AMERICAN PETROLEUM INSTITUTE

Modifying Dual Capacity Taxpayer Rules Leads to Double Taxation of US Companies

Foreign Tax Credit and the US tax System. Among developed nations, the United States is one of the only countries still using a worldwide tax system. This means, US-based companies are taxed on their income earned here in the US and income earned in other countries when that income is brought back to the US. However, their foreign income is also subject to taxation by the foreign country where it is earned – making it subject to two totally separate income tax regimes.

No country wants their global companies to face double taxation. Unlike a territorial/exemption regime which excludes the income outright, the US employs a foreign tax credit system, to prevent double taxation. This system recognizes that foreign income has already been subject to tax in the foreign country where income is earned such that the US tax on foreign income is reduced by legitimate income taxes also paid to the foreign government where the company operates. Without this basic mechanism, US-based companies simply could not pursue or develop foreign opportunities. Companies would otherwise face the prohibitive cost of double taxation on foreign operations, while their non-U.S. based competitors would only be taxed once.

Dual Capacity Taxpayers already face additional 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.

Dual Capacity Proposals deny taxpayer's right to be heard in court. 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. The impact can be significant, for example:

> Qatar has two income tax rates: a general rate of 10% and a petroleum rate of 35%. Proposals to modify the dual capacity rules will reclassify a portion of the petroleum tax rate as a royalty. Therefore only US based companies will pay the Qatar petroleum tax PLUS an additional 23% U.S. income tax, for an all-in rate of 58%. Non-U.S. based oil and gas competitors will pay only the 35% Qatar tax.

The current rules work. 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.

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