OIL PRODUCTION, THE FOREIGN TAX CREDIT 
AND THE NATIONAL INTEREST

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The provision in our tax legislation which permits foreign
income taxes paid by U.S. citizens or companies on their foreign
earnings to be credited against their U.S. tax liabilities arising
out of these earnings has been in existence for nearly 50 years.
Its stated purpose is to minimize double taxation of such income, by
the home country and the host country of the tax payer.

With one major exception the foreign tax credit provision has
not created much controversy over the years. That exception is the
U.S. oil industry which accounts for well over half of the total
foreign tax credit claimed by U.S. business firms. The debate over
both the legitimacy and the desirability of foreign tax credits for
U.S. companies producing oil abroad has cropped up periodically since
the mid-1950's. Not surprisingly, the huge increases in taxes and
prices by the OPEC nations in 1973 and 1974 have sparked new interest
in the subject. The U.S. Treasury estimates it would have collected
about $1.2 billion in additional revenue in 1976 if there had been no
foreign tax credit provision for the U.S. oil industry.

The renewed interest has been reflected in hearings held in
October by a Congressional subcommittee headed by Rep. Benjamin
Rosenthal (N.Y.), followed by a letter to the President by 9 members
of that Committee, urging him to abolish foreign tax credits for companies producing oil in the OPEC nations. A similar request had been made earlier by Senator Church (Idaho). The entire subject is currently under active study by the U.S. Treasury.

Underlying the renewed controversy are both legal and policy questions: Do the taxes paid by U.S. oil companies to OPEC governments still qualify for tax credit, given the changed conditions under which these companies are now operating there? Is it in the national interest to continue granting foreign tax credits for tax payments to OPEC and other oil exporting nations with similar tax structures?

The legal aspect involves a number of complex issues such as these:

(1) Are the taxes paid to OPEC bona fide income taxes or are they in effect royalties or excise taxes which are ineligible for foreign tax credit treatment under the law.

(2) Should the U.S. Treasury base the calculation of the foreign tax credit on the posted prices for oil, set unilaterally by OPEC governments, or on market prices which are somewhat lower.

(3) With the past and impending nationalization of U.S. oil operations in most OPEC countries, the companies' role in some has changed from a concession operator to a contractor receiving a fixed fee per barrel of output for services rendered (such as management, technical advice, market information, etc.), and paying the standard
local income tax on that fee. The question has been raised whether the taxes now paid on the fee income are as eligible for foreign tax credit treatment as those previously paid on income from producing and marketing operations in these countries.

These issues involve interpretations of the existing law. But the interpretations could, in effect, render the law as inoperative for many U.S. foreign oil ventures as its abolition by Congress. A key question for both Treasury and Congress is therefore whether the principle of granting foreign tax credit status to tax payments in OPEC nations is in the national interest.

The current debate has focused mostly on the validity of the arguments against continuation of the foreign tax credit. These fall into three general categories: (1) equity, (2) oil import levels, and (3) allocations of exploration funds between the U.S. and foreign countries. All are based on misconceptions of the foreign tax credit or the operations of U.S. international oil companies.

The equity issue has been defined by the nine Representatives who wrote to the President, in these words: "these (foreign tax) credits place solely domestic producers who are not internationally integrated at a competitive disadvantage vis-a-vis multinationals. The latter are granted credits....not available to domestic producers."

The fact is, that in countries where the multinational oil companies still retain an equity interest in crude production, they pay both a royalty and an income tax, just as do U.S. domestic oil companies. The royalty is about in line with recent U.S. rates but the foreign tax
rate is of course much higher. In Saudi Arabia, for instance, it is 85% while the royalty is 20%. The foreign tax credit merely protects these companies from paying a further tax on these same earnings to the U.S. Treasury. It does not apply to foreign royalty payments and it cannot exceed the statutory U.S. corporate tax rate of 48%, nor can it be used to offset U.S. tax liability on foreign earnings unrelated to production. And of course, it cannot, and never could, be used to reduce the multinationals' tax liability on their U.S. domestic income. Thus, the foreign tax credit clearly does not disadvantage domestic producers relative to multinational ones. Which is why domestic producers have expressed very little concern about it.

