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A SUMMARY OF ADMINISTRATION RECOMMENDATIONS ON

U.S. TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS

COMMITTEE ON FINANCE
UNITED STATES SENATE
RUSSELL B. LONG, *Chairman*

Material Requested of the Department of the Treasury
by the Committee on Finance

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ANALYSIS OF U.S. TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS

It is the purpose of this memorandum to provide an analysis of U.S. tax provisions relating to the taxation of foreign income and income of foreign persons. The paper emphasizes the taxation of corporations because the Administration's tax proposals would primarily affect corporations.

Present U.S. Tax Structure

A U.S. corporation is taxed on its worldwide income because of the broad scope of section 61(a). The worldwide taxable income is computed by deducting from worldwide gross income all allowable deductions on a worldwide basis. If the income of the corporation is subjected to tax in a foreign jurisdiction that tax can be credited against the corporation's U.S. tax to the extent that the tax was levied on foreign source income. In the alternative those taxes can be deducted from its gross income under section 164(a)(3). Special provisions provide exemptions from tax or lower rates of tax for certain corporations doing business abroad. These corporations are Western Hemisphere Trade Corporations, Possessions Corporations and China Trade Act Corporations. In addition, a special provision is provided for certain corporations engaged primarily in exporting from the U.S. Domestic International Sales Corporation provisions, sections 991 through 997 of the Code.

A more detailed explanation of the Administration's proposals are contained in the Department of the Treasury's Proposals for Tax Change dated April 30, 1973 (at pages 159–168), in the Department's releases dated April 10, and June 11, 1973, and in testimony by Frederic W. Hickman, Assistant Secretary of the Treasury for Tax Policy, before the Ways and Means Committee on May 10, 1973. A copy of all four documents is attached hereto. In addition, an explanation of the Administration's proposals relating to the taxation of foreign oil and gas income is contained in testimony by the Honorable George P. Shultz, Secretary of the Treasury, before the Ways and Means Committee on February 4, 1974, and in the Department of the Treasury's press release of the same date. A copy of Secretary Shultz's testimony is attached.[1]

Foreign corporations (as well as nonresident alien individuals) are generally taxed only on their income from U.S. sources, although in limited cases foreign source income may be taxed as well. The method of taxation and the rate of taxation depends upon whether the income is effectively connected with the conduct of a trade or business within the U.S.

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[1] See pages 26 ff.

If the income of a foreign corporation is not effectively connected it is taxed by section 881 of the Code only if it is from sources within the U.S. and is fixed or determinable income (such as interest, dividends, or rents). These items are taxed at a rate of 30 percent of their gross amount, or at a lower rate provided by treaty. All other non-effectively connected income is exempt. Thus, capital gains from the sale of property of a foreign corporation is exempt provided it is not effectively connected with the conduct of a trade or business in the U.S.

The income of a foreign corporation that is effectively connected with the conduct by that corporation of a trade or business in the U.S. is taxed under section 882 at the regular corporate rates. Generally, only U.S. source income is taxed although in certain cases effectively connected foreign source income would also be taxed. Deductions are allowed against effectively connected gross income to the extent that they are connected with income which is effectively connected with the conduct of a trade or business within the U.S. The foreign tax credit is available to foreign corporations only in special circumstances in an amount determined under section 906.

The U.S. shareholders of a foreign corporation are generally not taxable on the income of that corporation until a dividend is actually paid. There are two exceptions to this: foreign personal holding companies and controlled foreign corporations. These will be discussed below. Under section 243 of the Code, a corporation receiving a dividend from a domestic corporation is entitled to exclude most of that dividend from its taxable income on the theory that it has already been subject to tax. Dividends from a foreign corporation are not entitled to the exclusion. Likewise, dividends from a foreign corporation are not entitled to the $100 exclusion of dividends received by individuals provided by section 116. Therefore, the U.S. shareholders of foreign corporations would be taxed fully on dividends received from those corporations. A United States corporation which in any taxable year owns at least 10% of the voting stock of a foreign corporation from which it receives dividends is entitled to a foreign tax credit for the taxes paid by that corporation. Section 902.

A U.S. corporation or resident taxpayer may elect under section 901 to credit the foreign income taxes paid against U.S. taxes. In addition, nonresident aliens and foreign corporations may take the credit to the extent foreign taxes are levied on income which is effectively connected with the conduct of a trade or business in the U.S. In general, the provisions provide a credit against the U.S. tax for foreign income taxes actually paid by the taxpayer. The amount of the tax which may be credited in any one year is limited by section 904. Section 904(a) provides the taxpayer with a choice of one of two separate limitations on the amount of foreign tax which he may credit against his U.S. tax. The first is the "per-country limitation" under which the credit may not exceed the same proportion of the U.S. tax which the taxpayer's taxable income from sources within the country assessing the tax bears to his entire taxable income for that taxable year. The limitation is computed on a country-by-country basis if the taxpayer has foreign source income from more than one country. The alternative choice is provided by section 904(a)(2) and is called the "overall limitation". Under that limitation the taxpayer's entire foreign source income is aggregated in determining the amount of foreign tax for a particular year which exceeds the amount allowed under the elected limitation. In addition, special rules are provided under section 904(f) for aggregating interest income and dividends from a Domestic International Sales Corporation on a country-by-country basis. Examples of the operation of the foreign tax credit appear in the Treasury Department explanation of February 4, 1974.

As explained above, with two exceptions, the United States shareholders of foreign corporations are not currently taxable on the income of those corporations until the income is repatriated in the form of a dividend.

The first category of corporations, the income of which may be currently taxable to its shareholders even though not distributed, is a "foreign personal holding company." Sections 551 through 558 of the Code. A foreign corporation is a foreign personal holding company if at least 60% of the corporation's gross income for the taxable year is foreign personal holding company income (which is passive income such as dividends, interest, rents and royalties), and if at any time during the taxable year more than 50% in value of the corporation's outstanding stock is owned directly or indirectly by not more than 5 individuals who are citizens or residents of the United States. The intent of the foreign personal holding company provision is to prevent a small group of taxpayers from incorporating their investments overseas in order to escape taxation of investment income at the individual level. If the requirements are met then the shareholders of the corporation will be taxable on their pro rata share of that corporation's "personal holding company income."

The second category of corporations, the income of which may be currently taxable to its shareholders even though not distributed are corporations subject to the provisions of Subpart F of the Internal Revenue Code. Sections 951 through 964. Subpart F taxes certain United States shareholders on their pro rata share of defined categories of foreign income (subpart F income) even though that income is not distributed currently. The subpart was aimed at the practice of using "a foreign base company" in international business operations to shelter foreign source income from foreign taxes as well as U.S. taxes. Prior to the adoption of subpart F a corporation could establish a sales subsidiary (called a "base company") in a tax haven country and sell manufactured goods to that subsidiary. The subsidiary would in turn sell those goods to buyers outside of the tax haven country. By proper manipulation of prices a good portion of the profit could be allocated to the "base company" and thus taxes could be avoided or minimized.

To be subject to subpart F a corporation must be a "controlled foreign corporation". A controlled foreign corporation is one more than 50% of whose combined voting power is owned by U.S. persons on any day of the taxable year. U.S. persons for purposes of this test are limited to those owning 10% or more of the total combined voting power of the corporation. Section 957. Once it is determined that the corporation is a controlled foreign corporation each of the shareholders who owned 10% or more of the combined voting power of the corporation on the last day of the taxable year must report their pro rata share of the undistributed subpart F income of the corporation. Complex rules are provided for increasing the basis of the stock of the corporation for amounts of undistributed income taxed to the shareholders and for insuring that income which has been taxed under subpart F will not be subject to tax a second time. Sections 961 and 959, respectively. In addition, section 960 provides for a deemed paid tax credit, similar to that provided by section 902, for the amount taxable to shareholders of controlled foreign corporations.

The shareholders of a controlled foreign corporation are taxed on three classes of income: "Subpart F income" as defined in section 952; withdrawals of amounts previously excluded from Subpart F by reason of their having been invested in less developed countries (section 955); and increased earnings which are invested in the U.S. within the meaning of section 956.

"Subpart F income" consists of "foreign base company income" and income from the insurance of U.S. risks. Foreign base company income in turn includes "foreign personal holding company income" which is foreign personal holding income as defined in section 553 adjusted in accordance with the provisions of section 954(c), and foreign base company sales and service income. "Foreign base company sales income" is the income of a controlled foreign corporation derived from the selling of property purchased from a related person, or from buying personal property for sale to a related person, if the property is produced and sold outside of the country of incorporation of the controlled foreign corporation. "Foreign base company service income" is income derived from the performance of technical, managerial, engineering, architectural, or like services outside of the country of incorporation of the controlled foreign corporation if such services are performed for, or on behalf of, a related person.

Exceptions to the definition of foreign base company income are provided in the case of income derived from the use of vessels and airplanes in foreign commerce, and certain income from qualified investments in less developed countries. In addition, the income of a foreign corporation is exempted if less than 30% of its gross income for the taxable year is foreign base company income. If more than 70% of the corporation's income for the taxable year is foreign base company income its entire gross income will be treated as foreign base company income for the year. Another safehaven from subpart F is provided through the mechanism of making minimum distributions within the meaning of section 963, which allows the U.S. corporate shareholder to average income from high tax countries with income from low tax countries.

Administration Proposals

The Administration's proposals would not change the basic tax structure which is outlined above. However, in three situations the Administration's foreign tax proposals would provide changes in the above described provisions.

FOREIGN TAX HAVEN MANUFACTURING CORPORATIONS

The first change, the Administration's "Foreign Tax Haven Manufacturing Corporation" proposal, would add to subpart F an additional defined category of corporation, the income of which would be taxable to its U.S. shareholders even if not distributed.

Where a foreign country gives undue tax incentives to encourage American investment there, by means of a "tax holiday" or similar income tax incentive, the earnings of a controlled foreign corporation that manufactures within that country would be taxed currently if the corporation makes a new or additional investment there. In addition, where a controlled foreign corporation makes a new or additional investment in a foreign country, the corporation's earnings would be taxed currently to its U.S. shareholders (whether or not distributed to them) if 25% or more of the corporation's gross receipts are from the manufacture and sale of products destined for the United States, and if the effective foreign tax rate on the corporation's income is less than 80% of the U.S. tax rate.

These changes would be accomplished by an amendment to the subpart F provisions by adding a new category of income taxable to shareholders of controlled foreign corporations under section 951. This would be the shareholders pro rata share of foreign tax haven manufacturing income as defined in a new section 965. The proposal would not create a new class of subpart F income in order to avoid the exclusions from subpart F which were discussed above (such as the so-called 70–30 rule, and the minimum distribution rule). The rules contained in subpart F would apply for purposes of determining whether or not the corporation is a controlled foreign corporation. In addition, the mechanical rules for computing the exclusion from gross income for previously taxed income, the increase in basis for amounts taxed to a shareholder under section 961, and the election by individual shareholders of a controlled foreign corporation to be taxed as a corporation under section 962 would apply.

The proposal would also amend section 904(f), which provides for a separate limitation on the foreign tax credit in the case of certain interest income and dividends from a DISC, to provide for a separate limitation in the case of foreign tax haven manufacturing income. This will prevent a United States shareholder from using excess foreign tax credit to offset his tax liability under the new rules.

RECOVERY OF FOREIGN LOSSES

The second change, The Administration's "Recovery of Foreign Losses" proposal, would amend the foreign tax credit limitation to reduce it (and consequently the allowable credit) in certain cases, and would provide for the inclusion in income in certain cases of amounts previously deducted. Under present law it is possible for U.S. companies to reduce their U.S. income tax by operating through a foreign branch, rather than through a foreign subsidiary, during the initial loss years of a foreign business operation. As explained above, in this case the U.S. corporation is actually conducting the operations abroad and would be fully taxable on its worldwide income, and likewise would be entitled to take these initial losses as an offset against its U.S. income. If the corporation is on the per-country limitation at the time a loss from a foreign transaction has occurred, it does not have to reduce the limitation for foreign taxes paid on foreign income from other countries as it would if it were on the overall limitation.

Thus, the corporation gets the full credit for other foreign taxes paid, plus the full deduction for the foreign losses. When the foreign operation in the country of loss becomes profitable, taxes are often paid to such country without taking into account the prior losses. As explained above under the discussion of the foreign tax credit, the credit would be allowed by the United States for such taxes and it may effectively eliminate any United States tax on the income earned during the profitable period. The same result occurs in the case of a taxpayer on the overall limitation who has an overall loss on his foreign operations. In either case the United States bears the burden of the taxpayer deducting large losses which greatly reduce United States taxes, while the foreign country collects the taxes on the operations once it becomes profitable with the United States tax eliminated by the foreign tax credit.

The same result is possible where taxpayers incur large start-up losses in the early years of an operation in a foreign country, and then incorporate the operation in the foreign country once it becomes profitable. Assuming that the new corporation does not meet the requirements of the Foreign Personal Holding Company or subpart F provisions no United States tax would be paid, even if the foreign country takes the prior losses into account, unless the earnings are repatriated.

In much the same way a domestic corporation deriving its income from sources within a possession of the United States can file a consolidated return with an affiliated group of which it is a member in years in which it has losses and offset those losses against the domestic income of the group. In profitable years that same corporation may be treated as a "Possessions Corporation" under section 931 of the Code. A corporation qualifying as a "Possessions Corporation", although incorporated in the United States, is not taxable by the United States on its foreign source income. This means that the losses are used to offset United States taxable income of the group while the income of the later years will not be considered as gross income for purposes of computing the United States tax.

The Administration's proposals would seek to change these results in two ways. In cases in which the domestic corporation continues to operate as a branch abroad the proposal would reduce the limitation on the foreign tax credit in those subsequent years by the amount of the previously deducted losses. This rule would not apply if the foreign country allows for a carryover of the losses. In cases in which a corporation first files a consolidated return and then elects to be treated as a Possessions Corporation or in cases in which a foreign branch is later incorporated, a new section 84 would be added to the Code to provide for an inclusion in gross income of an amount equal to the amount of the earlier losses. This subsequent inclusion in gross income would also take place where property which incurred the losses is disposed of.

Foreign Oil and Gas Income

The third change, the Administration's proposals affecting foreign oil and gas income, would modify existing law by limiting the percentage depletion allowance for oil and gas to wells located in the United States. In addition, the foreign tax credit would be amended to treat only a portion of the foreign tax paid with respect to income from foreign oil and gas properties as a creditable tax. The balance would be treated as a deduction.

The proposals would change the system explained above in two respects. First, in denying percentage depletion to U.S. taxpayers operating oil and gas wells abroad they would make such taxpayer's taxable income from foreign sources greater than a similarly situated taxpayer doing business only in the U.S. Second, in recharacterizing an otherwise creditable income tax payment as a deductible expense, they would deny the ability to credit the foreign tax payments against the U.S. tax on other foreign source income.

