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93d Congress
2d Session

COMMITTEE PRINT

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES

MATERIAL RELATING TO THE PROPOSED "EMERGENCY WINDFALL PROFITS TAX"

INCLUDING THE

PRESS RELEASE ANNOUNCING PUBLIC HEARINGS
TO BE CONDUCTED BY THE

COMMITTEE ON WAYS AND MEANS

BEGINNING ON

FEBRUARY 4, 1974

Draft Bill, and Prepared Statement Submitted by the
HONORABLE GEORGE P. SHULTZ,
Secretary of the Treasury

NOTE: This material is printed for information only so as to make it generally available, and is not to be construed as the statement or position of the Committee on Ways and Means or any member thereof.

U.S. GOVERNMENT PRINTING OFFICE

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"EMERGENCY WINDFALL PROFITS TAX"

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FOR THE PRESS
FOR IMMEDIATE RELEASE
TUESDAY, JANUARY 22, 1974

COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D. C. 20515
Telephone: (202)225-3625

CHAIRMAN WILBUR D. MILLS (D., ARK.), COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES PUBLIC HEARINGS TO BEGIN ON MONDAY, FEBRUARY 4, 1974, ON ADMINISTRATION AND OTHER PENDING PROPOSALS ON WINDFALL PROFITS

Chairman Wilbur D. Mills (D., Ark.), Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee on Ways and Means would begin public hearings on Monday, February 4, 1974, on the Administration proposal on windfall profits as well as on other proposals pending before the Committee on this subject. On December 19, 1973, President Nixon announced that he would recommend an "Emergency Windfall Tax" to the Congress when it reconvened in January 1974. This proposal has not yet officially been transmitted to the House, but it was released by the Treasury Department on December 19, 1973, and copies are available from the Treasury Department.

The leadoff witnesses will be the Honorable George P. Shultz, Secretary of the Treasury, and the Honorable William E. Simon, Administrator, Federal Energy Office. Upon completion of the testimony from these Administration officials, the Committee will receive testimony from the general public. Due to the limited time available, it is urgently important that all witnesses with identical or similar positions coordinate their testimony to the greatest extent possible.

DETAILS FOR SUBMISSION BY INTERESTED PUBLIC OF REQUESTS TO BE HEARD

Cutoff Date for Requests to be Heard -- Requests to be heard must be submitted by no later than the close of business Thursday, January 31, 1974. All requests should be submitted to John M. Martin, Jr., Chief Counsel, Committee on Ways and Means, 1102 Longworth House Office Building, Washington, D. C. 20515 (telephone: (202)225-3625).

Notification will be made as promptly as possible after this cutoff date as to when witnesses have been scheduled to appear. Once the witness has been advised of his date of appearance, it is not possible for this date to be changed. If a witness finds that he cannot appear on that day, he may wish to either substitute another spokesman in his stead or

file a written statement for the record of the hearing in lieu of a personal appearance, because under no circumstance will the date of an appearance be changed.

Coordination of Testimony -- In view of the overall heavy legislative schedule of the Committee for this session of the Congress and thus the limited amount of time that can be set aside by the Committee in which to complete this hearing, it is requested and it is most important that all persons and organizations with the same general interest designate one spokesman to represent them so as to conserve the time of the Committee and the other witnesses, prevent repetition and assure that all aspects of the subject being discussed at this hearing can be given appropriate attention.

The Committee will be pleased to receive from any interested organization or person a written statement for consideration for inclusion in the printed record of the hearing in lieu of a personal appearance. These statements will be given the same full consideration as though the statements had been presented in person.

Allocation of Time of Witnesses -- Because of the heavy legislative schedule of the Committee, which will limit the total time available to the Committee in which to conduct this hearing, and to assure fairness to all witnesses and all points of view, it will be necessary to allocate time to witnesses for the presentation of their own direct oral testimony. Witnesses are urged to verbally summarize their statements rather than read them. Any detailed statements submitted to the Committee will be reviewed and considered by the members of the Committee and will be included in the printed record of the hearing.

Contents of Requests to be Heard -- The request to be heard must contain the following information, otherwise delay may result in the proper processing of a request:

1. The name, full address and capacity in which the witness will appear;

2. The list of persons or organizations the witness represents and in the case of associations and organizations their address or addresses, their total membership and where possible a membership list;

3. If a witness wishes to make a statement on his own behalf, he must still nevertheless indicate whether he has any specific clients who have an interest in the subject, or in the alternative, he must indicate that he does not represent any clients having an interest in the subject he will be discussing;

4. The amount of time the witness desires in which to present his own direct oral testimony (answers to questions of Committee members are, of course, not to be included in the time the witness may request); and

5. A topical outline or summary of the comments and recommendations which the witness proposes to make.

Submission of Prepared Written Statements by Witnesses Making Personal Appearances -- With respect to oral testimony, the rules of the Committee require that prepared statements be submitted to the Committee office no later than 48 hours prior to the scheduled appearance of the witness. Seventy-five (75) copies of the written statements would be required in this instance; an additional seventy-five (75) copies may be submitted for distribution to the press and the interested public on the witness' date of appearance.

