SYMPOSIUM

Multinational Corporations and the Energy Crisis

Foreign Governmental Control of Multinational Corporations Marketing in the United States

American Tax Credits and Foreign Taxes and Royalties

Expropriation, Threats of Expropriation and Developmental Policy

FEDERAL INCOME TAX TREATMENT OF UNITED STATES OIL CORPORATIONS*

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I. INTRODUCTION

Oil and gas operations are the single most important activity carried on by American multinational corporations. Five of the largest ten U.S. multinational corporations are international oil companies. The book value of U.S. investment abroad in petroleum approached $25 billion in 1971 and represented almost 30 percent of total U.S. direct investments abroad.

Despite its great importance, there is almost a complete dearth of information on the subject of U.S. and foreign taxation of these international oil operations. There has never been a comprehensive study published by either a government or private body. It is hard to find even partial data necessary to an analysis of the tax situation of the major companies. While there is a vast general literature on the tax laws applicable to foreign income, the particular application of this law to the oil industry is so sparse that one can count on the fingers of one hand the number of significant articles that have dealt specifically with this subject.

What information there is indicates that U.S. oil corporations pay very low taxes to the United States. Thus, one estimate is that in 1972 the 19 leading oil companies paid about $700 million in federal income taxes on a net income of about $11.5 billion or an overall effective U.S. rate of about 6 percent. In contrast, these companies paid about $5.1 billion to foreign governments. If it is assumed that about one-half of the net income of these companies was domestic and about one-half was foreign, and that a sufficient part of the $5.1 billion of foreign taxes was used as credits to offset residual U.S. taxes on the foreign income, it would mean an effective U.S. tax rate on domestic income of between 10 and 20 percent and an effective U.S. tax rate on foreign income of

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close to zero. Of course, 1972 was a low income year for oil companies, particularly as compared to 1973, and the assumptions here are very rough. However, if not precisely accurate, these estimates are sufficient to suggest the problem. We are basically dealing with a major U.S. industry that operates without payment of significant U.S. taxes. This raises four basic questions:

1. How do American international oil companies achieve this highly favorable U.S. tax treatment? What are the key tax provisions and how do they operate to produce this virtual exemption from U.S. tax on foreign income?
2. What is the rationale for these key tax provisions? How did these key provisions of our tax laws develop historically?
3. What proposals for reform of taxation in this area have been made? What changes would be needed to produce a more substantial tax contribution from international oil operations?
4. What are the likely effects of proposed tax reforms as compared with the present system? What would be the ultimate consequences of tax changes affecting the oil and gas industry?

Having raised these four questions, let me hasten to say that I cannot hope to set forth complete or definitive answers. The most that I can do is to provide such thoughts as I have that may be relevant to the answers.

II. NATURE OF THE ACTIVITIES OF INTERNATIONAL OIL COMPANIES

Two complex areas of the tax law are applicable to the activities of U.S. oil companies, namely, that dealing with natural resources and that dealing with foreign income. The interaction of the rules in these two areas raises a host of difficult issues at both the technical and policy levels. For example, the question of the U.S. credit given for the taxes imposed by Saudi Arabia raises the technical issue of whether they are "income taxes" and the policy issue of whether, however they are classified technically, they should be fully credited. Before dealing with the major technical provisions and the policy issues they raise, however, it is necessary to briefly classify the operations of international oil companies in a way that permits analysis for U.S. tax purposes.

First, there are those activities which are the core activities of oil and gas companies. These involve, first, exploration for oil and gas; next, development of oil and gas properties once found to a point where they are ready to produce oil and gas; and, third, production of oil and gas, the actual lifting of oil and gas out of the developed wells.

Second, there are those activities which are closely related to the core activities. These include storage of oil and gas once taken from the ground; transportation, usually by shipping in tankers or through pipelines; financing the basic and related operations; and ancillary service activities such as insurance and administration. Also in this category one might include marketing of the crude oil or refining, since most major oil companies are integrated operations which carry on these activities as a normal matter.

Finally, there are those activities which are essentially unrelated to the basic activities. These occur, for example, when an international oil company invests in a petrochemical complex to utilize certain of the products of its refinery or sets up its own controlled retail operations or invests its income in real estate. While many oil companies carry on these activities, they are not necessarily required by the core oil business.

With this categorization of activities as a framework, I turn to an analysis of the federal income tax treatment of these companies.

III. KEY TAX PROVISIONS UTILIZED BY OIL COMPANIES

There are at least eight key aspects of U.S. tax law which must be understood in order to have an appreciation of the tax treatment of international oil companies.

A. *Expensing Intangible Drilling and Development Costs*

Expenses incurred during exploration and development may be written off immediately in full under the tax laws. This applies to expenditures made both abroad and in the United States. Expenditures made abroad must be made through domestic subsidiary corporations, but this is a formal requirement that generally presents no practical problems. Even if a foreign country requires use of a local (foreign) corporation to explore and develop oil and gas properties, agreements between the required foreign corporation and a domestic subsidiary corporation can make the domestic corporation the entity holding the economic interest and entitled to receive the U.S. tax deductions.

These deductions incurred in exploration, even those incurred abroad, can immediately offset U.S. income. This U.S. income can be from any source, such as domestic retail operations or even real estate ventures. Assuming the company has sufficient income to use the deductions, the U.S. Government in effect is absorbing about 48 percent of the expenses incurred by oil companies in the exploration and development of new oil and gas properties.

The tax treatment here can be contrasted with that applicable to manufacturing industries generally. With respect to manufacturing industries, amounts spent to secure a new plant are allowed an investment tax credit and depreciation. The investment tax credit provides for an immediate write-off that is an extraordinary allowance. But while accelerated methods are available, depreciation basically must be taken over the useful life of the property. Thus, the tax treatment of oil and gas is significantly more favorable than that of manufacturing generally in terms of the immediate deductibility of capital costs.

B. Percentage Depletion Allowances

The removal of a mineral from its natural reservoir during production diminishes the quantity remaining until eventually the recoverable supply is exhausted. The exhaustion of a wasting asset is considered to be depletion for which the tax laws must take account.