DEPARTMENT OF THE TREASURY RECOMMENDATIONS ON CHANGES IN THE TAXATION OF FOREIGN SOURCE INCOME

Summary

The Treasury recommends the following modifications in the rules relating to the taxation of foreign income:

(1) United States shareholders would be taxed on future undistributed earnings of a controlled foreign corporation engaged in manufacturing or processing activities where the corporation makes new or additional investment and is allowed a foreign "tax holiday" or similar tax incentive with respect to such investment.

(2) United States shareholders would be taxed on the future undistributed earnings of a controlled foreign corporation where the corporation makes new or additional foreign investment in the manufacturing or processing of products exported to the United States market, if the income from such investment is subject to foreign corporate tax significantly lower than in the United States.

(3) Where a United States taxpayer has deducted foreign losses against United States income, such losses would be taken into account to reduce the amount of foreign tax credit claimed by such taxpayer on foreign earnings in later years.

Explanation

TAX HOLIDAY PROPOSAL

1. Background.

Under existing law, the income of foreign corporations operating abroad is generally not subject to current United States taxation, regardless of whether the stockholders of the corporation are U.S. or foreign. The Subpart F provisions of the Internal Revenue Code, adopted by the Congress in 1962, represent an exception to this general rule in the case of certain tax haven activities conducted by corporations controlled by U.S. stockholders. The great bulk of United States investment abroad in manufacturing and processing facilities is located in countries which impose substantial corporate income taxes. Investment decisions in such cases are made on the basis of general business considerations in which tax burdens are a largely neutral factor. However, there has been an increasing tendency by both developed and developing countries to deviate from their normal corporate tax structures by offering tax related incentives, such as holidays from taxation, to attract foreign investment. This has led in some significant cases to United States companies making investments in manufacturing facilities abroad in order to obtain special tax benefits. These tax incentives are an unwarranted and undesirable use of income tax structures and create a distortion in the application of our existing tax rules with respect to foreign source income.

2. Basic Proposal.

United States shareholders would be taxed on future undistributed earnings of a controlled foreign corporation engaged in manufacturing or processing activities where the corporation makes new or additional investment and is allowed a foreign "tax holiday" or similar tax incentive with respect to such investment.

3. Detailed Description.

A. *Taxation of United States Shareholders.* It is proposed that a new section 951(a)(1)(C) be added to the Internal Revenue Code to provide that the United States shareholders, as defined in section 951(b), of a controlled foreign corporation engaged in manufacturing or processing aboard be taxed currently on their pro rata share of the earnings of such corporation if it is allowed a foreign tax investment incentive (i.e., the earnings of such a corporation would be deemed to be distributed currently to its shareholders). These provisions would operate independently of the exceptions of Subpart F. Once the income of a foreign corporation is subject to current taxation, its income would continue to be taxed currently thereafter, whether to the same shareholders or to the new shareholders and whether or not the foreign tax incentive continues to apply.

B. *Manufacturing and Processing.* A new section would be added to the Code to define a corporation engaged in manufacturing and processing abroad. The new rules would apply to a controlled foreign corporation engaged in manufacturing or processing (including refining) outside of the United States, provided that more than 10 percent of the unadjusted basis of the corporation's assets are used in manufacturing and processing operations.

C. *Existing Foreign Investment.* In the case of an existing facility, current taxation would not occur unless or until the investment made after the effective date and during a period when the applicable foreign tax incentives are still in effect exceeds 20 percent of the unadjusted basis of existing manufacturing assets. It would make no difference whether the investment was funded from new capital or reinvested earnings. This rule provides a margin for normal modernization and replacement of existing facilities.

D. *Foreign Branches of Controlled Foreign Corporations.* For purposes of applying these rules, a branch of a foreign corporation located outside of the country of incorporation will be treated as a separate corporation.

4. Foreign Tax Incentive

The Treasury Department would be granted authority to determine which foreign practices constitute tax investment incentives. This authority could be exercised by determinations with respect to general categories of incentives, such as an exemption or reduction of tax for a period of time or for cash grants that are not required to be taken into account as taxable income. The authority could also be exercised by determinations with respect to specific incentives in specific countries, including local and regional incentives. Incentives would include those provided by law or regulations or individually negotiated arrangements. The fact that there is a generally low rate of tax in a country would not be considered by itself a tax incentive. The Treasury would have authority to exempt tax benefits determined not to be significant in amount or effect and to make determinations prospective in appropriate cases, and would be prepared to rule on the status of tax arrangements under which foreign investments are made.

5. Treaty Exceptions

The legislation would preserve discretion in the Executive, subject to Senate approval, to enter into bilateral income tax treaties which would make these rules inapplicable to specific incentives, in order to promote investment in appropriate situations and with appropriate safeguards.

6. Limitation on Tax Credit

Income treated as distributed under this provision would not be entitled to be taken into account for the over-all foreign tax credit computation, but would be separately computated.

PROPOSAL WITH RESPECT TO CONTROLLED FOREIGN CORPORATIONS EXPORTING TO THE UNITED STATES

1. Background

In addition to the problem of foreign "tax holidays" and similar tax incentives designed to induce United States investment abroad, there are certain cases where United States companies make foreign investments with the specific purpose of producing for the United States market. Such "runaway plants" are often established to take advantage of significantly lower foreign corporate tax rates.

2. Basic Proposal

In addition to taxing shareholders on the future undistributed earnings of controlled foreign corporations taking advantage of a tax holiday or other foreign tax incentive, United States shareholders would be taxed on the future undistributed earnings of a controlled foreign corporation where the corporation makes new or additional foreign investment in the manufacturing or processing of products exported to the United States market, if the income from such investment is subject to foreign corporate tax significantly lower than in the United States.

3. Detailed Description

A. *Taxation of United States Shareholders.* New section 951(a)(1)(C) of the Code would provide that the United States shareholders, as defined in section 951(b), of a controlled foreign corporation engaged in manufacturing or processing abroad be taxed currently on their pro rata share of the earnings of such corporation, even though the corporation is not taking or has not taken advantage of a foreign tax investment incentive, if:

(1) 25 percent or more of the corporation's gross receipts are from the manufacture and sale of products destined for the United States market, and

(2) The effective rate of tax on the income of the controlled foreign corporation is less than 80 percent of the United States tax rate.

B. *Existing Investment.* This provision would not apply unless or until investment made after the effective date of this proposal exceeds 20 percent of the unadjusted basis of existing manufacturing and processing assets.

C. *Foreign Branches of Controlled Foreign Corporations.* For purposes of applying these rules, a branch of a foreign corporation located outside of the country of incorporation will be treated as a separate corporation.

D. *Limitation on Tax Credit.* Income treated as distributed under this provision would not be entitled to be taken into account for the over-all foreign tax credit computation, but would be separately computated.

E. *Exceptions.* The President would be given authority to exempt companies in particular industries if he determines that it is in the public interest to do so. The legislation would preserve discretion in the Executive to enter into income tax treaties, subject to Senate approval, which would make these rules inapplicable in specific situations, in order to promote investment in appropriate situations and with appropriate safeguards.

RECOVERY OF FOREIGN LOSSES PROPOSAL

1. Background

Under existing law, United States taxpayers may deduct losses from foreign transactions for purposes of computing their taxable income. Thus, the foreign losses reduce the U.S. tax on U.S. source income. In addition, a United States taxpayer is allowed to credit against his United States tax on foreign income an amount equal to the U.S. tax imposed on the foreign income with respect to which the foreign taxes were paid. In the alternative, the foreign taxes may be deducted. If the taxpayer chooses to credit his foreign taxes the amount creditable is limited to the U.S. tax imposed on the foreign income with respect to which the foreign taxes were paid. The limitation may be computed either separately for each country (the "per-country" limitation), or on an over-all basis (the "over-all" limitation) under which all foreign income taxes and foreign source income are aggregated.

A taxpayer who is on the per-country limitation at the time a loss from a foreign transaction is incurred does not have to reduce the limitation for foreign taxes paid on foreign income from other countries as he would if he were on the over-all limitations. Thus, he gets the full credit for other foreign taxes paid, plus the full deduction for the foreign losses. When the foreign operations in the country of loss become profitable, taxes are often paid to such country without taking into account the prior losses. The tax credit allowed by the United States for such taxes may effectively eliminate any United States tax on the earned income during the profitable period. The same result occurs in the case of a taxpayer on the over-all limitations who has an over-all loss on his foreign operations. In such cases the United States bears the burden of the taxpayer's deducting large losses which greatly reduce U.S. taxes, while the foreign country collects the taxes on the operation once it becomes profitable with the U.S. tax eliminated by the foreign tax credit.

It is also presently possible for taxpayers to incur large start-up losses in the early years of an operation in a foreign country, and then to incorporate the operation once it becomes profitable. In this case no U.S. tax would be paid, even if the foreign country takes the prior losses into account, unless the earnings were repatriated.

2. Basic Proposal

Modify the limitations on the foreign tax credit provided by section 904 to provide a special limitation for taxes of a foreign country which are excessive because the foreign country has not permitted losses of the enterprise to be offset against subsequent profits, and to provide recapture of losses where the legal form or ownership of the enterprise changes.

3. Detailed Description

A. It is proposed that a new subparagraph (3) be added to section 904(a) of the Code to provide that if a taxpayer sustained a loss (whether ordinary or capital) in a foreign country or possession of the United State in a taxable year, then to the extent that the loss was not taken into account in such year for purposes of computing the foreign tax credit limitations provided by section 904(a) (1) or (2), then for purposes of computing the limitation on the foreign tax credit such loss would be taken into account in succeeding taxable years as a reduction of the taxpayer's taxable income from sources within such country or possession. The amount of the reduction in any one year is not to exceed 25 percent of the taxpayer's income from such country or possession computed without regard to such reduction. The amount of the losses not taken into account shall be carried forward in the ten succeeding years until exhausted. Such a reduction will not be made, however, to the extent that the loss has been allowed by the foreign country where the loss was incurred and has thereby reduced the amount of foreign tax paid.

Thus, if a taxpayer has elected the per-country limitation, and sustains a loss for 1973 in country X, the taxable income from sources within such country for 1974, for purposes of computing the limitation on the amount of the foreign tax credit that may be taken, is to be reduced by the amount of the 1973 loss but only to the extent that the adjustment does not exceed 25 percent of the corporation's taxable income from X for 1974. Any excess would be carried over to subsequent years. Likewise, a taxpayer who has elected the over-all limitation and sustains an over-all loss on his foreign operations in 1973 would reduce his taxable income from sources without the U.S. in 1974 by the amount of that loss subject to the 25 percent of taxable income limitation. Detailed rules relating to the allocations of losses among years, countries and classes of income would be provided in Treasury regulations.

B. In cases in which material income producing capital assets used in the trade or business which gave rise to the losses are disposed of before the prior losses have been fully taken into account, including cases in which the enterprise is transferred to a corporation before the losses have been fully taken into account, the losses not previously taken into account would be included in the taxpayer's gross income in the year of disposition of the property.

C. Section 904(d) will be amended to provide that taxes not allowed as a credit by reason of the application of new section 904(a)(3) may not be carried back or carried forward.

DEPARTMENT OF THE TREASURY MEMORANDUM FOR THE PRESS

(For Immediate Release—June 11, 1973)

The Treasury Department today issued the attached statement explaining in greater detail the tax changes relating to "foreign tax haven manufacturing corporations" which the Department proposed on April 30, 1973.

Foreign Tax Haven Manufacturing Corporations

The Treasury Department "Proposals for Tax Change" presented to the Ways and Means Committee on April 30, 1973, contained proposals with respect to "foreign tax haven manufacturing corporations." The proposals were stated in broad terms and numerous inquiries have been received concerning the application of those proposals to particular situations. This further statement is intended to respond more particularly to those inquiries.

Taxpayer testimony before the Ways and Means Committee expressed particular concern over the Treasury's proposal that the statutory definition of a "tax holiday" be stated in broad standards, leaving substantial discretion to the Treasury Department. This statement outlines Treasury views as to how those and other standards might be expressed in the drafting of a statute. Where particular numerical tests are employed, they are tests which appear reasonable on the basis of facts presently known to the Treasury staff. The Treasury Department remains open to suggestions for tests which might better achieve the objectives of the proposals and would support appropriate changes of this nature in the legislative deliberations.

The objective of the Treasury's proposals is to deal with those situations in which foreign tax systems provide tax inducements which are so major that they cause American capital which would otherwise be invested in the United States to be invested abroad—thus exporting jobs and prosperity. Most foreign investment does not fall in this category, but is made in response to cost and market factors unrelated to taxes. It is the Treasury purpose to so fashion the proposals that they would not apply to investment decisions made on the basis of non-tax costs and market factors. Thus, the legislation would affect only a minority of situations and would operate primarily as a deterrent and not as a revenue producing measure. Specific features of the proposal should be evaluated in the light of that objective, and the Treasury is amenable to such changes in the proposals as may serve to further that objective. It is as important, in the Treasury view, to exclude from the provisions those investments which are clearly made for non-tax reasons as it is to include those investments which are made for tax reasons. However, in achieving these purposes, it remains necessary that there be objective standards which may be administered with a minimum of uncertainty and controversy.

A. Incentives Covered by Proposal

The following incentives would be considered as major tax inducements to investment to be covered by the proposal:

1. *Exemption from Income Tax.* An exemption from income tax of manufacturing and processing income for a period of years from the time the facility is placed in substantially full operation. A period of more than a single year, perhaps three to five years from the time operations begin, is appropriate, since very few companies would make a long term major investment decision based solely on income taxes for a very short term period. In setting the period, account should also be taken of the fact that the first year or more of operation is often, if not usually, a period of tax loss in which a tax holiday is of no benefit. The period prescribed might, alternatively, be measured from the time construction commenced (in which case a longer period would be appropriate) or from the time the company commenced to show profits (in which case a shorter period would be appropriate).

2. *Rate Reduction or Partial Exemption.* A reduction of the generally applicable corporate income tax rate of more than 30 percent for manufacturing and processing income (including situations in which the equivalent of such a rate reduction is achieved through "reinvestment reserves," i.e., deductions allowed by some countries for profits reinvested in the business).

3. *Capital Cost Recovery Incentives.* Any Combination of depreciation, investment allowance, and investment credit which results in an aggregate cost recovery which is substantially greater than the equivalent U.S. cost recovery that would result if such assets were eligible for the investment credit and depreciation (other than buildings) were computed under ADR rules. Such a rule might, for example, be expressed in terms of an aggregate cost recovery in the foreign country which is 50 percent greater than the maximum equivalent U.S. cost recovery over some specified period, such as the first 30 percent of the cost recovery period assumed for ADR purposes. Some taxpayers have urged that depreciation deductions should be deleted from such a test because they are a deduction to which the taxpayer is entitled at some point. However, depreciation is included in the Treasury proposal on the ground that extreme depreciation deductions can create the practical equivalent of a tax holiday.

4. *Grants.* Grants of cash or property would be treated as a cost recovery tax benefit, subject to paragraph 3. (To the extent that such grants reduce basis, they are comparable to depreciation allowances, to the extent that they do not reduce basis they are comparable to an investment credit.)

