The Foreign Tax Credit for American Oil Contractors in Indonesia: An Allocation Approach

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THE FOREIGN TAX CREDIT FOR AMERICAN OIL CONTRACTORS IN INDONESIA: AN ALLOCATION APPROACH

The Internal Revenue Code subjects American corporations to federal income taxation on all income from foreign sources but allows the corporate taxpayer a credit for income taxes paid to foreign governments. Subject to certain maximum limitations on this foreign tax credit, the American corporate taxpayer may offset its United States tax liability by the amount of the foreign income tax on a dollar-for-dollar basis. However, this favorable tax treatment applies only to foreign levies which qualify as a foreign income tax under the statutory requirements; a levy which does not qualify is merely deductible.

American oil companies have generally enjoyed favorable United States tax treatment of foreign income derived from oil production, because the Internal Revenue Service has upheld the creditability of most of the income taxes imposed by the foreign host governments which harbor the major international oil reserves. Since most host

1. I.R.C. § 11, as amended by Tax Reform Act of 1976, Pub. L. No. 94-455, § 901(a), 90 Stat. 1606 (hereinafter all sections of the I.R.C. amended by the Tax Reform Act of 1976 are cited as if codified). For taxable years ending before January 1, 1978, corporate income is taxed at 20 percent on the first $25,000 of taxable income, 22 percent on the next $25,000, and 48 percent on taxable income in excess of $50,000. Id.
4. As an alternative to the credit, I.R.C. § 164(a)(3) provides that otherwise creditable foreign income taxes may be treated as a deduction. Since the credit offers the more favorable tax treatment, the deduction alternative is usually not elected unless the taxpayer suffers foreign losses. See Comment, Operation of the Foreign Tax Credit in the Petroleum Industry: A "Dry Hole"?, 15 Va. J. Int'l L. 421, 438 (1975). I.R.C. § 275(a)(4) prohibits the deduction of income taxes for which credit treatment is elected. The Tax Court has held that no part of any income tax for which a credit is claimed can be allowed as a deduction. Mary A. Maraman, 18 T.C. 1, 16 (1952), rev'd on other grounds, 205 F.2d 335 (4th Cir.), rehearing denied per curiam, 205 F.2d 43 (4th Cir. 1953).
5. I.R.C. § 164(a)(3) allows a deduction for levies which qualify as foreign taxes; levies which are not taxes but royalties paid to a foreign government as landowner may be excluded from gross income, resulting in tax treatment equivalent to a deduction. See I.R.C. § 613(a); Kirby Petroleum Co. v. Commissioner, 326 U.S. 599, 604 (1946); Helvering v. Twin Bell Oil Syndicate, 293 U.S. 312 (1934). See also C. BREEDING & A. BURTON, INCOME TAXATION OF NATURAL RESOURCES 813 (1971).
6. Rev. Rul. 69-338, 1969-2 C.B. 154 (Indonesia); Rev. Rul. 65-552, 1966-2 C.B. 306 (Libya); Rev. Rul. 55-286, 1955-1 C.B. 386 (Saudi Arabia); I.T. 4058, 1950-2 C.B. 54 (Venezuela); I.T. 4049, 1951-1 C.B. 32 (Canada). The IRS has also issued unpublished private rulings which have allowed foreign tax credit treatment for the taxes on oil extrac-
countries impose a higher income tax rate on oil companies than the United States corporate tax rate, American corporations pay little or no United States tax on this foreign income.7

Until recently, American oil companies operating under production-sharing contracts in Indonesia8 reaped the benefits of the foreign tax credit.9 However, in 1976, the IRS ruled that these production-sharing oil companies will no longer enjoy this favorable tax credit treatment. In Revenue Ruling 76-215,10 the contractual production-sharing obligation11 of American contractors12 to an Indonesian state enterprise13 was deemed ineligible for the foreign tax credit.14 The IRS characterized the
entire production-sharing obligation, which entitles Indonesia to the lion's share of "profit oil," as a royalty, and concluded that this obligation does not constitute an "income tax" within the meaning of I.R.C. § 901. Following this ruling, the IRS issued an announcement, IR-1638, which indicates that the criteria used to determine the creditability of a foreign levy in Revenue Ruling 76-215 applies not only to production-sharing contracts but to foreign levies on extraction income generally. IR-1638 supplements Revenue Ruling 76-215 and clarifies the requirements which a foreign levy must satisfy to be creditable.

This Note will critically assess Revenue Ruling 76-215 on the basis of established principles of federal income taxation. Attention will be

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15. "Profit oil" is the oil remaining after the contractor has recovered his costs. See notes 52-55 infra and accompanying text.

16. I.R.C. § 901. The ruling also denied a deduction for the production-sharing obligation, since the IRS deemed it to be a royalty paid for permission to extract minerals. As a royalty, it is excludable from gross income. See note 5 supra; note 87 infra and accompanying text.

17. [1976] 9 STAND. FED. TAX REP. (CCH) ¶ 6751 [hereinafter cited as IR-1638].

18. Because Rev. Rul. 76-215 imposes a higher "tax cost" upon production-sharing operations, the ruling is likely to adversely affect future production-sharing activities in Indonesia and other countries. A spokesman for Mobil Oil Corp. indicated that the ruling is likely to upset plans for future American investments needed to continue the development of Indonesian oil reserves. Wall St. J., April 16, 1976, at 7, cols. 2, 3. One contractor claims that the ruling will cut its earnings from production-sharing contracts in half and is prepared to contest its validity. Wall St. J., May 10, 1976, at 5, col. 1.

After the expiration of the brief grace period provided by Congress, currently operating contractors can be expected to raise their import price in an attempt to maintain current profit levels. This increase should have an impact upon the world energy market, since Indonesia accounts for approximately 2.5 percent of the total world crude oil production. COUNCIL ON INT'L ECONOMIC POLICY, EXECUTIVE OFFICE OF THE PRESIDENT, INTERNATIONAL ECONOMIC REPORT OF THE PRESIDENT 172 (1976) [hereinafter cited as INTERNATIONAL ECONOMIC REPORT].

In an effort to maintain their current rate of profitability at current price levels, the contractors have negotiated with Pertamina for the revision of the terms of the production-sharing contracts to satisfy the requirements of IR-1638 and allow the contractor foreign tax credit treatment. In August, 1976, some contractors agreed to revised terms along the lines of the "Original Terms of Reference" proposed by Indonesia. Letter from Piet Haryono to contractors (August 1976) [hereinafter cited as Original Terms of Reference] (on file at the offices of the Cornell International Law Journal). See Wall St. J., Aug. 3, 1976, at 6, col. 2; id., Aug. 9, 1976, at 26, col. 2. However, these new terms do not fully satisfy the requirements of IR-1638. See notes 93 & 94 infra. Further negotiations can be expected during the grace period, but Pertamina is not likely to agree to further new terms which might reduce its much needed oil revenues. See notes 41 & 55 infra. If the parties do not further modify the terms of the contracts along the lines of IR-1638, the IRS can be expected to deny foreign tax credit for taxable years ending after 1977.

19. Because Rev. Rul. 76-215 imposes a higher rate of taxation on production-sharing operations, the ruling has significant economic and energy policy ramifications. Some commentators have urged that United States energy needs demand that American oil
focused on the unique character of the production-sharing contract which stems from Indonesia’s dual role as foreign taxing authority and landowner. An alternative method of tax treatment is proposed, under which the production-sharing obligation is allocated into tax and royalty portions. Finally, this Note suggests the application of a similar allocation approach to American oil companies operating abroad under concession contracts.

I

FOREIGN TAX CREDIT

The foreign tax credit is designed to eliminate the international double taxation of income derived from foreign sources. Because an American taxpayer’s foreign income is usually taxed by the country where it is earned and also by the United States, he is subject to income taxation by two sovereigns. In the absence of the credit, a taxpayer with foreign income would incur a greater tax liability than would a taxpayer with a similar amount of income from purely domestic sources. The foreign tax credit eliminates this inequity and places taxpayers with foreign source income in roughly the same position as taxpayers with only domestic income. Thus, the foreign tax credit is consistent with a fundamental principle of federal income taxation: taxpayers with equal taxable ca-
capacity should bear an equal income tax burden.\textsuperscript{22}

Section 901 of the Internal Revenue Code, the cornerstone provision of the foreign tax credit, states that an American corporation\textsuperscript{23} may elect to credit against its United States taxes "the amount of any income . . . taxes paid or accrued during the taxable year to any foreign country."\textsuperscript{24} Since the credit is available only for foreign income taxes, a levy exacted by a foreign government qualifies for favorable foreign tax credit treatment only if it is a tax which is imposed on income. In applying these requirements, the courts have held that a foreign levy is creditable if it is "the substantial equivalent of an 'income tax' as that term is understood in the United States."\textsuperscript{25} Although most cases\textsuperscript{26} have

\textsuperscript{22} E. OwENS, supra note 20, at 3. In the past, economists generally supported the foreign tax credit, since it enabled American oil companies to maintain a competitive position in the world energy market and fostered the desirable goal of United States corporate investment in and control of international oil production. See Multinationals, supra note 7, at 89. Recently, however, the advantages of United States corporate "ownership" of foreign oil reserves have been questioned, and the foreign tax credit has been attacked as encouraging high foreign taxation of American taxpayers' foreign income. See Comment, supra note 4, at 429, 444-46. Various proposals have been advanced for the elimination or modification of the foreign tax credit provisions. See HOUSE COMM. ON WAYS AND MEANS, 93RD CONG., 1ST SESS., PANEL DISCUSSIONS ON GENERAL TAX REFORM, pt. 11, at 1760-61 (Comm. Print 1973) (statement of Professor Peggy Musgrave); H.R. 2166, 94th Cong., 1st Sess., 121 CONG. REC. S4299 (daily ed. Mar. 18, 1975). See Cox & Wright, The Impact of the Tax Reduction Act of 1975 on the Petroleum Industry, 17 B.C. INDUS. & COM. L. REV. 805, 827 (1976). Congress, however, has refused to alter the basic structure of the foreign tax credit. With the exception of I.R.C. § 901(f), recent legislative modifications have affected only the limitation provisions. See notes 34-39 & 115 infra and accompanying text. See generally Comment, supra note 19, at 1065-70. The retention of the credit would seem to constitute Congressional recognition of its importance for international tax neutrality and the financial security of multinational oil companies. Id. at 1070. This Note will assume the general economic validity of the foreign tax credit provisions.