There are basically two types of depletion. Cost depletion represents a write-off during removal on some appropriate basis of the actual costs expended to acquire the resource. Percentage depletion is an artificial allowance based on an arbitrary amount of the income received from the removal of the oil and gas from the property. The current rate of depletion for oil and gas is 22 percent. Because it is an artificial allowance, it is not limited to the costs incurred, which, as noted above, are generally already expensed as intangible drilling and development costs. Studies indicate that, generally, percentage depletion allowances may provide tax deductions which over the life of a productive property recover 10 to 20 times its cost. The major limitation is that percentage depletion cannot exceed 50 percent of the income from the property in any one year.

Again, percentage depletion is available with respect to production activities abroad as well as in the United States. As will be seen below, when taken on foreign income it has an important interrelationship with the foreign tax credit.

Certain other mineral properties also receive depletion allowances, although generally at a lower rate. Oil and gas are not unique here, except to the extent that the allowance is more generous and that one of the reasons other mineral properties receive this allowance is because of analogy to the oil and gas provisions. There is nothing comparable in the case of manufacturing industries. The investment tax credit is an extraordinary allowance, but it represents a one time incentive designed to induce the initial investment whereas percentage depletion is a continuous allowance as long as the taxpayer derives income from the property.

C. Foreign Tax Credits

The United States generally allows a credit against U.S. tax for taxes paid to a foreign government on income earned abroad. There is a direct credit for income taxes imposed directly on a U.S. taxpayer and an indirect foreign tax credit for income taxes paid by foreign subsidiaries of American companies. There are various qualifications and limitations on the foreign tax credit, the most important of which is that the taxpayer is required to elect between a per-country or overall limitation.

The per-country limitation generally is more favorable from the standpoint of the taxpayer when losses are incurred in one foreign country and there is income and foreign tax credits in other foreign countries. In this case the losses will not operate to reduce the foreign tax credits available from the income-producing operations in foreign countries.

The overall limitation generally is more favorable when there are significant variations in foreign effective rates, and maximum foreign tax credits can be achieved from an averaging of the various foreign effective rates.

Most major oil companies apparently use the per-country limitation, although at least some use the overall limitation. Regardless, since international oil companies pay high foreign taxes in countries where they own production facilities, the foreign tax credit permits the repatriation of earnings with little or no residual U.S. taxes. Further, these foreign taxes in appropriate circumstances can shelter low tax foreign income derived from non-production activities. As discussed below, the issue raised by these high foreign taxes on production income is whether the foreign tax credit allowance is proper.

D. Deferral of Tax on Foreign Income

Foreign corporations owned and controlled by Americans generally are not subject to current U.S. income tax on their foreign income. All American taxpayers have this privilege of avoiding current taxation on foreign income by the simple act of directing it into foreign corporations, but few outside of the largest corporations make extensive use of the privilege.

In the case of international oil activities, deferral has several aspects. With respect to some activities which are generally taxed at a low or zero rate abroad, like transportation (shipping) or finance, it effectively avoids any U.S. tax at the time income is earned. With respect to activities abroad that generally produce high foreign taxes, such as the production of oil and gas, deferral itself does not reduce U.S. taxes since foreign tax credits generally would eliminate any residual U.S. tax anyway. Deferral does, however, allow the taxpayer to time the distributions from foreign corporations to U.S. corporations so as to achieve maximum foreign tax credits and, thereby, to reduce or eliminate residual U.S. taxes.

E. Minimum Distributions Election

In reforming taxation of foreign income, Congress has enacted provisions intended to limit the deferral privilege. Thus, the Revenue Act of 1962 enacted Subpart F and related provisions designed to curb "tax haven" activities. Subpart F would impose current taxation on such foreign-based activities of international oil companies as sales to related parties, services rendered for related parties, and finance that gives rise to passive income. However, a safety valve provision, the minimum distributions election, was inserted in the law.

The basic concept of minimum distributions is that foreign taxes and U.S. taxes on distributions must produce an overall effective tax rate of 43 percent or more, roughly within 10 percent of the U.S. corporate tax rate. Where the foreign effective rate is itself 43 percent or more, no distribution is required, but complete relief from Subpart F is provided.

The minimum distributions provision may be elected on a consolidated basis in which a domestic parent and its domestic affiliates make the election with respect to all of their foreign subsidiaries. Moreover, branches of domestic corporations may be treated as foreign subsidiaries which have distributed all of their earnings. Thus, branches incurring intangible drilling and development cost deductions which are allowed to directly offset U.S. income are also taken account of in meeting minimum distributions requirements. This means that they reduce or eliminate any required distributions called for by this election.

For those international oil companies incurring high rates of foreign tax on production income the minimum distributions requirement is met almost automatically. Thus, international oil companies may effectively maintain tax haven activities and are indeed encouraged to find low tax activities to average out the high foreign taxes paid to producing countries.

F. Western Hemisphere Trade Corporation Provisions

Domestic corporations qualifying as Western Hemisphere Trade Corporations are permitted roughly a 14 percentage point reduction in tax. With respect to mineral activities conducted in Latin America, Venezuela, or in Canada, for example, the use of Western Hemisphere Trade Corporations can reduce the effective U.S. rate to 34 percent. Then foreign tax credit allowances can wipe out the residual U.S. tax computed at the reduced rate. Again, during exploration and development, these domestic corporations can immediately write off all of their intangible drilling and development costs.

G. Multiple Entities and Complexity

Separate corporations, domestic and foreign, are generally used for various activities. This use of multiple corporations also provides flexibility to achieve optimum tax rates in each foreign country of operation. Furthermore, the ability to file in the United States a consolidated federal income tax return and to make a consolidated minimum distributions election, allows international oil companies to achieve maximum results in the United States despite the use of separate corporations.

Complex arrangements are often needed between the various entities in the corporate group. Intercompany financial and contractual arrangements are often required so as to maximize results. U.S. tax laws generally allow the taxpayer to structure his affairs in a way which permits this use of multiple entities and intercompany arrangements. The resulting complexity generally helps the companies since it is more difficult for the Internal Revenue Service to audit and verify compliance. The Treasury Department's difficulty in accurately compiling totals for the intangible deductions, percentage depletion allowances, and foreign tax credit benefits utilized by major oil companies further complicates this situation.

