received by Indonesia under a production sharing agreement were royalties and not taxes.
- **1978** Rev. Rul. 78-63 denied the creditability of extraction taxes imposed by Libya and Saudi Arabia due to the use of posted prices to establish the taxable base.
- **1979** In June, the Treasury issued proposed regulations on the issue of defining a creditable foreign tax. With respect to oil and gas companies, foreign taxes paid would not be creditable if the aggregate amount taken by the foreign government did not change in relation to the net income of the taxpayer.
- **1980** In November, the Treasury issued proposed and temporary regulations on the issue of creditable income taxes. Creditability for extraction taxes would be dependent on whether the payments were comparable in amount to taxes paid by non-extraction taxpayers on their income. Therefore, if the rate on extraction activity was higher over non-extraction activity, the whole amount of the payment could be noncreditable.
- **1982** TEFRA enacted and changed the treatment of extraction income for purposes of the Section 907 limitation.
- **1983** In April, Treasury issued proposed regulations on the issue of creditable taxes. A taxpayer could get partial creditability if the foreign jurisdiction also had a generally imposed income tax applicable to other taxpayers.
- **1983** In October, final regulations were issued and allowed partial creditability as a safe harbor when there was no generally imposed tax in place.

The 1983 final regulations were relied on by taxpayers and IRS for the next thirteen years.

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- **1996** The Clinton Administration's F/Y 1997 budget proposal included a provision that would treat payments by a dual capacity taxpayer to a foreign country as creditable taxes only if there is a "generally applicable income tax" in that country. A generally applicable income tax was proposed to be an income tax that applied both to non-dual capacity taxpayers and to residents of that country.
- **1997 – 2000** The Clinton Administration continued to include provisions modifying the dual capacity taxpayer rules in each of its budget proposals.
- **2005** Sen. Snowe offered an amendment to S. 2020 that would have increased funding for LIHEAP for 2006 to be paid for with a modification of the dual capacity taxpayer rules. Payments by dual capacity taxpayers to foreign governments would be treated as creditable taxes if the foreign country imposed a generally applicable tax AND if the payment did not exceed the amount that would be paid under the generally applicable tax.
- **2007-2008** Bills similar to Snowe's amendment were introduced by Sens. Kerry, Schumer, Clinton and Casey.
- **2009** The Obama Administration's F/Y 2010 budget proposal included a provision modifying the dual capacity taxpayer rules by making a foreign levy a creditable tax only if the foreign country generally imposes an income tax. An income tax is generally imposed only if it has substantial application to non-dual capacity taxpayers and to residents of that country. The proposal would replace the part of the regulatory safe harbor that applies when a foreign country does not generally impose an income tax, but would retain present law where the foreign country does generally impose an income tax.
- **2010** The Administration's F/Y 2011 budget proposal again includes a provision modifying the dual capacity taxpayer rules. The proposal would treat as a creditable tax the portion of a foreign levy that does not exceed the foreign levy that the taxpayer would pay if it were not a dual capacity taxpayer. It would completely override the 1983 regulations, including the safe harbor, that apply to determine the amount of a foreign levy that qualifies as a creditable tax.

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