\textsuperscript{23} I.R.C. §§ 951-954 prevent American oil companies from avoiding tax liability by conducting foreign operations in the form of a controlled foreign subsidiary. Although the subsidiary might attempt to postpone tax liability by reinvesting its foreign profits in the foreign country rather than repatriating the profits to its American parent, I.R.C. § 951 provides that certain categories of income earned by the foreign subsidiary are included in the gross income of its shareholder, i.e. the parent, regardless of whether it is repatriated. One such category is foreign base company sales income, I.R.C. § 954(a)(2), which covers most oil production activities by controlled foreign subsidiaries. Comment, supra note 19, at 1065 n.154. But see I.R.C. § 954(b)(4) (exempting from I.R.C. §§ 951-954 income earned by a foreign subsidiary which does not have "as one of its significant purposes a substantial reduction of income . . . taxes"). See Comment, supra note 19, at 1065 n.154.

\textsuperscript{24} I.R.C. § 901(b). The statute also allows a credit for foreign "war profits and excess profits taxes paid or accrued." I.R.C. § 901(b)(1). Decisional law construing these two terms for foreign tax credit purposes is sparse. See E. OwENS, supra note 20, at 69.

\textsuperscript{25} New York & Honduras Rosario Mining Co. v. Commissioner, 168 F.2d 745, 747 (2d
allowed credit only where the foreign tax base roughly approximated taxable income under United States principles of federal income taxation, a recent decision suggests that the foreign tax credit is available for every foreign tax imposed with an eye toward reaching the taxpayer's net gain.

In addition to the credit for foreign income taxes, section 903 of the Code allows credit for foreign taxes paid "in lieu" of a general income tax. Prior to the enactment of this provision in 1942, the IRS had interpreted section 901 as permitting credit only for foreign taxes which

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26. Commissioner v. American Metal Co., 221 F.2d 134 (2d Cir.), cert. denied, 350 U.S. 829 (1955) (credit denied for Mexican tax on gross proceeds from mining operations); Kesheby & Mattison Co. v. Rothensies, 133 F.2d 894 (3d Cir.), cert. denied, 320 U.S. 739 (1943) (Canadian tax upon gross value of output from mining operations held not creditable); St. Paul Fire and Marine Ins. Co. v. Reynolds, 44 F. Supp. 863 (D. Minn. 1942) (credit denied for Canadian net premium tax on insurance companies). After an exhaustive examination of the pre-1961 cases and revenue rulings on the creditability of taxes imposed on general business receipts, one commentator concludes that credit is allowed under I.R.C. § 901 only where "the [foreign] tax base is net income either in the sense that deductions approximately the same as those under United States law are allowed or in the sense that the foreign tax base is estimated net income." E. OWENS, supra note 20, at 52. See generally id. at 33-54.

27. Credit has also been denied on the ground that the foreign tax is a "privilege tax," that is, a tax levied on the privilege of extracting minerals belonging to the foreign sovereign. Commissioner v. American Metal Co., 221 F.2d 134 (2d Cir.), cert. denied, 350 U.S. 829 (1955). Contra, New York & Honduras Rosario Mining Co. v. Commissioner, 168 F.2d 745 (2d Cir. 1948). However, American Metal suggests that this treatment is confined to additional taxes whose features differ substantially from the general income tax. See 221 F.2d at 137-40.

28. Bank of America National Trust & Sav. Ass'n v. United States, 459 F.2d 513, 524 (Ct.Cl. 1972), cert. denied, 409 U.S. 949 (1973). The court allowed foreign tax credit treatment for a tax on gross income on the grounds that it was highly unlikely that the tax would be imposed on any taxpayer when his activities were unprofitable. See note 92 infra and accompanying text.

29. The Supreme Court has ruled that a foreign sovereign's classification of a levy as an "income tax" does not determine the tax treatment under I.R.C. § 901. Biddle v. Commissioner, 302 U.S. 573, 578-79 (1938). Similarly, the denomination of a levy by a term other than "income tax" should not bear on its eligibility for the foreign tax credit. See New York & Honduras Rosario Mining Co. v. Commissioner, 168 F.2d 745 (2d Cir. 1948) (contractual obligation to pay 7 percent of mining profits to foreign government held to be creditable foreign tax).

30. I.R.C. § 903 provides:

For the purposes of this subpart and of sections 164(a) and 275(a), the term "income, war profits, and excess profits taxes" shall include a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States.
closely approximated the American income taxation scheme.\textsuperscript{31} Congress intended section 903 to enlarge the range of creditable taxes and provide credit treatment for taxes which a foreign country substituted for a general income tax.\textsuperscript{32} However, the IRS has narrowly interpreted section 903 to allow credit treatment only when the taxpayer pays a special tax which a foreign government imposes in complete substitution for a general foreign income tax to which the taxpayer would otherwise be subject.\textsuperscript{33}

Current Code provisions place a ceiling on the amount of foreign taxes which may be credited. Section 907(a)\textsuperscript{34} provides that a credit will not be allowed for the amount by which foreign income taxes exceed the product of oil and gas extraction income\textsuperscript{35} multiplied by the United States corporate tax rate.\textsuperscript{36} In addition, section 1035(c)(2) of the Tax

\begin{enumerate}
\item The term "income, war profits, and excess profits taxes" includes a tax imposed by statute or decree by a foreign country or by a possession of the United States if—
\begin{enumerate}
\item Such country or possession has in force a general income tax law,
\item The taxpayer claiming the credit would, in the absence of a specific provision applicable to such taxpayer, be subject to such general income tax, and
\item Such general income tax is not imposed upon the taxpayer thus subject to such substituted tax.
\end{enumerate}
\end{enumerate}

The courts have upheld these requirements and denied credit for taxes imposed in addition to rather than in substitution for a general income tax. Allstate Ins. Co. v. United States, 419 F.2d 409 (Ct. Cl. 1969) (gross premiums tax on stock casualty insurance corporations); Abbott Laboratories Int'l Co. v. United States, 160 F. Supp. 321, 331 (N.D. Ill. 1958), aff'd per curiam, 267 F.2d 940 (7th Cir. 1959) (Columbian patrimony tax). However, a substituted tax which satisfies the regulations is creditable regardless of whether it seeks to reach the taxpayer's net gain. Metropolitan Life Ins. Co. v. United States, 375 F.2d 835, 839-39 (Ct. Cl. 1967). Nor must "in lieu" taxes be imposed to relieve the "administrative difficulty" of collecting a general income tax, as the IRS has contended. 375 F.2d at 838. See S. Rep. No. 1631, 77th Cong., 2d Sess. 131-32 (1942).

32. Id. The report specifically mentions certain types of non-income taxes—such as taxes imposed on gross income, gross sales, or number of units produced—which are creditable under I.R.C. § 903 when imposed in substitution for a general income tax.
33. Treas. Reg. § 1.903-1(a), T.D. 6780, 1965-1 C.B. 96, 105 provides:
[T]he term "income, war profits, and excess profits taxes" includes a tax imposed by statute or decree by a foreign country or by a possession of the United States if—
\begin{enumerate}
\item Such country or possession has in force a general income tax law,
\item The taxpayer claiming the credit would, in the absence of a specific provision applicable to such taxpayer, be subject to such general income tax, and
\item Such general income tax is not imposed upon the taxpayer thus subject to such substituted tax.
\end{enumerate}

34. I.R.C. § 907(a).
35. I.R.C. § 907(c)(1) defines foreign oil and gas extraction income as income derived from the extraction of minerals from oil or gas wells outside of the United States or from the sale or exchange of assets used in extraction operations.
36. I.R.C. §§ 904(a), 907(b) contain an additional "overall limitation" on credit allowable on foreign oil related income, which I.R.C. § 907(c)(2) defines to include foreign extraction income as well as income from processing, transportation, and distribution operations. See S. Rep. No. 938, 94th Cong., 2d Sess. 250-51 (1976). I.R.C. § 904(a) subjects all taxpayers to the overall limitation, which provides that the total amount of credit shall not exceed the proportion of total United States income tax (before allowance for the foreign tax credit which the taxable income from foreign sources bears to total
Reform Act of 1976\textsuperscript{37} places a special restriction on income taxes paid under production-sharing contracts, whereby credit is limited to 48 percent of the extraction income derived from these contracts alone, without regard for the taxpayer's total worldwide extraction income.\textsuperscript{38} These provisions prevent an American oil company from using excess foreign tax credits generated by production-sharing operations to offset its United States tax liability on other foreign income.\textsuperscript{39}

taxable income. I.R.C. § 904(a). Mathematically, the limitation may be expressed as follows:

\[
\frac{\text{Credit}}{\text{Total Tax}} \leq \frac{\text{Foreign Income}}{\text{Total Income}}
\]

Comment, supra note 4, at 431 & n.58. I.R.C. § 907(b) requires corporate taxpayers to calculate the foreign tax credit allowable under this overall limitation separately for foreign oil related income and other taxable income.


