



Brian M Johnson MPA
Director

Federal Relations Department

1220 L Street, NW
Washington, DC 20005-4070
USA
Telephone 202-682-8409
Fax 202-682-8294
Email johnsonb@api.org
www.api.org

April 2, 2013

RE: Comments: International Tax Reform Working Group

On behalf of the American Petroleum Institute (API), the only national trade association that represents all aspects of America's oil and natural gas industry, we applaud the efforts of the House Ways & Means Committee and the International Tax Reform Working Group to understand the tax issues of concern to our industry.

Currently, America's oil and natural gas industry supports 9.2 million jobs in the United States and 7.7 percent of our nation's Gross Domestic Product. Every day we deliver on average around \$86 million to federal coffers in rents, royalties, bonus payments and income tax payments. Our effective tax rate – averaged over the years 2006 through 2011 – is 44.3 percent, well above the 35 percent general corporate tax rate.

Given the size and scope of our industry in the US, and our presence internationally, we understand that any fundamental changes to the international corporate tax code will impact our members, and the thousands of American jobs that support our international operations, our ability to compete when operating abroad, and US energy security.

In an effort to help lawmakers better understand the industry and our international activities with respect to taxation, enclosed are the following documents:

- API's general tax reform principles,
- Industry's comments on the Territorial Discussion Draft, and a
- Issue one-pager pertaining to the treatment of dual capacity taxpayers.

We hope you find these documents helpful as you work through these important issues. If you have any additional questions, please feel free to contact myself, and Stephen Comstock, Director of Tax & Accounting Policy at comstocks@api.org.

Sincerely,

A handwritten signature in black ink that reads "Brian M Johnson". The signature is stylized and cursive.

Brian M Johnson

API Tax Reform Principles

Introduction

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.

We recognize that tax reform will be a substantial undertaking and will significantly impact how businesses look at the economics of their investments. We also highlight that any new tax rules addressing America's oil and natural gas industry could directly impact the amount of energy that is produced and supplied to the economy. Therefore, in order to help frame the debate on how to approach tax reform with respect to energy, we raise the following considerations.

Domestic Pro-growth/Pro-job Considerations

The U.S. oil and natural gas industry currently supports 9.2 million jobs in the economy, over 2 million of which are supported by the refining and petrochemical segments. The industry as a whole accounts for 7.8 percent of the nation's Gross Domestic Product (GDP). One of the main reasons for this significant impact is the size and scope of the domestic capital investments which are necessary to produce and refine the energy demanded by U.S. consumers. For example, according to the U.S. Census Bureau, oil and natural gas extraction, refining and supporting activities accounted for over 13 percent of all new structure and equipment investment in 2010 – over \$100 billion¹. In addition, the top 50 exploration and production companies spent another \$100 billion on acquiring access to various U.S. properties for future development.²

Since oil and natural gas reserves are depleting resources, these substantial investments must be made on a recurring and continuous basis for the industry to maintain and continue to grow production and refining in the U.S., and to meet the economy's energy demands. Because investment needs to occur on a continuous basis, a stable and predictable stream of cash flow is critical to the economics supporting domestic projects. Given the risks inherent in the oil and gas business, and the level of the expenditures required, these costs must be recovered quickly in order for the industry to continue to reinvest in the next project or to hire new employees. The industry's oil and natural gas exploration and drilling investment analysis is very similar to the investments made by companies with a heavy concentration of research and development, where the technologies of tomorrow must be funded by the successes of today.

Therefore, any new pro-growth, pro-jobs tax regime must incorporate competitive and robust capital cost recovery provisions that take both risk and economic development goals into account. While a lower statutory rate will likely impact the after tax cash flow of all investments, we have found that in our industry there is not an exact "trade-off" between a lower corporate tax rate and the lengthening of cost recovery periods. We would

¹ 2010 Annual Capital Expenditures Survey, Table 4a, U.S. Census Bureau (released February 8, 2012). http://www.census.gov/econ/aces/xls/2010/full_report.html

² US oil and gas E&P benchmark study, 2010. <http://www.ey.com/US/en/Industries/Oil---Gas/US-oil-and-gas-E-P-benchmark-study>

API Tax Reform Principles (cont.)

note that, economy wide, a reduced tax rate can benefit existing investments (such as production from a factory already in place), but that lower rate may not provide for the continued after tax cash flow necessary to drive new investments and projected reinvestments. This is especially true if the capital cost recovery rules are significantly changed in the tax reform process.

Given the size of the oil and natural gas industry, we understand it will be impacted by any tax reform effort. But we believe it is imperative that any new tax system not specifically target any one industry over another for additional tax benefits, burdens, or costs. Using the tax code to pick winners and losers should be avoided. Specifically, within the energy sector we believe that any new tax system should not favor one form of energy at the expense of others or one type of taxpayer at the expense of others, particularly those engaged in the same activities.³ In a growing economy, all forms of energy production should be encouraged, but efforts to favor one form of energy over others should be avoided.

International Tax Reform – Territorial

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. economy⁴ 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 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 a territorial system must insure that all active operating and related income would qualify for exemption, and that all 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.

Additional Comments & Considerations

The industry recognizes the value of a lower corporate tax rate and supports movement in that direction. However, further base broadening measures used to support a lower tax rate could significantly impact the cash flow for domestic projects. As such, we are concerned that such measures could result in less domestic energy investment and ultimately undermine the goal of pro-growth tax reform. We would encourage the development of proposals that can achieve both of these objectives—lower rates and robust pro-growth capital cost recovery mechanisms.