H. Revenue Safeguards

The courts and the Internal Revenue Service have traditionally utilized various provisions to attempt to restrain tax avoidance and prevent tax evasion. Thus, there are section 482 provisions dealing with the allocation of income and deductions, including those dealing with pricing relations between related entities. There are also "substance over form," "business purpose," and "general tax avoidance" doctrines. These traditional governmental tools have been of limited assistance in policing the activities of international oil companies. While the Internal Revenue Service, during the 1960's, attempted to audit pricing arrangements, the results were apparently mixed. One reason is that the complexity and size of the taxpayers and the ornate and secret quality of many of the business arrangements made effective tax enforcement extremely difficult.

IV. RATIONALE FOR KEY TAX PROVISIONS

The next question to be dealt with is a brief summary of the rationale for the key aspects of the tax laws described above. These will be taken up in the same order as the provisions themselves.

A. Expensing of Intangible Drilling and Development Costs

The basic rationale here is that the exploration for oil and gas is a high risk type of business. The thought is that unless there are adequate tax incentives this kind of high risk activity will not be undertaken.

A question here is whether the same incentive should be provided for foreign exploration and development as is provided for domestic. Recent international events make this a doubtful matter. From the standpoint of the national interest of the United States, properties discovered abroad do not necessarily have the same benefits as those discovered domestically. A question can be raised as to why any tax incentives should be given to Americans to discover foreign oil and gas.

B. Percentage Depletion Allowances

Even most of its proponents readily admit that percentage depletion is an artificial allowance. The rationale is that this allowance is justified by important public policy considerations, primarily national security. In the past, proponents have also maintained that the benefits of special tax allowances were largely passed along to consumers in the form of lower prices.

We now seem to be in a new era where the price of energy is to rise, both to encourage conservation by consumers and to increase production by suppliers. The question then becomes whether tax incentives that might artificially hold down prices are appropriate. Another essential question is whether the allowance does not result in an over-allocation of capital investment to discovery of this resource. It is no answer to say that we need all the energy resources discoverable, for there can be misallocation within the energy area. Percentage depletion, in effect, provides tax incentives for undertaking oil and gas activities as opposed to undertaking research and development to develop alternative energy sources and reduce consumption.

There is also a question of how much incentive is needed. For years the rate was 27.5 percent. It is currently 22 percent. In view of the prices oil and gas presently command, would oil and gas investment decrease at all if the allowance went down to 15 percent? How much less investment would be made in oil and gas if percentage depletion were repealed?

Regardless of its justification for domestic wells, percentage depletion for foreign properties is questionable. As with the intangible drilling cost deduction, foreign properties are not the same as domestic ones from the standpoint of the national interest of the United States.

Finally, I would point out that in the Estimates of Federal Tax Expenditures for 1972, prepared by the Staffs of the Treasury Department and Joint Committee on Internal Revenue Taxation, the expensing of exploration and development costs was estimated to be $650 million and the excess of percentage over cost depletion was estimated at $1,700 million, for a total tax subsidy of $2.35 billion. Undoubtedly the 1973 figures will be significantly higher. These amounts loom, I assume, very large compared to any amounts the Government might realistically provide for direct subsidies to develop or encourage additional energy supply.

C. *Foreign Tax Credits*

While the rationale for the expensing of intangible drilling costs and percentage depletion is essentially rooted in tax subsidy concepts, the allowance of the foreign tax credit is basically rooted in concepts of tax equity. The fundamental tax problem raised by international transactions is that they generally involve the taxing jurisdictions of two or more independent countries. Foreign countries often impose tax burdens comparable to those that prevail in the United States. If both countries with a claim for taxing a particular international transaction were to impose their tax without regard to the other, the result would be double taxation with tax burdens that would deter or prevent international business. Indeed, it would be possible in the absence of accommodation mechanisms for tax burdens to exceed 100 percent of the income earned.

The foreign tax credit is the basic mechanism by which the United States accommodates its tax system to that of foreign jurisdictions. It allows the source country to tax in the first instance, but the country of nationality then imposes its tax to the extent it exceeds that of the source country.

The foreign tax credit is a particularly equitable method of accommodating conflicting jurisdictional claims. It is used by many countries. It recognizes both the primary rights of the source country of income and the residual rights of the country of nationality. It provides an alternative to an exemption method, used by some countries, under which the country of nationality would never impose tax on foreign income, and a deduction method, which basically involves an under-allowance of the claims of the source country.

If there were no foreign tax credit, American companies in many instances would have no practical alternative to divesting themselves of their foreign operations. Repeal of the foreign tax credit would be logical only if Congress decided to penalize foreign investment, just as adoption of an exemption method would be a decision to give a tax subsidy to foreign investment.

On the other hand, there could be significant reforms of the foreign tax credit to make it operate more equitably. Thus, the present limitations on its use are in need of review. There is little justification, for example, in allowing the taxpayer an election between the per-country and overall limitations.

In the case of international oil, some unique questions are raised by the foreign tax credit mechanism. First is the question of whether the taxes imposed by producing countries are truly foreign income taxes. These countries have few activities to which their income taxes apply apart from oil production. The tax is imposed on an artificially created price and does not necessarily relate to the true income of the taxpayer.

Furthermore, the government is also the owner of the property and is presumably indifferent whether it receives royalties or taxes, as long as it is satisfied with the total amount of payments. Finally, the foreign tax credit applies to offset a U.S. tax liability on a net income already sharply reduced by intangible drilling deductions and percentage depletion allowances, so it seems to be the final step towards tax avoidance.

From a technical standpoint, it seems unclear to me that under current conditions the foreign taxes imposed on oil production are income taxes of the kind that should be allowed as a credit against U.S. tax liability. Under current law it seems that these foreign taxes either are or are not creditable, and it would be difficult in principle to allow a credit for only a portion of them. Most importantly, even those who generally advocate the foreign tax credit mechanism must ask the question whether these particular foreign taxes should, as a policy matter, be creditable.

D. *Deferral of Income for Foreign Corporations*

The basic notion here is that foreign corporations, even those owned by Americans, compete abroad with other foreign corporations and therefore should have to pay currently no more taxes than are paid abroad by their competitors. In the case of the American international oil companies, their principal competitors, such as those incorporated in the United Kingdom, the Netherlands, France, Italy or Japan, generally are allowed deferral. All of these foreign oil companies probably achieve low effective tax rates. If deferral were eliminated by the United States, and the result were to impose substantial taxes, the argument would be that this would put the American companies at a competitive disadvantage.