B. Incentives Not Covered by the Proposal

The following incentives would *not* be major tax inducements to be covered by the proposal:

1. *Exemptions, Rate Reduction and Capital Cost Recovery Items.* Any such item which is not included under the tests described in section A, above.

2. *Local Incentives.* Income tax concessions, other than grants, by any local, regional or similar governmental authority of a non-national nature, where the income taxes at the local governmental level under consideration, in the absence of a concession, would constitute less than perhaps 20 to 30 percent of the combined local and national income taxes otherwise applicable.

3. *Public Facilities.* Expenditures by a public body of a public or public utility character, including improvements to water supplies, sewers, roads, railway spurs, harbors and waterways and similar items.

4. *Tax Concessions Other Than Income Taxes.* Remission or other concessions of property, transfer, excise, customs duties, and similar taxes, by whatever authority imposed.

C. Treaty Exceptions.

1. *General Principles.* Tax treaties would be used to exempt incentives from the preceding rules on a bilateral negotiated basis. In order to avoid economic disruption during the period required to negotiate treaty exemptions, adjustment might be made in the effective date provisions, as explained below. Any such treaty recognition of foreign tax incentives would be contingent upon the existence of satisfactory bilateral tax, trade and economic relations with the foreign country which would warrant the extension of an incentive to U.S. investors.

The United States need not passively and unilaterally permit tax incentives to be offered by any country and accepted by U.S. investors regardless of economic distortions that might be involved. In the European Economic Community the member nations have, and continue to negotiate rules among themselves, based upon reciprocal benefits and with appropriate safeguards, as to which incentives will be permitted to affect investment decisions. By requiring that exceptions be made by treaty, the United States can recognize appropriate exceptions to the general rule but still retain a strong bargaining position with respect to the excessive practices of other countries.

The Congress can, if it deems it desirable, control the shape of those treaty provisions by including standards for treaty exceptions in the Internal Revenue Code.

2. *Specific Exemptions.* The Treasury Department view is that the tax holiday rules and run-away plant rules should not be applied to situations in which there is no reasonable possibility that United States exports could replace the foreign manufacturing or processing operation. These determinations are best made on a country-by-country basis, and not on a company-by-company basis. However, in order to allow time for the negotiation of appropriate treaties, one of the following alternatives might be provided in the statutory provisions:

(*a*) The provisions would be effective immediately to determine whether the investment constituted a tax holiday or run-away plant investment, but earnings from affected corporations would not be currently taxable to shareholders until an effective date following the date of enactment (e.g., 5 years after the enactment) at which time they might, or might not, be exempted by treaty, or, if they met the criteria described below, by an executive order.

(*b*) Alternatively, the provisions would be effective immediately except that the following categories of operations would be exempt from the effective date for a period of five years, and new investments of this type made thereafter would be exempt only if covered by treaties or an executive order. Such possible exceptions would include:

1. The flow of raw materials, in crude or processed form, where the country of origin and destination are both foreign countries.

2. Operations where facilities must be located abroad because:

(*a*) processing must be done before raw materials can be economically transported,

(*b*) local law presently requires the foreign production or processing,

(*c*) excessive transportation costs would make it impracticable to conduct the operations in the United States, or

(*d*) existing tariffs make processing outside the country of destination uneconomical.

D. Waiver of Tax Holiday Benefits

A foreign subsidiary could avoid tax holiday status by waiving tax benefits to the extent required to bring them outside the tests described in section A above.

E. Quarantine of Tax Haven Provisions.

Where there is new investment which is a tax holiday or runaway plant investment, the earnings from that investment can be quarantined from the earnings of existing investments (so that earnings of the latter will not be affected by the new rules). The Treasury proposals contemplated that this would be done by using a separate corporation for the new investment, whether or not the separate corporation is a subsidiary of the existing foreign corporation. The reason for requiring a separate corporation is to facilitate the segregation of earnings.

F. Expansion of Existing Investments.

The 20 percent increased asset test in the proposals is intended as a mechanism to identify modernization and replacement of existing facilities and to leave it free from the new rules, which would apply only to expansion or wholly new investments. The "increase" in investment to be used under the test is the excess of the cost of new assets over the cost (i.e., unadjusted basis) of assets retired. A number of taxpayers have suggested that this test—or at least the 20 percent number—is too stringent and would in fact cover normal modernization and replacement or expenditures, like those for pollution control, which do not represent expansion. Consideration will be given to suggestions for alternative tests which might better meet the objective that the proposal should apply only to significant expansion of existing activities.

STATEMENT OF HON. FREDERIC W. HICKMAN, ASSISTANT SECRETARY OF THE TREASURY, BEFORE THE HOUSE WAYS AND MEANS COMMITTEE, THURSDAY, MAY 10, 1973

My testimony today concerns the relationship of our tax system to international trade policy. I will explain the Administration's proposals for changes in the tax laws relating to income from foreign sources.

Some would use our tax system as a tool to deter foreign investment. We believe that would be a mistake. As Secretary Shultz stated in his testimony yesterday, the evidence is that foreign investment has made a positive contribution to our balance of payments, to our exports and to jobs and prosperity at home.

The Administration's tax proposals rest on the conviction, stated in the President's trade message, that "Our income taxes are not the cause of our trade problems and tax changes will not solve them." The basic dislocations and distortions that exist with respect to international trade and investment must be solved by hard bargaining with other countries. The route to increased domestic investment for exports lies in realistic monetary exchange rates and in assuring fair access to foreign markets for United States made products. It does not lie in inhibiting foreign investment by use of the tax laws.

Our proposals for tax changes deal with distortions created by existing tax laws, both domestic and foreign. What is wrong with the tax system we aim to remedy. But we do not propose to use our tax laws to correct or to mask broader problems not caused by taxes.

The Present System—Basic Concepts

Under existing law, we impose an income tax on individuals and an income tax on corporations. Corporate earnings which are distributed are taxed twice—once to the corporation when it earns them and again to the shareholders when they receive them. We do not purport to tax foreign citizens or foreign corporations except on income earned in the United States.

These general principles apply to U.S. investment at home and abroad. Thus, we tax the world-wide income of a corporation that is incorporated in the United States, and we tax a foreign corporation on income earned in the United States. But, we generally do not tax a foreign corporation on income earned outside the United States, whether or not that corporation is controlled by United States owners. However, when the income of such a corporation is distributed as a dividend to its shareholders, if those shareholders are United States citizens, residents or corporations, we tax them on the dividends they receive. In order to eliminate double taxation of the same income at the corporate level, we give a tax credit to corporate shareholders for foreign income taxes paid by the foreign corporation.

The result is that foreign subsidiaries compete in foreign markets under the same tax burdens as their foreign competition. As a foreign corporation operating abroad, it pays tax abroad and not in the United States. However, at the stockholder level, the earnings are subject to U.S. tax under the general rules applicable to shareholders. When income is repatriated from the subsidiary to the United States shareholders it is taxed to the shareholders at regular U.S. tax rates, subject to a credit for foreign income taxes. This credit cannot exceed the amount of tax due to the United States on the foreign income, so that it does not reduce tax liability on U.S. source income.

Effects of the Present System

Our present system of taxing foreign source income has on the whole served us well. It minimizes the intrusion of taxes into investment decisions. At present, a business can—and typically does—decide whether or not to invest in a particular foreign country on the basis of market and business factors, knowing that it will be taxed in that country just as its local competitors are taxed.

Thus, the present system has maximized the responsiveness of investment to the forces of a free market. By being competitive abroad, American-owned foreign businesses have opened major new markets to American companies and have promoted exports, prosperity, and jobs at home.

Table 1 indicates the contribution which American investment abroad is making to our balance of payments problem. The income flowing back to the United States from investments abroad is today roughly twice as large as the flow of new investment out. Foreign investment makes a major contribution on the basis of repatriated earnings alone, to say nothing of the indirect benefits which flow from the opening of foreign markets to Americans.

Not too many years ago, foreign tax rates were substantially lower than U.S. tax rates, and it was argued by some that those lesser tax rates were a critical factor in many investment decisions to locate abroad. Whatever the logical merits of that position, the facts have changed very significantly in recent years. Tax rates in the major industrial nations which are open to U.S. investment are now in roughly the same range as U.S. tax rates. This is apparent from Table 2. In addition to the income tax rates indicated in Table 2, it is important to keep in mind that the foreign governments listed collect additional withholding taxes at rates ranging up to 35 percent on the payment of dividends and interest flowing from foreign subsidiaries to U.S. shareholders. Thus, in many cases, the combination of foreign income and withholding taxes exceeds the rate at which a corporation's income would be taxed in the United States. Under these circumstances, it is apparent that comparative tax rates are of only marginal significance in normal cases and major countries.

Table 3 illustrates still a further fact, that foreign subsidiaries repatriate about half of their foreign earnings and reinvest about half abroad. Students of corporate activity know that corporations today must reinvest a substantial portion of their earnings if they are to stay healthy and competitive. The pay out rate for foreign corporations indicated in Table 3 is comparable to the dividend pay out ratio for American industry generally. There may, of course, be individual cases in which companies reinvest abroad solely to avoid the additional tax occasioned by repatriation. But in the aggregate, the situation seems to be a fundamentally healthy one in which normal percentages of income are returned to the United States and taxed here.

Tax Proposals of H.R. 62

H.R. 62 proposes two major changes in the existing tax system. It would eliminate the credit for taxes paid to foreign countries and it would abolish the rule that shareholders are taxed on dividends only when those dividends are paid to them. We have considered these proposals at length and have concluded that they are undesirable because they would destroy the neutrality of our tax system with respect to decisions to invest abroad. Let me deal briefly with each of the two proposals.

1. Proposals to replace the foreign tax credit with a deduction for foreign taxes.

No major nation taxes foreign source income in the manner or to the extent contemplated in H.R. 62. Every major industrial nation has devised some system for preventing double taxation of the same income by itself and other nations. These unilateral rules have been supplemented by international conventions for the avoidance of double taxation. There are two methods generally employed to that end. One method is simply to exempt from domestic tax income having its source in some other nation. This is the method followed, for example, by France. A second method is to tax foreign source income domestically but to allow credit against domestic tax for foreign taxes paid on the same income. This is the method followed by the United States.

Within countries there may be double taxation of the same income at different political levels. For example, in our country both the states and the federal government may tax the same income. Where that occurs, the nation must work out internally the interrelations between local and national taxes in order to arrive at a total level of tax which is tolerable. As a practical matter, that kind of accommodation is simply not possible between nations, as the levels of total tax in each nation have become relatively high.

Let me illustrate the level of tax which would result if we were to allow foreign taxes only as a deduction. If, for example, $100 of corporate income pays $46 of corporate tax in England, a deduction for that tax would leave the remaining $54 subject to tax at 48 percent in the United States. The corporation would pay an additional $26 of U.S. tax for a total of $72 tax on each $100 at corporate income. That would be an effective tax rate of 72 percent. If the remaining $28 were taxed when distributed to shareholders, at say 50 percent, the result would be an effective tax rate on distributed corporate income of 86 percent. That is an unrealistic level of taxation. People simply will not invest if the tax collector claims too large a share of the profits.

Thus, the primary reason why elimination of the foreign tax credit is unrealistic is that it would, in fact, be nearly confiscatory.

2. Proposal to accelerate taxation of shareholders.

H.R. 62 would abandon the general rule that shareholders are taxed on corporate income only when that income is received. The proposal would accelerate the time at which shareholders are taxed on foreign source income by disregarding the corporate entity and taxing such income directly to the shareholders as earned. That is a fundamental change in our system of corporate taxation and in rejecting it we were influenced by the following considerations:

(1) There is no persuasive evidence that the present system distorts investment decisions except in unusual cases. As previously noted the income and withholding tax rates in the major industrial nations are sufficiently close to U.S. rates that any differences would be unimportant.

(2) Such a system would mean that American-controlled corporations operating abroad would in many instances be at a substantial disadvantage compared to their foreign competitors with respect to the tax burden on profits retained in the business.

(3) Where there is a disadvantage at the corporate level, only American-controlled companies would be subject to it and there would

be a substantial incentive, if not a necessity, for Americans to divest themselves of control. That would entail a substantial loss in American investment values and a substantial decrease in the ability of American firms to manage their foreign investments. We do not believe that to be desirable.

(4) The revenue gain to the Treasury from accelerating the taxation of shareholders would be minor in comparison to the depressing effect on U.S. economic activity abroad. We estimate that the acceleration of the tax on shareholders would produce about $300 million of additional revenue to the United States. One of the chief effects of such a proposal would be simply to increase the amount of tax which corporations pay to foreign governments. Let me illustrate why that is so by assuming a corporation which earns $100 and is subject to a 40 percent income tax rate in country X. The company knows that when it ultimately repatriates its earnings there will be an additional 10 percent withholding tax due to country X. If taxation of the U.S. corporate shareholders were accelerated and they were required to pay $48 of tax to the United States, it would make sense for the foreign subsidiary to declare a dividend of the $60 which remains net after taxes in country X and to pay a $6 withholding tax to country X on that amount. It would then have paid a total of $46 tax to country X, all of which would be creditable against the $48 of tax owing to the United States. It would thus satisfy its potential withholding tax liability to country X without increasing its total tax. The net result is that the company's tax has increased from $40 to $48, but of that $8 increase, only $2 goes to the U.S. Treasury and the remaining $6 goes to the treasury of country X. The results would be different where the rates are different from those assumed, but the point is that a substantial amount of additional tax would go to foreign governments.

For all these reasons, we believe it desirable to stay with the general rule that corporate earnings are taxed to shareholders only when received.

1961–1962 Congressional Review of Foreign Source Income

These issues are not new. In 1961 and 1962, Congress reviewed in depth U.S. tax policy with respect to the taxation of foreign income and concluded that it was generally appropriate to tax the earnings of United States controlled foreign corporations when those earnings are distributed to U.S. shareholders, i.e., to continue to apply the same rules that we apply to shareholders of U.S. corporations. This Committee rejected a general proposal to tax the undistributed income of foreign corporations to their U.S. shareholders. The Report of the Committee on Ways and Means on the Revenue Act of 1962 stated that:

> "Testimony in hearings before your committee suggested that the location of investments in these countries is an important factor in stimulating American exports to the same areas. Moreover, it appeared that to impose the U.S. tax currently on the U.S. shareholders of American-owned businesses operating abroad would place such firms at a disadvantage with other firms located in the same areas not subject to U.S. tax." (H.R. Rept. No. 1447, 87th Congress, 2d Session 57–8 (1962).)

However, Congress recognized in 1962—and the Administration's proposals recognize now—that changes in our tax structure should be made where the tax rules themselves create inequities or artificial distortions in investment decisions. Thus, in 1962 the Congress provided a special rule for foreign source income of holding companies and certain selling and service subsidiaries operating in foreign "tax havens," and in that limited situation accelerated the time at which U.S. shareholders were taxed on that income. Also in 1962, the law was changed to ensure that untaxed and undistributed profits of a controlled foreign corporation, whether or not operating in a tax haven, would not escape ordinary income tax as a result of a sale liquidation of the foreign corporation.