\textsuperscript{38} The Senate Report explains the relationship of § 1035(c)(2) of the Tax Reform Act and I.R.C. § 907(a) as follows:

[T]he total amount treated as creditable taxes under this provision is not to exceed the lesser of two amounts. The first amount is the total foreign oil and gas extraction income with respect to production-sharing contracts covered under the rule multiplied by the U.S. corporate tax rate (generally 48 percent) less the otherwise allowable (if any) foreign tax credits attributable to income from those contracts. The second amount is the total foreign oil and gas extraction income multiplied by the U.S. corporate tax rate (generally 48 percent) less the total amount of the otherwise allowable foreign tax credits (if any) attributable to the total foreign oil and gas extraction income.

S. REP. No. 938, 94th Cong., 2d Sess. 254 (1976). The Report then gives an example of the tax treatment for a taxpayer with the following income and foreign taxes:

<table>
<thead>
<tr>
<th>Source of foreign extraction income</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Production-sharing contracts</td>
<td>10</td>
</tr>
<tr>
<td>Other extraction operations</td>
<td>90</td>
</tr>
<tr>
<td><strong>Total extraction income</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Foreign income taxes</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Production-sharing contracts</td>
<td>45</td>
</tr>
<tr>
<td>Other extraction operations</td>
<td>6</td>
</tr>
<tr>
<td><strong>Total foreign income taxes</strong></td>
<td><strong>51</strong></td>
</tr>
</tbody>
</table>

The taxpayer is allowed a credit for the production-sharing obligation equal to the lesser of (48 percent of $10) or [(48 percent of $100) less $45], namely $3. \textit{Id.} at 254-55.

\textsuperscript{39} See Cox & Wright, supra note 22, at 827. After the expiration of the brief grace period provided by Congress, see note 14 supra, I.R.C. § 907(a) will impose a much heavier tax burden on the smaller contractors operating exclusively under production-sharing contracts, while the larger multinationals will be left unscathed. The multinationals will be able to use excess foreign tax credits generated by their worldwide extraction operations.
II
IRS TREATMENT OF INDONESIAN PRODUCTION-SHARING CONTRACTS

A. THE PRODUCTION-SHARING CONTRACT

Under Indonesian law, the Indonesian government holds the title to all oil and gas within the country, and Pertamina, a state enterprise, controls the exclusive right to develop and produce these minerals. Pertamina in turn is authorized to enter into contracts with foreign oil companies for the development and extraction of oil and gas. However, Pertamina may not transfer ownership of the minerals in place to the foreign contractor, and both Pertamina and the Indonesian government are required by law to exercise a certain degree of control and supervision over the production operations.

The smaller contractors, however, do not have these excess credits and must pay a greater proportion of United States tax. This unfortunate result suggests that Congress should further extend the grace period if the smaller contractors and Pertamina are not able to agree to revised terms which qualify for the foreign tax credit under the IRS's restrictive interpretation of I.R.C. § 901. See note 18 supra, and notes 93 & 94 infra and accompanying text.

40. UNDANG-UNDANG DASAR (Constitution) art. 33(3) (Indonesia 1945, reinstated 1957).
41. Pertamina was created by PERTAMINA LAW, Law No. 8, [1971] Lembaron Negara [LN] (1971), reprinted in R. FABRIKANT, The Indonesian Petroleum Industry, Miscellaneous Source Material, in 2 OIL DISCOVERY AND TECHNICAL CHANGE IN SOUTHEAST ASIA 284 (1973). Pertamina replaced P.N. Pertamina, a prior state petroleum enterprise established by a 1961 enactment designed to secure greater government control over petroleum operations of foreign oil companies. Although Pertamina is wholly owned by the Indonesian government, its officers are businessmen not government bureaucrats, and manage its affairs without close government supervision. Recently, however, Pertamina's officers have badly mismanaged its international financial investments, resulting in staggering losses and a long-term debt of over ten billion dollars. The government has reacted to this mismanagement by replacing Pertamina's officers and increasing its direct control of Pertamina's financial affairs. See Fabrikant, Pertamina: A Legal and Financial Analysis of a National Oil Company in a Developing Country, 10 Tex. Int'l L.J. 495, 535-36 (1975) [hereinafter cited as Pertamina Analysis]; Grant, Wealth of the Indies, BARRONS, July 12, 1976, at 3; BUSINESS WEEK, May 3, 1976, at 58-59.
42. PERTAMINA LAW, Law No. 8, art. 11(1), [1971] LN (1971).
43. PERTAMINA LAW, Law No. 8, art. 12(1), [1971] LN (1971).
44. Id. arts. 12(2)-(3). Before 1960, Indonesian oil production was conducted under traditional concession contracts whereby the foreign concessionaire acquired title to minerals in place and exercised exclusive control over all oil production operations. Reacting to this foreign domination, Indonesia enacted, in 1960, restrictive regulatory legislation aimed at regaining Indonesian sovereignty over its natural resources. UNDANG-UNDANG DASAR (Constitution) art. 33(3) (Indonesia 1945, reinstated 1957). Extensive governmental supervision of the petroleum industry made investment in Indonesia unattractive for foreign oil companies, many of which abandoned their Indonesian operations. The disfavor with which foreign oil companies received this restrictive legislation distressed Indonesian
The production-sharing contract is the agreement between the foreign contractor and Pertamina which stipulates the terms under which the extraction operations will be carried out. The contract provides that the contractor must pay Pertamina an initial signature bonus, invest a minimum amount in exploration activities in the contract area, and pay all expenses incurred in exploration and production. To recover its expenses, the contractor must look solely to the extraction of oil and gas, from which it is entitled to recover its costs in barrels of

government officials who, in addition to desiring governmental control over Indonesian mineral resources, wished to restore the crumbling Indonesian economy through the injection of foreign capital. In order to secure a financial arrangement which would assure foreign operators substantial and continuing profits without excessive governmental interference and, at the same time, allow Indonesian supervision of oil production operations, the Indonesian Parliament enacted the less regulatory legislation which is presently in force. Subsequent negotiations between Pertamina and foreign operators developed the production-sharing contract. Under the management clause of this arrangement, Pertamina has the contractual right to revise the contractor's budget and work program. However, since Pertamina's substantial influence in Indonesian politics depends largely on maintaining the contractor's goodwill, Pertamina has exercised this right sparingly. As a result, the contractor exercises actual control of development and production operations, although the specter of possible governmental supervision no doubt influences its management decisions. See generally Fabrikant, Production Sharing Contracts in the Indonesian Petroleum Industry, 16 Harv. Int'l L.J. 303, 307-17, 327, 330 (1975) [hereinafter cited as Indonesian Petroleum Industry].

45. Although American contractors account for the bulk of production-sharing operations, contracts are also held by French, Japanese and Canadian contractors. See Grant, supra note 41, at 3, col. 4. To the extent that the American contractors are adversely affected by Rev. Rul. 76-215, these other foreign contractors enjoy a relative advantage over their American competitors.

46. Production-sharing contracts denominate the contracting oil company as contractor, perhaps because this term implies that foreign oil companies no longer dominate the Indonesian petroleum industry as "concessionaires" but have been reduced to a subordinate position, in accordance with Indonesia's nationalistic goals. See note 44 supra.

47. All Indonesian production-sharing contracts are substantially similar in their essential terms and provisions. See generally Indonesian Petroleum Industry, supra note 44, at 312, 321-30. The specific terms discussed in the text are those contained in the contract which Rev. Rul. 76-215 addresses. However, the terms of the Rev. Rul. 76-215 contract are not binding upon the contractor and Pertamina, as this contract was only proposed but not signed at the time of the ruling. Letter from John Clark to William P. McClure (April 7, 1976) (on file at the offices of the Cornell International Law Journal). Consequently, the contractor, Mobil Oil Indonesia, may negotiate with Pertamina to revise the contractual terms along the lines of IR-1638 before Mobil begins production. See note 18 supra.

48. Rev. Rul. 76-215, 1976-23 I.R.B. 6, 7. A unique feature of the production-sharing contract is the provision which vests title in Indonesia to all the equipment used by the contractor when landed at an Indonesian port. Indonesian Petroleum Industry, supra note 44, at 331. The contractor may recover his expenditures toward this equipment in "cost oil."
oil, or "cost oil." The recovery for each contract year is limited to 40 percent of the value of all barrels of oil produced; costs in excess of 40 percent of total gross production may be carried forward and recouped in subsequent years. Cost recovery is computed separately under each contract held by the contractor, so that the contractor may not recover expenses or losses incurred under a non-producing contract.