Submission of Written Statements for the Printed Record instead of Appearing in Person -- Any interested organization or person may submit a written statement in lieu of a personal appearance for consideration for inclusion in the printed record of this hearing. Such statements should be submitted by a date to be specified later, in triplicate. In any event, such written statements will be accepted by the Committee during the entire course of this hearing. An additional seventy-five (75) copies of written statements for the printed record will be accepted for distribution to the press and the interested public, if submitted before the final day of the public hearing.

Re-submission of Requests to be Heard Where Request Already Made -- If a prospective witness has already submitted a request to be heard on this subject, it is now at this time necessary to re-submit the request if the individual or organization is still interested in appearing in person, furnishing the above information and otherwise conforming to the rules set forth for conducting this hearing.

LETTER OF TRANSMITTAL

THE SECRETARY OF THE TREASURY
WASHINGTON

FEB 1 1974

Dear Mr. Speaker:

I am enclosing a proposed bill entitled "Emergency Windfall Profits Tax Act of 1974" to tax windfall profits of producers of crude oil as recommended by the President on December 19, 1973, and in his message of January 23, 1974, on energy matters.

This legislation is designed to capture the windfall profits realized by oil producers during the period of adjustment in the supply of crude oil. The rates of tax are graduated from 10 percent to 85 percent. The tax would apply to the sale of each barrel of crude oil produced in the United States. The tax brackets would automatically adjust upward each month to phase the tax out gradually over the period during which oil supplies are expected to increase. The tax would expire by its terms five years after it becomes effective.

It would be appreciated if you would lay the proposed legislation before the House of Representatives. A similar communication has been addressed to the President of the Senate.

Sincerely yours,

George P. Shultz

George P. Shultz

The Honorable
Carl Albert
Speaker of the House
of Representatives
Washington, D. C. 20515

Enclosure

28-088 O - 74 - 2

A BILL

To impose a tax on windfall profits by producers of crude oil.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE, ETC.

(a) Short Title.--This Act may be cited as the "Emergency Windfall Profits Tax Act of 1974".

(b) Amendment of 1954 Code.--Except as otherwise expressly provided, whenever in this Act an amendment is expressed in terms of an amendment to a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1954.

SEC. 2. EMERGENCY WINDFALL PROFITS TAX.

(a) Imposition of Tax.--Subtitle A (relating to income taxes) is amended by adding at the end thereof the following new chapter:

"Chapter 7.--EMERGENCY WINDFALL PROFITS TAX.

"Sec. 1601. Imposition of Tax.

"Sec. 1602. Computation of Tax.

"Sec. 1603. Definitions.

"Sec. 1604. Liability For and Collection and Payment of Tax.

"SEC. 1601. IMPOSITION OF TAX.

There is hereby imposed on the producer a tax computed as provided in this chapter on the windfall profits from crude oil produced in the United States. The Secretary or his delegate shall prescribe such rules and regulations as may be necessary to carry out the purposes of this chapter.

"SEC. 1602. COMPUTATION OF TAX.

"(a) Initial Month.--The amount of tax on windfall profits from crude oil shall be determined by applying the table of brackets and rates in this subsection separately to the windfall profit from each unit of crude oil sold in the first calendar month in which the tax imposed by section 1601 applies:

Bracket:	If the windfall profit from the unit of crude oil is:	The tax is:
First:	Not over $0.50	$0
Second:	Over $0.50 but not over $0.75	10% of the excess over $0.50
Third:	Over $0.75 but not over $1.10	2.5 cents plus 20% of the excess over $0.75
Fourth:	Over $1.10 but not over $1.70	9.5 cents plus 30% of the excess over $1.10
Fifth:	Over $1.70 but not over $2.50	27.5 cents plus 50% of the excess over $1.70
Sixth:	Over $2.50	67.5 cents plus 85% of the excess over $2.50

"(b) Each Succeeding Month.--The amount of tax on windfall profits from crude oil in the second calendar month in which the tax imposed by section 1601 applies and each succeeding calendar month shall be determined by applying separately to the windfall profit from each unit of crude oil sold in such month the table of brackets and rates in subsection (a) modified--

"(1) Increase in first bracket.--By increasing on the first day of each such month until expiration of the tax imposed by this chapter the upper limit of the first bracket at the uniform percentage rate (when applied to the upper limit of the first bracket at the end of the next preceding month) required to increase such upper limit to three dollars at the beginning of the thirty-sixth month in which the tax is imposed.

"(2) Increase in other brackets.--By increasing on the first day of each such month until the expiration of the tax imposed by this chapter the lower and the upper limits of each of the second through the fifth brackets and the lower limit of the sixth bracket by the same number of cents the upper limit of the first bracket is increased for such month under paragraph (1) of this subsection.

