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To: Senate Finance Committee – International Tax Working Group
RE: Comments to the Senate Finance Committee International Tax Reform Working Group

The American Petroleum Institute (API), on behalf of our members, appreciates the opportunity to provide some input to the working group process as the Senate Finance Committee begins to work through various tax policy issues. Given the size and scope of our industry, changes to the US tax code can impact the economics driving the jobs and outlook for our vibrant energy sector. Of course, the goal of any well-structured tax system should be to raise revenue in a way that does the least amount of economic harm, while encouraging domestic investment and job creation, and allowing taxpayers to compete internationally for new opportunities. To achieve these goals, tax rules should be non-discriminatory among industries and should provide a level playing field for taxpayers engaged in similar activities.

Recently, concerns have grown about the current U.S. tax system, (i.e., that the rules limit U.S. competitiveness in an increasingly global economy), leading to calls for tax reform. Any tax reform should be based on sound, transparent policies, and tax rates should be lowered to support a tax structure that promotes investment and is competitive with other major trading partners.

**Taxation of Foreign Operations - General**

We recognize that the taxation of foreign operations by a home country is a very complex area to address in tax reform. However, the industry's main focus in reforming international tax provisions is fairly simple: rules ensuring that foreign source operating income of U.S. based companies is not subject to double taxation are essential for supporting the competitiveness of U.S. companies internationally.

As an extractive industry, we must operate where the resource is located rather than where the tax rate is the lowest. In fact, the industry pays substantial income taxes on its foreign operations, which often causes the industry's effective tax rate to be over 40 percent. The industry is currently able to repatriate a substantial amount of international cash back to the U.S. economy[1] under the foreign tax credit mechanism, which allows U.S. taxes on foreign sourced income to be offset by foreign taxes paid on those operations. This tax system generally alleviates the double taxation concerns.

Therefore, in general, the industry can support a territorial/exemption system provided it is competitive with the tax laws of the other major developed countries and allows U.S. based oil and natural gas companies to compete internationally with non U.S. oil and natural gas companies. For example, any move to an exemption system must insure that all active operating and related income would qualify for exemption, and that all

[1] Over $87 billion was repatriated by the industry in 2012 according to IRS data. These amounts only include dividends received from foreign operations – additional foreign income was earned directly by the industry through branch operations and subject to tax.

industry specific tax restrictions are eliminated. Of course, until such time as a new system is implemented, a fully functioning and competitive foreign tax credit system must remain in place.

Any new tax regime will be difficult for businesses to immediately adopt. Therefore, we support the development and implementation of fair and equitable transition rules. Establishing transition rules that provide adequate time for implementation and that take into account prior reliance on the current tax code as manifested in existing agreements, practices, and other requirements is essential for the success of any new tax system.

**Specific Issues/Proposals**

Over the past few years, API has commented on the US taxation of international operations. We have identified a few specific areas that may be unique to our industry that we believe deserve consideration if international tax reform takes shape. They are as follows:

**a. Section 907 Special Foreign Tax Credit Rules for Oil and Gas Income**

In addition to the foreign tax credit limitations found in section 904 that apply to all foreign tax credits, a special limitation is placed on foreign income taxes paid on foreign oil and gas income. Under this special limitation, amounts claimed as taxes paid on (combined) foreign oil and gas income (CFOGI) are creditable in a given taxable year only to the extent they do not exceed the product of the highest marginal U.S. tax rate on corporations multiplied by such combined foreign oil and gas income for such taxable year. Excess foreign taxes may be carried back to the immediately preceding taxable year and carried forward 10 taxable years and credited to the extent that the taxpayer otherwise has excess limitation with regard to combined foreign oil and gas income in a carryover year.

Our recommendation would be to repeal Section 907 and rules for transitioning to Section 904 should be adopted. This recommendation is consistent with the goal of simplifying the international tax area. Furthermore, the underlying policy rationale for section 907 is not relevant even in the current system, let alone a new approach adopting an exemption system or minimum tax structure.