The Administration's Proposals

We have three proposals for legislative change. They are advanced in the belief that our system is fair in its general application, but that in certain limited situations we need changes in our tax system to neutralize distortions in investment decisions and revenue collections caused by certain features of some foreign tax systems.

TAX HOLIDAYS

There has been an increasing tendency for both developed and developing countries to provide "holidays" from their income taxes in order to attract investment in manufacturing. This can mean that no income tax, or very little tax, is paid with respect to the earnings of certain foreign corporations until the income is distributed as a dividend. This kind of deliberate and wholesale tax enticement does often control investment decisions. We believe that is a tax distortion and that it should be neutralized.

We are requesting amendment of the tax laws so that earnings from new or additional U.S. investments in manufacturing or processing facilities which take advantage of such tax incentives will be taxed to the U.S. shareholders at the time they are earned. Where such an incentive is availed of, the income of the foreign corporation will be taxed currently thereafter, regardless of whether the incentive is in effect for a subsequent year, unless the corporation ceases to be engaged in manufacturing or processing operations. We are prepared, in appropriate circumstances, to enter into tax treaties with other countries, subject to Senate approval, to recognize incentives under appropriate safeguards.

In order to give the Secretary of the Treasury or his delegate broad authority to define by rules or regulations the general categories of foreign tax investment incentives subject to the rule and to determine whether specific practices or benefits constitute such an investment incentive, the proposal will define a foreign tax investment incentive in broad terms. It will include any income tax related benefit, however effected, which is intended to encourage or has the effect of encouraging investment in the foreign country which provides the benefit, and whether or not granted to nationals as well as foreigners.

Such a benefit may be provided by law, regulation, or individually negotiated arrangements. However, the fact that there is a generally low rate of tax in a country will not be considered by itself a tax incentive. It is intended that only major tax concessions would be affected. Examples of benefits or practices of the type which constitute investment incentives include tax holidays (which are partial or complete exemptions from tax for a period of time); deductions for reinvestment reserves; certain grants; and certain depreciation rules bearing no relationship to useful life.

RUNAWAY PLANTS

We also believe that the United States has a legitimate interest in taxing currently the income of a corporation that has moved abroad to take advantage of lower tax rates to manufacture goods destined for the United States. To accomplish this we propose, in addition to the tax holiday rule, that where a U.S. owned foreign corporation has more than 25 percent of its receipts from the manufacture of goods destined for the United States and is subject to a significantly lower tax rate, the income of such corporation will be taxed currently to the U.S. shareholders. A foreign tax will be deemed significantly lower where the foreign effective tax rate is less than 80 percent of the United States statutory corporate tax rate. The tests as to the percentage of exports to the United States and the effective foreign tax rates will be applied annually.

APPLICATION OF TAX HOLIDAY AND RUNAWAY PLANT RULES

Our proposal for tax holidays and runaway plants will add a new section to the Internal Revenue Code providing that a U.S. shareholder (i.e., a shareholder who is a U.S. person owning 10 percent or more of the stock) of a controlled foreign corporation will be treated as having received his pro rata share of the corporation's earnings and profits for a taxable year if the corporation is one that receives a tax holiday or a similar tax investment incentive or is a runaway plant. A controlled foreign corporation is one having more than 50 percent of its combined voting power owned by U.S. shareholders. The tax holiday and runaway plant rules would be in addition to those added by the Congress in 1962 in its tax haven legislation, and the mechanism for taxing the shareholders would be comparable, but without certain escape clauses that were provided in the 1962 legislation.

A corporation will be regarded as engaged in manufacturing or processing operations if the unadjusted basis of the tangible property and real property used in its manufacturing or processing operations exceeds 10 percent of the unadjusted basis of all tangible property and real property of the corporation. Corporations engaged in other businesses, such as mining, would be unaffected. The provisions will apply to any new investment or additional investment in existing manufacturing or processing operations after April 9, 1973. In the case of additional investment or replacement of existing investment, a transitional rule is proposed so that these provisions will not be applicable until the increased investment exceeds 20 percent of the investment on April 9, 1973.

FOREIGN ISSUES

We have also proposed that where U.S. taxpayers have used foreign losses to offset other income taxable by the United States and those foreign losses are not taken into account by the foreign jurisdictions in later years, then the United States will, in effect, recapture those losses by a reduction of the foreign tax credit or an inclusion in the gross income of the taxpayer in later years. This proposal modifies the present system under which the United States bears the cost during the loss years, but receives none of the revenue during the profitable years. In these circumstances, we wish to be certain of our fair share of the tax revenues.

The reduction in the tax credit would apply where the taxpayer itself continues to operate abroad in profitable years. However, since initial losses are frequently anticipated, one tax planning technique has been to operate in a branch form to deduct losses against U.S. income during the start-up period followed by incorporation of the foreign branch as a foreign subsidiary at or near the time the operation becomes profitable. In order to prevent this maneuver, the legislation proposes the recapture of losses by taking the previous losses into income upon the incorporation of a branch or comparable change in its tax status.

TABLE 1.—*U.S. direct foreign investment: balance of payments flows, 1970 and 1971*

[In millions of dollars]

	1970		1971	
	Net capital outflow	Income inflow [1]	Net capital outflow	Income inflow [1]
All areas	$4,400	$7,920	$4,765	$9,455
Developing countries [2]	1,162	3,784	1,940	4,743
Developed countries	3,238	4,136	2,824	4,713
Canada	908	1,301	226	1,397
Europe	1,914	2,200	2,083	2,595
European Economic Community	994	1,198	1,305	1,392
All other Europe	920	1,002	778	1,203
Western Hemisphere	568	1,375	668	1,460
Other areas	1,010	3,045	1,788	4,004

[1] Includes after-tax branch profits plus dividends, interest, royalties, fees, and film rentals net of foreign withholding taxes.
[2] Includes unallocated international direct investment.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis and U.S. Department of Commerce, Survey of Current Business, November 1972.

TABLE 2.—*Statutory (1972) tax rates for selected countries*

Country	Statutory corporate income tax rate	Withholding rates on dividends[1]
Canada	[2] 50	15
Mexico	[3] 42	15
Panama	[4] 50	8
Argentina	33	12
Brazil	[5] 30/5	20
Venezuela	[6] 50/60	15
Belgium	[7] 35/10	15
France	50	5
Germany	[8] 51/15	15
Italy	[9] 43	5
Netherlands	48	5
Sweden	40	15
Switzerland	[10] 29	5
United Kingdom	[11] 40/38. 75	15
Republic of South Africa	[12] 43/25	15
Japan	[13] 36. 75/26	10
Philippines	[14] 35	35
Australia	47. 5	15

[1] Where a reduced rate of withholding is applied for parent-subsidiary dividends, that rate is shown.
[2] 21 percent of 1st $35,000, and 50 percent of the excess.
[3] Progressive rate structure of 5 to 42 percent.
[4] Corporations are taxed according to a progressive rate structure with bracket progression. The highest percent on the excess is 50 percent.
[5] 30 percent of taxable income and 5 percent on distributed profits of other than service corporations.
[6] Progressive rate structure with a maximum rate of 50 percent of income over 28,000,000 bolivares. Corporations engaged in oil and mining activity are subject to a rate of 60 percent on gross increments.
[7] 30 percent for distributed income with a floating rate on undistributed income; maximum is 35 percent on excess over B.F.5,000,000. 10 percent surcharge on basic rate.
[8] Tax on undistributed profits/distributed profits. Distributed profits also bear substantial local taxes.
[9] Companies in Italy are subject to both the income tax, at rates varying from 18 to 25 percent, and to the company tax of 18 percent.
[10] Federal tax is a maximum of 7.2 percent; however, the cantons assess a progressive corporation tax. The maximum rate is 29.78 percent including Federal and communal rates.
[11] A corporate tax of 40 percent is levied on all corporate profits and a 38¾-percent tax is applied on distributed profits.
[12] The normal tax on companies is 43 percent. There is a 25-percent tax on undistributed profits. Mining income is taxed at 40 percent except for diamond mining (45 percent) and gold mining (special formula).
[13] Undistributed profits are taxed at a maximum rate of 36¾ percent. Distributed profits are taxed at a maximum rate of 26 percent.
[14] Corporate tax is 25 percent of 1st 100,000 pesos and 35 percent of the excess.

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

TABLE 3.—*Payout ratios of earnings of U.S. subsidiaries abroad*

[Dollar amounts in millions]

	Developed countries		Other areas		All areas	
	1970	[1] 1971	1970	[1] 1971	1970	[1] 1971
I. All industries:						
(a) Dividends paid	$2, 247	$2, 472	$1, 144	$1, 510	$3, 391	$3, 982
(b) Foreign withholding taxes	298	319	118	129	416	448
(c) Dividends received	1, 949	2, 153	1, 026	1, 381	2, 975	3, 534
(d) Reinvested earnings	2, 075	2, 375	874	741	2, 948	3, 116
(e) Total earnings	4, 322	4, 847	2, 018	2, 251	6, 339	7, 098
(f) Payout ratio ((a) as percent of (d))	52	51	57	67	53	56

See footnotes at end of table.

TABLE 3.—*Payout ratios of earnings of U.S. subsidiaries abroad*—Continued

[Dollar amounts in millions]

	Developed countries		Other areas		All areas	
	1970	[1] 1971	1970	[1] 1971	1970	[1] 1971
II. Manufacturing:						
(*a*) Dividends paid	$1,499	$1,584	$299	$294	$1,799	$1,878
(*b*) Foreign withholding taxes	206	214	51	53	257	267
(*c*) Dividends received	1,293	1,370	248	241	1,542	1,611
(*d*) Reinvested earnings	1,252	1,508	282	277	1,534	1,785
(*e*) Total earnings	2,751	3,092	581	571	3,333	3,663
(*f*) Payout ratio ((*a*) as percent of (*d*))	54	51	51	51	54	51

[1] Preliminary.

Note: Data exclude interest earnings as well as royalties and fees.

Source: Department of Commerce, Survey of Current Business.

TESTIMONY BY THE HONORABLE GEORGE P. SHULTZ, SECRETARY OF THE TREASURY, BEFORE THE HOUSE WAYS AND MEANS COMMITTEE, FEBRUARY 4, 1974

Mr. Chairman and Members of the Committee:

I am pleased to be with you this morning to discuss the fiscal effects of the energy problem and the Administration's tax proposals which deal with aspects of this situation.

The proposals I will discuss today have several purposes. The first proposal is for an Emergency Windfall Profits Tax. It is designd to recover excessive profits from oil producers. The next group of proposals were among those I presented to your Committee last April. They affect incentives for the domestic production of oil and gas and include the proposals for a Minimum Taxable Income, for a Limitation on Artificial Accounting Losses and for an Exploratory Drilling Credit.

The remaining proposals are designed to eliminate several undesirable tax rules which now exist in connection with foreign oil and gas operations. Elimination of those rules would make foreign investment in oil somewhat less desirable than it now is. We believe these proposals relating to foreign operations to be important in the overall picture, but they are directed at limited situations and should not be confused with the broader effort to recover excessive profits.

Before I commence that detailed discussion, let me give you a brief overview of the problem.

THE OVERVIEW

Prior to the Arab bloc embargo, the United States demand for oil had increased to an annual rate of about 17 million barrels of oil per day, only 11 million of which were produced here. Our domestic oil output and capacity stabilized at about 11 million barrels per day around 1970. In fact, the current rate of exploration and development of new domestic reserves is barely sufficient to cover the natural decline in productivity from existing oil fields. This situation is attributable to a number of interrelated factors, including:

Government regulation of natural gas prices at artificially low levels since around 1960. Low gas prices obviously reduce the potential profitability of the gas discovery effort. Since most gas is "associated" with oil, whatever makes gas discovery less profitable makes the discovery of both *oil and gas* less profitable.

Rising costs of discovering additional on-shore reserves. After a century of intensive discovery effort, the remaining on-shore prospects are less attractive than off-shore prospects. The best on-shore prospects today are wells much deeper than most now in operation and they involve much higher discovery costs.

Delays in drilling Outer Continental Shelf prospects. Although costly to drill, these prospects should yield large oil and gas capacities. The delays have been due in large part to government leasing policies and concerns with environmental questions.

Delays in the output from Alaskan and off-shore California fields. These fields should yield large oil and gas reserves but their production has also been delayed due to government leasing policies and concerns with environmental questions.

Government regulation of domestic crude oil prices. Crude oil prices were frozen at August 1971 levels until January 1973 when small price increases were allowed. "New oil" prices were freed after two years of controls in August of 1973, but "old oil" prices are still controlled. The presence of price controls discouraged additional investment which could have increased productive capacity.

To satisfy our increasing energy demands in the face of the restrictions on domestic supplies resulting from the above factors, we turned increasingly to imports.

But under the mandatory import program that had been in effect since 1959, quotas existed which significantly limited imports of oil and refinery products. As demand grew but domestic production held steady after 1970, import quotas were increased, but not at a rate which kept up with increases in demand. Investment in additional refinery capacity in this country thus became unattractive because of the uncertainty that sufficient supplies of crude oil—either domestic or imported—would be available for refining. Accordingly, many U.S. companies built refineries offshore and most of the increase in U.S. imports took the form of refined products such as middle distillate fuels and, particularly, heating oils.

By the beginning of 1973, these domestic circumstances—controlled prices of oil and gas, rising discovery costs, delays in exploration and production for environmental and other reasons and a growing reliance on imports to satisfy increasing demands—converged with a growing foreign demand for oil stimulated by world-wide economic boom conditions. The result: world oil prices began to advance from their historical levels. And, when the dollar was devalued for the second time in February 1973, the *dollar* price of oil in world markets began to rise higher.

The continued high level of demand for oil through the first nine months of 1973 quickly brought foreign production to maximum short-run capacity, further increased world oil prices, and set the stage for the world crisis precipitated by the embargo invoked by Arab bloc producers in October 1973, and the consequent skyrocketing of oil prices.

Most of the profits produced by these very major increases in the price of imported crude oil have gone to the foreign governments that own or control the oil, in the form of higher taxes or royalties. However, a significant part of the increased profits from this source has gone to United States companies and individuals in the business of producing and shipping this oil, primarily as a result of sales in foreign countries and, to a lesser degree, as a result of sales to United States consumers.

Through the Federal Energy Office, the Administration has requested sacrifices in oil use from all citizens so that as little as possible disruption to our lives and our economy will result from the oil supply disruption. The Administration believes that it would be unfair for United States producers to be advantaged while their fellow citizens are making sacrifices required, by retaining excessive profits from the abnormally high prices caused by the shortage.

Increased profits from higher prices to oil owners which occurred in 1973 are reflected in Table 1, which compares reported profits and rates of return on equity for the years 1969–1972 and the nine-month period ended September 30, 1973, for 22 of the largest United States oil companies. It is important to keep in mind that increased profits are not necessarily "excessive" profits.