The amount of increase in each bracket limit computed under paragraphs (1) and (2) of this subsection shall be rounded to the nearest whole cent. The Secretary or his delegate shall cause to be published in the Federal Register within 15 days after the effective date of this section tables with brackets computed in accordance with this section for each month the tax is imposed.

"SEC. 1603. DEFINITIONS.

"For purposes of this chapter--

"(1) The windfall profit of a producer from each unit of crude oil sold shall be the excess of the sales price of such unit over the base price of such unit.

"(2) In the case of a unit of crude oil sold as provided in paragraph (4)(A), the sales price shall be the amount for which such unit is sold (but in the case of a sale between related persons specified in section 267 or between members of a controlled group of corporations as defined in section 1563, not less than the representative market or field price for such unit, in the month sold, determined in accordance with section 613). In the case of a unit of crude oil sold as provided in paragraph (4) (B) or (C) the sales

price shall be the representative market or field price for such unit, in the month sold, determined in accordance with section 613. For this purpose, such sales price and such representative market or field price shall not include the costs of any transportation or conversion processes which would not be included in gross income from the property under section 613, but shall not be reduced by the amount of the tax imposed by this chapter as required by section 613(a).

"(3) The base price of each unit of crude oil shall be the ceiling price on December 1, 1973, under regulations section 150.353 prescribed by the Cost of Living Council, as in effect on December 1, 1973, for domestic crude oil of the same grade and location, or in the event no ceiling price then existed for a unit of crude oil of the same grade and location, the base price shall be the ceiling price on December 1, 1973, for crude oil of comparable grade and location.

"(4) A unit of crude oil shall be deemed to be sold no later than--

"(A) the date sold,

"(B) the date transported from the premises within the meaning of section 613 and the regulations thereunder, or

"(C) the date of commencement of manufacture or conversion into a refined

product within the meaning of section 613 and the regulations thereunder,

whichever first occurs.

"(5) The term "crude oil" shall mean--

"(A) a mixture of hydrocarbons which existed in the liquid phase in natural underground reservoirs and which remains liquid at atmospheric pressure after passing through surface separating facilities (and which may include small amounts of nonhydrocarbons produced with the mixture),

"(B) hydrocarbons which existed in the gaseous phase in natural underground reservoirs but which are liquid at atmospheric pressure after being recovered from oil well (casinghead) gas in lease separators (and which may include small amounts of nonhydrocarbons produced with the hydrocarbons), and

"(C) lease condensate.

"(6) The term "lease condensate" shall mean a natural gas liquid recovered from a gas well in lease separators or field facilities.

"(7) The term 'unit of crude oil' shall mean one barrel of crude oil consisting of 42 U. S. gallons.

"(8) The term 'producer' shall mean each person entitled to the deduction for depletion under section 611.

"(9) The term 'United States' shall mean the several States, the District of Columbia and the 'outer continental shelf' as defined in 43 U.S.C. §1331.

"SEC. 1604. LIABILITY FOR AND COLLECTION AND PAYMENT OF TAX.

"(a) Liability for Tax.--The producer subject to the tax imposed by section 1601 shall incur liability for the tax on the date that the unit of crude oil is deemed to be sold as provided in section 1603(4).

"(b) Responsibility for Collection and Remittance of Tax.--In the case of a unit of crude oil sold as provided in section 1603(4)(A) to a United States person (as defined in section 7701(a)(30))--

"(1) the tax imposed by section 1601, determined by reference to the certification required by subsection (c), shall be collected from the producer by the purchaser, and

"(2) the producer shall be treated as having been required to make a return of the tax collected by the purchaser under this subsection, as having made such return on the date the return of such tax by the purchaser was due, and as having paid such tax on the last day of the calendar month for which such tax was collected.

"(c) Certification by Producer of Oil.--At the time a unit of crude oil is sold as provided in section 1603(4)(A), the producer shall certify to the purchaser the base price for such unit of crude oil and such other information on such forms and in accordance with such regulations as the Secretary or his delegate shall prescribe. If no such certification is provided, the purchaser shall collect tax as if the base price were zero.

"(d) Liability Under Other Chapters.--Liability for tax under this chapter shall not be reduced by an overpayment of tax under another chapter of this Subtitle.

"(e) Cross Reference.--

"(1) Liability of purchaser.--For liability of a purchaser of crude oil for tax collected by him pursuant to subsection (b) (1), see section 7501.

"(2) Returns of tax.--For requirement of making returns of tax imposed by this chapter, see section 6011(f)."

(b) Returns of Tax.--

(1) Section 6011 (relating to general requirement of return, statement, or list) is amended by redesignating subsection (f) as subsection (g) and by adding the following new subsection (f):

"(f) Returns of Emergency Windfall Profits Tax.--

"(1) Each purchaser of a unit of crude oil sold as provided in section 1603(4)(A) shall, at the time prescribed in section 6077, make a return of the tax collected by him with respect to sales made to him during the preceding calendar month.