**b. Foreign Base Company Oil-Related Income**

Foreign base company oil-related income (FBCORI) generally includes all oil-related income (i.e. income from processing, transportation, distribution, and sales and services) derived from foreign sources other than income derived from a source within a foreign country in connection with either (1) oil or gas which was extracted from a well located in that foreign country, or (2) oil, gas, or a primary product of oil or gas which is sold by the foreign corporation or a related person for use or consumption within that foreign country, or is loaded in that country on a vessel or aircraft as fuel for that vessel or aircraft.

There was little, if any, justification for enactment of these rules as they have nothing to do with U.S. base erosion or the shifting of mobile income. They are associated with large capital operations such as refineries and pipelines that by necessity must be located near the producing fields and markets that they serve.

We would recommend that the FBCORI category of foreign base company income found in sections 954(a)(5) and (g) should be repealed as it clearly captures only active income where there is no concern about base

erosion or profit shifting. If there is a proposal to retain some part of a Subpart F structure, it should be focused on preventing highly mobile income from moving outside of the U.S. taxing jurisdiction. It is hard to image a less mobile form of income than revenue derived from operating a pipeline or a refinery. In addition to treating the oil industry differently than other industries, they also treat similarly situated taxpayers within the oil industry differently. Only large producers are subject to FBCORI while their competitors, who only engage in refining or pipeline operations, are not. It is not logical that the income of one refiner, who happens to engage in production activity, is treated as mobile while the exact same income of its competitor, who is not a large producer, is not.

c. **Dual Capacity Rules**

Specific tax rules have been in place for decades that apply to dual capacity taxpayers, i.e. taxpayers who make payments to foreign governments in two capacities – once as a taxpayer and again as payment for some specific benefit the taxpayer receives from the government, such as rights to extract oil and gas. These rules require dual capacity taxpayers to prove – in a court of law if so ordered by the IRS – that only *legitimate income tax* is being claimed for foreign tax credit calculations, and royalties or other payments to the foreign government are not inappropriately characterized as income taxes.

The industry supports the policy that royalties are never eligible for a foreign tax credit. However, our industry is often subject to income taxes that are higher than the country's general corporate rate. The IRS can and does challenge the nature of those payments as legitimate income taxes. Taxpayers expect to be able to prove to a court that such payments are indeed income taxes and not some royalty. It is this proven approach that protects the U.S. Treasury from inappropriate foreign tax credit claims and allows US based companies to operate competitively in foreign markets.

Proposals to change the dual capacity rules will take away the taxpayer's right to have their case heard in a court of law. Thus, even in cases where a taxpayer can prove (or has proven in past audits) that their payments were legitimate income taxes, the proposals will deem all or a portion of them to be royalties and automatically disallow a foreign tax credit. There has been no real showing of any abuse or issue with the dual capacity rules for the 30 years they have been in place. Changing these rules guarantees double taxation for the industry and undermines the ability for US based companies to compete and operate abroad.

**d. Minimum Tax Ideas**

Recent proposals from the Administration as well as Congress have raised the idea that some amount of minimum tax should apply to foreign source income. The determination of whether such a minimum tax should apply to all foreign source income and the minimum tax rate that must be applied are questions that are still being considered and there is no known consensus. The industry is very concerned about the application of a minimum rate test that would be aimed at certain activities but inadvertently impact our operations.

The specific concern is that the application of such a policy could lead to double taxation of capital intensive industries where there are significant timing differences between US tax principles and host country rules. Large capital intensive industries generally recover costs on an accelerated basis for host country tax purposes and reduce taxes in the early years of a project. However, U.S. based companies are required to compute U.S. E&P using the slowest method of cost recovery. In the oil and natural gas industry, it means using ADS straight line for tangible assets and ten-year amortization for foreign intangible drilling costs (IDCs). When accelerated

host country cost recovery is coupled with increased foreign E&P from adjustments required under U.S. rules, the result is a low effective tax rate in early years that will reverse of the life of the project. Income could then be treated as "low-taxed" in the early years even if the foreign tax rate is equal to or above the U.S. rate over the life of the project. The resulting incremental U.S. tax, based on a snapshot in time, would be a permanent cost, which penalizes industries requiring heavy capital investment.

A presentation on application of the minimum tax to the industry is attached to this letter for reference.