The remaining 60 percent of the oil is "profit oil" and is divided between the contractor and Pertamina. Pursuant to the contract, the contractor is entitled to 30 percent of the profit oil and must deliver to Pertamina the remaining 70 percent as its production-sharing obligation. Pertamina is then required by law to deposit into the Indonesian Treasury the equivalent of 60 percent of the total profit oil.

After stating that the contractor remains subject to certain Indonesian taxes, including the Corporation Tax, the production-sharing con-

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51. Id. at 7.

52. Nordberg & Kelleher, supra note 9, at 218. One significant feature of the typical production-sharing contract, the "domestic obligation," is not mentioned in Rev. Rul. 76-215, either because the contract did not contain a domestic obligation provision or because the IRS deemed this feature immaterial to tax treatment of the production-sharing obligation. Generally, the domestic obligation requires the contractor to sell to Pertamina, at a nominal price, roughly 20 percent of gross production remaining after cost oil is recovered but before the division of the profit oil at the negotiated percentages. Nordberg & Kelleher, supra note 9, at 218, col. 2.


55. Rev. Rul. 76-215, 1976-23 I.R.B. 6, 7. After recovery of expenditures, the contractor receives 30 percent of the profit oil, and the Indonesian government and Pertamina, respectively, receive 60 percent and 10 percent. Recently, the Indonesian government compelled all production-sharing contractors to "renegotiate" their contracts, so that Indonesia is now entitled to 85 percent of the profit oil and the contractor 15 percent. Wall St. J., Aug. 3, 1976, at 6, col. 2; id. Aug. 8, 1976, at 26, col. 2. By increasing the government's share, Indonesian officials hope to increase total revenues from foreign oil producers and discharge the government's liability on the debts incurred by Pertamina. Grant, supra note 41, at 3. The Indonesian Treasury will most likely receive the entire amount of this additional profit oil; Pertamina will be only indirectly benefited by discharge of its debts.

tract provides that Pertamina is obligated to discharge the contractor's liability for these taxes. However, Article 15 of the Pertamina Law states that Pertamina's deposit into the Indonesian Treasury of the 60 percent share of the profit oil shall "discharge [Pertamina] and [the] Contractor from and constitute payment of" these taxes. Thus, the contractual provision requiring Pertamina to discharge the contractor's tax liabilities becomes superfluous upon the Indonesian Treasury's receipt of the amount to which it is entitled. The inclusion of this discharge provision seems to stem from the contractor's desire to avoid tax liability to the Indonesian government if Pertamina fails to make the required deposit.

B. REVENUE RULING 76-215

In Revenue Ruling 76-215 the IRS determined that the 70 percent share which the contractor must deliver to Pertamina is a royalty paid for permission to extract minerals which are the property of the Indonesian government. Since sections 901 and 903 restrict the foreign tax credit to taxes, the IRS disallowed credit for the production-sharing obligation.

In analyzing the production-sharing obligation, the IRS focused on three features which it found characteristic of a royalty rather than a

57. Rev. Rul. 76-215, 1976-23 I.R.B. 6, 7. For the purposes of the Corporation Tax, the contract states that the contractor's taxable income is the amount received from disposing of his 30 percent share of profit oil plus an amount equal to the Corporation Tax thereon.


59. The word "exempt" appeared in the original English translation instead of "discharge." Contractors objected to the former version on the grounds that they might not obtain foreign tax credit treatment for their production-sharing obligations under I.R.C. § 903 unless this obligation "discharged" them from Corporation Tax liability. Indonesian Petroleum Industry, supra note 44, at 328 n.50.

60. In the event of Pertamina's default, this contractual provision might not discharge the contractor from the Corporation Tax, since Pertamina is not legally empowered to relieve the contractor of tax liability imposed on him by the Indonesian Parliament. See id. at 328-29.

61. Rev. Rul. 76-215, 1976-23 I.R.B. 6. This public ruling was issued after the IRS denied foreign tax credit treatment in a private ruling which one contractor, Mobil Oil Indonesia, sought in accordance with Rev. Proc. 72-3, 1972-1 C.B. 698, and Rev. Rul. 67-308, 1967-2 C.B. 254. Letter from John Clark to William P. McClure (April 7, 1976) (on file at the offices of the Cornell International Law Journal). See Nordberg & Kelleher, supra note 9, at 219, col. 2. Although Rev. Rul. 76-215 addresses the creditability of a particular Indonesian production-sharing contract, the ruling indicates that all American oil companies operating under production-sharing contracts in Indonesia can expect similar tax treatment. See note 47 supra. Production-sharing obligations levied by other countries will require independent examination under I.R.C. §§ 901, 903; however, the principles of analysis developed in this Note should serve as a model for the tax treatment of all varieties of production-sharing contracts. See note 9 supra.
tax. First, the IRS held that the contractor's entire obligation comes
within the basic definition of a private royalty\textsuperscript{62} under case law: a fixed
percentage of production, or a payment received by a person with an
"economic interest" in the minerals which is (1) based on production;
(2) for permitting another to extract the minerals; and (3) payable only
from the minerals produced or the proceeds from their disposition.\textsuperscript{63}

Second, Revenue Ruling 76-215 focused on two provisions of the
production-sharing contract which limit the contractor's recovery of
expenses to 40 percent of annual production and entitle the government
to separately computed amounts of production under each production-
sharing contract held by the contractor. The IRS reasoned that these
provisions also are characteristic of a royalty because they guarantee
Indonesia a share of production without regard for the profitability of
the contractor's operations.\textsuperscript{64}

The third aspect of the contract which the IRS relied upon is the
provision which specifies that title to Indonesia's 70 percent share of the
"profit oil" remains with Indonesia. Emphasizing that a levy is not a
tax unless paid out of assets owned by the contractor, the IRS found that
the production-sharing obligation does not qualify as a tax because the
contractor never acquired title to this 70 percent share.\textsuperscript{65} The IRS rea-
soned that this non-tax feature buttressed its conclusion that the entire
obligation is characteristic of a royalty.

III
ANALYSIS

Implicit in Revenue Ruling 76-215 is the assumption that the
production-sharing obligation constitutes either a royalty or a tax in its
entirety. Consequently, the IRS has embraced an analytical approach
which classifies each particular levy imposed by a foreign government
into one of the two categories, depending upon its primary character.\textsuperscript{66}
This approach ignores the possibility that a single levy might be im-
posed partly as a tax and partly as a royalty, and that apportionment

\textsuperscript{62}. A private royalty, paid to a private landowner to compensate him for the extraction
of his minerals, is to be distinguished from a royalty paid to a government/landowner with
taxing authority.

\textsuperscript{63}. 1976-23 I.R.B. 6, 8, citing Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25
(1946); Kirby Petroleum Co. v. Commissioner, 328 U.S. 599 (1946); Cox v. United States,
497 F.2d 348 (4th Cir. 1974); Logan Coal & Timber Ass'n v. Helvering, 122 F.2d 848 (3d
Cir. 1941); United States Steel Corp. v. United States, 270 F. Supp. 263 (S.D.N.Y. 1967).

\textsuperscript{64}. 1976-23 I.R.B. 6, 8.

\textsuperscript{65}. \textit{Id}.

\textsuperscript{66}. \textit{See }E. OWENS, supra note 20, at 61-62; Comment, supra note 4, at 447.
of a single levy into tax and royalty portions might be proper. This rigid, "black or white," "tax or no tax" approach is open to serious criticism. The following examination of the production-sharing obligation will focus on two issues: first, whether this levy actually constitutes a tax, in whole or in part—the "tax-royalty" issue; and second, if so, whether that tax is imposed on income or imposed in lieu of a tax on income—the "imposed-on-income" issue. It will be argued that the obligation is partly a tax and partly a royalty, and that the tax portion is creditable under section 903.

A. THE PRODUCTION-SHARING OBLIGATION AS A TAX AND A ROYALTY

The fundamental flaw in Revenue Ruling 76-215 is the IRS's failure to recognize the Indonesian government's dual role. As taxing authority and landowner, the government has the option to collect revenues either in its capacity as a sovereign exercising its rights of taxation, or as an ordinary owner of mineral rights collecting royalties for permitting their extraction, or as both. In exacting production-sharing obligations, however, Indonesia has not specified which revenue-collecting power it exercises. This silence is not surprising, since Indonesia is more concerned with actually obtaining oil revenues than with the precise legal basis for their receipt. Given the unclear basis on which Indonesia has exacted the production-sharing levy from the contractor, the IRS should be hesitant to classify the entire levy as tax or royalty unless the features of the obligation clearly indicate that it is exacted solely on the basis of either the sovereign's taxing power or landowner rights. A close examination of the production-sharing obligation reveals that Indonesia imposes this single levy in a simultaneous exercise of its taxing authority and landowner rights.