"(2) Each producer of a unit of crude oil sold as provided in section 1603(4) shall, at the time prescribed in section 6077, make a return of tax for which he incurred liability under section 1604 during the preceding calendar month and which was not collected by the purchaser under section 1604(b)(1).

"(3) Records and information.--Any person subject to the provisions of sections 1601 through 1604 shall--

"(A) keep such records or furnish such information as may be required by regulations or forms, and

"(B) file such forms and furnish such information as may be prescribed by the Secretary or his delegate by rules or regulations."

(2) (A) Part V of subchapter A of chapter 61 (relating to time for filing returns and other documents) is amended by adding at the end thereof the following new section:

"SEC. 6077. TIME FOR FILING EMERGENCY WINDFALL PROFITS TAX RETURNS.

"Each return required to be made under section 6011(f) (relating to emergency windfall profits tax) shall be filed on or before the 15th day following the close of the calendar month to which the return relates."

(B) The table of sections for Part V of subchapter A of chapter 61 is amended by adding at the end thereof the following:

"Sec. 6077. Time for Filing Emergency Windfall Profits Tax Returns."

(c) Technical and Conforming Amendments.--

(1) The table of chapters for subtitle A is amended by adding at the end thereof the following new item:

"Chapter 7. Emergency windfall profits tax."

(2) Section 5 (a) (relating to cross references to other rates of tax on individuals, etc.) is amended by adding at the end thereof the following new paragraph:

"(6) For emergency windfall profits tax, see section 1601."

(3) Section 12 (relating to cross references relating to tax on corporations) is amended by adding at the end thereof the following new paragraph:

"(9) For emergency windfall profits tax, see section 1601."

(4) Section 164 (a) (relating to deduction for taxes) is amended by adding the following new paragraph immediately following paragraph (5):

"(6) The emergency windfall profits tax imposed by section 1601."

(5) Section 275 (relating to disallowance of deduction for certain taxes) is amended by redesignating subsection (b) as subsection (c) and by adding the following new subsection (b):

"(b) Exception for Emergency Windfall Profits Tax.--Notwithstanding subsection (a), a deduction shall be allowed for the tax imposed by section 1601."

(6) Section 511 (relating to imposition of tax on unrelated business income of charitable, etc., organizations) is amended by adding the following new subsection at the end thereof:

"(e) Emergency Windfall Profits Tax.--The tax imposed by section 1601 shall apply to an organization subject to tax under this section."

(7) Section 535(b)(1) (relating to adjustments to taxable income with respect to taxes in determining the accumulated earnings tax) is amended by striking out "December 31, 1940)" and inserting in lieu thereof "December 31, 1940, and the emergency windfall profits tax imposed by section 1601)".

(8) Sections 545(b)(1) and 556(b)(1) (relating to adjustments to taxable income with respect to taxes in determining undistributed personal holding company income) are amended by striking out "December 31, 1940)" and inserting in lieu thereof "December 31, 1940, and the emergency windfall profits tax imposed by section 1601)".

(9) Section 613(a) (relating to percentage depletion) is amended by striking out "rents or royalties" and inserting in lieu thereof "rents or royalties and any tax imposed by section 1601".

(10) Section 6201(a) is amended by adding at the end thereof the following new paragraph (5):

"(5) Erroneous windfall profits tax payments.--If on any return or claim for refund of taxes imposed by chapter 7 of Subtitle A there is an overstatement of the amount the taxpayer is treated as having paid pursuant to section 1604(b)(1), the amount so overstated which is allowed against the tax shown on the return or which is allowed as a payment or refund may be assessed by the Secretary or his delegate in the same manner as in the case of a mathematical error appearing upon the return."

SEC. 3. EFFECTIVE DATE.

Except as otherwise expressly provided, the amendments made by this Act shall apply to the first calendar month following the date of enactment of this Act. The amendments made by section 2 of this Act shall not apply to the sale of crude oil made after the last day of the first calendar month which ends more than 60 months after the date of enactment of this Act.

STATEMENT OF THE HONORABLE GEORGE P. SHULTZ
SECRETARY OF THE TREASURY
BEFORE THE
COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
February 4, 1974

Mr. Chairman and Members of the Committee:

I am pleased to be with you this morning to discuss the fiscal effects of the energy problem and the Administration's tax proposals which deal with aspects of this situation.

The proposals I will discuss today have several purposes. The first proposal is for an Emergency Windfall Profits Tax. It is designed to recover excessive profits from oil producers. The next group of proposals were among those I presented to your Committee last April. They affect incentives for the domestic production of oil and gas and include the proposals for a Minimum Taxable Income, for a Limitation on Artificial Accounting Losses and for an Exploratory Drilling Credit.

The remaining proposals are designed to eliminate several undesirable tax rules which now exist in connection with foreign oil and gas operations. Elimination of those rules would make foreign investment in oil somewhat less desirable than it now is. We believe these proposals relating to foreign operations to be important in the overall picture, but they are directed at limited situations and should not be confused with the broader effort to recover excessive profits.