The charge that foreign tax credits encourage U.S. oil imports at the expense of domestic output is based on the assumption that the tax credit makes foreign oil production more profitable than domestic production for multinational producers. "It then would be natural for them to allow their domestic production to decline and import more", state the Congressmen in their letter to the President.

It would make little sense for U.S. companies to do that, since on a per barrel basis the after-tax margin on U.S. crude oil production is generally significantly higher than on the companies' remaining production in the OPEC countries. In Saudi Arabia, Aramco's net margin is under 30¢ per barrel. This is less than the margin from most price controlled domestic crude oil. Thus, measured by the criterion of current cash flow, existing U.S. crude production is, by and large,
significantly more attractive than production in OPEC countries. Multinational companies have therefore no incentive to give preference to the latter over the former in supplying their U.S. refineries. In fact, the incentive is in the opposite direction.

The argument that the foreign tax credit induces U.S. multinational companies to invest more exploration and production money in the OPEC countries and correspondingly less at home reflects the same ignorance of the relative production economics in the two areas. Given current U.S. tax rates and prevailing and expected U.S. prices on newly discovered oil, it is certainly becoming more attractive to find and produce a barrel of oil in the U.S. than in most foreign countries. It is also considerably more secure. New investments in OPEC countries must therefore be geologically substantially more attractive to offset the more favorable fiscal and other conditions in the U.S. It is interesting in this connection that the 29 major oil companies regularly analyzed by the Chase Manhattan Bank increased their exploration and production expenditures in 1976 by 24% in the U.S. but by only 4% abroad. The same trend appears to hold true for 1977.

Removal of the foreign tax credit would not perceptibly accelerate this trend, since the limit on domestic exploration activities is provided much less by capital constraints than by lack of drilling prospects. Thus, without foreign tax credit, U.S. companies might drill fewer wells abroad but probably not more at home, particularly since their investment opportunities, at home and abroad, are not
limited to well drilling.

The argument of some economists that removal of the U.S. foreign tax credit would force OPEC to reduce its prices to maintain its volume of exports, is also unsound. U.S. companies currently have controlled access to less than half of OPEC's oil output, compared to over 60% in 1972. If removal of the tax provision makes some U.S. operations there unattractive, national or non-U.S. foreign companies stand ready to take over.

The arguments for continuation of the existing foreign tax credit on U.S. foreign oil operations have hardly been mentioned in the current debate. Yet, their validity determines whether the provision actually is in the national interest. There is evidence that it is. Under any realistic scenario we will continue to import large quantities of foreign oil for the next 15-20 years. Thus, both the availability of foreign oil and access to it by U.S. companies are of obvious major long-term importance to us. The more oil is found anywhere in the world the less likely is a future physical supply constraint, and the more diversified the foreign supply sources the less likely is a political supply constraint, and the more access U.S. companies have to foreign supplies the more secure will be our import requirements.

Other countries, such as Germany, Sweden and Japan, are trying to emulate the U.S. foreign oil position by subsidizing foreign exploration costs, while none are collecting taxes on the foreign earnings of their domestic oil companies. Depriving U.S. oil companies
of foreign tax credits would therefore weaken them vis-a-vis their foreign competitors in the OPEC nations and elsewhere. This would cause an eventual decline in the share of oil imported from U.S. foreign operations and a reduction in repatriated oil industry earnings which have averaged $4 billion annually in recent years.

Taking all these factors into account, it is difficult to see how an action by the Administration or Congress which will decrease the incentive for U.S. companies to find and produce oil and gas abroad, weaken their international competitiveness, but stimulate no additional domestic production, could be in the national interest.