TABLE 1.—NET INCOME AFTER TAX AND THE RATE OF RETURN ON EQUITY OF SELECTED OIL COMPANIES (1963-73)

[In millions of dollars]

Company	1973 Net income	1973 Percent return [1]	1972 Net income	1972 Percent return	1971 Net income	1971 Percent return	1970 Net income	1970 Percent return	1969 Net income	1969 Percent return	1968 Net income	1968 Percent return
Total	9,087.3	15.1	5,951.7	9.7	6,007.3	10.2	5,556.7	10.4	5,549.9	10.9	5,539.4	11.8
Amerada Hess Corp.[2]	151.8	23.5	46.2	8.3	133.3	24.0	114.0	25.7	86.5	23.7	89.8	19.8
Ashland Oil Corp	98.3	17.3	68.0	13.5	40.5	8.8	52.0	11.7	56.9	13.3	53.6	14.6
Atlantic Richfield Co	270.2	8.9	192.5	6.5	210.5	7.3	209.5	7.5	230.1	8.5	105.8	7.8
Cities Service Co	135.6	9.8	99.1	6.9	104.5	7.7	118.6	8.9	127.2	10.0	121.3	9.9
Clark Oil & Refining Corp	30.5	29.9	8.3	9.8	3.6	4.7	10.8	14.0	13.0	18.7	12.1	20.4
Continental Oil Co	242.7	14.0	170.2	10.4	140.1	9.1	160.3	10.7	146.4	9.8	150.0	10.6
Exxon Corp	2,440.0	18.5	1,531.8	12.5	1,516.6	13.1	1,309.5	12.0	1,242.6	12.3	1,276.7	13.0
Getty Oil Co	135.0	8.8	76.1	5.2	120.1	8.5	103.2	7.8	105.8	8.3	98.3	8.3
Gulf Oil Corp.[2]	760.0	14.0	447.0	8.3	561.0	10.2	550.0	10.4	610.6	12.1	626.6	13.2
Kerr-McGee Corp.[2]	58.8	10.8	50.6	10.1	40.7	10.8	35.9	10.3	33.6	10.3	36.4	12.0
Marathon Oil Co	129.4	15.2	79.8	10.2	88.7	11.7	86.5	11.8	89.4	12.1	83.3	12.7
Mobil Oil Corp	842.8	15.7	574.2	10.9	540.8	10.9	482.7	10.4	456.5	10.4	430.7	10.3
Murphy Oil Corp	53.6	24.4	14.3	7.6	11.1	6.2	9.3	6.5	6.2	4.5	7.3	5.4
Phillips Petroleum Co	230.4	12.1	148.4	8.1	132.3	7.6	132.3	7.8	127.8	7.7	129.9	8.0
Shell Oil Co	332.7	10.9	260.5	8.9	244.5	8.7	237.2	8.6	291.2	10.9	312.1	12.3
Skelly Oil Co	44.0	7.5	37.6	6.8	38.3	7.0	36.1	7.0	38.4	7.7	40.3	8.5
Standard Oil (California)	843.6	14.4	547.1	10.5	511.1	10.4	454.8	9.8	453.8	10.3	451.8	10.7
Standard Oil Co. (Indiana)	511.2	12.4	374.7	10.0	340.6	9.6	314.0	9.3	321.0	10.0	309.5	10.1
Standard Oil Co. (Ohio)	74.1	6.6	59.7	5.6	58.8	5.7	64.4	6.3	51.9	5.3	70.1	13.0
Sun Oil Co	230.0	12.3	154.7	8.8	151.6	8.9	139.1	8.4	152.3	9.4	164.4	10.9
Texaco Inc	1,292.4	25.0	889.0	12.4	903.9	13.4	822.0	13.1	769.8	13.1	819.6	14.5
Union Oil of California	180.2	10.6	121.9	7.6	114.7	7.4	114.5	7.6	138.9	9.5	149.8	10.9

See footnotes at end of table.

TABLE 1.—NET INCOME AFTER TAX AND THE RATE OF RETURN ON EQUITY OF SELECTED OIL COMPANIES (1963-73)—Continued

Company	1967		1966		1965		1964		1963	
	Net income	Percent return	Net income	Percent return	Net income	Percent return	Net income	Percent return	Net income	Percent return
Total	5,175.6	12.0	4,701.9	11.7	4,203.7	11.2	3,846.9	10.8	3,579.7	11.0
Amerada Hess Corp.[2]	76.8	22.2	73.1	22.6	63.4	22.2	59.4	23.0	52.4	22.7
Ashland Oil Corp	48.4	15.5	45.0	17.6	35.8	15.5	23.7	14.0	18.1	11.7
Atlantic Ricfield Co	130.0	10.2	113.5	9.4	90.1	8.1	47.1	7.3	44.0	7.0
Cities Service Co	127.8	10.9	120.1	11.0	100.6	10.2	84.5	9.1	77.5	8.6
Clark Oil & Refining Corp	11.5	23.4	9.6	24.2	8.7	27.8	2.1	8.9	1.5	6.8
Continental Oil Co	136.1	10.1	115.6	10.3	96.2	10.2	100.1	11.1	87.4	10.5
Exxon Corp	1,155.0	12.3	1,090.1	12.1	1,021.4	11.9	1,050.6	12.6	1,019.5	12.8
Getty Oil Co	118.2	10.5	92.3	9.0	57.7	6.9	43.0	5.6	43.0	6.1
Gulf Oil Corp.[2]	568.3	12.9	540.8	12.3	427.2	11.2	395.1	11.0	371.4	10.9
Kerr-McGee Corp.[2]	32.1	11.5	33.0	12.9	25.1	14.6	20.7	14.7	18.8	15.8
Marathon Oil Co	73.9	12.3	68.8	12.3	60.1	11.3	60.4	11.8	43.1	10.2
Mobil Oil Corp	385.4	9.8	356.1	9.5	320.1	9.1	234.2	8.8	271.9	8.6
Murphy Oil Corp	8.2	6.2	8.4	7.6	6.4	6.1	4.3	4.9	4.8	5.7
Phillips Petroleum Co	164.0	11.0	138.4	10.3	127.7	9.9	115.0	9.3	108.1	8.9
Shell Oil Co	284.9	13.8	255.2	13.4	234.0	13.4	198.2	12.3	179.9	12.0
Skelly Oil Co	42.0	9.3	37.0	8.8	34.0	8.8	25.7	7.1	24.2	7.0
Standard Oil (California)	409.4	10.3	401.2	10.8	391.2	11.1	345.3	10.5	322.1	10.5
Standard Oil Co. (Indiana)	280.9	9.6	255.9	9.1	219.3	8.1	194.9	7.5	183.1	7.3
Standard Oil Co. (Ohio)	67.1	14.5	56.9	13.3	49.7	12.7	43.8	12.0	38.9	11.4
Sun Oil Co	156.2	15.2	100.6	10.8	85.5	10.1	68.5	8.8	61.2	8.4
Texaco Inc	754.4	14.8	692.1	15.0	636.7	14.9	577.4	14.6	547.6	15.6
Union Oil of California	145.0	11.2	134.2	11.2	112.6	10.4	92.9	14.7	55.2	9.9

[1] Equity as of Sept. 30, 1973.
[2] Full years income estimated on the basis of income reported for the 1st 9 months of 1973.

Source: Standard and Poors' Industrial Survey, Moody's Industrial Manual, quarterly financial statements filed with the Security Exchange Commission (10 Q forms).

Our preliminary investigation indicates that the 1973 profit increases are primarily attributable to foreign inventory profits from skyrocketing prices, increased profits from increases in foreign product prices and efficiences in foreign refinery and other operations unrelated to the prices paid by United States consumers. A number of the companies have pointed out that the higher 1973 profits must be interpreted in the light of the lower than normal profits realized in 1972 and the several years immediately prior.

Whatever conclusions may be drawn from the 1973 figures, if the shortage in 1974 produces even higher prices for oil, that fact will cause increased profits to major oil companies from domestic oil sales. The estimated amount of increase attributable to this single element may be seen from Table 2.

TABLE 2

Average price per barrel of crude [1]	Annaul profit after income tax (billions)	
	Increase [2]	Total
1973		[3] $9.0
1974:		
$6.50	$1.7	10.2
$8.00	3.4	12.4
$9.00	4.5	13.5
$10.00	5.6	14.6

[1] The estimated average price for domestic crude oil as of Jan. 1, 1974, is $5.25 in the case of old oil and $9.50 in the case of new oil.
[2] The increased net incomes shown for 1974 relate only to domestic crude oil production.
[3] Estimated 1973 net income after taxes from table 1.

While the Administration believes oil owners should not be permitted excessive profits at the expense of their fellow Americans, let us be clear that United States oil prices must adjust upward if higher cost methods of extracting oil are to be used to satisfy our demands. Higher costs of producing oil will mean higher *prices* for oil. Producers will not produce unless prices cover their costs. And government production would be no solution, for a government producer would have the same costs or, if less efficient, greater costs. However, short run price increases for oil above the level necessary to call forth the supplies we need give rise to windfall profits. Those windfalls may be taxed very heavily to the producers of oil without impeding the desired free market processes and without imposing additional costs on consumers.

The Windfall Profits Tax is designed:

First, to tax very heavily windfall profits to owners of oil.

Second, to avoid interference with the legitimate profit expectations which will be required to meet our demands and make us independent of foreign supplies, and

Third, to avoid any tax-generated price increases for consumers.

ECONOMIC BACKGROUND

The ability of oil producers to increase the production of oil during the next two or three years is considered by experts to be quite limited. Prospects have to be found, geological and geophysical work has to be done, wells have to be drilled, pipelines have to be built and refineries may have to be expanded or built. Therefore, price increases do not have the effect of stimulating nearly immediate supply increases as is the case with some other products, such as foodstuffs.

The expert consensus is that only a small amount of additional oil from domestic sources can be expected in the next 6 to 18 months. There are marginal wells which were previously capped and which might be economically produced now at the increased prices available for oil, but this supply source is not major in the overall context. Within 18 to 24 months oil could begin to be economically produced at current increased price levels by secondary and tertiary recovery methods. Over a three to five year period, significant additional production at current increased price levels could probably be obtained from new domestic prospects. And after three to four years, the Alaska pipeline should be completed.

In contrast to the short run, then, over a period of about three to five years, it is reasonable to expect that oil supplies can be increased significantly. Historically, the amount of the increase in supplies of oil has been at least 1 percent for every 1 percent increase in the price of oil.

Table 3 shows the relationship between price increases and supply increases for the years 1936 to 1972.

Over each of the two five-year periods from 1953–1958 and 1963–1968, a price increase of 9 percent was followed by a productive capacity increase of 35 percent and an actual production increase of 17 percent. Additionally, available econometric studies indicate that oil supplies will be increased by at least 50 percent as a result of a 50 percent price increase, given sufficient time. Based upon these data, it is reasonable to assume that after about three to five years, and allowing for some inflation, if the price of oil increases by about 50 percent from mid-1973 levels, to around $7 per barrel, sufficient domestic oil supplies should flow to satisfy about 85–90 percent of our demands. Accordingly, we have for planning purposes estimated that the "long-term supply price" is about $7 per barrel. But that $7 per barrel figure is an estimate and the ultimate figure may be somewhat more or somewhat less.

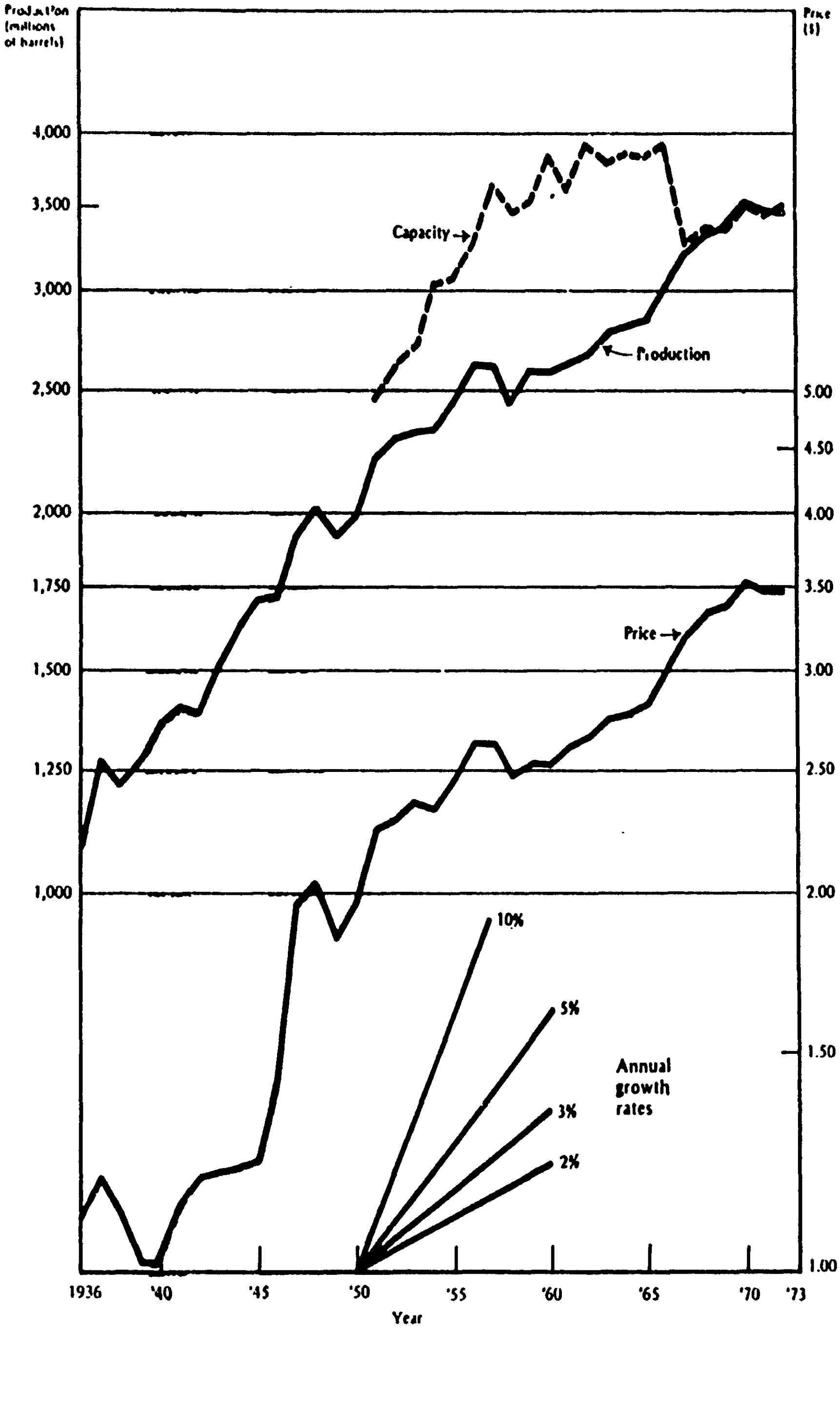
Therefore, a tax which bites hard on immediate price increases should not interfere with the production of needed oil supplies if it gradually phases out so that after three years there will be no tax on oil prices at around $7 or less per barrel.