Before I commence that detailed discussion, let me give you a brief overview of the problem.

The Overview

Prior to the Arab bloc embargo, the United States demand for oil had increased to an annual rate of about 17 million barrels of oil per day, only 11 million of which were produced here. Our domestic oil output and capacity stabilized at about 11 million barrels per day around 1970. In fact, the current rate of exploration and development of new domestic reserves is barely sufficient to cover the natural decline in productivity from existing oil fields. This situation is attributable to a number of interrelated factors, including:

. Government regulation of natural gas prices at artifically low levels since around 1960. Low gas prices obviously reduce the potential profitability of the gas discovery effort. Since most gas is "associated" with oil, whatever makes gas discovery less profitable makes the discovery of both oil and gas less profitable.

. Rising costs of discovering additional on-shore reserves. After a century of intensive discovery effort, the remaining on-shore prospects are less attractive than off-shore prospects. The best on-shore prospects today are wells much deeper than most now in operation and they involve much higher discovery costs.

. Delays in drilling outer continental shelf prospects. Although costly to drill, these prospects should yield large oil and gas capacities. The delays have been due in large part to government leasing policies and concerns with environmental questions.

. Delays in the output from Alaskan and off-shore California fields. These fields should yield large oil and gas reserves but their production has also been delayed due to government leasing policies and concerns with environmental questions.

. Government regulation of domestic crude oil prices. Crude oil prices were frozen at August 1971 levels until January 1973 when small price increases were allowed. "New oil" prices were freed after two years of controls in August of 1973, but "old oil" prices are still controlled. The presence of price controls discouraged additional investment which could have increased productive capacity.

To satisfy our increasing energy demands in the face of the restrictions on domestic supplies resulting from the above factors, we turned increasingly to imports.

But under the mandatory import program that had been in effect since 1959, quotas existed which significantly limited imports of oil and refinery products. As demand grew but domestic production held steady after 1970, import quotas were increased, but not at a rate which kept up with increases in demand. Investment in additional refinery capacity in this country thus became unattractive because of the uncertainty that sufficient supplies of crude oil--either domestic or imported--would be available for refining. Accordingly, many U.S. companies built refineries offshore and most of the increase in U.S. imports took the form of refined products such as middle distillate fuels and, particularly, heating oils.

By the beginning of 1973, these domestic circumstances--controlled prices of oil and gas, rising discovery costs, delays in exploration and production for environmental and other reasons and a growing

reliance on imports to satisfy increasing demands--converged with a growing foreign demand for oil stimulated by world-wide economic boom conditions. The result: world oil prices began to advance from their historical levels. And, when the dollar was devalued for the second time in February 1973, the dollar price of oil in world markets began to rise higher.

The continued high level of demand for oil through the first nine months of 1973 quickly brought foreign production to maximum short-run capacity, further increased world oil prices, and set the stage for the world crisis precipitated by the embargo invoked by Arab bloc producers in October 1973, and the consequent skyrocketing of oil prices.

Most of the profits produced by these very major increases in the price of imported crude oil have gone to the foreign governments that own or control the oil, in the form of higher taxes or royalties. However, a significant part of the increased profits from this source has gone to United States companies and individuals in the business of producing and shipping this oil, primarily as a result of sales in foreign countries and, to a lesser degree, as a result of sales to United States consumers.

Through the Federal Energy Office, the Administration has requested sacrifices in oil use from all citizens so that as little as possible disruption to our lives and our economy will result from the oil supply disruption. The Administration believes that it would be unfair for United States producers to be advantaged while their fellow citizens are making the sacrifices required, by retaining excessive profits from the abnormally high prices caused by the shortage.

Increased profits from higher prices to oil owners which occurred in 1973 are reflected in Table 1, which compares reported profits and rates of return on equity for the years 1969-1972 and the nine-month period ended September 30, 1973, for 22 of the largest United States oil companies. It is important to keep in mind that increased profits are not necessarily "excessive" profits.

Table 1
Net Income After Tax and the Rate of Return on Equity of Selected Oil Companies (1963-1973)
($mill)