³ The U.S. oil and natural gas industry is the only industry in which the tax rules apply differently to significant members of that industry based on size (or involvement in additional business lines such as retail marketing of gasoline or refining). Pro-growth tax reform and an efficient tax system require that tax provisions be nondiscriminatory and evenly applied among taxpayers within an industry.

⁴ Over \$70 billion was repatriated by the industry in 2009 according to IRS data.

API Tax Reform Principles (cont.)

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.

Finally, we recognize the difficulty in tackling truly comprehensive tax reform. Subject to addressing the above tax reform principles and considerations, phased corporate or individual tax reform could be a way to facilitate the process for broad tax reform. However, in all cases, targeted, isolated, or piecemeal changes should be avoided.

General Comments on Ways & Means Territorial Discussion Draft

The industry supports movement toward a territorial system that meets the guiding principle of establishing an international taxation regime that is competitive with those of the other major developed countries and thus allows U.S. based oil and natural gas companies to compete internationally with non-U.S. based companies. A participation exemption of no less than 95% would be acceptable (assuming no allocation of indirect expenses such as interest and headquarters costs.) Specific issues we wish to comment are:

1. Exempt Income Principle: Should cover all “active” income. Only passive income in the nature of portfolio type income should be taxable as a general proposition.
 - a. All operating and related income other than income that is “passive” under section 904 “basketing” should qualify for exemption as a threshold matter. Look-through and same country rules should be retained.
 - b. Foreign base company sales, services and oil related income should be exempt.
 - c. Active finance income that is not “passive basket” should also qualify for exemption.
2. Income “Basketing” Principle: Consistent with the exempt income principle, foreign income basketing in future should at most be “active” and “passive.”
 - a. No other separate 904 baskets need be maintained, and further no “sub-basketing” as under section 907 is required or appropriate.
 - b. Any U.S. tax on income that is active but for some other reason is “taxable” (either under a base erosion rule, or branch income (see below), or foreign income earned directly by a U.S. corporation without a foreign branch (e.g., without a foreign permanent establishment)) should be reduced by foreign tax credits on non-exempt income.
 - c. Transition rule for FTC carryforwards from pre-effective date years should permit utilization against future non-exempt active foreign income, as all such carryforwards by definition resulted from U.S. taxation of active income.
3. Branches: As a principle, branches should not be “deemed” to be separate corporations “for all purposes of the code.” Instead, several options exist for less complex, balanced treatment.
 - a. Option 1: Treat branch income as not qualifying for exemption like Germany, Japan, and the initial approach taken by the U.K. to its international tax reform. Branch income would be taxable in the US immediately, but under a worldwide FTC system.
 - b. Option 2: Adopt a one-time election to treat branches as not qualifying for exemption (like the current U.K. approach). For taxpayers not making the election, branch income would be treated as exempt to the extent of dividend income (e.g., foreign branch taxable income less foreign income taxes paid would be 95% exempt if that is the participation exemption percentage on dividends, with the remaining 5% being taxable immediately, i.e., not qualifying for deferral).
 - c. Option 3. Consider “grandfather” treatment of branches existing at the time of enactment for either Option 1 or 2 treatment, with non-grandfathered branch income treated as exempt to the extent of dividend income (same as taxpayers who do not make the one time election in Option 2 above).
 - d. Option 4. Treat branch income as exempt to the extent of taxable income (i.e., same as taxpayers who do not make the one time election under Option 2 above).
4. Anti Base Erosion Options
 - a. Options A and C relate mostly to intangible income issues not necessarily as applicable to oil and gas as to certain other industries.

- b. Option B is problematic—at a minimum, it should not apply where country of incorporation is different from country of operation, since many non-tax factors are involved in this business

General Comments on Ways & Means Territorial Discussion Draft (cont.)

structure. Also, the “exception” should not be limited to manufacturing in a country for domestic use—export centers need to be recognized.

5. Thin-Capitalization rules

- a. The relative leverage test creates unworkable compliance and administrative burdens.
- b. If a thin cap rule is necessary, suggest conformity with 163(j) rules currently in Code.

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

Present Law

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.

Discussion Draft Proposal

The Discussion Draft does not address section 907.

Recommendation

Section 907 should be repealed and transition rules should be adopted consistent with Section 313(c)(2) of the Discussion Draft.

Discussion

The recommendation is consistent with the goal of simplifying the international tax area. The recommendation is also consistent with Section 313 of the Discussion Draft, which eliminates the separate category limitations contained in Section 904.

Furthermore, the underlying policy rationale for section 907 is no longer relevant in a territorial system of international taxation. The Joint Committee explains that section 907 was “designed to address the perceived problem of “disguised royalties” being improperly treated as creditable foreign taxes... In addition, the section 907 rules have also been described as intended to prevent the crediting of high foreign taxes on FOGEI and FORI against the residual U.S. tax on other types of lower-taxed foreign source income.”⁵ Under the Discussion Draft, high taxed oil related income should qualify for the dividend exemption, and therefore, no foreign tax credits could be claimed for the foreign taxes attributable to such income. Accordingly, the “disguised royalties” and “high foreign tax” issues no longer exist, and therefore, there is no reason to retain Section 907.

⁵ Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 110th Congress, p. 359.

Foreign Base Company Oil-Related Income

Present Law

The Technical Explanation of the Discussion Draft sets forth a summary of the Subpart F rules and lists the categories of foreign base company income, including foreign base company sales income, foreign base company services income and foreign base company oil-related income.

Foreign base company oil-related income (FBCORI): 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.

The FBCORI rules do not apply to a foreign corporation that, together with related persons, does not constitute a large oil producer (i.e. does not produce greater than 1,000 barrels of oil equivalent per day). Unlike foreign base company sales income, there is no manufacturing exception for FBCORI.