On the other hand, proponents of the elimination of deferral point out that U.S. taxpayers operating domestically have to pay substantial taxes and that American-owned corporations operating abroad should pay equal taxes. A difficulty with this argument in the case of international oil companies is that their domestic tax rates are also very low, so that in applying a domestic standard it may be necessary to look to domestic taxpayers outside the oil and gas industry. This may suggest that reform in this area probably cannot, and should not, be focused solely, or even primarily, on the foreign activities of the oil companies, but should be focused on their overall activities, both domestic and foreign, so as to achieve an appropriate tax regime with respect to their worldwide income.

E. *Minimum Distributions*

The minimum distributions concept provides a comparison between the overall effective rate of consolidated overseas activities and the U.S. tax rate. Based on this comparison, an abuse of the deferral privilege can be discovered. In contrast, it may be argued that income from particular tax haven transactions should be taxed by the United States regardless of the overall situation of the multinational company conducting the transactions. Those who favor the overall limitation on the foreign tax credit tend to favor the minimum distributions concept, while those who favor the per-country limitation are more likely to find fault with the concept.

Even if the minimum distributions provision is sound, however, there could well be changes to make it work more equitably. Perhaps the overall effective rate should be equal to the U.S. rate, *i.e.*, 48 percent. Also, the ability to treat branches (where the deductions are taken currently as domestic deductions) the same as foreign corporations could be reconsidered. The approach taken would likely depend on whether deferral was being eliminated generally or whether an attempt was being made to specifically deter only foreign tax haven activities.

F. *Western Hemisphere Trade Corporations*

The Western Hemisphere Trade Corporation provisions were enacted in 1942. Congress apparently was concerned about encouraging American multinational corporations to operate in Latin America and it desired to provide some tax incentive to this end. However, after some 30 years in the Code, there has been no demonstration of the benefits or, indeed, who it is that is benefiting. Exporters have reaped benefits, as well as oil companies and others operating in Canada or Latin America. Justification for these provisions in terms of the national interest seems absent.

G. *Multiple Entities and Complexity*

The tax laws generally permit taxpayers to arrange their affairs so as to minimize income taxes. There is nothing peculiar or improper in the use of multiple corporations by U.S. oil companies, except that by virtue of the various other provisions discussed above and their sheer size and complexity, they are able to achieve an overall tax regime that provides virtual exemption from tax on foreign income and a particularly low effective rate on domestic income.

H. *Revenue Safeguards*

Here again, there is nothing peculiar or improper about international oil operations, except that because of their sheer size and complexity and the interplay of so many favorable provisions, it is difficult for the traditional safeguards used by the Government to be effectively brought to bear. Further, the absence of public disclosure as to the administrative application of the tax law to large oil companies makes it difficult for the American taxpayer to know whether the Internal Revenue Service is carrying out its responsibilities.

V. *INTERACTION OF KEY TAX PROVISIONS*

It should be pointed out that these key aspects of the U.S. tax law are inter-related. Any proposed changes in the law must take account of the complex and, sometimes, surprising interactions between provisions.

For example, the following illustration is an attempt to show in simplified fashion how the change from treating payments to a foreign government as a tax to a royalty would operate. The assumptions in the illustration are that a domestic company has gross receipts from the production of oil of $1,000; recoupable exploration and development expenditures of $250; operating expenses of $100; and other costs of $50.

		(1)		(2)		(3)		(4)
Gross Receipts		1000		1000		1000		1000
Less: Royalty		300		-0-		150		225
Gross Income		700		1000		850		775
Less: Percentage depletion (22%)	150*		220		187		170	
Intangible drilling costs	250		250		250		250	
Operating costs	100		100		100		100	
Other costs	50		50		50		50	
		550		620		587		570
Taxable Income		150		380		263		205
Tentative U.S. Income Tax (48%)		75		182		126		98
Less: Foreign tax credit		0		300		150		75
Net U.S. tax liability		75		-0-		-0-		23
Excess foreign tax credit		---		(118)		(24)		---
Net after tax return to company:								
Gross receipts		1000		1000		1000		1000
Less: Costs other than percentage depletion		400		400		400		400
Less: Payments to foreign country		300		300		300		300
Less: Payments to U.S.		75		-0-		-0-		23
		225		300		300		277

* 50% limitation applicable.

(1) Company pays 50% of net profits in form of royalty to lessor country.

(2) Company pays no royalty, but 50% income tax to lessor country.

(3) Company pays 25% of net profit as a royalty and an income tax sufficient to bring to 50% the total payments to lessor country.

(4) Half of tax in Column 3 treated as a royalty (*i.e.*, 12.5%) and a royalty sufficient to bring to 50% the total payments to lessor country.

Column one shows the U.S. tax result if the company pays 50 percent of the net profits, *i.e.*, $600 ($1,000 less $250, $100, and $50) to the lessor country in the form of a royalty. In this case, the U.S. tax is $75, and the company's net after tax return is $225.

Column two shows the U.S. tax result if the company pays no royalty but a 50 percent income tax to the lessor country. In this case the U.S. tax is zero. In fact, there are $118 of excess foreign tax credits to be used; and the company's net after tax return rises to $300.

Column three shows the U.S. tax result if the company pays 25 percent of the net profits as a royalty and an income tax sufficient to bring to 50 percent the total payments to the lessor country. In this case, the U.S. tax is still zero. In fact, there are $24 of excess foreign tax credits to be used, and the company's net after tax return remains at $300. In all three cases, the lessor country has received $300.

Further, the illustration shows that the amount of percentage depletion allowed is affected by whether a royalty or tax is paid. Payment of a tax rather than a royalty increases the amount of the depletion allowance.

It might also be noted that even if the percentage depletion allowance were not available, there would still be no U.S. tax in the column two case (50 percent foreign tax) because the foreign tax credits would still be sufficient to offset the tentative U.S. tax. Further, if in the column two case, the United States were by law to treat half of the foreign tax as a royalty, the result would be that of the column three case, where the company still paid no U.S. tax. On the other hand, if half of the tax in the column three case were treated as a royalty, the result would be, as shown in column four, that the United States would collect a residual tax of $23 and the company's net after tax return would be decreased by that much. The foreign government would still receive $300.