1. The IRS Analysis

None of the three features on which the IRS relied support the holding of Revenue Ruling 76-215; each feature is equally characteristic of a landowner's royalty as it is characteristic of a levy imposed by a foreign

67. See E. Owens, supra note 20, at 32-33; Tannenbaum, supra note 6, at 27; Comment, supra note 4, at 447.

68. The Indonesian government's ownership of the corporate assets of Pertamina creates a financial interrelationship between the government and the corporation which makes it appropriate to refer to the entire production-sharing obligation as being received by "Indonesia." See note 83 infra. Moreover, the Tax Reform Act of 1976 evidences legislative intent to treat payments made to an entity owned by a foreign government in the same manner as payments made directly to the foreign government. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1035(c)(3), 90 Stat. 1631, reprinted in I.R.C. § 907 note.
sovereign exercising its rights of taxation. First, the cases upon which the IRS relied as defining a private royalty do not apply to the Indonesian production-sharing obligation. These cases concerned payments to private landowners in exchange for mineral rights; the disputed issue was not whether the obligation was eligible for the foreign tax credit, but whether a particular taxpayer had a sufficient economic interest in the minerals in place in order to qualify for the percentage depletion allowance. Absent from these cases was the essential feature of the Indonesian production-sharing situation: the dual role of the recipient as taxing sovereign and royalty-collecting landowner. Moreover, the ruling is contrary to case law which has held government-imposed levies possessing royalty features to be creditable.

69. See note 63 supra.
70. I.R.C. § 613(a) allows a percentage depletion deduction for a specified portion of the gross income which a taxpayer generates from oil-producing property and retains after making payments for rent or royalties. The Supreme Court has interpreted this provision to allow the depletion deduction to all taxpayers who hold an “economic interest” in minerals in place. Palmer v. Bender, 287 U.S. 551 (1933); Burton-Sutton Oil Co. v. Commissioner, 328 U.S. 25 (1946); Kirby Petroleum Co. v. Commissioner, 326 U.S. 599 (1946). An “economic interest” is defined as any interest in the minerals which gives its holder a right to profits which is “dependent solely upon the extraction and sale of the oil,” 326 U.S. at 604 (footnote omitted), and therefore includes any royalty interest. Consequently, the economic interest concept includes not only fee interests in minerals but also royalty and net profit interests, and has been developed to provide, for any one mineral deposit, only a single depletion allowance, equitably apportioned between the holders of the economic interests. I.R.C. § 611(b)(1); see Burton-Sutton Oil Co. v. Commissioner, 328 U.S. at 33-34; Mesa Petroleum Co. v. Commissioner, 58 T.C. 374, 375 (1972). However, the notion of a royalty as an “economic interest” contemplates a right to a share of production carved out of or given in exchange for an ownership or leasehold interest in a mineral estate. See Palmer v. Bender, 287 U.S. at 557. Since a royalty interest stems from its holder’s exercise of his rights as “landowner,” an obligation attributable to the obligee’s exercise of a non-landowner right, e.g., the right to tax, is not a royalty. Although such a non-royalty obligation may possess the characteristics of a royalty as defined by the case law under I.R.C. § 613, this similarity should not cause the non-landowner obligation to be characterized as a royalty for foreign tax credit purposes.

71. While legal systems of property ownership in the United States recognize private ownership of subsurface minerals, title to such minerals in most major oil-producing countries is vested in the state. G. BROWNING, supra note 19, at 61 (1974). The uniqueness of the American legal system suggests the inapplicability of domestic royalty cases to levies exacted by foreign governments on mineral income.
72. New York & Honduras Rosario Mining Co. v. Commissioner, 168 F.2d 745 (2d Cir. 1948) (contractual obligation to pay 7 percent of mining profits to foreign government held to be creditable foreign tax).
73. The characterization of the entire production-sharing obligation as a royalty is not consistent with Rev. Rul. 72-579, 1972-2 C.B. 441, which held that a payment by a United States employee to Great Britain pursuant to the National Insurance Act was a creditable foreign income tax. This ruling suggests that the capacity in which a foreign government exacts a levy (in Rev. Rul. 72-579, as “insurer”) is not relevant to the creditability of that
The second feature of the production-sharing obligation on which the IRS based its ruling is Indonesia's contractual right to an assured share of production without regard for the profitability of the contractor's operations. The thrust of this argument is that, since the production-sharing levy is not imposed on the contractor with an eye toward reaching net gain, its obligation is not a tax but rather a royalty. This analysis is inconsistent with a wealth of case law and revenue rulings which have recognized levies which do not reach net gain as taxes.\textsuperscript{74}

The final feature on which the IRS relied is the contractual provision by which title to Indonesia's share of production always remains with Indonesia. However, technical title to oil under a production-sharing contract has little relevance to the substance of the economic arrangement between the contractor and Indonesia. The provision concerning title does not stem from the economic or financial motives of the contracting parties; Indonesia insists upon this arrangement to create the appearance that the country is acquiring greater control and supervision over foreign oil companies.\textsuperscript{75} The economic and financial mechanics of production-sharing operations would be the same if the terms of the contract temporarily vested title to all profit oil in the contractor and then obligated it to transfer the 70 percent share to Indonesia. Consequently, Indonesia's retention of technical title does not indicate that the entire levy is a royalty; rather, the economic substance of the production-sharing contract suggests the presence of both tax and royalty elements in the single production-sharing levy.\textsuperscript{76} By focusing on the
contractor's legal rights to the exclusion of the underlying economic realities, Revenue Ruling 76-215 is inconsistent with cases in other tax contexts which have looked to economic substance rather than technical legal title.77

Moreover, the mechanism by which Indonesia exacts a percentage share of oil does not differ in substance from the revenue-collecting machinery by which other host countries exact levies from oil companies operating under concession contracts for which credit treatment is allowed. Under a concession contract, the oil company acquires title to all production, makes a relatively small "royalty" payment, and is free to sell its production to any contracting party. However, the concessionaire must reserve a substantial percentage of its net profits, often more than 50 percent,78 for payment of income taxes to the host

See also Missouri Pac. R.R. v. United States, 497 F.2d 1386, 1394-95 (Ct. Cl. 1974). Nordberg and Kelleher's contention does not recognize the close relationship between Indonesia and Pertamina which makes it inappropriate to characterize Pertamina's deposit into the Treasury as payment of a tax. See note 83 infra. Rather, the contractor should be deemed to discharge its tax liability by satisfaction of the production-sharing obligation. See note 68 supra.

77. In Burnet v. Harmel, 287 U.S. 103 (1932), the Supreme Court held that an oil and gas lease executed under Texas law was not a sale of a capital asset which would entitle the lessor to capital gains treatment on bonuses and royalties received. Texas law differs from the law of the majority of jurisdictions in that it gives the lessee present title to oil and gas in place; under the majority rule, title is transferred to the lessee only upon extraction. Although income derived from a lease under the majority rule is treated as ordinary income for tax purposes, the lessor in Harmel argued that Texas law effects a present exchange of a capital asset and thus requires that the lessor's income receive capital gains treatment. The Court rejected this argument on the grounds that the economic consequences to the lessor under each type of lease were the same and that income derived from both leases should therefore receive similar tax treatment "irrespective of any particular characterization of the payments in the local law." Id. at 110. See also West v. Commissioner, 150 F.2d 723 (5th Cir. 1945), cert. denied, 326 U.S. 756 (1946) (grantor of entire surface and mineral estate held to receive ordinary income where the economic substance of the transaction constituted an oil and gas lease with a reserved royalty to the grantor). See generally Hambrick, Another Look at Some Old Problems—Percentage Depletion and the ABC Transaction, 34 Geo. WASH. L. REV. 1, 15-17 (1965). Similar reasoning requires that tax treatment of the Indonesian production-sharing obligation turn on the economic substance of the relationship between the contractor and Indonesia. Oil operators in the same economic posture vis-a-vis several different host sovereigns should receive the same foreign tax credit treatment for levies which are substantially similar, regardless of the particular property rights which each operator may enjoy under the local law of each host sovereign. Cf. Commissioner v. Southwest Exploration Co., 350 U.S. 208 (1956) (taxpayer who never acquired a proprietary interest in an adjacent tract but who granted an easement over his own land to the adjacent operator in return for a share of the net profits acquired an "economic interest" in the minerals covered by the adjacent tract for percentage depletion purposes).

78. The major Middle East oil producing countries impose varying rates of income taxation. Saudi Arabia taxes foreign oil companies at 85 percent of net profit. International Bureau of Fiscal Documentation, Conference Manual for Tax and Legal Aspects of
country.79 The practical result is substantially the same as that achieved under the Indonesian production-sharing contract.80 The object of the host government in both instances is to secure a share of the contractor's net production; the fact that Indonesia receives its share directly from the contractor rather than indirectly through a levy denominated as an "income tax" should not lead to inequitable United States tax consequences.81

2. Allocation of Tax and Royalty

The ruling's classification of the entire levy as a royalty leads to the highly unlikely conclusion that Indonesia, as taxing sovereign, has refrained from exercising its taxing power on petroleum operations. On the other hand, classifying the entire levy as a tax would imply that Indone-

79. Note, From Concession to Participation: Restructuring the Middle East Oil Industry, 48 N.Y.U.L. Rev. 774, 776-77 (1973). In recent years, host countries, which have insisted on greater participation in petroleum operations, have eroded exclusive production management and ownership rights which characterize the traditional concession contract. See generally Brenschel, Petroleum Legislation in the North Sea Countries, 11 Tex. Int'l L.J. 281 (1976); Note, From Concession to Participation: Restructuring the Middle East Oil Industry, 48 N.Y.U.L. Rev. 774 (1973). Some host countries have insisted on "participation" agreements, whereby the host country acquires ownership to a share of the oil company's concession, together with a proportionate share of the oil produced. Note, supra, at 793-99. While the contractual agreements concerning the host's share of production differ substantially from the concession arrangement, the terms under which the oil company acquires its share, the "equity" oil, continue to reflect the economic substance of the concession contract. See note 115 supra.