**e. CFC and Branch Treatment**

The income tax rate incurred by the oil and gas industry on overseas earnings generally equals or exceeds the U.S. rate, and thus most US multinational oil and gas companies do not rely on deferral to the extent those in other industries do. Therefore, the industry is able to conduct foreign operations in both CFC and branch form on essentially equivalent economic bases from a U.S. income tax standpoint—i.e., there is generally no significant advantage to "deferral" that a CFC provides, and therefore no tax penalty for investing via a branch . But there are non-tax advantages that operating in branch form provides, most of them related to the host country in which operations are conducted. Many developing countries do not have established corporate legal principles that provide certainty around governance of the local corporate entity. It is typically easier in those cases to avoid the local entity status and instead operate as a branch.

Some proposals have struggled with the taxation of branches and whether there should be some type of parity between branches and CFCs. If policy makers are considering this issue we would suggest that it be approached cautiously. To the extent parity between branches and CFCs is desirable, preferably on an elective basis, it is not necessary to treat branches, especially existing branches, as CFCs for all purposes of the Code in order to achieve such parity. Doing so imposes a harsh toll charge and substantial administrative complexities as branches are transformed to CFCs as the deemed transfer of assets and liabilities of a foreign branch to a foreign corporation triggers some of the most complicated provisions of the Code. This could result in an immediate recognition of unrealized gains, and immediate recapture of prior branch losses. In considering the branch issue, we have looked at various options to avoid the complexities and other detrimental effects noted above that we would be happy to discuss further with the staff.

**f. Thin Capitalization Comments**

The industry understands the need to address potential base erosion due to "excess" leverage is problematical, but we believe that proposals based on the existing rules will address this consideration adequately and negate a need to introduce a new set of administratively complex rules and calculations, e.g., the worldwide calculation. Current rules that address "excessive" leverage are well developed, provide appropriate protections, and can easily be utilized in addressing the same issue under the proposed territorial system. This avoids the complexity and uncertainty that would inevitably occur from introducing a new set of thin cap rules, something which has occurred when other countries (such as Germany) addressed these issues. In addition, complicated rules are counter to the simplification goals of tax reform and could actually have a negative impact on U.S. competitiveness. Specifically, a worldwide safe harbor is technically complex, and is likely to provide limited relief given administrative burdens in implementation and audit. On the other hand, Section 163(j) limits the deduction for interest paid or accrued to foreign payees who are not subject to full U.S. tax on the interest received. If the debtor's debt-to-equity ratio exceeds 1.5 to 1, net interest is deductible only to the extent of

50% of adjusted taxable income (which is essentially a cash flow/EBITDA amount). These are relatively straight forward tests that avoid the administrative complexities noted above.

In summary, given that Section 163(j) provides an existing mechanism to address base erosion with respect to interest payments to foreign related parties – and that the Camp proposal already uses certain parts of section 163(j) to address base erosion – we recommend that existing section 163(j) simply be applied in full in the Camp Proposal, rather than introducing new concepts, e.g., a worldwide safe harbor. In addition, we would note that the Camp proposal would reduce the 50% limit to 40%, and not 10% as proposed by the US Treasury. We believe that using 10% to "catch" excess leverage will deviate from the well-developed standards and rules which target base erosion, is not arm's length, and will create double taxation for taxpayers

Again, we thank you for the opportunity to comment as part of this process and welcome any questions that you may have. Should you wish to discuss these points further, please do not hesitate to contact me at 202-682-8455.

Sincerely,

Stephen Comstock

Attachment

ATTACHMENT

# Oil & Gas Overseas Operations

American Petroleum Institute

March 25th, 2015

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## Overseas Upstream Operations – Distinctions with Other Industries

- Location of operations driven by resource - not tax planning
  - No U.S. base erosion issue
- Product is fungible
  - No intangible value associated with hydrocarbons
  - Prices established on commodities markets
- Operations subject to high tax rates
  - "Tax haven" entities used for non-tax business purposes
- Large capital costs up front
  - Generates host country/US timing differences
  - Access to resources highly competitive – US, Foreign, and State Owned oil companies
- Double taxation results in costs for US based companies not borne by foreign competitors