The illustration can also be used to show that at some point a proper mix of royalties (deductions) and taxes (credits) can achieve better results than just taxes (credits) and that converting part, or even all, of a foreign tax into a royalty can actually reduce U.S. taxes. Suppose in the column two case the company incurred $380 of additional intangible drilling costs on another property in the lessor country and also realized $200 of U.S. source income. The additional $380 of deductions would wipe out the taxable income from the lessor country; the entire $300 of foreign tax credits would be an excess to be carried over; and the company would pay a U.S. tax of $96 (48%) on its $200 of domestic income.

On the other hand, if the United States were by law to treat half of the foreign tax as a royalty, as shown in column three, the result would be that the company would have a net loss in the lessor country of $117, which could offset domestic income; the $96 of potential U.S. tax on its $200 domestic income would be reduced to $40; and the remaining $150 of foreign tax credits would be an excess to be carried over. The $150 of disallowed excess foreign tax credits would have, in effect, offset $117 of domestic income. The change in U.S. law would have saved the company $56.

Indeed, if three-quarters of the payments to the lessor country were treated as a royalty, as shown in column four, the $96 of potential U.S. tax on the $200 of domestic income would be reduced to $12, and the change in the U.S. law would have saved the company $84. Finally, I would note that if all of the foreign tax were treated as a royalty, as shown in column one, the $200 of domestic taxable income of the company would be entirely offset, and the company would pay no U.S. taxes at all; indeed, it would have a net operating loss carryover of $30 to use in later years.

Additional and more complex examples would be necessary to even begin to do justice to the subtleties involved in the interaction of the key tax provisions described above. Major oil companies themselves, as I understand it, have large numbers of accountants and analysts equipped with computers and advanced methodology to do the various calculations necessary for tax planning. Suffice it to say that considerable data relevant to tax analysis broken down by companies and careful study by experts are a prerequisite to any attempt to predict the actual results of changing one or more aspects of the tax law applicable to international oil operations.

VI. HISTORY OF FOREIGN TAX RULES

A look at the historical development of some of the principal foreign tax rules applicable to international oil activities is helpful to provide a perspective on current problems. Current deduction for intangible drilling and development costs goes back to the very beginnings of the modern income tax in 1917. Percentage depletion was enacted in the Revenue Act of 1926 effective retrospectively to 1925. Little consideration was given over the years to whether these special allowances should apply only to domestic as opposed to foreign activities. Foreign corporations owned and controlled by Americans have had deferral on foreign earnings going back to the beginning of the modern income tax in 1913. The foreign tax credit was also introduced at an early stage in 1918.

The taxation of foreign income was reformed by the Revenue Act of 1962. While there had been piecemeal changes in the rules over the years, this was the first major reform of this area of the tax law. The debates during 1961 and 1962 covered a wide range of issues. Even then, however, little special attention was given to international oil companies, which were largely treated the same as all other multinational companies.

In 1963, President Kennedy recommended in his tax message that measures be adopted to prevent U.S. companies from using deductions for the development of mineral resources in foreign countries to reduce their U.S. tax on income earned in the United States. He also recommended that consideration be given to preventing excess foreign tax credits on mineral income from offsetting U.S. taxes on other nonmineral foreign income. These excess foreign credits arise from the allowance of percentage depletion and the deduction of development costs on foreign mineral operations. The Treasury explanation of these recommendations pointed out that the tax laws created a strong incentive to develop foreign natural resources since part of the cost of undertaking the development program is borne by taxes which would otherwise be paid on domestic income. This proposal did not meet with success, but it did, for the first time, raise publicly the issue of whether there were not special characteristics of international oil operations that required rules different from those generally governing foreign operations of American multinational companies.

In 1969 the House Ways and Means Committee again directed attention to some of the international tax aspects of foreign oil operations, and the House version of the Revenue Act of 1969 contained several provisions designed to deal with this subject. First, it was provided that a taxpayer who reduces his U.S. tax on domestic income by means of a loss from a foreign country would have this tax benefit recaptured by the United States when income subsequently is derived from the country. The mechanism for recapture would be a disallowance of the foreign tax credit in an amount sufficient to prevent a double tax benefit.

A second provision provided for a separate foreign tax credit limitation on foreign taxes paid with respect to income derived from foreign mineral production. Such a foreign tax credit limitation would preclude excess foreign tax credits, which arise from foreign mineral production, from being used to offset what would be the U.S. tax on other foreign income in the same or other countries. The House Ways and Means Committee report justified this separate treatment of income taxes on production income on the grounds of the difficulty of distinguishing a royalty payment from a tax payment where the foreign tax authority is also the owner of the mineral rights.

Finally, the House bill eliminated percentage depletion with respect to foreign source income, largely on the ground that it was not a necessary or appropriate incentive.

Strong objections were made to these House provisions and ultimately the Revenue Act of 1969 contained only a provision that excess foreign tax credits attributable to percentage depletion could not offset tax on non-mineral income. However, the definition of "mineral income" was sufficiently broad so as to include substantial low-tax foreign income, such as that from shipping, thereby enabling the oil companies to use much of the credits from production income against other types of foreign income. In short, the action that was taken did not significantly affect the highly favorable tax treatment accorded the oil companies.

In 1973 the Burke-Hartke bill was introduced. Persistent and active support of this legislation by organized labor concerned with the effect of American multinational corporations on domestic employment had generated considerable support in the Congress for reform of the taxation of foreign income. The tax provisions of Burke-Hartke itself would have eliminated deferral for all foreign subsidiaries, converted the foreign tax credit into a deduction, and made other extensive changes. While relatively few Congressmen were prepared to support Burke-Hartke in all respects, there seemed to be substantial support for some sort of tax reform which would move in the direction outlined in the bill.

In holding hearings on general tax reform in early 1973, the Ways and Means Committee put on its agenda various items under taxation of foreign income. The record developed was by far the most extensive since the enactment of the Revenue Act of 1962. The Treasury Department, however, took no position until the public hearings were over. Then, on April 30, 1973, the Treasury Department made important legislative proposals affecting the foreign area as part of its proposed tax reform package.

The Treasury proposed that certain losses incurred in foreign operations and deducted against domestic income would reduce foreign tax credits when the taxpayer earned profits from those operations. A second reform proposed by the Treasury was to eliminate deferral for controlled foreign manufacturing corporations which either benefit from a tax holiday or similar tax incentive or which manufacture abroad for sale to the United States and benefit from significantly lower foreign income taxes. Tax holidays were defined to include not only partial or complete exemptions from taxes, but such items as accelerated depreciation or reinvestment reserves.