80. After comparing the different features of traditional concession contracts with production-sharing contracts, Fabrikant states: "On the basis of empirical investigation, it is reasonable to conclude that the operational differences between production-sharing and concession contracts [is] insubstantial . . . . [T]he operational and legal significance of [provisions relating to title] appears to be minimal. . . ." Pertamina Analysis, supra note 41, at 535-36. For an analysis of the production-sharing contract as a disguised concession contract, see Indonesian Petroleum Industry, supra note 44, at 334-41.

81. See Nordberg & Kelleher, supra note 9, at 222.
sia, as landowner, permits foreign contractors to remove its valuable minerals free of charge.82

Proper tax treatment should recognize that the production-sharing obligation is neither a tax nor a royalty in its entirety, but is exacted in a simultaneous exercise of Indonesia’s taxation authority and landowner rights.83 The production-sharing obligation is comprised of both tax and royalty charges; consequently, its dual character should be reflected in tax treatment which pierces the form of Indonesia’s revenue-collecting machinery and allocates the single levy into its two separate components for foreign tax credit purposes.84 After studying the economics of

82. Under this “tax” classification, the contractor does not extract minerals entirely without charge, since most contracts entitle Indonesia to a production bonus when production reaches a certain level. See note 49 supra. The production bonus should be considered an additional “tax/royalty” obligation exacted by Indonesia in its dual capacity as taxing authority and royalty-collecting landowner; for foreign tax credit purposes, it should be examined independently of the production-sharing obligation. It should not be viewed as the only royalty charge imposed by Indonesia, because few private landowners would agree to wait until production reaches a specified level before receiving any royalty payments. Furthermore, some contracts do not oblige the contractor to pay a production bonus.

83.  See E. Owens, supra note 20, at 33; Comment, supra note 4, at 447. Since Pertamina and the Indonesian Treasury split Indonesia’s share of profit oil, and because the Indonesian Treasury issues a “tax receipt” upon Pertamina’s deposit of 60 percent of the profit oil into the Treasury, see Indonesian Petroleum Industry, supra note 44, at 326, Nordberg and Kelleher maintain that the share received by the Indonesian Treasury is a tax and that the share received by Pertamina is a royalty or “net profits interest.” Nordberg & Kelleher, supra note 9, at 219. This view fails to recognize that the character of Pertamina’s share of oil revenues does not differ in substance from the oil revenues which the Indonesian Treasury receives and distributes to various other governmental branches and operations. While other branches of the government receive oil revenues indirectly through the Treasury, Pertamina is allowed to retain its share in advance. Under the mechanics of this system of revenue distribution, the share which Pertamina retains is no more a royalty than is the distributive share which any other arm of the Indonesian government receives. Indonesia has not transferred to Pertamina its right as landowner to collect royalties but has allocated a share of total government revenues to the wholly-owned state petroleum enterprise. The precise amount of this share has no relation to the portion of the contractor’s production-sharing obligation which actually compensates Indonesia for the extraction of its minerals. Cf. Chicago, B. & Q.R.R. Co. v. United States, 455 F.2d 993, 1023 (Ct. Cl. 1972), rev’d on other grounds, 412 U.S. 401 (1973) (distribution of collected tax revenues within a foreign country is irrelevant to the foreign tax credit treatment of foreign levies).

84. The courts in other contexts have recognized the appropriateness of apportioning a single obligation into separate portions for tax purposes. See Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962) (single payment received for surrender of certain rights in a play allocated into two portions, one portion representing the amount received in exchange for the taxpayer’s “capital assets” in the play, the second portion representing the amount received for surrender of the taxpayer’s “compensation” rights for services to be rendered in producing the play). See also Helvering v. Taylor, 293 U.S. 507 (1935); Ditmars v. Commissioner, 302 F.2d 481 (2d Cir. 1962); Meister v. Commissioner, 302 F.2d 54 (2d Cir. 1962); Webster Investors, Inc. v. Commissioner, 291 F.2d 192 (2d Cir. 1961).
oil production in Indonesia and other host countries, the IRS should formulate a scheme to divide the single levy into tax and royalty portions corresponding to the separate amounts which would have been exacted as independent tax and royalty charges. The contractor would exclude the royalty portion from his gross income and, if the tax portion satisfied either the "imposed-on-income" or "in lieu" requirements of sections 901 and 903, credit the tax portion against its United States tax liability. This tax treatment would reflect the extent to which the production-sharing obligation is traceable to Indonesia's exercise of its

85. Nordberg and Kelleher suggest that the domestic obligation, see note 52 supra, should be treated as a royalty obligation. Nordberg & Kelleher, supra note 9, at 219. If the contractor were to adopt this view, it could argue against an allocation scheme and insist that the Indonesian tax consists of the entire production-sharing obligation. Alternatively, the contractor could argue that the tax consists of the 60 percent share of the profit oil deposited in the Indonesian Treasury, and that Indonesia collects two royalties: the domestic obligation and Pertamina's share of the production-sharing obligation. But see note 83 supra. Rather than distinguish between the royalty and tax exactions with reference to these formal, technical distinctions, the allocation approach suggests that the domestic obligation should be added to the production-sharing obligation and the total amount allocated into tax and royalty portions on the basis of the economic realities of the production-sharing setting.

86. See notes 23-33 supra and accompanying text.

87. Assuming that the tax portion is found to be creditable, the contractor's Indonesian extraction income for United States tax purposes is the entire amount of profit oil less that portion allocated to royalty. For example, assume that total profit oil is 100, broken down as follows:

<table>
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<tr>
<th>Contractor's share</th>
<th>30</th>
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<tbody>
<tr>
<td>Indonesia's share</td>
<td></td>
</tr>
<tr>
<td>Income tax</td>
<td>45</td>
</tr>
<tr>
<td>Royalty</td>
<td>25</td>
</tr>
<tr>
<td>Total profit oil</td>
<td>100</td>
</tr>
</tbody>
</table>

The contractor's foreign extraction income is the total profit oil (100) less the royalty (25), or 75. Assuming a United States corporate tax rate of 48 percent, the contractor incurs a United States tax liability of .48 x 75, or 36. However, the contractor is eligible for the foreign tax credit for income taxes paid to Indonesia, subject to the limitation provisions of § 1035(c)(2) of the Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1631, reprinted in I.R.C. § 907 note. See notes 37-39 supra and accompanying text. The contractor therefore receives a foreign tax credit in an amount which equals the United States corporate tax rate (48 percent) multiplied by his foreign extraction income from Indonesia (75), or 36. The contractor's United States tax liability (36) is offset entirely by the maximum allowable credit (36), but the excess of Indonesian income taxes over the maximum allowable credit (45 - 39 = 9) is neither creditable nor deductible in computing the contractor's total taxable income from its worldwide operations.
taxing authority and would avoid the double international taxation of income.

One obstacle to this allocation scheme is IR-1638,\(^8\) which interprets the foreign tax credit provisions as prohibiting allocation of a single levy into tax and royalty portions. This interpretation, however, finds no support in the case law.\(^9\) Moreover, an examination of the legislative history\(^8\) of sections 901 and 903 reveals that Congress did not consider the application of the foreign tax credit provisions to a single tax/royalty levy exacted by foreign government/landlords.\(^9\) In the absence of legislative direction, the IRS should apply these sections to the production-sharing contract in a manner consistent with the rationale behind the foreign tax credit; the single levy should be allocated.

**B. THE PRODUCTION-SHARING OBLIGATION AS AN “IN LIEU” TAX**

The tax portion of the production-sharing obligation will qualify for the foreign tax credit if it is imposed on income within the meaning of section 901 or imposed in lieu of an otherwise generally applicable income tax as provided by section 903.