TAXING THE WINDFALL PROFIT

A windfall profit is one resulting from a change in price caused by a circumstance which is accidental and transitory, such as a temporary shortage of a product because of a strike or, in this case, the cartel-embargo of foreign governments. It is difficult to separate ordinary market prices from prices which permit windfall profits in this context. The price of "new" oil produced in the U.S. rose from about $4 to more than $9, between May and December 31, 1973, because of our demands for that oil. This is a very major price increase and some price increase was necessary to call forth the needed additions to our domestic supplies which will occur over a period of three to five years. Over the near term, however, some part of that price reflects a windfall resulting from actions by the Arab-bloc nations.

TABLE 3

Crude Oil Production, Capacity, and Price Per Barrel at Wells, 1936-1972



Source: United States Department of the Interior, Bureau of Mines

Thus for the next year or two, the price rises which have already occurred are *more* than sufficient to call forth the additional domestic oil which will in fact be produced during that period. Some part of present prices produces windfall profit and additional price increases resulting from the cartel-embargo would be pure windfall.

A determination of the amount on which to impose the Windfall Profits Tax requires selection of a base amount which can be received without tax and from which to determine the taxable amount. In this respect it is similar to and will act as an excess profits tax. The Cost of Living Council's *ceiling* price as of December 1, 1973 (CLC Reg. § 150.353) was selected as the reference point for the base price. It is a known price and no new, separate or costly calculations will have to be made. It also significantly exceeds historical oil price levels and it was the maximum price permitted on any domestic production until late August 1973.

Under the Windfall Profits Tax, the rates of tax on selling prices of oil in excess of base prices range from 10% to 85% under the following graduated rate schedule:

TABLE 4.—PER 42-GALLON BARREL OF CRUDE OIL

Amount in excess of base price	Bracket rate, percent	Bracket tax, cents	Cumulative tax, cents
0 to $0.50	0	0	0
$0.51 to $0.75	10	2½	2½
$0.76 to $1.10	20	7	9½
$1.11 to $1.70	30	18	27½
$1.71 to $2.50	50	40	67½
$2.51 and over	85		

In accordance with Treasury regulations to be prescribed, the top level of the lowest bracket (initially 0 to $0.50) and the bottom level of each higher bracket will be automatically adjusted upward monthly in the uniform percentage required to make the 10 percent rate of tax applicable after 36 months only to amounts in excess of the expected average long-run supply price of about $7 per barrel. Each higher bracket will be adjusted upward to apply to a constant number of cents per barrel above the next lower bracket. That portion of the price increase which remains after payment of the above Windfall Profits Tax is subjected to ordinary income tax.

As you can see from Table 5, the Windfall Profits Tax on the oil will be large if the oil shortage is severe enough to cause large price increases in oil and modest if the shortages and price increases are modest:

TABLE 5.—NET PRICE RECEIVED BY OIL PRODUCER AFTER PROPOSED EMERGENCY WINDFALL PROFITS TAX

[Base price of $4 per barrel]

Price	Months— 1	6	12	18	24	30	36
$10	$6.35	$6.47	$6.67	$6.94	$7.30	$7.80	$8.47
$9	6.20	6.32	6.52	6.79	7.15	7.65	8.32
$8	6.05	6.17	6.37	6.64	7.00	7.43	7.78
$7	5.90	6.02	6.22	6.42	6.63	6.85	7.00
$6	5.58	5.65	5.75	5.84	5.94	6.00	6.00

If we have underestimated the long-run supply price, the tax imposes little penalty. For example, suppose it turns out that three years hence a price of $8, rather than $7, is necessary to elicit a domestic supply equal to 85–90 percent of consumption at the then corresponding product prices. In that event, a tax would still apply but it would only be 22 cents a barrel, less than 3 percent of the price. Thus, producers who believe the $7 price is too low can nonetheless proceed on the basis of their own price judgments in the knowledge that when the windfall disappears and their investments become productive, the tax should also disappear, and that even if the tax does not then disappear, it will impose only a minor and vanishing penalty. This is to be contrasted with the situation which would result if prices were controlled. A $7 price ceiling would be equivalent to a 100 percent tax on prices above that amount, and if the long-term supply price should turn out to be higher than $7—or if producers *expect* it to be—we simply would not get the supplies we need.

However, the tax rates and bracket changes have been designed so that an owner of oil will be discouraged from withholding production until after the tax rate declines or the tax expires. The price of oil is or shortly will be as high as it is likely to be for the next five years (in terms of 1974 dollars) and will begin a gradual decline to the long-term supply price. Higher prices now increase the incentives to increase supplies, and gradually increasing supplies will gradually reduce prices. Accordingly, apart from the tax, the owner of oil must attempt to produce the oil quickly to take advantage of the higher existing prices. Taking the rate of decline of the tax into account along with the expected price decline, we estimate that the gain from delaying producing of oil to avoid the tax would be less than ½ of 1 percent per month on the average (see Table 6 below). Therefore, we believe that no sensible producer will fail to convert his oil to money since the value of the use of that money would be greater than the ½ of 1 percent per month he could gain by leaving his oil in the ground.

TABLE 6.—ILLUSTRATIVE EFFECT OF THE WINDFALL PROFITS TAX ON NET PROCEEDS REALIZED BY OIL PRODUCERS, FOR 2 PATTERNS OF OIL PRICES

Number of months after enactment	Hypothetical prevailing price of oil	Net producer proceeds	Average increase per month (percent)
Pattern A:			
1	$10	$6.35	
12	9	6.52	0.24
24	8	7.00	.59
36	7	7.00	0
Pattern B:			
1	9	6.20	
12	8	6.37	.25
24	7	6.63	.33
36	7	7.00	.45

The combination of graduated rates and a scheduled upward adjustment of the brackets accomplishes three major purposes:

First, the graduated rates impose very high rates of tax on extraordinary price increases and "windfall" profits which are attributable more to an externally induced shortage in crude supplies than to long-run market conditions, but impose a lesser amount of tax on relatively small increases above the Cost of Living Council ceiling price.

Second, the automatic upward adjustment of the tax brackets recognizes that windfalls will be shortlived and that prices should peak in the near future and return to lower levels as they gradually result in greater supplies. Most important, it recognizes that if producers are to make the investments which will be required to make us independent, they must be able to count on an absence of burdensome special taxes on prices when those investments become productive several years hence.

Third, the phaseout of the tax as the windfall disappears assures that the tax will not cause higher prices for consumers, for the technical reasons I shall discuss later.

The tax will be imposed on the oil producer at the time of sale of the crude oil or at the end of the month in which produced if not sold. It is contemplated that the tax will be collected and remitted on a monthly basis as follows:

(i) The purchaser of crude oil will withhold and remit the amount of the tax from the sales price paid to the oil producer by the 15th day following the end of each month for all crude petroleum purchased during the month.

(ii) In the case of crude produced but not sold, as in the case of an integrated producer, the tax will be paid by the producer by the 15th day following the end of the month of production.

In computing percentage depletion, the amount of the Windfall Profits Tax is subtracted from gross income from the oil property before computing percentage depletion. The effect of this is to deny percentage depletion on the amount of the windfall which is taxed away.

Because the period of extraordinary profits is expected to be limited in duration, it is important that Congress reconsider the tax after several years of experience. Accordingly, the tax is to expire by its terms 60 months after the date of enactment.

PRICE ROLLBACKS ARE NOT A REASONABLE ALTERNATIVE TO THE WINDFALL PROFITS TAX

It would be a fundamental mistake—for everyone except foreign oil producers—to roll back oil prices to some former level. The reasons are several:

First, consumers will end up paying about the same prices in any event. The most they would be spared is a few cents a gallon for a few months. (A $1 reduction in the price paid for "new oil," for example, would translate initially into less than a one-half cent per gallon decrease in the price of gasoline and the market would quickly offset that initial decrease.) The principal effect would be to shift profits from the U.S. to abroad.

Second, the mere presence of ceilings of any sort will tend to dampen the new investment required to produce the increased oil we need. Investors are understandably wary of activities which come to be governed primarily by the laws of politics rather than the laws of economics.

Third, ceiling prices which are less than the prices producers think will prevail will deter them from investing—regardless of whether it is the price authority or the producers whose cost assumptions are correct. Judgments on complex matters like this always differ. Even supposing the government's price controllers could correctly guess the long-term supply price and use that as a ceiling, the ceiling would inhibit needed investment by producers whose judgments differ. In order to get to the long-term supply price, the ceiling would have to be set substantially higher.

Although it is plainly true, many observers fail to recognize that whatever we do with price controls cannot affect the price of the more than 30 percent of our oil we now import to satisfy our demands. The price of that oil fluctuates according to world demands and world supplies. Recognizing this, our Cost of Living Council rules permit refiners to pass through the foreign price they must pay. Thus, the prices of U.S. petroleum products are subject to controls, but the control system, in a sense, rides on top of the price of crude—and products go up in price when the world crude oil price goes up regardless of what we do to control the price of domestic crude oil. This means that the price levels at which no more petroleum products will be bought by consumers, the so-called "market clearing prices," cannot be controlled by controlling domestic crude oil prices. Consumers will eventually pay the same prices for petroleum products whether or not domestic crude prices are controlled. What we do when we control domestic prices at levels below world market levels is simply to permit our refiners to buy our domestic oil too cheaply—compared with world prices—and to bid higher for foreign oil to satisfy our consumers' demands. This, in turn, means that the larger amounts spent by consumers go not to domestic producers and to our government in taxes. but to foreign oil producers and foreign governments.

Of course, we could prevent this by denying U.S. consumers the right to buy the foreign oil products for which they are willing to pay or by not permitting cost pass-throughs for foreign oil prices. But if we do so, we will only be spiting ourselves since either of these measures will prevent foreigners from exporting oil to the United States at a time when we need it, before we have increased our degree of self-sufficiency.

Price rollbacks sound good to consumers until the consequences are appreciated. The consequences would be large transfers of dollars to foreigners and an ultimate reduction in oil for the U.S. consumers, all ironically incurred for price reductions which would be minor and evanescent.

WINDFALL PROFITS TAX COMPARED WITH ALTERNATIVE TAXES

We believe that the Windfall Profits Tax will be considerably more effective and efficient than would either an excise tax or an excess profits tax.

The Windfall Profits Tax differs from an excise tax in that it will in fact operate to tax profits, as the portion of the price to which it will apply is above the level required to cover costs in all but exceptional cases. At the present price of $10 for new oil, the tax in its first month would exceed profits only if costs exceed $6.35 a barrel (see

Table 5)—which is hardly likely for production planned months ago when prices were much lower. (Prices were controlled at levels below $4 until late August.) If in some small fraction of cases that should not be true, the tax could not exceed profits by more than a few cents per barrel.

An ordinary excise tax shares with the Windfall Profits Tax the virtue of simplicity but, in contrast, is not necessarily a tax on profits and is an undesirably blunt instrument to use in this case. Excise taxes are usually stated as so much per unit or as a percentage of the price of the unit. An excise tax stated as so many cents per barrel or gallon of oil would have to be paid regardless of the amount by which oil prices rose (or didn't rise). That is undesirable since the tax would not be related to the windfall. An excise tax stated as a percentage of the sales price would tax more heavily those who produce oil of higher quality and price than those who produce oil of lower quality and price, which is undesirable since, again, the tax would not be related to the windfall.

A classic excess profits tax of the type in effect during World War II or the Korean War would be a nightmare of complexity and uncertainty. It would be very difficult to design and administer a tax which would not impair the ability and incentive of oil producers to make the investment necessary to produce the additional oil needed to make us independent.

While prior excess profits taxes differed significantly, they contained the common elements of (i) a determination of profit in excess of some base amount, (ii) the application of a high rate of tax to the excess amount and (iii) complex exceptions designed to alleviate the penal nature of the high tax rate in situations in which the general rule determination of excess profits yielded an inequitable result. The following problems existed in prior excess profits tax laws:

Determination of base period and fair rate of return.—No period can be selected which was a normal period for all taxpayers. That is to say, during any taxable year or years selected, some taxpayers' rates of return on investment or profits will be higher or lower than others for many extraneous reasons, such as strikes, floods, etc. Two basic methods have been used to determine a normal profit for the base period. One method is to compute a rate of return on invested capital during the base period, treat that as a normal profit rate, and impose a tax on any profits realized in excess of that rate. The other is to treat the absolute amount of profits realized during the base period as normal profits and impose a tax on any profits realized in excess of that amount. Combinations of the two basic methods have also been used. The assumption of normality for any historical rate of profits or any absolute amount of profits for a particular taxpayer for a particular period is subject to challenge because of the infinite variations in taxpayers' situations. For example, during whatever base period is selected, some taxpayers' businesses were contracting, some expanding; some used heavy amounts of equity capital, some relied heavily on debt; some engaged in heavy research and development expenses, others maximized earnings by postponing research and development expenses, and on and on.

Exceptions for abnormalties.—Because of the problems referred to above and others, complex machinery has always been required to adjust the inevitable inequities arising from the selection of base periods and the calculation of base period profits. Administrative boards and courts become entangled for years over these questions. The World War II and Korean War excess profits tax cases spawned over 54,000 applications for over $6½ billion of relief because of claimed abnormalties in the computation of excess profits. Thousands of lawsuits, the last of which has not yet been decided, required large expenditures of time and manpower for both government and taxpayer in complex economic arguments over how much was too much profit.

Incentive for wasteful expenditures.—Since the tax is conventionally imposed at a high rate and only on net profits, it has the effect of causing expenditures which would not otherwise be made and which are wasteful. For example, the corporate taxpayer at a 48% income tax rate must use 52 cents of its own money for every $1 expended. However, if the marginal tax rate is raised to 85% by the addition of an excess profits tax, only 15 cents of every $1.00 of excess profits spent by the taxpayer comes from its pocket—the other 85 cents will be taken in taxes if not spent. Experience teaches that this leads to wasteful practices and inefficiencies which increase or maintain product prices to consumers without creating corresponding benefits to society.

Applying an excess profits tax only to the net profit of oil production would be even more difficult, for the following reasons:

Increased Coverage.—The expected windfalls will accrue to all owners of oil, who include thousands of individuals, trusts, estates, specially taxed corporations such as insurance companies, and other corporations not generally associated by the public with oil companies. Accordingly, the windfall tax must apply to *all* owners of oil, not just to large oil companies, if it is to be effective. The World War II and Korean War excess profits taxes have applied only to *corporate* taxpayers. It is safe to say that as complex to administer as prior taxes have been, an excess profits tax affecting thousands of non-corporate taxpayers would be greatly more complex.