There was little, if any, justification for enactment of these rules back in 1982. These rules have nothing to do with U.S. base erosion or the shifting of mobile income because 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.

Recommendation

The FBCORI category of foreign base company income found in sections 954(a)(5) and (g) should be repealed.

Discussion

The FBCORI rules do not belong in a competitive territorial system. The purpose of the Subpart F rules is to prevent U.S. base erosion by 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. Yet, the FBCORI rules do not provide an exception for these activities such as the manufacturing exception that exists for other industries under the foreign base company sales income rules. There is no reason why these investments should be treated any differently than those in other industries. Concerns about mobile income in the oil industry are no different than those for other industries, and therefore, no special rules for the oil industry are required

Not only do these rules treat 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. Under what logic is the income of one refiner who happens to engage in production activity considered mobile while the exact same income of its competitor, who is not a large producer, not considered mobile?

The FBCORI rules should be repealed and the American oil industry treated the same as every other industry.

CFC and Branch Treatment

Background

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 and instead operate as a branch.

Furthermore, branches typically have less burdensome reporting and disclosure requirements than a local entity. In addition, it is sometimes easier to transfer funds into and out of a local branch rather through a local entity. Finally, there can sometimes be local tax benefits to using a branch. For example, some countries have a lower withholding tax on branch remittances than on dividends. At the end of the day, the decision on whether to use a branch or local entity depends on many factors but most of the critical ones will relate to local issues.

Proposal

The proposal treats any first tier “foreign branch” as a CFC for all purposes of the Code⁶. This results in the following consequences:

1. The assets and liabilities of a branch are deemed to be transferred to a foreign corporation, and the reorganization provisions of the code, including section 367, apply to the transfer.
2. The domestic corporation is deemed to be a U.S. shareholder of the deemed CFC.
3. Non-subpart F income generated in a foreign branch would be eligible for deferral.
4. “Payments treated as dividends” between the deemed CFC and the deemed U.S. shareholder are eligible for the new dividends-received deduction.
5. All rules applicable to intercompany transactions, including section 482, apply to transactions between the deemed U.S. shareholder and the deemed CFC.
6. Subpart F income of the foreign branch is immediately taxable and foreign tax credits may be claimed only for the foreign taxes incurred by the foreign branch that are attributable to subpart F income.

The proposal aims to create parity between foreign operations conducted in branch form and foreign operations conducted in a CFC. It is believed that treating all foreign branches as CFCs for all purposes of the Code would achieve this parity and would prevent abusive tax planning through “cherry-picking” of operations to be conducted in branch form versus corporate form. It should be noted that since branches do not qualify for the deferral benefit that CFC treatment affords, there is a logical basis for not otherwise trying to achieve “parity” with CFCs. Thus, some alternative approaches, like that of Senator Enzi—and like those of certain other

⁶ The technical explanation provides that “[i]t is intended that the rules and principles applicable in determining whether a foreign corporation is engaged in a U.S. trade or business govern whether foreign business operations constitute a foreign branch.”

countries—do not treat branches and CFCs precisely the same, and of course, our own tax laws have historically treated them differently.

CFC and Branch Treatment (cont.)

In addition, if the goal of international tax reform is to move towards a competitive territorial system that solves the lock out effect and protects the US tax base, then it is not necessary to move branches to an exemption system to achieve those goals. Thus, while some may view parity as an admirable objective, it should not be an end goal of itself. However, 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 on branches. This actually introduces a “disparity” in treatment, particularly as it punishes existing foreign operations that happen to be conducted in branch form. The sections below outline the specific concerns with the proposal and propose options for a more equitable approach.

Concerns with the proposal

The technical explanation provides that “[i]t is intended that the rules and principles applicable in determining whether a foreign corporation is engaged in a U.S. trade or business govern whether foreign business operations constitute a foreign branch.” The first issue that taxpayers will face is whether their foreign operations rise to the level of a foreign branch. Once that issue is resolved, the next question is what functions, assets and liabilities comprise the foreign branch? It can be challenging to identify the functions, assets and liabilities that belong in a foreign branch. Consider the case of a U.S. corporation with active headquarters and branch operations, some foreign and some domestic. Today’s rules handle such a case by directly allocating certain costs, regardless of where incurred, to branch income when such costs are solely for the benefit of the branch. Other costs, such as G&A, R&D and interest are more difficult to identify with a specific operation, and therefore, are apportioned throughout the entire entity. By treating foreign branches as a CFC, branch functions and liabilities that benefit all operations of the taxpayer would need to be allocated in some way into the separate “deemed entities”—something not required under today’s rules and arguably undermining the appropriate apportionment of these costs.

Once identified, the assets and liabilities of a foreign branch are deemed to be transferred to a foreign corporation. 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, and could result in an immediate tax liability from any number of them. These tax liabilities can be divided into two categories: (1) immediate recognition of unrealized gains (357(c), 367(a)(3) & (d) and 987)), and (2) immediate recapture of prior branch losses (367(a)(3)(C), 904(f) and 1503(d)). Each of these provisions is briefly discussed in the attached appendix.

Aside from the potential tax liabilities, the deemed outbound of the foreign branch will result in burdensome reporting requirements on the initial transaction and on an ongoing basis. This includes reporting under the general non-recognition provisions of the code, as well as section 367 and the 6038B regulations. In addition, branch operations would now be subject to reporting under Form 5471, which was designed for actual CFCs.