A foreign tax is creditable under section 901 only if it is imposed with an eye towards reaching the taxpayer's net gain and is very unlikely to fall on the taxpayer when his operations are not profitable.\(^9\) Under this

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88. IR-1638, supra note 17.
89. No court has considered whether a single payment may be split into separate tax and royalty parts for foreign tax credit purposes. Moreover, the IRS refusal to allow allocation is inconsistent with Biddle v. Commissioner, 302 U.S. 573, 578-79 (1938), where the Supreme Court declared that foreign tax credit treatment should look behind the form of a foreign levy and determine creditability with a view to the substance of the charge, according to United States principles of foreign tax classification. Since a portion of the contractor’s production-sharing obligation is traceable to Indonesia’s taxing power, the presence of a tax should be recognized for foreign tax credit purposes, regardless of the “tax/royalty” form in which the contractor is obligated to pay it.
91. No foreign charges of this “tax/royalty” nature were levied at the time the foreign tax credit provisions were enacted.
92. Bank of America Nat'l Trust & Savs. Ass'n v. United States, 459 F.2d 513, 523 (Ct. Cl.), cert. denied, 409 U.S. 949 (1972). This standard for determining creditability under I.R.C. § 901 is less restrictive than the criteria of the less recent cases which required that the foreign tax base roughly approximate taxable income according to United States income taxation principles. See note 26 supra. The inconsistency between the two standards under I.R.C. § 901 does not affect the tax treatment afforded the tax portion of production-sharing obligations, since the tax will not satisfy the more restrictive standard
test, the production-sharing obligation does not qualify for credit treatment. Because each contract limits recoverable costs to 40 percent of total production under each contract\textsuperscript{93} and denies recovery for costs incurred under other contracts held by the contractor,\textsuperscript{94} Indonesia is entitled to an assured share of production whether or not the contractor's operations are profitable.\textsuperscript{95} Although net losses may occur infrequently, the possibility that the contractor might have to discharge a

\textsuperscript{93} The method of cost recovery has been recently revised to allow the contractors to amortize capital expenditures and noncapital expenses over a 7 to 14 year period. Wall St. J., Oct. 12, 1976, at 4, col. 2; Original Terms of Reference, supra note 18. For capital expenditures, this recovery method should satisfy the fifth guideline of IR-1638, supra note 17. However, the revised terms provide that noncapital costs, while "considered to be currently recoverable," can be actually recovered only over a 10 year period, with interest of 8 percent on the unpaid balance. Original Terms of Reference, supra note 18. Since the contract continues to subject the contractor to the production-sharing obligation in a loss year, this method of noncapital cost recovery does not meet the requirements of IR-1638; consequently, the revised contracts will not allow foreign tax credit treatment under the current IRS approach.

\textsuperscript{94} The fourth guideline in IR-1638, supra note 17, requires that the contractor's foreign tax liability be computed on the basis of its entire extraction operations within the foreign country. The contractors have attempted to negotiate with Indonesia for the revision of the contracts to conform to the guideline, but Indonesia thus far has refused to agree to a consolidation of contracts for the purpose of computing each contractor's production-sharing obligation. Original Terms of Reference, supra note 18. Since Indonesia continues to insist that the contractor bear all the risks of exploration and development, revision of the contracts along the lines of the fourth guideline is unlikely.

To avoid the consolidation requirement in the guidelines; an American oil company might establish (or be required by Indonesia to establish) separate subsidiary corporations, each of which would acquire one contract. In form, this device would create a separate taxable entity for each contract, the gain from which would constitute the subsidiary's entire income from its Indonesian operations. However, the IRS might regard the creation of these subsidiaries as a sham and recognize the parent as the only taxable entity for the separate operations of its subsidiaries.

\textsuperscript{95} See note 64 supra and accompanying text. Although the IRS incorrectly objected to these "assured share" features on the threshold "tax-royalty" issue, the presence of this feature does prevent credit treatment under I.R.C. § 901 on the second issue, the "imposed-on-income" requirement. The provision limiting maximum cost recovery entitles Indonesia to an assured share regardless of whether the contractor produces enough oil to recover its costs. The contractor's signature and production bonus obligations, and nonrecoverable interest expenses further increase the likelihood that the contractor may incur a production-sharing obligation when it does not realize a profit. See note 49 supra. Moreover, the provision requiring separate production-sharing computation for each contract assures Indonesia a share of production from a contractor holding several contracts, some in the production stage, and others in which substantial exploration expenditures have been made but no oil has been discovered. Despite expenditures under the unproductive contracts which are greater than profit under the productive contracts, the contractor would nonetheless incur production-sharing obligations under the productive contracts.
The Foreign Tax Credit

production-sharing obligation when its operations are unprofitable disqualifies the production-sharing tax from credit treatment under section 901.

Unlike a section 901 tax, a section 903 tax need not be directed at net gain to be creditable. The IRS has interpreted the "in lieu" provision to allow credit treatment for a substituted tax which satisfies three requirements: (1) the foreign country has in force a general income tax; (2) the taxpayer would be subject to the general income tax in the absence of the substituted tax; and (3) the general income tax is not imposed upon the taxpayer.

The first requirement is easily satisfied; a prior revenue ruling has held that the Indonesian Corporation Tax is a general income tax. Similarly, the second requirement is met because Indonesian law provides that the contractor remains liable for the Corporation Tax until the Indonesian Treasury receives its share of profit oil. The third requirement, however, poses a problem. Article 15 of the Pertamina Law provides that the contractor's Corporation Tax liability is discharged only when the Indonesian Treasury receives its 60 percent share from Pertamina. Consequently, it might be argued that the tax portion of the production-sharing obligation is a non-creditable additional, rather than a substituted, tax, since Pertamina might fail to make this deposit and leave the contractor liable for the general income tax. In situations where the contractor is held liable for both the production-sharing obligation and the general income tax, this argument has merit. However,

96. Metropolitan Life Ins. Co. v. United States, 375 F.2d 835, 838-39 (Ct. Cl. 1967). The court expressly rejected the IRS's contention that I.R.C. § 903 applies only to "empirical" income taxes, i.e. taxes aimed solely at net income but using a simplified formula to calculate the tax. Id. at 837.

97. Treas. Reg. § 1.903-1, T.D. 6780, 1965-1 C.B. 105. See note 33 supra. The IRS has indicated that the requirements which IR-1638 promulgated for I.R.C. § 901 do not apply to I.R.C. § 903. IR-1638, supra note 17. The regulations do not require that the "in lieu" tax be a substitute for the general income tax alone; consequently, the fact that the production-sharing obligation relieves the contractor of other tax liabilities in addition to the general income tax should not affect its creditability under I.R.C. § 903. See note 56 supra and accompanying text. But since these additional taxes are not imposed on income, proper tax treatment requires that, before allocation, the production-sharing obligation be decreased by the amount which the contractor would otherwise have been separately charged for these additional taxes.

98. Rev. Rul. 69-388, 1969-2 C.B. 154. The ruling held that credit treatment under I.R.C. § 903 was available for a tax paid to Indonesia pursuant to a contract between the taxpayer and Indonesia which provided that the taxpayer's tax liability was to be calculated by a method different than that under the Corporation Tax. To reach that conclusion, the IRS necessarily found that the Corporation Tax is a general income tax, in accordance with Treas. Reg. § 1.903-1(a), T.D. 6780, 1965-1 C.B. 96.

speculation about what might occur should not affect the tax status of those contractors whose Corporation Tax liability has been discharged by the Treasury's receipt of its share of profit oil. Multiple taxation of this kind has not occurred in Indonesia and is unlikely in the future. Nevertheless, if this situation should arise, credit should be given only after Pertamina deposits the 60 percent share into the Indonesian Treasury, or after the Indonesian government has indicated that the contractor will not be held liable for the Corporation Tax.

IV

A PROPOSED SCHEME OF ALLOCATION

However theoretically sound the justification for allocation may be, allocation is desirable only if a workable method of computing the separate tax and royalty portions can be formulated. The division of the production-sharing obligation must accurately reflect the economic realities of the entire transaction between Indonesia and the contractors, so that the creditable tax portion will approximate the amount which would have been paid as a tax had Indonesia elected to collect its revenues by separate tax and royalty exactions. This allocation scheme should also apply to United States oil companies operating abroad under concession contracts.

A. THE REASONABLE INCOME TAX RATE

A contractor's production-sharing obligation should be allocated on the basis of a reasonable income tax rate. Subject to the limitation provisions, the amount of the production-sharing obligation eligible for foreign tax credit treatment should equal the reasonable income tax

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100. For a general discussion of the contractor's potential liability for the Corporation Tax upon Pertamina's default, see Indonesian Petroleum Industry, supra note 44 at 323-30. Although Pertamina has recently withheld the Treasury's share to satisfy its enormous debts, the Indonesian government is unlikely to risk the damage which multiple taxation would inflict on its relationship with the contractors. See Grant, supra note 41, at 3; Indonesian Petroleum Industry, supra note 44, at 329-30. Fear of multiple taxation might induce many contractors to decrease their level of operations or terminate operations entirely. Since Indonesia's projected future revenues depend largely on production-sharing obligations, it can ill-afford this risk.

101. The contractor's liability for the production bonus has no bearing on the computation of the separate tax and royalty portions of the production-sharing obligation. See note 82 supra.

102. A contractor who challenges Rev. Rul. 76-215 or IR-1638 will stand in a stronger position if he is armed with a relatively precise formula for allocation which reflects the economic substance of the contractor's relationship with Indonesia.

103. See notes 34-39 supra and accompanying text.
rate multiplied by the sum of the contractor's share of profit oil plus the income tax portion of the levy. The balance of the production-sharing obligation would constitute the royalty portion and would be excluded from the contractor's gross income for United States tax purposes.