Determination of excess profits.—It would be necessary to determine the excess profits *from oil production alone* if the tax were to be confined to the windfall. Complex allocations of income and expense would have to be made. In the case of the numerous individuals, estates and trusts who keep minimum formal records, the allocation problem would be even more sizeable.

Taxable income management.—Taxable income management through wasteful expenditures would be easier to achieve for oil producers since their incomes are reduced currently through the deduction of most of the costs of new wells and percentage depletion. Wasteful drilling practices and wasteful expenditures for overhead items could reduce the impact of the tax to a large extent without corresponding benefits to society from productive new wells or research.

OTHER ASPECTS OF THE WINDFALL PROFITS TAX

The Windfall Profits Tax would tax only the person who has the windfall, the owner of crude petroleum. This can be illustrated by looking at gasoline price increases. From October 1, 1973, to late January 1974, average gasoline prices increased by 9.5 cents per gallon.

In the same period, average crude oil prices increased by between $3 and $3.50 per barrel or about 8 cents per gallon (there are 42 gallons to a barrel). The remaining 1½ cents of the 10 cent increase was permitted to refineries and distributors by the Cost of Living Council to offset higher costs based on a thorough evaluation of their costs and profits. The windfall profit is reflected in the 8 cents which inured to the owner of crude oil and he is the person who must pay the tax if the windfall profit is to be taxed. Refiners, wholesalers, and retailers of petroleum products have been permitted only price increases under the Cost of Living Council rules which reflected, on a dollar-for-dollar basis, the actual costs they experienced.

It should also be noted that the Windfall Profits Tax will tax similarly those oil producers who are similarly situated. A producer who receives a $1 per barrel increase for low-priced oil with a base price of, say $3.00, is taxed the same as a producer who receives a price increase of $1 per barrel for his higher quality and higher priced oil with a base price of, say $4.50. These relative base prices were previously established by market forces and are doubtless fairer than any which could be devised administratively.

The Windfall Profits Tax applies only to domestic production. It is not sensible to attempt to tax the windfall on imported oil for two reasons. First, anything which reduces the net price received by the foreign producer below what he would receive if the oil were sold in another country will only prevent imports from coming to the United States. The oil will tend instead to be sold elsewhere if the net price to producers is higher there because of a U.S. tax. Second, the amount of windfall realized by the company from which the imported oil is purchased is limited the windfall will be realized primarily instead by the foreign government. This is easily seen by looking at increases in reference or posted prices of oil by foreign governments, which have increased radically and repeatedly in recent months to capture the windfalls from the operating companies. A tax or tariff on imported oil should be imposed only to discourage imports for national security or other reasons, which goes beyond what is appropriate at this time.

THE TAX IS NOT PASSED ON TO CONSUMERS

The consumer currently receives government protection against unfair price increases through a combination of price controls and allocation policies. The Windfall Profits Tax complements these rules and will not have the effect some claim of increasing prices to consumers. Statements to that effect indicate a lack of understanding of how the tax operates. A tax which is less than the windfall profit will always fall on the oil producer.

Why isn't the tax passed on to the consumer? It is because the producers of oil are willing, even if reluctantly, to take less for the oil than the amount consumers are willing to pay and are in fact paying. Producers made their decisions to produce oil expecting prices below the current higher prices which are all that consumers will pay. (If consumers were willing to pay more, and were permitted by price controls to do so, producers would already be charging it.) If consumers will pay no more and producers are willing to take less, producers will absorb any tax which does not reduce their expected profit, i.e., reduce it by more than the windfall profit. On the other hand, if the tax is more than the windfall, the tax could fall on consumers in varying degrees, depending upon supply response (the greater the supply response, the more apt the tax is to fall on the consumer). The following example may be helpful.

Suppose that producers are producing at full capacity and are willing to sell at a price of $x. For extraordinary reasons the price rises to $x+2, producing a "windfall" profit of $2. That represents the maximum price that consumers are willing to pay because if they were willing to pay more producers would be charging more.

If a tax of $1 is imposed it will not affect supply, since by definition the supply is the same at any level above $x. If producers could previously have added $1 to the price they would have done so already. If they now try to add $1 to the price, demand will simply fall. Thus, the price to consumers will not change and the oil producers will have to pay the $1 to the tax collector.

However, if there is no windfall profit in the price, a tax will affect the amount which oil producers are willing to supply and some part of the tax will inevitably be passed on in the form of a price increase, as a lesser supply will result in price increases. The greater the supply response (i.e., the greater the contraction in supply), the closer to the amount of the tax the price increase will tend to be.

PROPOSALS RELATING TO DOMESTIC INCENTIVES

Among the tax proposals which I presented to you in April 1973 were several which affect incentives for domestic exploration for and production of oil and gas. They are the proposals for the Exploratory Drilling Credit, for a Minimum Taxable Income and for a Limitation on Artificial Accounting Losses.

I said to you in April:

> . . . the need is for new exploration in the United States which will add to the national wealth of known oil and gas reserves for the future and assure the continued availability at reasonable prices at home—not abroad—of adequate fuel supplies.

To that end we proposed a new investment credit for exploratory drilling. This credit operates in much the same way that the investment credit operates, and we expect it to be similarly effective in encouraging new exploration.

The tax law now contains incentives for oil and gas production in the form of the percentage depletion allowance and the deduction for intangible drilling costs. Of these, the provisions for intangible drilling costs are the more effective incentive for new production because they relate to the drilling operation itself and because the deductions may be taken whether or not the drilling is successful. Percentage depletion, on the other hand, relates only to production, and is a more diffused incentive because its benefits are available only if the drilling is successful and then only over a period of years.

The new exploratory drilling credit is concentrated on the activities which are most needed, namely, the discovery of new fields and reservoirs. And since it provides a major and immediate benefit for drilling activity, it should have a significant incentive effect on that activity.

The existing incentives provided by percentage depletion and the immediate deduction of intangible drilling costs would be lessened respectively by the Administration's proposals with respect to Minimum Taxable Income (MTI) and Limitation on Artificial Accounting Losses (LAL). These reductions in existing incentives, which are not large in relation to aggregate investment in the industry, are necessary for other reasons and are more than offset by the somewhat larger and more efficient incentives which would be provided by the proposed Exploratory Drilling Credit.

The purpose of both the MTI and LAL proposals is to stop the spectacle of high income taxpayers paying little or no federal income tax and thus to remove an element which tends to corrode the indispensable public confidence in our tax system. The Internal Revenue Code contains many preferences designed to provide incentives for particular activities. We believe that Congress should review them individually from time to time so that those which have become outmoded and unnecessary can be revitalized or eliminated. However, the pressing need at this time is to see that such provisions, in total, do not give rise to the public impression that tax laws apply unfairly in favor of the wealthy, who are the persons most likely to respond to the incentives. Thus, the Minimum Taxable Income proposal deals with existing incentives (leaving their reexamination to another day) and proceeds on the philosophy that while individual incentives may be good, there may be too much of a good thing. The Minimum Taxable Income proposal would place a limit on the aggregate amount of certain incentives which may be used by a particular taxpayer. Stated very roughly, the concept is that a taxpayer should not be permitted to use such incentives in an aggregate amount which exceeds half of his "economic" income. Just as the Code now places limits on particular incentives—such as the 50 percent of income limitation on the charitable deduction—the Minimum Taxable Income proposal would place a limitation on aggregate incentives.

In designing the Minimum Taxable Income provision, we were mindful that it would affect the use of percentage depletion in cases where percentage depletion in combination with other covered items exceeded half of the taxpayer's economic income. We concluded after careful consideration that, while individual taxpayers would complain, the proposal's effect on percentage depletion would be minimal in the aggregate and would not significantly affect capital investment for increased production of oil and gas. Whatever slight adverse effect the proposal might have in that regard, we believe it is the necessary price of preserving public confidence in the tax system generally.

The LAL proposal also lessens somewhat the incentives provided by the immediate deduction of intangible drilling costs. In the case of producing wells, such deductions often create accounting losses even though the well is in fact profitable. Under the proposal such losses could be used only to offset income from oil and gas properties, and not to offset other income. The purpose of the proposal is to prevent high income taxpayers from eliminating their current taxable income from other sources by using deductions which do not represent economic losses. Drilling expenses incurred in connection with holes which turn out to be dry are not artificial losses and are unaffected by the proposal. While the proposal limits the use of such artificial losses, it does not permit their utilization against oil and gas income and in that sense provides an incentive to oil and gas investment which partially offsets the disincentive.

Looking at the April 30 proposals as a package, the proposals for MTI and LAL would reduce to some degree the existing incentives for investment in oil and gas, but the proposal for an exploratory drilling credit would, in terms of dollar benefits to taxpayers, more than offset the dollar detriments arising from those proposals. Thus, when both proposals are considered together, the dollar tax incentives offered for investment in oil and gas remain essentially unchanged—but a significant portion of those dollar incentives has been rechanneled to operate in a much more efficient way to produce new oil and gas reserves.

Thus, we urge your Committee to act promptly on the proposed exploratory drilling credit, but to keep in mind that it must be considered in the total context of the proposals for Minimum Taxable Income, to which we hope you will also accord a high priority.

PROPOSALS RELATING TO FOREIGN OPERATIONS

As a part of the program to make our nation independent in energy resources, we believe it desirable, within the limits of fairness, economic efficiency, and national security to emphasize incentives for domestic exploration as distinguished from foreign exploration. With that in mind, we presented to you last April a proposal relating to the recovery of foreign losses that are deducted against United States income. We now have two additional proposals relating to foreign operations which we ask that you consider.

THE FOREIGN TAX CREDIT

All of these proposals require an understanding of the international system for avoiding double taxation of income earned in one country by a citizen of another country.

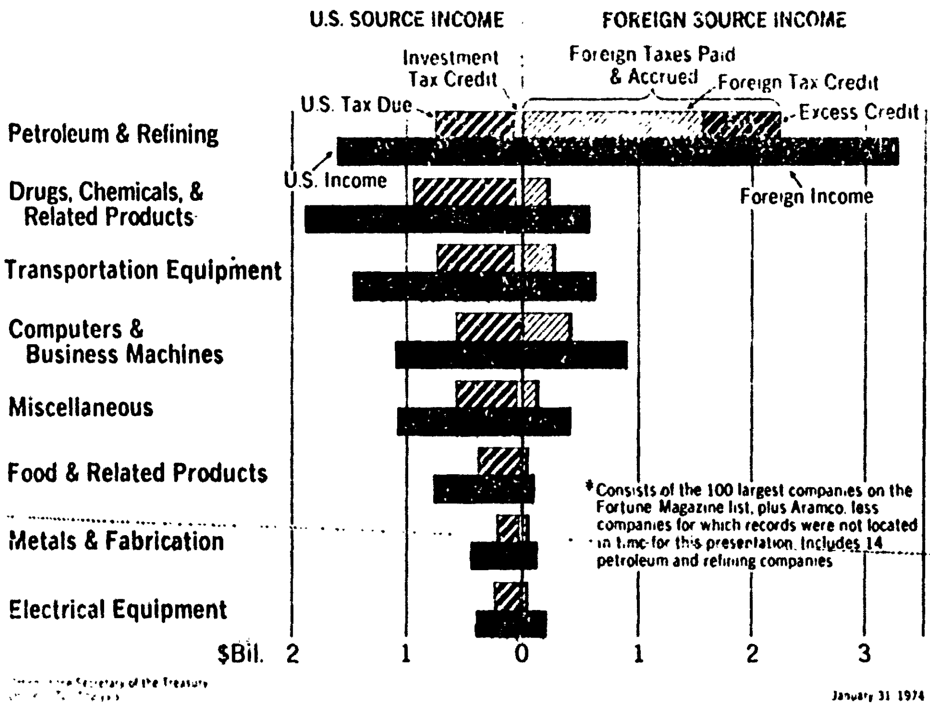
The major nations of the world have a network of systems designed to avoid excessive double taxation of income. Those systems vary in detail but fall into two general categories. Under some systems, income earned abroad is simply not taxed in the home country. France, and the Netherlands, for example, have systems which generally follows that basic concept. Other countries, including the United States, Great Britain, Germany, Canada, and Japan—our major trading partners—have tax credit systems.

The basic concept of a tax credit system is that the country in which the business activity is carried on has the first right to tax the income from it even though the activity is carried on by a foreigner. The foreigner's home country also taxes the income, but only to the extent the home tax does not duplicate the tax of the country where the income is earned. The duplication is eliminated by a foreign tax credit. For example, if a U.S. corporation were taxed at a 30 percent rate in country X on its income from operations in country X, the U.S. would not duplicate country X's 30 percent tax on that income. But since the U.S. corporate income tax rate is at 48 percent, the U.S. would collect—i.e., "pick-up" the 18 percent which remained over and above the 30 percent collected by country X. Technically the result is achieved by imposing a hypothetical 48 percent U.S. tax on the income earned in country X, with the first 30 percentage points rebated by a credit. However, if the foreign rate were 48 percent or more, there would be nothing left for the U.S. to pick up and thus no tax payable to the U.S. on that foreign income.

Note that the foreign tax credit only affects income earned in some foreign country through activities conducted in that country. Income arising out of operations conducted in the U.S. and the taxes on that income are totally unaffected by the credit.

The following table permits one to understand the fact that high taxes are being paid by the oil industry to foreign governments on the large proportion of non-U.S. income that is earned by these corporations; that the United States gives a credit for U.S. taxes on the foreign source income that results in an excess credit; that these credits do not reduce U.S. income taxes on the income earned from U.S. operations; and that the same basic tax credit principle operates for all U.S. industries, not merely oil.

INCOME AND TAXES PAID, OF THE 79 LARGEST U.S. COMPANIES,* 1970



It is also important to note that the satisfactory functioning of this credit system depends upon reciprocity among nations. Thus, the U.S. reciprocally has the first right to tax income of foreigners arising out of operations in the U.S., and the home foreign countries either give those foreigners a credit for the U.S. tax or they exclude the U.S. income entirely from the home country's tax base.

When Congress wrote the basic tax credit provisions in 1918 and when the question o: oil country taxes first became controversial twenty-odd years ago, circumstances were different from what they are today. Most foreign countries today have income tax rates nearly as great or greater than the U.S. tax rate. Thus, after our companies have paid their tax abroad, there is little or nothing left for the U.S. to "pick-up" on that foreign income unless we wish to impose a tax which duplicates the foreign tax. It has been the broad position of our government, under this and previous administrations, that the avoidance of double taxation is a sound principle and that we should continue to participate in the international system designed to avoid it. If we were now to withdraw from the system, we would invite retaliation and discrimination from other nations and would be required to rethink and renegotiate international arrangements. Excessive tax burdens would be imposed on U.S. companies operations abroad and their international competitive position would be severely affected.

In summary, the basic foreign tax credit must be understood not as a taxloophole or positive incentive to foreign investment, but rather as part of a system designed to allocate primary taxing jurisdiction to the government within whose borders the income is earned. The system does not reduce the *total* tax bill of U.S. companies below the amount they would have paid to the U.S. if the income had been earned here. They are excused from paying U.S. tax on *foreign* income only to the extent that they have paid an equivalent tax on that income to a foreign government. We must accept the fact that other countries now impose taxes comparable to ours, so that the U.S. now collects little or no tax from operations conducted by its corporations in most major foreign countries.