Some branches may require the creation of new accounting systems in order to identify and calculate “payments treated as dividends.” In addition, a branch would be required to separately calculate subpart F income in the same manner as though it were a CFC. Furthermore, providing an exemption to branch earnings puts more pressure on the pricing of intra-company transactions and triggers section 482 concerns where none existed before.

CFC and Branch Treatment (cont.)

Recommendations

We present five options, all of which provide an alternative to treating branch as CFCs for all purposes of the Code. Each alternative would avoid the complexities and other detrimental effects noted above that arise from the “deemed CFC” approach.

Option 1: Keep the current rules for all branches

The existing worldwide system of taxation works as intended for the oil and gas industry. The current foreign tax rules prevent double taxation of our foreign earnings and the foreign tax credit limitation, in conjunction with the section 861 allocation and apportionment rules, protect the U.S. tax base. Because the industry does not generally need to rely on deferral, it is not impacted by the lock out effect. Thus, from the industry’s perspective there is no policy reason for moving towards a territorial system. We recognize, however, the lock out effect is a problem for many other taxpayers and that continued reliance on deferral is not providing the competitive type of system American companies need to compete in the global economy. Therefore, the industry understands the need to do away with over reliance on deferral and switch to a dividend received deduction for CFCs, even though such a system (under the current 95% exemption proposal) would result in guaranteed double taxation of 5% of our foreign earnings. But the pressure for reform that exists for CFCs does not exist for branches. If the major goals of international tax reform are to solve the lock out effect and move to a competitive territorial system, then there is no reason to change the treatment of branches. The lock out effect only presents itself when there is deferral, but branch income cannot be deferred. The branch rules go back almost one hundred years (and some of our branch operations go back almost as far). They fit within a framework of tax principles that are understood by taxpayers and auditors alike. While we have identified some of the concerns for changing the treatment of branches, there are likely additional as yet unidentified issues that will arise from such a fundamental change. We urge following a conservative principle in tax reform and only changing those provisions that need to be changed in order to achieve the overall objective, and respectfully suggest that the branch rules do not meet those criteria.

We do recognize that continuing the different treatment for branches and CFCs may lead to legitimate concerns about future tax planning and that it is appropriate to address those concerns. We point to the recent international tax reform proposal submitted by Senator Enzi. Senator Enzi’s proposal maintains the current tax rules for branches, but then directs the Treasury to issue regulations that would prevent the “inappropriate” planning through the use of branches. We believe that this more limited approach for reforming the tax treatment of branches is the correct one and would avoid many unnecessary and unintended complications. We also point out that other countries, such as Germany and Japan (and the UK on an elective basis), treat branch income as not qualifying for exemption. Surely, these countries share the U.S.’ concerns with base erosion, yet they have managed to make their systems work.

Option 2: A one-time election to treat branches as not qualifying for exemption

This follows the approach in the UK. This option would give taxpayers the choice to either change to a new exemption system or elect to stay with the current system (modified as necessary by Treasury regulations) for all of its branches.

Branches not electing to remain with the current system would be subject to an exemption system that does not take them all of the way to CFC status.⁷ Treating a foreign branch as a CFC for all purposes of the Code is

CFC and Branch Treatment (cont.)

unnecessary in order to extend the benefits of territorial system to foreign branch operations. The industry believes that the benefits of territoriality can be extended to foreign branches in the following manner:

1. Foreign branches would continue to calculate taxable income and loss as under current law.
2. A [95%] exemption would be applied to net foreign branch taxable income.
3. [95%] of net foreign branch loss would be disallowed.
4. Foreign tax credits would not be available for foreign taxes that are attributable to income eligible for exemption.
5. Each branch's subpart F income will be calculated as if it were a CFC. Such income would not be eligible for the exemption but the taxpayer would be entitled to claim foreign tax credits for taxes attributable to such income.
6. Appropriate rules would be needed to address intra-company (branch to branch) transactions and to ensure the proper allocation and apportionment of more general expenses.

This recommendation avoids unwarranted complexity and costs from a deemed outbound of an existing branch, and would achieve rough parity with a CFC, except no deferral would be afforded to any branch income. In contrast, the current proposal, which would force a foreign branch to immediately recognize certain unrealized gains and to recapture prior losses, is actually contrary to the overall policy goal of treating foreign branches and CFCs similarly. The proposal would not cause the immediate recognition of unrealized gains for CFCs when the switch to an exemption system becomes effective. Why then should foreign branches be required to recognize such gains? To keep parity between CFCs and foreign branches, the answer is that they should not have to. The recommended approach avoids the problem by simply avoiding the deemed outbound of the foreign branch. As a result, provisions such as 357(c), 367 and 987 would not be implicated, and therefore, no resulting tax liability. This solution satisfies the goals of both policy makers and taxpayers. The overriding policy goal of treating foreign branches the same as CFCs is accomplished while at the same time taxpayers avoid undue complexity and potentially severe and non-uniform transition costs.

To the extent it is desirable to maintain the potential for recapturing prior branch losses; the recommendation preserves the ability to do so without immediately triggering the recapture. For example, the exemption amount could be reduced in the appropriate case as a way to recapture prior losses. The industry recommends, however, that the recapture rules be reviewed and modified to ensure that only branch losses that created an actual U.S. tax benefit are subject to recapture.

Under the recommendation, active income earned in both foreign branches and CFCs would be eligible for a 95% exemption; either directly applied to taxable income, in the case of a branch, or in the form of a dividend received deduction, in the case of a CFC. The recommendation does not achieve perfect symmetry between branches and CFCs. Income earned in a foreign branch is not eligible for deferral, while 5% of losses incurred in a foreign branch can be deducted against other income. Taxpayers would likely weigh these factors in making their entity selection but given the modest amounts, i.e. only 5% of net income or loss; it seems unlikely that they would cause significant "cherry picking".⁸ Avoiding the establishment of new rules and accounting systems to identify and calculate "payments treated as dividends" justifies this slight loss of perfect symmetry.