Company	1973 Net income	1973 % b/ return	1972 Net Income	1972 %	1971 Net income	1971 %	1970 Net income	1970 %	1969 Net income	1969 %	1968 Net income	1968 %	1967 Net income	1967 %	1966 Net income	1966 %	1965 Net income	1965 %	1964 Net income	1964 %	1963 Net income	1963 %
Totals	9,087.3	15.1	5,951.7	9.7	6,007.3	10.2	5,556.7	10.4	5,549.9	10.9	5,539.4	11.8	5,175.6	12.0	4,701.9	11.7	4,203.7	11.2	3,846.9	10.8	3,579.7	11.0
a/Amerada Hess Corp.	151.8	23.5	46.2	8.3	133.3	24.0	114.0	25.7	86.5	23.7	89.8	19.8	76.8	22.2	73.1	22.6	63.4	22.2	59.4	23.0	52.4	22.7
Ashland Oil Corp.	98.3	17.3	68.0	13.5	40.5	8.8	52.0	11.7	56.9	13.3	53.6	14.6	48.4	15.5	45.0	17.6	35.8	15.5	23.7	14.0	18.1	11.7
Atlantic Richfield Co.	270.2	8.9	192.5	6.5	210.5	7.3	209.5	7.5	230.1	8.5	105.8	7.8	130.0	10.2	113.5	9.4	90.1	8.1	47.1	7.3	44.0	7.0
Cities Service Co.	135.6	9.8	99.1	6.9	104.5	7.7	118.6	8.9	127.2	10.0	121.3	9.9	127.8	10.9	120.1	11.0	100.6	10.2	84.5	9.1	77.5	8.6
Clark Oil & Refining Corp.	30.5	29.9	8.3	9.8	3.6	4.7	10.8	14.0	13.0	18.7	12.1	20.4	11.5	23.4	9.6	24.2	8.7	27.8	2.1	8.9	1.5	6.8
Continental Oil Co.	242.7	14.0	170.2	10.4	140.1	9.1	160.3	10.7	146.4	9.8	150.0	10.6	136.1	10.1	115.6	10.3	96.2	10.2	100.1	11.1	87.4	10.5
Exxon Corp.	2,440.0	18.5	1,531.8	12.5	1,516.6	13.1	1,309.5	12.0	1,242.6	12.3	1,276.7	13.0	1,155.0	12.3	1,090.1	12.1	1,021.4	11.9	1,050.6	12.6	1,019.5	12.8
Getty Oil Co.	135.0	8.8	76.1	5.2	120.1	8.5	103.2	7.8	105.8	8.3	98.3	8.3	118.2	10.5	92.3	9.0	57.7	6.9	43.0	5.6	43.0	6.1
a/Gulf Oil Corp.	760.0	14.0	447.0	8.3	561.0	10.2	550.0	10.4	610.6	12.1	626.6	13.2	568.3	12.9	504.8	12.3	427.2	11.2	395.1	11.0	371.4	10.9
a/Kerr-McGee Corp.	58.8	10.8	50.6	10.1	40.7	10.8	35.9	10.3	33.6	10.3	36.4	12.0	32.1	11.5	33.0	12.9	25.1	14.6	20.7	14.7	18.8	15.8
Marathon Oil Co.	129.4	15.2	79.8	10.2	88.7	11.7	86.5	11.8	89.4	12.1	83.3	12.7	73.9	12.3	68.8	12.3	60.1	11.3	60.4	11.8	49.1	10.2
Mobil Oil Corp.	842.8	15.7	574.2	10.9	540.8	10.9	482.7	10.4	456.5	10.4	430.7	10.3	385.4	9.8	356.1	9.5	320.1	9.1	294.2	8.8	271.9	8.6
Murphy Oil Corp.	53.6	24.4	14.3	7.6	11.1	6.2	9.3	6.5	6.2	4.5	7.3	5.4	8.2	6.2	8.4	7.6	6.4	6.1	4.3	4.9	4.8	5.7
Phillips Petroleum Co.	230.4	12.1	148.4	8.1	132.3	7.6	132.3	7.8	127.8	7.7	129.9	8.0	164.0	11.0	138.4	10.3	127.7	9.9	115.0	9.3	108.1	8.9
Shell Oil Co.	332.7	10.9	260.5	8.9	244.5	8.7	237.2	8.6	291.2	10.9	312.1	12.3	284.9	13.8	255.2	13.4	234.0	13.4	198.2	12.3	179.9	12.0
Skelly Oil Co.	44.0	7.5	37.6	6.8	38.3	7.0	36.1	7.0	38.4	7.7	40.3	8.5	42.0	9.3	37.0	8.8	34.0	8.8	25.7	7.1	24.2	7.0
Standard Oil of Calif.	843.6	14.4	547.1	10.5	511.1	10.4	454.8	9.8	453.8	10.3	451.8	10.7	409.4	10.3	401.2	10.8	391.2	11.1	345.3	10.5	322.1	10.5
Standard Oil Co. (Ind.)	511.2	12.4	374.7	10.0	340.6	9.6	314.0	9.3	321.0	10.0	309.5	10.1	280.9	9.6	255.9	9.1	219.3	8.1	194.9	7.5	183.1	7.3
Standard Oil Co. (Ohio)	74.1	6.6	59.7	5.6	58.8	5.7	64.4	6.3	51.9	5.3	70.1	13.0	67.1	14.5	56.9	13.3	49.7	12.7	43.8	12.0	38.9	11.4
Sun Oil Co.	230.0	12.3	154.7	8.8	151.6	8.9	139.1	8.4	152.3	9.4	164.4	10.9	156.2	15.2	100.6	10.8	85.5	10.1	68.5	8.8	61.2	8.4
Texaco Incorporated	1,292.4	25.0	889.0	12.4	903.9	13.4	822.0	13.1	769.8	13.1	819.6	14.5	754.4	14.8	692.1	15.0	636.7	14.9	577.4	14.6	547.6	15.6
Union Oil of Calif.	180.2	10.6	121.9	7.6	114.7	7.4	114.5	7.6	138.9	9.5	149.8	10.9	145.0	11.2	134.2	11.2	112.8	10.4	92.9	14.7	55.2	9.9

a/ Full years income estimated on the basis of income reported for the first nine months of 1973.
b/ Equity as of September 30, 1973.