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## International Upstream Taxation

| | | All Taxpayers | Oil and Gas Companies |
|---|---|---|---|
| Foreign Tax Credits | Creditability rules under 1.901-2 | Prove creditability of taxes through criteria | Prove creditability of taxes through criteria |
| | Dual Capacity Taxpayer Rules under 1.901-2A | | Prove creditable taxes are not royalties (upstream operations) |
| FTC Limitation | Section 907 | | Separate limitation for FOGI qualifying taxes |
| | Section 904 | Overall credit limitation | Overall credit limitation |

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## International Refining Operations

- Refining is taxed locally like manufacturing
  - Capital intensive
  - Low margin commodities business
  - Typically located near resources or markets
- US Tax overlay
  - Subpart F treatment (FBCORI) on refinery exports unless derived from oil and gas extracted from same country
  - Applies only to refiners with substantial oil production
  - No "manufacturing exception" like other industries
  - Falls within the 907 FTC limitation

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# Camp Comparison – Facts and Assumptions

- Minimum tax
  - Commodity Exception
  - Retains FBCORI

| FACT PATTERN | | | | |
|---|---|---|---|---|
| Type of Income | Income | Country | Tax Rate | Taxes |
| Extraction E&P | 500,000 | A | 55% | 610,000 |
| Refining & Marketing FBCORI | 1,000,000 | B | 18% | 220,000 |
| TOTAL | 1,500,000 | | | 830,000 |

| Foreign Tax Credit Calculation | Income | Taxes | Income Subject to US Tax |
|---|---|---|---|
| Extraction | 500,000 | 610,000 | 1,110,000 |
| Refining & Marketing (FBCORI) | 1,000,000 | 220,000 | 1,220,000 |
| | | TOTAL (FOGI) | 2,330,000 |

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# Camp Comparison to Current

| | Current Law | | Camp | |
|---|---|---|---|---|
| Statutory Rate | 35% | | 25% | |
| Tax Treatment | FORI is FBCORI per (954(g)); income is FOGI and combined with extraction for 907; Full foreign tax credit under 904 | | FOGI subject to 95% exemption; FBCORI subject to current year tax at 25% | |
| Tax Result | US Tax on FOGI<br>FOGI * 35% | 815,500 | US Tax Extraction<br>Extraction *5%*25% | 13,875 |
| | | | US Tax On Refining<br>FBCORI * 25% | 305,000 |
| | Current Year FTC | (815,500) | Current Year FTC | (220,000) |
| | Residual US Tax | - | Residual US Tax | 98,875 |
| | Foreign Tax | 830,000 | Foreign Tax | 830,000 |
| | Total Tax Paid | 830,000 | Total Tax Paid | 928,875 |
| | Tax Credit Carry Forward if Foreign Tax greater than US Tax | 14,500 | Tax Credit Carry Forward | 0 |
| | Effective Tax Rate<br>Total Tax Paid/Total FOGI | 36% | Effective Tax Rate | 40% |

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# President's Minimum Tax Approach

- Minimum Tax
  - All foreign income subject 19% tax
  - ACE Adjustment
  - Reduction equal to 85% of 5 average year host country effective rate.
- For example
  - Host Country statutory rate of 55%
  - 5 Year Average Effective Tax Rate: 15% due to timing differences
  - Overall Project life ETR: roughly 55%

| 5 year average | Host | US |
|---|---|---|
| BAIT | 1,000,000 | 3,666,667 |
| Host tax paid | 550,000 | 550,000 |
| ETR | 55% | 15% |

- Main Reasons for Timing Differences
  - Host Country: IDC current expensing; Tangible costs 25% pool
  - US: IDC amortize over 10; tangible costs ADS @ 14yr

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# Minimum Tax Takeaways

- Double-taxation on income can easily happen even with averaging
  - Local timing differences can result in temporary low effective host country tax rates
  - Income ultimately taxed at high statutory rate over life of project
  - No refund of prior minimum tax available
- Additional elements exacerbate the competitiveness concerns
  - Per Country
  - Dual Capacity
  - FBCORI

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