The President also announced that he had instructed the Department of the Treasury, in conjunction with the Department of Justice, to institute procedures involving mineral importing companies, which import from their foreign affiliates, to determine intercompany selling price and tax payments in advance. The purpose of this reform was to expedite the determination and payment of their taxes. This announcement apparently was made to indicate the Government's frustration with certain mineral pricing practices and the delay in securing revenues in subsequent years from section 482 allocations of previous years.

Dispute over what constituted appropriate foreign income reform prevented the inclusion of tax provisions in the Foreign Trade Bill prepared by the House Ways and Means Committee and ultimately enacted by the House in December 1973. Instead, it was announced that the House Ways and Means Committee would undertake general tax reform in 1974 and that reform of the taxation of foreign income would be one of the items dealt with at that time.

More recently, in February 1974, the Treasury made two new proposals and reemphasized one old proposal (from April 30, 1973) with respect to foreign oil operations. The first new proposal is for the elimination of percentage depletion for foreign oil production. This is a proposal which was incorporated in the House Bill version of the 1969 Tax Reform Act but which was deleted in conference after the Senate did not pass a comparable provision. The second new Treasury proposal relates to the foreign tax credit on production income. The proposal would limit the amount of foreign tax treated as a creditable tax to 48 percent of taxable income from the foreign oil and gas property. The non-credited amount of foreign tax would be treated as a royalty deduction, which means that a complicated mathematical formula is necessary in order to determine the breaking point for the amount of foreign tax which is treated as a deduction and the amount which is allowed as a creditable tax. This new limitation appears to be a per-item type of limitation which is applicable whether the taxpayer is on the per-country or overall limitation. The Treasury also reemphasized its April 30, 1973 proposal to recover losses previously allowed in the United States by disallowance of foreign tax credits. This proposal may have been inserted out of necessity. Otherwise the conversion of foreign tax credits, which are largely excess in many cases, to deductions could well have improved the tax position of some taxpayers by throwing them into an overall or per-country loss position, which loss could then have offset domestic income.

The history of the foreign tax credit available to oil companies is largely an administrative rather than a legislative history. Following World War II, U.S. oil companies began to conduct extensive exploration and development ventures in the Middle East. In late 1950, apparently by arrangement with the companies and with the participation of the State Department, Saudi Arabia adopted income tax provisions which required the companies to pay a 50 percent tax based on trading companies taking oil from production companies at a posted price. Prior to 1950, the companies paid royalties, but no substantial income taxes, to Saudi Arabia. While some may say that the United States Government suggested this new arrangement, I know of nothing published that clarifies what the exact roles of the particular parties were. The American companies that were part of the Arabian American Oil Company began to claim substantial foreign tax credits beginning around 1951. It is not clear that there was any challenge by the Treasury Department to this claim that the Saudi Arabian tax was an income tax. However, given the magnitudes of money involved and the obvious sensitivity of the problem, it seems clear that beginning in the latter part of the Truman Administration and continuing on through the Eisenhower Administration an important pending issue was whether the Saudi Arabian tax was an income tax for foreign tax credit purposes. Eventually, probably around 1953 or 1954, the Treasury Department decided that it was an income tax and issued private rulings to this effect. Subsequently, in 1955 this ruling was published as Rev. Rul. 296, 1955-1 *Cum. Bull.* 386.

While the status of the Saudi Arabian tax was under consideration in the early 1950's, the problem of Iran erupted. When a consortium including American companies was worked out to gain Iranian concessions, it was part of the arrangement that Iran would adopt provisions to secure a 50 percent tax based on the posted price. Since there was no prior history of royalties in this case, the issue here was somewhat different than with Saudi Arabia. Thus, it may actually have happened that the Iranian tax, rather than the Saudi Arabian tax, was the first Middle Eastern tax to be ruled an income tax.

The extent of Congressional involvement in the decisions with respect to the foreign tax credit is not clear. It would seem likely that leading members of the House Ways and Means Committee and Senate Finance Committee had some knowledge of what was taking place administratively. Further, my understanding is that in 1958, the Senate Finance Committee requested that the Staff of the Joint Committee on Internal Revenue Taxation undertake to determine the background and reasons that the Arabian American Oil Company, a U.S. corporation, had been given a tax credit which essentially moved it from a taxpaying to a non-taxpaying status with respect to the United States. I understand that a thorough study was done and printed by the Government Printing Office but ultimately was not made public by instruction of the Committee. This study did, however, undoubtedly make at least one of the two chief tax-writing committees of Congress formally and fully aware of the situation.

During the 1960's there were administrative challenges by the Internal Revenue Service to the tax return positions being taken by U.S. oil companies. There were audits, as I understand it, several times during the 1960's which focused primarily on questions of intercompany prices, *i.e.*, whether the posted price at which production companies sold to trading companies were arms-length prices. Apparently there were substantial arguments during the early 1950's, at the time the foreign tax credit issue first arose, that the posted price was an arms-length price. However, by the late 1950's, after the advent of the U.S. oil import program and other events, the posted price was less likely to be a true market price. Public information on these audits is not available, but it is my understanding that compromises were reached with the oil companies and substantial payments were made to the Treasury. As far as I know, the issue of whether the taxes were income taxes was not reopened during the 1960's.

VII. CURRENT REFORM PROPOSALS

There are several varieties of reform proposals currently being broached before Congress. First, there are what can be called emergency-type proposals. Thus, the proposal for a windfall profits tax as a temporary measure to take away much of the profits attributable to recent price rises is intended as a temporary measure. It would hopefully only be imposed for a short period and would be used as a kind of regulatory tool, perhaps with a trust fund and a plow back feature to turn earnings of oil companies into developing additional domestic reserves or other sources of domestic energy supply. Several versions of this tax have been suggested by the Administration and others.

Closely related to the windfall profits tax proposal are excess profits tax proposals. As experience with excess profits taxes during World War I, World War II, and the Korean War has shown, such taxes are inherently inequitable and unadministrable. They are repealed within a relatively short time of the end of emergency conditions. Whether they are an appropriate response to current conditions is not clear either from the standpoint of the emergency at hand or the goals sought to be accomplished.