The reasonable income tax rate should approximate the tax rate which would have been imposed on the contractor if the host country had exacted separately computed tax and royalty charges. However, the reasonable income tax rate should not be based solely on the foreign sovereign's general income tax rate; apportionment of the production-sharing obligation should take into account the profitability of the contractor's operations. Since landowners generally exact a higher royalty from production operations where a high rate of profitability is expected, the IRS should treat a greater percentage of the production-sharing obligation as a royalty where production costs are relatively low and profits high. In this situation, the reasonable income tax rate should be lower than the general income tax rate. Conversely, less profitable

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104. Mathematically, this formula is expressed as follows:

Let \( P \) = contractor's share of profit oil

\[ R = \text{reasonable income tax rate} \]

\[ X = \text{portions of the production-sharing obligation allocated to the "tax" portion.} \]

\[
X = (R) \times (P + X)
\]

\[
X = (R) \times (P) + (R) \times (X)
\]

\[
X - (R) \times (X) = (R) \times (P)
\]

\[
X \left(1 - R\right) = (R) \times (P)
\]

\[
X = \frac{(R) \times (P)}{1 - R}
\]

Assuming a reasonable income tax rate of 60 percent and that the contractor's share of profit oil is 30, the tax portion shall be \( (.60) \times (3) \) \( \div (1 - .60) = 45 \). The difference between Indonesia's total share (70) and the tax portion (45) would constitute the royalty portion (25). See note 87 supra.

105. The Indonesian Corporation Tax imposes an income tax rate of 56 percent, which falls within the range of income tax rates imposed by the major oil producing Middle East countries (50 to 85 percent). Nordberg & Kelleher, supra note 9, at 220; see note 78 supra. The income tax rates imposed by host countries upon North Sea oil production are generally lower, in the range of 40 to 50 percent. See generally Brenscheidt, supra note 79.

106. For allocation purposes, profit should be measured by gross profit per barrel, which is the market price less cost of production, not including the royalty and income tax charges.

107. See G. Brannon, supra note 19, at 61-62.

108. The integration of factors into a mathematically weighted formula involves economic analysis which is beyond the scope of this Note. It should be observed, however, that the formulation of the reasonable income tax rate would not impose an undue burden on the IRS. Although the IRS would have to stay abreast of the economics of oil production in foreign countries and the intricacies of foreign taxation schemes, this administrative
operations should be assigned a lower royalty rate and a correspondingly higher income tax rate.  

B. APPLICATION TO CONCESSION CONTRACTS

This allocation scheme should also be applied to levies imposed on American oil companies operating abroad under traditional concession contracts. Although the foreign host government typically imposes separately stated tax and royalty charges on the concessionaire, the "income tax" charge may not accurately reflect the portion of the concessionaire's total obligation traceable to the sovereign's exercise of its taxing authority. In order to accommodate the tax desires of American oil companies, a host government may exact the royalty charge at a responsibility would not significantly increase the extensive administrative activity in which the IRS is currently engaged with respect to corporate taxpayers' foreign extraction income. Comment, supra note 4, at 447. The equitable tax treatment which allocation offers is well worth a slight addition to this administrative burden.

109. Although this allocation scheme may not provide an exact formula for apportioning the tax and royalty portions, this scheme is preferable to tax treatment which characterizes the entire obligation as one or the other. In Commissioner v. Ferrer, 304 F.2d 125 (2d Cir. 1962), Judge Friendly directed allocation of a single contractual obligation for tax purposes and stated:

In such instances, where part of a transaction calls for one tax treatment and another for a different kind, allocation is demanded . . . If it be said that to remand for this purpose is asking the Tax Court to separate the inseparable, we answer that no one expects scientific exactness; that however roughly hewn the decision may be, the result is certain to be fairer than either extreme; and that similar tasks must be performed by the Tax Court in other areas.

Id. at 135. See note 84 supra.

110. See notes 78-79 supra and accompanying text. Similarly, the allocation scheme should apply to production-sharing contracts which may be revised to obligate the contractor to discharge separately stated royalty and income tax levies. See note 18 supra.

111. See Cox & Wright, supra note 22, at 825-26. American oil companies will pay lower United States income taxes if the foreign government splits its total charge into a relatively high income tax and a relatively low royalty. The following table illustrates the United States tax differential for two countries which each exact $50 from a taxpayer whose net production (less royalties and income tax) is $100:

<table>
<thead>
<tr>
<th>Country A</th>
<th>Country B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalty</td>
<td>20</td>
</tr>
<tr>
<td>Income tax (computed on net income less royalty) $ at 32.5% = 30</td>
<td>at 44.5% = 40</td>
</tr>
<tr>
<td>Total revenue</td>
<td>50</td>
</tr>
<tr>
<td>U.S. taxable income</td>
<td>80</td>
</tr>
<tr>
<td>U.S. income tax without credit</td>
<td>80</td>
</tr>
<tr>
<td>Less: credit for foreign income taxes</td>
<td>30</td>
</tr>
<tr>
<td>U.S. income tax</td>
<td>$8.4</td>
</tr>
</tbody>
</table>
low rate not commensurate with the value of the concession and impose a relatively high rate of income taxation. Proper tax treatment should recognize that part of the charge which such a revenue collection scheme denominates as an "income tax" is actually a disguised royalty charge.112 Foreign tax credit treatment should reflect the economic substance of the concessionaire's tax and royalty obligations and allow credit only for that portion which constitutes a true income tax.113 The reasonable income tax rate114 approach suggested for production-sharing contracts should be used to determine the creditable amount.115

Thus, the taxpayer pays $5.2 more in United States taxes on income from country A for every $100 of revenue than he pays on his income from country B. American oil companies have in the past influenced host countries to adopt the revenue-collecting scheme represented by country B in order to obtain more favorable United States tax treatment. See Comment, supra note 4, at 429.

112. IR-1638 indicates that the IRS intends only to allow a deduction for foreign income taxes which contain a disguised royalty portion. IR-1638, supra note 17, at 71,670. Such tax treatment would impose an inequitably heavy tax burden on those taxpayers paying levies denominated as income taxes but not recognized as creditable by the IRS.

113. Congress has already enacted legislation which addresses the foreign tax credit afforded income taxes calculated on the basis of a posted price. I.R.C. § 907(d) provides that foreign extraction income is determined by the fair market value of the oil produced rather than by the higher posted price. Because this valuation method decreases foreign extraction income, the foreign tax credit allowable under the limitation provisions is reduced correspondingly. See notes 34-39 supra and accompanying text. The amount of foreign tax eliminated from the foreign tax credit by I.R.C. § 907(d) is not deductible as a tax under I.R.C. § 164(a)(3). See note 4 supra. However, some or all of this "tax" amount should be excludable from gross income if it actually constitutes a disguised royalty payment. But regardless of this royalty exclusion, I.R.C. § 907(d) evidences legislative intent not to deny the foreign tax credit completely when the foreign taxation scheme generates excessive foreign income taxes which do not precisely reflect the economic realities underlying the taxpayer's relationship with the host government.

114. The fact that a host country may exact royalties in the form of a levy on gross rather than net production does not affect the applicability of the allocation scheme, provided that the tax portion satisfies the requirements of I.R.C. §§ 901, 903. Where the gross royalty rate in a particular country is found to be unreasonably low, the allocation scheme may be adjusted to apportion the tax and royalty revenues on the basis of a royalty calculated upon net rather than gross production.

115. The applicability of the allocation scheme to concession contracts is not prevented by I.R.C. § 901(f), which denies foreign tax credit treatment for a levy paid in connection with the purchase or sale of oil if: (a) the taxpayer does not have an economic interest in the oil; and (b) the price differs from the fair market value. The legislative history of this provision indicates that it is intended to apply only to "buyback" oil. 121 Cong. Rec. S9246 (daily ed. Mar. 26, 1975) (remarks of Sen. Long). See S. Rep. No. 938, 94th Cong., 2d Sess. 251 (1976). "Buyback" oil refers to the share of oil to which the host government retains title under a participation agreement permitting or requiring the oil company to purchase this oil when the host government's marketing efforts fail. Yager & Steinberg, Trends in the International Oil Market, in Higher Oil Prices and the World Economy 227, 233 (E. Fried & C. Schultze eds. 1975). See note 79 supra. I.R.C. § 901(f) disallows...
CONCLUSION

Revenue Ruling 76-215 fails to treat the production-sharing obligation in a manner which reflects the economic realities of the relationship between the contractor and Indonesia. The characterization of the entire obligation as a royalty is not supported by the reasoning set forth by the IRS in the ruling and produces inequitable tax treatment of taxpayers in substantially similar economic positions. Proper tax treatment should allocate the production-sharing obligation into separate tax and royalty portions for foreign tax credit purposes. This allocation scheme would afford credit treatment for the portion of the production-sharing obligation attributable to Indonesia’s income taxation authority and exclude from the contractor’s gross income the portion traceable to its exercise of landowner rights. This tax treatment would properly reflect the substance of the production-sharing relationship and provide tax equity between concessionaires and production-sharing contractors.

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credit for foreign “income taxes” upon the oil company’s subsequent resale of this buyback oil if the host government establishes an artificially inflated posted price upon which the income tax on the resale is calculated.

“Equity” oil, to which the oil company acquires title upon production, is not covered by I.R.C. § 901(f), even though the host government may require the calculation of the income tax at a posted price which does not reflect the market value of the oil produced. See Tannenbaum, supra note 6, at 23. Consequently, the “income taxes” on equity oil production levied by Saudi Arabia and other Middle Eastern countries should be eligible for the foreign tax credit under an allocation scheme to the extent that these “income taxes” do not constitute disguised royalty charges. But see Comment, supra note 19, at 1066-67.