There still remain, however, certain "tax haven" countries which impose little or no tax, and there exist also some countries where the tax rates are much higher than U.S. tax rates. Much of the complication in the present system arises out of the desire of taxpayers either to average or not to average (depending upon the circumstances) the income and taxes of high tax and low tax countries.

At the present time, the oil producing countries impose taxes at very high rates. If these taxes were expressed as a percentage of taxable income as defined by our rules, they would be in the neighborhood of 90 percent. But if they were only as high as our corporate income taxes, namely 48 percent, the U.S. would still collect no tax on earnings in those countries. However, the difference of 40-odd percentage points between those rates and U.S. rates produces very large "excess tax credits" which, under existing rules, can be used to eliminate the tax that the U.S. would otherwise "pick up" in the low tax, tax haven countries. One of the proposals I shall discuss later deals with an aspect of that fact.

RECOVERY OF FOREIGN LOSSES

The April proposal with respect to the recovery of foreign losses is directed to a situation that arises because a taxpayer with losses in a foreign country can deduct those losses against income earned in the U.S. in the year of the loss. When the foreign operation becomes profitable in a later year, the foreign country often collects tax on the profits without regard to the prior loss, and if that tax is as large as our 48 percent tax, the resulting credit will absorb any U.S. tax on those foreign earnings. The result is that the United States shoulders the burden of the start-up deductions, but the foreign country collects the tax when the operation becomes profitable. Such losses often arise in connection with the exploration for oil or gas deposits abroad, involving large intangible drilling and development costs.

The April proposal would modify the foreign tax credit provisions to require that where a United States taxpayer has deducted foreign losses against United States income, such losses would be taken into account to reduce the amount of foreign tax credit claimed by such taxpayer on foreign earnings in later years. This would eliminate the present situation which permits the current deduction of intangible drilling costs and other start-up expenses in a foreign country against United States source income and then permits a foreign country to claim the full income taxes on the profits, with a United States tax credit for such taxes when production begins. The proposal, by restricting this possibility, would eliminate a present United States tax benefit for commencing foreign drilling operations. The estimated revenue gain from this proposal is $100 million annually after five years.

ELIMINATION OF PERCENTAGE DEPLETION IN THE CASE OF FOREIGN OIL AND GAS PRODUCTION

Percentage depletion was first allowed in 1926. Through the years it has been retained as an incentive for exploration for new reserves.

Percentage depletion has been available regardless of whether the producing property is located in the United States or in a foreign country. However, from time to time adjustments have been made in rates and rules, and under existing law percentage depletion is unavailable, or available at a lower rate, for foreign production of a number of minerals other than oil and gas. In the case of oil and gas the depletion deduction is and has always been available abroad to the same extent as in the U.S.

In recent years, percentage depletion on foreign oil and gas has not produced a benefit in many, if not most, cases because of the generally high foreign taxes imposed abroad. (The precise amount of the hypothetical U.S. tax is irrelevant if the foreign tax is in any event higher, so that the foreign tax credit eliminates the U.S. tax.) However, there is a potential benefiit for production in countries with lower tax rates.

It is now apparent that our primary aim should be to encourage the exploration for new sources of oil and gas in the United States. There is no longer any policy support for giving special encouragement to oil and gas exploration and production abroad. Thus, we now propose that the Internal Revenue Code be amended to provide that percentage depletion shall not be allowed with respect to oil and gas wells located in foreign countries. The percentage depletion allowance for oil and gas would be limited to wells located in the United States, in its possessions, in the Commonwealth of Puerto Rico or on the outer continental shelf.

Because the taxes of the major countries where oil and gas is now being produced by U.S. companies are now imposed at rates equal to or in excess of those which would be imposed by the U.S., no major revenue effect is expected from this change, although it may have a significant effect on some producers. The estimated revenue gain is $50 million.

We are not now proposing any change in the percentage depletion deduction available for other natural deposits located in foreign countries. However, that question should be examined from time to time and adjustments made when appropriate.

EXCESSIVE FOREIGN TAX RATES

Using artificially high posted prices for oil and high tax rates, many oil producing countries now collect "income taxes" on petroleum profits which greatly exceed income taxes normally collected by governments on other business activities. This has created what we believe to be a distortion in the normal and equitable operation of our foreign tax credit system.

We continue to support the principle of avoiding double taxation through a tax credit system. But like other basically sound principles, it can be subject to distortion and abuse in particular situations. The special problem that we are dealing with arises particularly where the taxing authority and the ownership of the oil are embodied in one and the same entity, which thus has the power to extract payments from oil producers in the form of taxes or in some other form, at its discretion. The high artificial posted prices on which the taxes of a number of oil producing countries are based have created legitimate concern over whether the payments treated as creditable tax are "income taxes" or taxes "in lieu of a tax on income." It is argued that these payments, at least in part, more realistically represent some other business expense.

Business expenses are excludible or deductible from gross income, but they may not be credited against U.S. income tax. Foreign income taxes, on the other hand, may be either deducted from income or credited against U.S. tax, at the option of the taxpayer. Thus, if the tax law allows payments which in substance are not income taxes to be treated as income taxes, taxpayers will receive larger credits than they should. When the amount of the "tax" payment on foreign oil production exceeds the U.S. tax on the same income, the excess payment gives rise to an excess foreign tax credit which may be used as a credit against U.S. tax on income from other operations in that country, or on income from other foreign countries, depending on whether the foreign tax credit is computed on the per-country limitation or the overall limitation.

In the case of oil production, foreign producing countries generally base their tax on the "posted price" for crude oil. The posted price is a fictitious price which may or may not have any relationship to the market value of the oil. It is, however, almost always higher and has moved dramatically higher in recent months. As the posted price has risen, the foreign taxes have gone higher. This has led to greatly increased excess credits for taxes paid the oil producing countries.

Under the tax credit system, as the foreign tax rate goes up, the U.S. tax goes down, until the foreign rate becomes 48 percent and the U.S. rate becomes zero. Thereafter any increases in the foreign rate have no further effect on the U.S. rate on the foreign income but simply create "excess credits," which most companies cannot use. However, companies electing the "overall limitation" on the foreign tax credit, may average foreign tax rates so that "excess credits" in one country may, in effect, be used to pay U.S. taxes with respect to income earned in another foreign country which imposes little or no tax. While we believe this result to be satisfactory in general, we believe it leads to a distortion of the credit mechanism in the case of oil companies under present circumstances.

The total amounts of these payments to the foreign producing countries, and the effective rate of taxes have grown so large that, whether or not they technically qualify as "income taxes," we do not think that we should continue to treat them entirely as an income tax for tax credit purposes since they exceed normal levels of taxation and can affect very significantly the U.S. treatment of other foreign source income of U.S. oil companies. For a number of years, the existence of increasingly large excess tax credits was of minor importance because there was no U.S. tax payable in any event, and the companies simply accumulated excess credits which they could not use. It now appears, however, that major international oil companies are beginning to engage more heavily in foreign operations other than oil extraction, including operations such as shipping, which are subject to little or no foreign tax. The number of companies electing the overall tax credit limitation appears to be increasing, and the income from these low-taxed foreign operations is thus shielded from U.S. tax by using the excess credits resulting from the extremely high "taxes" paid to the foreign governments on the foreign oil and gas income.

Our proposal would continue the foreign tax credit mechanism substantially as it has existed over the years, and it would not tamper with the basic definition of an income tax. We do not underestimate the ability of foreign oil producing countries to design the structure of their levies to correspond to any definition of an income tax that we require. But under our proposal only a reasonable part of the foreign income tax would be treated as a *creditable* tax. The balance would be treated as an expense. We propose to use U.S. tax levels as a standard in determining what is a reasonable level of foreign tax to be creditable. Thus in the case of these foreign taxes on oil and gas production, we would treat as creditable only an amount equivalent to the U.S. tax on the same income—i.e., in most cases the 48 percent general corporate rate or, the lesser 34 percent rate for Western Hemisphere Trade Corporations, as the case may be.

Since the expense part of the tax is deductible in determining taxable income, the determination of the creditable portion must be made by an algebraic formula. The explanatory material in the Appendix sets forth this formula and shows how it is derived. Its practical result is that foreign oil production will no longer generate excess foreign tax credits.

For purposes of applying these rules, the foreign oil taxable income of the taxpayer and the foreign tax paid with respect to that income would be determined separately for each foreign country, and the proposed new limit on creditable taxes would be computed separately for each foreign country. After application of the limit, the creditable taxes would be aggregated with other creditable taxes and subjected to the normal per-country or overall limitation on the foreign tax credit. Excess tax credits accumulated in taxable years beginning before the effective date of this proposal could be carried over to years beginning after the effective date of this proposal as under present law, but would be denied to the extent that they could not have been utilized had this change not been enacted. The proposal would become effective with respect to taxes paid during, or accrued with respect to, taxable years ending after December 31, 1973.

It is not possible to estimate the revenue gain from this proposal with precision because its enactment will cause taxpayers to change their operations in ways which we cannot predict. If more companies were to devise ways to use the excess credits generated under the present system, the revenue loss could be in excess of $1 billion a year. The proposal would foreclose that possibility. If the proposal were applied to existing patterns of operations we would expect it to produce revenues of about $400 million a year over current levels. However, taxpayers can be expected to change their procedures to reduce that amount substantially.

It has been suggested that the proper approach to this problem is to deny the foreign tax credit entirely with respect to the existing taxes on oil income. We believe that our proposed limitation is far more desirable. The result of denying the credit would be to subject U.S. companies to higher tax burdens than their foreign competitors. The step of denying any tax credit should not be taken unless it is determined that United States oil companies should not participate in foreign oil and gas production.

It has been suggested that the problem in this area is that the international oil companies are paying absurdly low taxes, sometimes alleged to be on the order of 2 or 3 percent, and that those taxes should be raised to the level of other U.S. companies. This is a simplistic way of looking at the problem. The fact is that these companies are paying *high* taxes on their *foreign* production. It is true that these taxes are not being paid to the U.S., but it is also true that there is no reason under the international system that they should be paid to the U.S. If a U.S. company can go to Saudi Arabia, find and produce oil, take it to Japan or Western Europe, sell it at a profit, pay reasonable taxes to the countries concerned, and repatriate the after-tax profits to the U.S., U.S. policy-makers should not be dismayed; they should be pleased.

We are all upset because the price of oil is high, but the reaction should not be to strike out blindly at the most available target. The approach of our proposal is not a vindictive one. We are not trying to penalize oil producers. Nor are we trying to restrict U.S. companies to U.S. business. What we are suggesting is a technical change which will remove the possibility of the oil producers obtaining an undue benefit from changed circumstances.

In conclusion, let me emphasize our conviction that all of these proposals, together with those which we made last year, are of great importance to our nation's welfare. We urge that you give them a high priority. The Treasury Department will be pleased to assist in every way it can.

Appendix

Determination of Creditable Portion of Foreign Income Taxes on Oil and Gas Production

Many countries collect income taxes on oil and gas production at excessive levels. The Treasury proposal would characterize part of those income taxes as deductible expenses.

The method of dividing foreign income taxes between a portion which would be creditable against U.S. taxes, and the remainder, which would be characterized as an expense, may be described in three steps:

(1) The creditable portion of the tax would be equal to the U.S. tax rate applicable to corporations times foreign source petroleum income *defined according to U.S. law*. (The rate would be 48 percent for corporations other than Western Hemisphere Trade Corporations and also for individuals, trusts and estates, but would be 34 percent for Western Hemisphere Trade Corporations.)

(2) Foreign source petroleum income defined according to U.S. standards would be equal to the fair market value of the petroleum, less royalties, lifting costs, and other allowable expenses, and less that portion of foreign income taxes which is characterized by the U.S. as an expense.

(3) The portion of the foreign income tax characterized as an expense would be equal to the total foreign income tax less that portion of the foreign income tax which is creditable against U.S. taxes.

Each step in the apportionment of foreign income taxes depends on some other step. Thus, to determine the creditable portion of the foreign tax, it is necessary to express the principle as the algebraic formula. The general statement of the principle is that the maximum creditable portion (M) of the foreign income tax (T) is equal to the U.S. tax rate (R) times the excess of foreign petroleum taxable income computed without deducting any portion of the foreign tax (I) over the deductible portion of the foreign tax (T—M). This may be expressed as the equation:

$$M = R[I - (T - M)]$$

This equation may be simplified into the form:

$$M = \frac{R\ (I - T)}{1 - R}$$

In most cases R will equal 48%, and the equation may be further simplified into (approximately): M=.923 (I—T).

In the case of a Western Hemisphere Trade Corporation, R=34%, and the equation becomes (approximately) M=.515 (I—T).

In practical terms, under the proposal, foreign petroleum ventures would no longer generate "excess" foreign tax credits. This is illustrated by the following table:

	Present law	Proposal
Calculation of foreign tax:		
Posted price, per barrel	$11.65	$11.65
Royalty (12.5 percent)	-1.46	-1.46
Lifting, etc., costs	-.20	-.20
Income as defined by foreign government	9.99	9.99
Foreign income tax (55 percent)	5.49	4.59
Calculation of U.S. tax:		
Fair market value	7.65	7.65
Royalty	-1.46	-1.46
Gross income	6.19	6.19
Depletion allowance (22 percent of $6.19)	-1.36	0
Lifting, etc., costs	.20	.20
Portion of foreign income tax recharacterized	0	-5.03
Taxable income for U.S. purposes	4.63	.96
U.S. income tax (48 percent)	2.22	.46
Calculation of credit:		
Maximum credit for foreign income tax	2.22	.46
Excess foreign tax credit	3.27	0
Portion of excess disallowed because of depletion deduction	-.65	0
Available excess credit	2.62	

Under the proposal, excess foreign tax credits carried forward from years prior to the effective date of the proposal would still be characterized as excess credits available in the future to the extent they would have been used if the proposal had not become law. The excess foreign tax credits from such years would *not* be converted into deduction. If they were deductible from taxable income, the result would be a substantial revenue loss. The additional deduction would typically exceed taxable income before the deduction leaving the companies with a loss which they could offset against taxable income from U.S. sources.

For example, assuming that the figures shown in the table apply in 1973 and 1974, an excess credit of $2.62 from 1973 would more than offset the taxable income for U.S. purposes of $0.96 for 1974, leaving a net loss in 1974 of $1.66. This loss could be used to offset U.S. source income of an equivalent amount, on which the U.S. government would lose the tax of 48 percent or $0.80.

Treatment of a portion of the foreign income taxes as deductible cannot result in a reduction of U.S. taxes on U.S. income except in the unlikely case in which the foreign income taxes together with the costs associated with the petroleum exceed the value of the foreign petroleum. This case is particularly unlikely under our proposals because of the denial of a deduction for percentage depletion.