Emergency-type measures involve a layering of the tax system. They build on existing tax rules without determining whether that foundation is strong or weak. Perhaps this is necessary, but to professional tax experts it generally seems undesirable. Generally speaking, tax experts would favor the use of direct controls or other kinds of regulation to accomplish goals that largely do not relate to tax or fiscal policy. The tax laws often are not an adequate regulatory tool, and in making tax changes it is often better to accomplish those goals which are more specifically part of the tax system.

A second kind of response is offered by spokesmen for energy companies who want to keep all existing tax provisions as they are. Moreover, some believe the energy crisis would justify additional tax incentives, such as a return of percentage depletion to 27.5 percent or investment credits for new drilling. At the other extreme are those who would use the energy crisis to call for an immediate repeal of percentage depletion, a capitalization of intangible drilling costs, and a conversion of all foreign tax credits into royalties. There are also all shades of opinion in between.

What I believe is needed is a thorough review and study of how the present law is operating and what impact there would be, in the light of recent price rises and prospective energy conditions, of various modifications of the existing tax regime. Whatever changes are made, they should be well thought out and the consequences calculated. Hopefully, a long range program could be developed that is both fair to oil companies and in the best interests of the country.

The tax-writing committees of Congress, with the assistance of the Staff of the Joint Committee on Internal Revenue Taxation, are now undertaking a thorough examination of the present provisions and possible changes in such provisions as well as the adoption of emergency measures. The House Ways and Means Committee is at this time in the process of making initial decisions. Thus, it has tentatively indicated that it favors a phase-out of the percentage depletion allowance for domestic operations. It also seems to favor some form of windfall profits or excess profits tax with a plowback feature. With respect to foreign operations, it favors an elimination of percentage depletion, a repeal of the per-country limitation, and an additional limitation on the foreign tax credit which would restrict the extent to which foreign taxes paid on crude oil production could offset tax on income from other foreign activities.

The House Ways and Means Committee can be expected to make final decisions and report a Bill within the next few weeks. Next, the House itself will take action, and depending upon what the Ways and Means Committee has decided, the full House may or may not require changes. After the House completes its action, the Bill will go to the Senate Finance Committee for hearings and action and finally the full Senate will take up the subject. If the House and Senate versions differ, a conference will be required. Given the highly controversial nature of the subject matter, it seems likely that there will be large areas of dispute and the whole process could well be time-consuming. It could be that any legislation will not be enacted until near the end of the present session of Congress.

VIII. OBSERVATIONS

Without attempting to prejudge the results of careful study and considered action, there are two concluding observations I would make. First, there are no simple and correct answers to what constitutes appropriate tax treatment for international oil companies. A balancing of interests and considered judgments on difficult issues is inevitably required. For example, in evaluating the present rules governing foreign oil activities, it is clear that in terms of equitable tax principles, the strongest case can be made for the allowance of foreign tax credits to the extent that the payments are truly income taxes and not royalties. At the other extreme, the percentage depletion allowance is unquestionably an artificial tax incentive device which can only be justified on strong policy grounds that do not appear present with foreign oil. The current deduction for intangible drilling and development losses is somewhere in between. As an incentive device, it is less objectionable than percentage depletion because it affects the timing of deductions but does not provide additional artificial allowances unrelated to actual capital costs. Even here, however, justification on policy grounds must be shown, or else normal tax principles would call for capitalization of these costs and a write-off over the period of production.

Further, it is important to understand that a mere tinkering with one aspect of the overall regime of tax rules is not likely to be constructive from anyone's standpoint. For example, turning part of the foreign tax credit into a royalty deduction would probably not change much from the standpoint of the major companies. In fact, splitting the foreign tax into income tax and royalty without more could even be helpful to some oil companies; most have excess credits in abundance and could in some circumstances derive U.S. tax benefits from additional deductions. Alternatively, repealing percentage depletion for foreign operations in combination with converting all of the foreign tax into a royalty might produce U.S. tax, and doing both of these things and requiring a capitalization of intangible drilling costs would be likely to result in residual U.S. taxes.

On the other hand, it is not clear that such a tax regime would be equitable. Oil companies as well as manufacturing and other multinational companies should expect to pay some reasonable amount of income taxes to host or source countries, and, in fairness, only a part of what is paid to the Middle Eastern countries could equitably be treated as a royalty.

Whether repealing of percentage depletion and converting part of the foreign tax into a royalty, as recently proposed by the Nixon Administration, would significantly change things is doubtful. Residual U.S. taxes would probably continue to be wiped out by the remaining foreign tax credits.

It is difficult to evaluate most of the specific proposals made to date. Instead of focusing so heavily on the particular tax provisions, which are highly complex, it would be helpful to focus more heavily on the specific goals to be accomplished. The ultimate question is really what is the proper level of U.S. taxes that should be paid by U.S. oil companies? What will the economic and political consequences of such taxes likely be?

I venture to say that if the Congress could reach agreement on goals, the tax experts on the Staff of the Joint Committee on Internal Revenue

Taxation could readily produce the technical provisions required to implement the decision. If a proper assortment of amendments to the foreign tax credit, percentage depletion, intangible drilling costs and other existing provisions could not be found, it would be possible to construct a minimum tax mechanism that simply required a payment to the United States of, say, 10 percent, on some appropriate economic net income concept.

As prior discussion has shown, many of the key questions are essentially political questions disguised as technical tax questions. For example, does it make a difference in our foreign relationships that American multinationals are deeply involved in international oil? Are these differences helpful or harmful to our national interests? Would the United States be better or worse off if the American oil companies were not deeply engaged in the Middle East?

Foreign governments often own part of, or are closely tied to, their oil companies. Most countries do not tax their international oil companies on foreign operations whether through the vehicle of simple exemption or allowing foreign tax credits or granting reduced rates of tax or otherwise. Is it important for the United States to provide a comparable low tax regime for its companies? If so, should the United States simply begin to regulate and direct its oil companies more specifically? What level of U.S. taxes would be possible before American companies became burdened with a competitive disadvantage? If this level is exceeded, what difference would it make if American companies could not be competitive with foreign companies in terms of conducting foreign oil operations? Is this resource so special that at an international level it should largely be a tax exempt industry? Might other governments, if the United States took the lead, also impose tax burdens on their companies?

I point out these considerations because tax reform ultimately depends on political judgments. International political considerations are vital to correct determinations of what the federal income tax treatment of the foreign earnings of oil companies should be.