⁷ The industry also recommends expanding the scope of the exemption system to all non-passive foreign income, including section 863(b) type income.

⁸ Another small benefit for a branch would be to avoid the additional tax burden imposed on the distribution of previously taxed subpart F income from a CFC.

The recommendation does not entirely avoid imposing complexities on existing branches. To approach parity between CFCs and branches, a branch would be required to separately calculate subpart F income in the same

CFC and Branch Treatment (cont.)

manner as though it were a CFC. In addition, rules would be needed to ensure headquarters-type costs (like G&A and R&D) and other fungible expenses (such as interest expense) are treated appropriately.

Option 3: Continue current rules only for existing branches

Another option is to do away with the election but continue current rules only for existing branches. One way to address the issue of inappropriate tax planning with branches under a new territorial system is to limit the current rules to only existing branches. Because these branches existed prior to the enactment of a territorial system it should be clear that they were not put in place to “game” the new system.

Option 4: A one-time election to treat existing branches as not qualifying for exemption

Same as Option 2 above but only for existing branches and for the same reasons as stated in Option 3 above.

Option 5: Exemption applied to all branches

Under this approach, all branches would be forced into the exemption system described in Option 2. above.

Appendix

Section 357(c) – Unrealized gains from liabilities in excess of tax basis

While the deemed transfer should qualify under one or more of the nonrecognition provisions of the Code (i.e. section 351 or 361), that is not the end of the story. Depending on the mix of assets and liabilities that are deemed transferred, taxpayers would be required to recognize gain under section 357(c) if the liabilities transferred to the deemed CFC exceed the tax basis of the assets transferred.

Section 367(a)(3) & (d) Unrealized gains

Section 367(a)(1) turns off the nonrecognition provisions of sections 351 and 361 when property is transferred to a foreign corporation at a gain. Subject to certain modifications, Section 367(a)(3) turns those provisions back on when the transferred property is to be used in the active conduct of a foreign trade or business. Given that only foreign branches would be subject to the deemed transfer and given that the definition of a foreign branch will require the existence of a foreign trade or business, it is likely that the deemed transfer will meet the requirements of section 367(a)(3). As a result, the code’s nonrecognition provisions will apply to the deemed transfers, but so will certain toll charges and recapture requirements imposed by section 367.

In general, these toll charges are designed to deny the benefits of deferral to any built in gain existing in certain types of property transferred to a CFC in a nonrecognition transaction. This is done by recognizing unrealized gain on such property on the date of transfer. The types of property subject to the immediate recognition of unrealized gain are listed in 367(a)(3)(B)(i) through (v) and include such items as inventory-type property and certain installment obligations, account receivables, foreign currency instruments and leased property. In

addition, section 367(d) requires that gain be recognized on any intangible property, within the meaning of section 936(h)(3)(B), that is transferred to the CFC.

CFC and Branch Treatment (cont.)

Section 987 – Unrecognized Foreign Currency Exchange Gain/Loss

Another provision that could accelerate the recognition of unrealized gains is section 987. The foreign branch likely constitutes a qualified business unit (QBU) under section 987 and if the functional currency of the branch is other than the U.S. dollar, then the translation of the QBU's taxable income or loss into U.S. dollars is governed by section 987. Section 987 also governs how foreign currency exchange gain or loss is calculated with respect to remittances between the QBU/branch and the home office. The deemed incorporation of the branch will likely be treated as a termination of the QBU. The termination of a QBU triggers recognition of all unrecognized foreign currency exchange gain or loss remaining in the QBU/branch.

Section 367(a)(3)(C) – Recapture of branch losses

In addition to the section 367 toll charges described above, section 367(a)(3)(C) requires the recapture of previously deducted branch losses. It is important to note that only branch losses that have reduced foreign source income are subject to this rule. Foreign losses that reduced U.S. source income are subject to the recapture provisions of the overall foreign loss rules of section 904(f), which trump the section 367 recapture rules.

Section 904(f) Overall Foreign Loss Recapture

In the case of a taxpayer that has an overall foreign loss that reduced U.S. tax on U.S. source income, up to 50% of the taxpayer's future foreign source income is subject to characterization as U.S. source income under 904(f)(1). Furthermore, a complete recapture of any remaining overall foreign loss is required when the taxpayer disposes of property that has been used in a foreign trade or business, even if such disposition otherwise qualifies for nonrecognition treatment.

Section 1503(d) Dual Consolidated Loss Recapture

The foreign branch likely constitutes a separate business unit (SBU) under section 1503(d)(3), and therefore, prior branch losses, if any, also would be subject to the dual consolidated loss rules. To the extent that the taxpayer has previously deducted branch losses against consolidated income, the deemed incorporation of the foreign branch would probably trigger the recapture of those losses. This is unlikely to cause a great deal of concern, however, because the recapture provisions of sections 367 and 904, discussed above, both trump section 1503(d). Accordingly, only losses not already recaptured under those provisions would have to be recaptured under 1503(d).

Prevention of Base Erosion: Option B

Discussion of Draft Proposal

Option B of the proposal will treat certain low-taxed income (as defined by Option B) earned by a controlled foreign corporation (CFC), even if active income, as Subpart F income and not subject to the participation exemption. In addition, the proposal notes that a foreign tax credit is allowed for foreign tax “imposed on income included under Subpart F.” Includible income under Option B is income that is:

1. Neither derived in an active trade or business within the country of incorporation (“home country exception”); nor
2. Subject to an effective tax rate of at least 10%.