Source: Standard and Poors' Industrial Survey, Moody's Industrial Manual, Quarterly Financial Statements Filed with the Security Exchange Commission (10 Q Forms).

Office of the Secretary of Treasury
Office of Tax Analysis

February 1, 1974

Our preliminary investigation indicates that the 1973 profit increases are primarily attributable to foreign inventory profits from skyrocketing prices, increased profits from increases in foreign product prices and efficiencies in foreign refinery and other operations unrelated to the prices paid by United States consumers. A number of the companies have pointed out that the higher 1973 profits must be interpreted in the light of the lower than normal profits realized in 1972 and the several years immediately prior.

Whatever conclusions may be drawn from the 1973 figures, if the shortage in 1974 produces even higher prices for oil, that fact will cause increased profits to major oil companies from domestic oil sales. The estimated amount of increase attributable to this single element may be seen from Table 2.

Table 2

Average Price - $/bbl. Crude 1/	Annual Profit After Income Tax (billion $)	
	Increase 2/	Total
1973		9.0 3/
1974:		
6.50	1.7	10.7
8.00	3.4	12.4
9.00	4.5	13.5
10.00	5.6	14.6

1/ The estimated average price for domestic crude oil as of January 1, 1974, is $5.25 in the case of old oil and $9.50 in the case of new oil.
2/ The increased net incomes shown for 1974 relate only to domestic crude oil production.
3/ Estimated 1973 net income after taxes from Table 1.

While the Administration believes oil owners should not be permitted excessive profits at the expense of their fellow Americans, let us be clear that United States oil prices must adjust upward if higher cost methods of extracting oil are to be used to satisfy our demands. Higher costs of producing oil will mean higher prices for oil. Producers will not produce unless prices cover their costs. And government production would be no solution, for a government producer would have the same costs or, if less efficient, greater costs. However, short run price increases for oil above the level necessary to call forth the supplies we need give rise to windfall profits. Those windfalls may be taxed very heavily to the producers of oil without impeding the desired free market processes and without imposing additional costs on consumers.

The Windfall Profits Tax is designed:

First, to tax very heavily windfall profits to owners of oil,

Second, to avoid interference with the legitimate profit expectations which will be required to meet our demands and make us independent of foreign supplies, and

Third, to avoid any tax-generated price increases for consumers.

Economic Background

The ability of oil producers to increase the production of oil during the next two or three years is considered by experts to be quite limited. Prospects have to be found, geological and geophysical work has to be done, wells have to be drilled, pipelines have to be built and refineries may have to be expanded or built. Therefore, price increases do not have the effect of stimulating nearly immediate supply increases as is the case with some other products, such as foodstuffs.