My second observation relates to procedural issues. In view of recent events, it seems clear that a reopening of the foreign tax credit issue is justified. The Middle Eastern countries, indeed all oil exporting countries, no longer even try to maintain a facade that a so-called posted or tax reference price is a market price. Prices used for tax purposes are obviously no more than a price set in order to produce the so-called tax that the traffic will bear. Since the 1950's when the Internal Revenue Service rulings were first issued treating Middle Eastern taxes as income taxes, there have been many other changes in facts, additional cases as to what constitutes an income tax, and generally greater sophistication in the tax laws as to foreign tax matters. In short, the context and jurisprudence relevant to this issue have dramatically changed.

It does not seem to me to be worthwhile to debate whether the decision in the 1950's to treat the Saudi Arabian and Iranian taxes as income taxes was correct. Substantial arguments could undoubtedly be made that they were true income taxes or that at least in substantial part they were true income taxes. However, the procedure by which this decision was made by our Government can be questioned. Rulings are often issued on the creditability of foreign taxes when the issues are technical. However, it is highly doubtful that the ruling process was a correct procedure for dealing with such a large and politically sensitive issue of tax policy as was involved in the Middle Eastern situation of the early 1950's.

An obvious course would have been for the Executive Branch to request the Congress to pass legislation on the subject. Both tax-writing committees could then have considered the issue in depth; the public could have been heard; and both the House and Senate would have acted in open fashion. This, to me, would have been the best way to make such a momentous decision, one whose effects are still with us 20 years later.

Alternatively, the mechanism of international tax treaties could have been used. The United States now has some 30 international tax agreements, most of which were negotiated after World War II. In various circumstances, international tax agreements have dealt with important issues such as whether certain taxes qualify as income taxes. Our Government has attempted to use these treaties in order to provide tax incentives to investment in less developed countries. Thus, during the 1950's, when the Eisenhower Administration sought to encourage investment by granting credits for taxes foregone by foreign countries, they negotiated several so-called tax-sparing treaties. In the 1960's, when investment tax credits were to be given for designated new investments in underdeveloped countries, several tax treaties were also negotiated. While none of these treaties was ever effectuated, it was because after full public disclosure and debate in open hearings, the Senate Foreign Relations Committee did not act affirmatively. No one would claim, I trust, that the United States would have been better off if the Treasury had simply acted by administrative ruling to grant such tax incentives.

Recently, when the Nixon Administration has sought to expand economic relationships with the Soviet Union and Eastern European countries, international tax agreements have been negotiated with these countries. These agreements are pending before the Senate Foreign Relations Committee. If the committee disagrees with the concepts, this will be known. If it agrees, proper constitutional procedures will have been adhered to. How different is the decision in this situation from that which was made in the Executive Branch alone in the 1950's?

A principal advantage of the international tax agreement approach is that tax relationships as an important international economic relationship are negotiated between governments. If the United States is making concessions, it does so with the other government directly and in a conspicuous public format. Further, the treaty then goes before the Senate Foreign Relations Committee and ultimately the Senate for approval. Thus, the political wisdom of a coordinant branch is brought to bear. The obligations being undertaken reflect, hopefully, a broad, national political consensus.

Moreover, employing appropriate constitutional procedure is in the best interests of the other government. Saudi Arabia, Iran, and other OPEC countries would have been, and presently would be, far better off if international tax treaties had been entered into in the 1950's.

Such treaties would have provided for many other advantageous tax relationships. For example, students and professors might have entered the United States in a preferred tax status. Dividends and interest remittances from U.S. investments could have passed preferentially without the need to incur the expense and burden of intermediaries in Switzerland and elsewhere. Perhaps, most importantly, tax agreements generally provide for administrative assistance, exchange of information, and mutual cooperation. Would it not have been over the past 20 years, and is it not now, in the best interests of the Middle Eastern countries, as well as the United States, to have a full exchange of data on the income, deductions, and other economic relationships relevant to taxes of the international oil companies? Who has benefited, or is benefiting, from the affected and interested governments being without official and regularized channels of communication on tax matters?

It would be entirely permissible at this point in time for the Treasury to announce that it was withdrawing prospectively the rulings that treat the taxes of Saudi Arabia, Iran, and other OPEC countries as income taxes, and that it would proceed to negotiate international tax agreements with these countries. If these countries still desire American oil companies to engage in business in their countries, they will undoubtedly negotiate tax agreements with the United States. If American oil companies are no longer welcome in these countries, then no tax agreements will be negotiated and companies of other countries will enter instead. I am assuming here, as seems likely, that it would not be economically feasible for American companies to engage in the oil business in these countries without treating some substantial part of their taxes as income taxes for U.S. foreign tax credit purposes. I am also assuming that the Middle Eastern countries will continue to be willing to deal with American companies who are willing to pay current, and higher prices for oil. Somehow the relationships of the governments and

Syracuse Journal of International Law and Commerce, Vol. 2, No. 2 [1974], Art. 6

the taxpayers involved in international oil transactions should be brought into proper legal perspective, and international tax agreements would be one way to accomplish this.

Finally, it may well be that under current circumstances international oil companies are so large and so complex that they are beyond the powers of any single government or even pairs of governments to effectively deal with them for tax purposes. For example, the oil companies' pricing decisions affect the taxes of not only one or two countries, but many countries. It could well be that rapid, unilateral action by the United States on oil company tax matters is not in our own best interests and that the interests of other countries, if properly assessed, would lead the United States to a different position than if it were acting entirely on its own. In short, we are not dealing with just a U.S. tax problem of American companies, although that is a major aspect—we are also dealing with international tax problems of multinational companies that affect many countries.

It may well be that some sort of multinational tax agreement between leading industrial countries such as the United States, the United Kingdom, France, Germany, the other Common Market countries, and Japan, as well as the leading oil exporting countries such as those involved in OPEC, is necessary to establish an equitable international tax regime.

Regardless of whether unilateral, bilateral, or multinational solutions are sought, two things seem clear:

1. Far more specific data relative to tax issues must be developed in the best interests of all countries, oil importing and oil exporting; and

2. An overall and deep view taking account of long term factors must be done. Overreaction to immediate circumstances and hasty solutions to complex international tax problems would be a great mistake.

Just as the energy crisis is a long term problem, current international tax rules should be set, if possible, for the longer term. Hard work, careful consideration and cooperation by all affected parties are ultimately necessary.