For these purposes, the home country exception is a three-prong test:

1. Income must be derived from the conduct of an active trade or business within the jurisdiction in which the CFC is incorporated;
2. The CFC must maintain an office or fixed place of business (e.g., permanent establishment in the treaty context); and
3. Activities must serve the local market of the home country, either through use of property in the home country or provision of services to people or for property located within the country.

Potential Impact of Proposal

The Technical Explanation of the participation exemption system proposed by the Ways and Means Committee explains that the exemption is intended to apply only to “income from the conduct of an active foreign business,” and not to “passive or highly mobile income,” which would continue to be subject to the Subpart F rules. This correctly articulates the principles that should be applied to balance the objectives of competitiveness and anti-base erosion. However, Option B does not adhere to these principles, because it potentially would include a broad category of “income from the conduct of an active foreign business” as Subpart F that is neither “passive” nor “highly mobile.”

Option B targets cross-border operations that are subject to a low effective rate of foreign tax. The nature of the oil and gas industry requires that its operations span national borders and, as a result, certain active foreign business income could be treated as Subpart F under Option B. The foreign business activities of the industry that could be impacted result from operations with geographically mandated locations, as opposed to those that have shifted from the United States to foreign jurisdictions, because of low foreign tax rates.

Option B’s potential impact on cross-border active business operations is inconsistent with improving the competitiveness of the US tax system. Global businesses, both U.S. and foreign-based, structure regional headquarters, service companies, and manufacturing operations (e.g., extraction and refining) to manage their companies effectively and economically, as opposed to investing in infrastructure in every market. Requiring a US company to satisfy a minimum tax test on its cross-border income will subject real, substantial and active foreign business activities of US companies to an additional tax burden that would not be imposed by the home countries of our major competitors.

An effective tax rate test is overly-broad, which can create arbitrary results in determining what is eligible for the exemption. Consider two taxpayers engaged in the same active foreign business each outside the country of incorporation of their respective CFCs. Taxpayer A has an effective tax rate of 9%, and Taxpayer B has an

Prevention of Base Erosion: Option B (cont.)

effective tax rate of 11%. Under Option B, Taxpayer B would not have Subpart F income, while Taxpayer A would not qualify for the exception.

For purposes of Option B, the effective tax rate of a CFC is determined under US tax principles, which implies that adjustments to earnings & profits (E&P) would be taken into account. Therefore, the effective tax rate could be impacted in a given year by the significant differences in cost recovery periods for CFCs under US rules compared to local country law or by items that are disregarded solely for US tax purposes. Industries requiring significant capital investments in infrastructure and debt-financing could be particularly sensitive to these adjustments. The result would be a US taxpayer with active foreign business income, even if subject to an effective foreign rate above 10% over the life of a project, being penalized because of a particular snapshot in time.

Under Internal Revenue Code § 954(g), foreign based company oil-related income (FBCORI) includes non-extractive, yet active, oil and gas business activities (e.g., transportation, refining, sales and services), which give rise to Subpart F income if not associated with extraction activities in the same country. This current category of active Subpart F income should be eliminated. However, if replaced by Option B, a broader category of active foreign business income could be treated as Subpart F than under the current foreign based company income rules. Similar to the current FBCORI rules, which differ from the current foreign based company sales and services income rules of §§ 954 (d) and (e), respectively, Subpart F income under Option B is not limited to transactions involving related parties. Unlike the FBCORI rules, Option B does not provide an exception for activities associated with same country extraction. Therefore, under Option B not only would certain FBCORI activities continue to be treated as Subpart F, but foreign oil and gas extraction income (FOGEI) could be included in certain instances. Examples of active foreign business income from oil and gas activities that could result in non-exempt Subpart F income under Option B are included below.

Examples of Active Income Potentially Covered by Option B

1. Extraction

Fact Pattern: Company undertakes extraction activity in an African country. For non-tax business reasons (e.g., ability to more freely remit cash), Company determines that it will not use a local country entity and incorporates a CFC in an offshore jurisdiction to hold its local country investment. CFC sells the extracted product in Africa for export.

Result: CFC would have active business income but may not meet any of the prongs of the home country exception and would have to rely on the effective tax rate test. Even if the income is subject to a high statutory rate of tax, price changes or differences in cost recovery periods between the US and the foreign jurisdiction, could result in an effective rate that falls below the 10% threshold in a given year. Natural resources must be developed in the country in which they are found and investment in these countries should not be viewed as an erosion of the US tax base. Taxing it as Subpart F income, as the proposal could, would expand the rules of the current system, achieve an improper result in terms of base erosion and make the US tax system even less competitive than those of other countries.

2. Refining

Fact Pattern: CFC, incorporated in a country within a geographic market, owns a refinery. CFC sells refined product to multiple jurisdictions. Because of the cost and logistics associated with

Prevention of Base Erosion: Option B (cont.)

transportation of both the feedstock (crude) and the end products, it is often most efficient to refine in a country proximate to the market for product. Accordingly, foreign refineries supplying product to multiple jurisdictions is typical in Europe and Asia.

Result: CFC would have active business income and a fixed place of business in its country of incorporation. However, because use of much of the product will be outside of the home country, CFC could not meet the third prong of the home country exception with respect to income on that product and would have to rely on the effective tax rate test. If the foreign jurisdiction has favorable tax provisions (e.g., immediate write-off of capital investment), then the effective rate could fall below the 10% threshold for a number of years and such active income would be taxable. The geographic proximity of major investments in refining assets to the local and regional markets they supply should not be viewed as an erosion of the US tax base. Therefore, to tax it as Subpart F income would achieve an improper result and make the US tax system even less competitive than those of other countries.

3. Pipeline

Fact Pattern: CFC invests in a 50% interest in a transnational pipeline controlled by a National Oil Company (NOC). CFC is required to fund its share of construction costs and to loan the pipeline consortium an amount to cover NOC's costs. The cost recovery period for US E&P adjustments is longer than the local cost recovery period. The accelerated recovery period and debt cost in the consortium drive the effective tax rate below 10% for the CFC. When complete, CFC will earn income from use of the pipeline by third parties and will pay tax in the jurisdiction of incorporation, as well as in each country through which the pipeline runs.

Result: CFC would have active business income in its country of incorporation and would have a fixed place of business via the pipeline in every country in which it earns income. However, not all income would be earned in the country of incorporation. Accordingly, for income earned in other jurisdictions, CFC would have to rely on the effective tax rate test. Even though the income is subject to tax, differences in cost recovery periods between US and foreign country rules could result in an effective rate that consistently falls below the 10% threshold. Natural resources must be developed in the country in which they are found and production must be transported to market in the most economic manner (e.g., via a pipeline). This activity should not be viewed as an erosion of the US tax base. Therefore, taxing this active business income as Subpart F would achieve an improper result and make the US tax system even less competitive than those of other countries.

The examples describing "regional" refining and transportation (pipeline) income are not describing business activities that are unique to the oil and gas industry. Refining is similar to other manufacturing activities and transportation by pipeline of production (from extraction or manufacturing) is the manner in which products get to market. Like manufacturing, the extractive industry requires enormous capital investment and tangible assets. What is unique to the industry is how geography dictates where substantial foreign investment is required. Location of natural resources is what drives capital investment decisions.

Recommendation

Option B does not effectively differentiate between active foreign business income and passive or highly mobile income and leads to arbitrary results. As such, it does not appropriately address the base erosion issues, which

Prevention of Base Erosion: Option B (cont.)

is the stated intent of the proposal. Therefore, we recommend that Option B be eliminated. The home country and minimum foreign tax test that Option B places on cross-border operations ignores the realities of the global economy and how multinational companies operate within it. Capturing such a broad base of active foreign business income will make US companies less competitive.

Under the stated principles of the territorial proposal, all active foreign business income should be afforded the benefits of that regime. However, if there is a concern about highly mobile income qualifying for the exemption, even if active business income, then the exception should focus on the substance of the operations generating such income (e.g., are tangible assets involved in deriving the income). For example, an anti-base erosion rule could be drafted to exclude income earned by a CFC, if: (1) that CFC owns substantial tangible assets (without regard to whether those assets are owned in the country of incorporation); and (2) those assets are a material factor in the realization of such income (whether output is sold within or without the country of incorporation). Maintaining a home country exception and effective tax rate test as safe-harbors could be useful to provide clear guidance and minimize audit disputes, but it should not be used as an irrefutable presumption of Subpart F income.

Other Base Erosion Options

Options A and C address income earned from exploitation of intangibles. Option A addresses transferred intangibles generating excess returns. Option C defines a broader base of intangible income, because neither a transfer from a US person nor excess income is required in order to generate the newly defined Option C category of “foreign base company intangible income”.

Any base erosion proposal involving intangible income should not apply to income from commodity products, since it is unlikely that proprietary intangibles have contributed to the value of such commodities. This is true even if exploitation of technology was involved in the production or manufacture of those products. Thus, if Options A or C are progressed, safe-harbor provisions should be added that exclude commodity products and other manufactured goods where little or no commodity value is attributable to intangibles. These safe-harbor provisions would still allow Options A and C to effectively target the type of income that is of most concern (i.e., income generated primarily from the exploitation of highly-mobile technology).

Summary

Option B could expand the scope of active foreign business income that is treated as Subpart F as compared with the current rules, which is inconsistent with the principles of a territorial system. With respect to the oil & gas industry, the burden created by subjecting any active foreign business income to the Subpart F regime will result in incremental cost and create a significant competitive disadvantage in the international marketplace. US companies, particularly those in the oil & gas industry, face increased competition from NOCs, which are some of the largest oil & gas companies in the world. When US companies compete for access to resources or markets in foreign countries, their competitors look only to the local tax rate when assessing the total cost of investment. Accordingly, any incremental US tax puts US multinationals at a disadvantage with respect to their cost structures. Competitiveness is not achieved by limiting a US multinational’s ability to operate in foreign jurisdictions in a cost-effective manner, especially when substantial investment is required to conduct its business.

Thin Capitalization Comments

Overview

In the context of overall tax reform and the proposed territorial system, the House Ways & Means Committee Summary accompanying the Camp Proposal includes “[t]hin capitalization rules that prevent U.S. companies from borrowing heavily in the United States (generating tax deductions to reduce taxes on their U.S. income) to finance income from overseas operations (which is eligible for the 95% exemption).” While we understand the need to address potential base erosion due to “excess” leverage, we recommend that the Committee adopt existing rules that address the same consideration, rather than introducing a new set of administratively complex rules and calculations.

Camp Proposal

On October 26, 2011, the House Ways and Means Committee released a draft plan (the “Camp Proposal”) to move the country to a territorial system of taxation and reduce the corporate tax rate to 25%. The Camp Proposal would limit the deductibility of net interest expense of a U.S. corporation that is a shareholder of a controlled foreign corporation (CFC) if both the CFC and U.S. Corporation are members of a worldwide affiliated group (50% common ownership) that fails each of two tests: (1) the U.S. group is overleveraged relative to the worldwide group; and (2) the U.S. company’s net interest expense exceeds a certain (yet to be specified) percentage of adjusted taxable income.

The Technical Explanation to the Camp Proposal states that “net interest for these purposes is defined in section 163(j)(6)(B) as the excess of interest paid or accrued over the interest includible in gross income for the taxable year.” The Technical Explanation also states that that the required “computation of adjusted taxable income...is taxable income increased by deductible losses, interest, depreciation and amortization, qualified production expenses and other items prescribed in section 163(j)(6)(A).” Finally, the Technical Explanation provides that “whether interest expenses exceed the prescribed percentage of adjusted taxable income is determined company by company, as is the actual disallowance of deduction.”

Section 163(j)

Section 163(j) was enacted in 1989 to limit the US tax impact of certain “earnings stripping” transactions involving excessive interest payments to related parties. Section 163(j) provides both a safe harbor to determine if there is excessive debt, and a comparison of net interest expense as a percentage of adjusted taxable income to limit the amount of deductible interest expense. Under Section 163(j), if a taxpayer’s debt to equity ratio is less than 1.5 to 1 (computed using tax asset basis rather than fair market value) it will meet the safe harbor rule and its interest expense will be fully deductible. Further, in making this calculation, section 163(j)(6)(C) provides that all members of the same group will be treated as one taxpayer; therefore, all section 163(j) required computations are made on a U.S. tax consolidated basis, i.e., the separately determined debt and assets of each US member are determined as of the end of the consolidated year and aggregated. This safe harbor ensures that only excessive debt is targeted; in addition, the safe harbor provides a failsafe for those companies in industries that are more highly leveraged but don’t have significant depreciable or amortizable assets, and thus could suffer greater disallowances under the 50% “percentage of income” test.

When the taxpayer fails to meet the safe harbor, i.e., where the payor's debt-to-equity ratio exceeds 1.5 to 1, a deduction for "disqualified interest" is disallowed to the extent of the payor's "excess interest expense, defined as the amount in excess of 50% of adjusted taxable income (which is essentially a cash flow/EBITDA amount). Again, the calculation of adjusted taxable income is also done on a US tax consolidated group basis. This

Thin Capitalization Comments (cont.)

calculation is based on taxable income, and adds back certain deductible items (as noted above) to derive a functional cash flow amount to limit excessive interest expense.

Recommendation

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.

Similarly, applying the rules on a separate company rather than a tax consolidation basis adds enormous complexity and arguably does not provide the correct result to the extent it would differ from a tax consolidation approach. 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 or separate company calculations.

LOSING OUR EDGE – How Current Attempts to Double Tax Profits Will Cost American Jobs and Decrease International Competition

To ensure that income earned in other countries by US-based companies is not taxed twice, U.S. tax law provides for an offset or foreign tax credit (FTC), for income taxes already paid on that income to those foreign governments. This is necessary since, unlike most OECD countries, the U.S. continues to tax the worldwide income of its residents and corporations. Without this foreign tax credit, US-based companies would be substantially disadvantaged when trying to develop foreign opportunities. Specifically, companies would face the cost of double taxation on foreign operations, while their competitors would only be taxed once.

The Obama Administration’s FY2012 budget, and certain Congressional proposals, would deny the FTC to American oil & gas companies doing business overseas – subjecting them to double taxation.

How would this work? These proposals would deem outright that, any time a US-based company is forced to pay a higher-than-standard tax rate in a foreign country, any amount above that rate could never be a payment for an income tax. This would result regardless of whether the taxes otherwise met the US definition of an income tax and regardless of the sovereign intent of the foreign country. Further, this rule would only apply to US based oil and gas companies.

For example: In a country like Qatar, with an income tax rate of 10% on non-energy companies and a 35% energy company tax rate, an American energy company investor would pay the 35% Qatar tax PLUS an additional 18% U.S. tax, for an all in rate of 53%, while competitors from the UK, China, or Russia would pay only the 35% Qatar tax. This differential simply makes American companies uncompetitive

What would happen? Oil and gas companies cannot pick which countries they will operate in based on their tax regime; they must go where the resources are, not where the tax is the lowest. By denying full creditability in this arbitrary manner, the proposed will:

- Render some existing foreign investments unprofitable while immediately decreasing the value of others – but will do so only for US-based oil & gas companies;⁹
- Immediately disadvantage American based companies and actually favor foreign competitors;
- “Directly harm U.S. energy security in an environment where the U.S. imports roughly 60 percent of the oil it consumes;¹⁰” and
- **“Translate directly into a loss of U.S. jobs . . . and a reduction in domestic activity at a crucial state of U.S. economic recovery.”¹¹**

What should be done? Nothing – longstanding rules have focused on creditability concerns and already place the full burden of proving the creditable nature of a tax payment to a foreign country on the US based taxpayer. If there is **any** doubt that such a payment is not a tax (e.g. a "disguised royalty,") then the US-based oil company is prevented from claiming a credit. However, denying treatment of a payment as an income tax, for no reason and where the taxpayer can in fact prove it is an income tax, will result in double income taxation for American based oil and gas companies – costing US jobs and compromising energy security.

⁹ *Economic and Foreign Policy Implications of the Administration’s “Dual Capacity Taxpayer” Proposals.* Split Rock International, Inc. July 2010.

¹⁰ *Ibid.*

¹¹ *Ibid.*

For more information, visit [API.org](https://www.api.org)