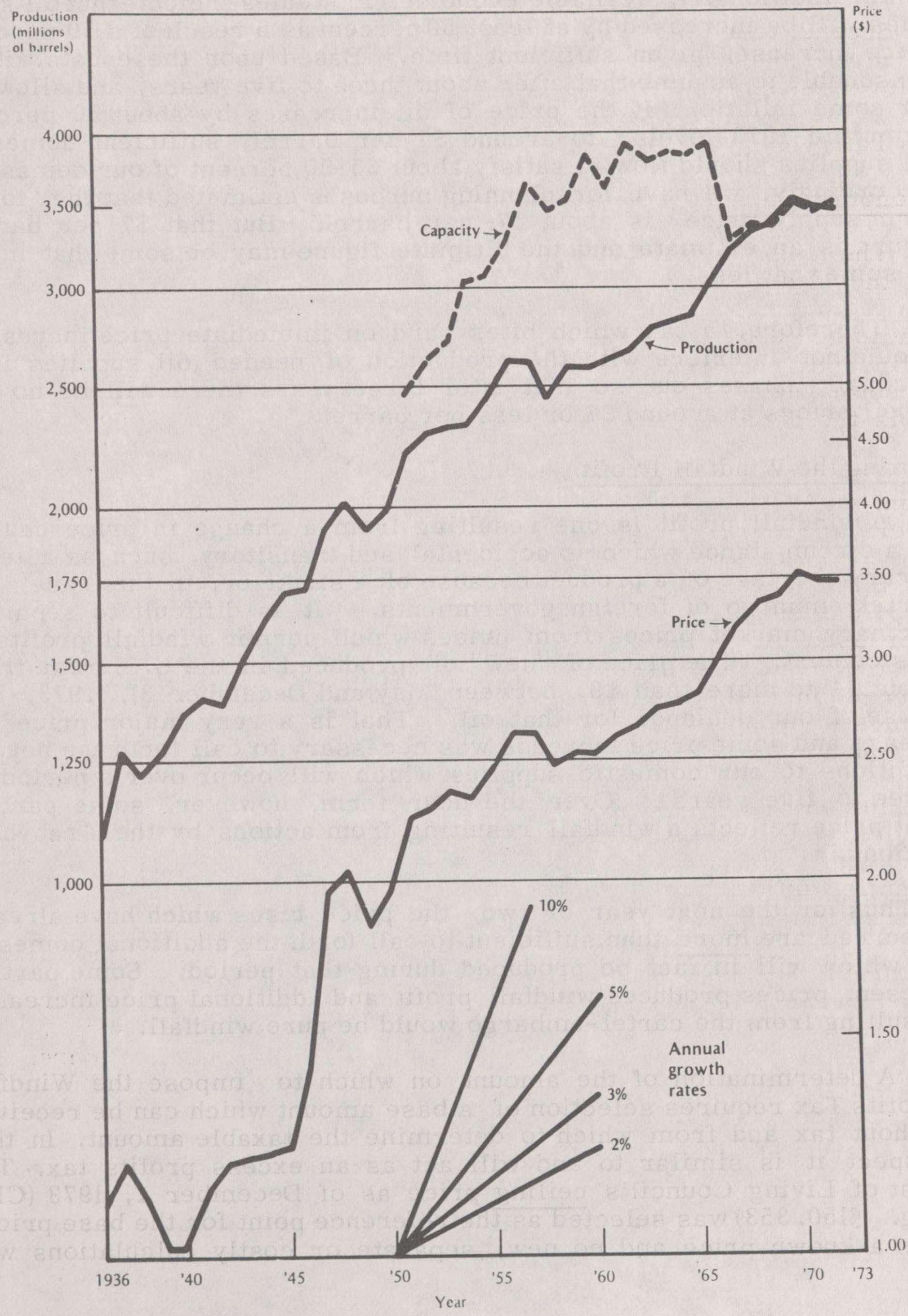
The expert consensus is that only a small amount of additional oil from domestic sources can be expected in the next 6 to 18 months. There are marginal wells which were previously capped and which might be economically produced now at the increased prices available for oil, but this supply source is not major in the overall context. Within 18 to 24 months oil could begin to be economically produced at current increased price levels by secondary and tertiary recovery methods. Over a three to five year period, significant additional production at current increased price levels could probably be obtained from new domestic prospects. And after three to four years, the Alaska pipeline should be completed.

In contrast to the short run, then, over a period of about three to five years, it is reasonable to expect that oil supplies can be increased significantly. Historically, the amount of the increase in supplies of oil has been at least 1 percent for every 1 percent increase in the price of oil.

Table 3 shows the relationship between price increases and supply increases for the years 1936 to 1972.

TABLE 3

Crude Oil Production, Capacity, and Price Per Barrel at Wells, 1936-1972



Source: United States Department of the Interior, Bureau of Mines

Over each of the two five-year periods from 1953-1958 and 1963-1968, a price increase of 9 percent was followed by a productive capacity increase of 35 percent and an actual production increase of 17 percent. Additionally, available econometric studies indicate that oil supplies will be increased by at least 50 percent as a result of a 50 percent price increase, given sufficient time. Based upon these data, it is reasonable to assume that after about three to five years, and allowing for some inflation, if the price of oil increases by about 50 percent from mid-1973 levels, to around $7 per barrel, sufficient domestic oil supplies should flow to satisfy about 85-90 percent of our demands. Accordingly, we have for planning purposes estimated that the "long-term supply price" is about $7 per barrel. But that $7 per barrel figure is an estimate and the ultimate figure may be somewhat more or somewhat less.

Therefore, a tax which bites hard on immediate price increases should not interfere with the production of needed oil supplies if it gradually phases out so that after three years there will be no tax on oil prices at around $7 or less per barrel.

Taxing the Windfall Profit

A windfall profit is one resulting from a change in price caused by a circumstance which is accidental and transitory, such as a temporary shortage of a product because of a strike or, in this case, the cartel-embargo of foreign governments. It is difficult to separate ordinary market prices from prices which permit windfall profits in this context. The price of "new" oil produced in the U.S. rose from about $4 to more than $9, between May and December 31, 1973, because of our demands for that oil. That is a very major price increase and some price increase was necessary to call forth the needed additions to our domestic supplies which will occur over a period of three to five years. Over the near term, however, some part of that price reflects a windfall resulting from actions by the Arab-bloc nations.

Thus for the next year or two, the price rises which have already occurred are more than sufficient to call forth the additional domestic oil which will in fact be produced during that period. Some part of present prices produces windfall profit and additional price increases resulting from the cartel-embargo would be pure windfall.

A determination of the amount on which to impose the Windfall Profits Tax requires selection of a base amount which can be received without tax and from which to determine the taxable amount. In this respect it is similar to and will act as an excess profits tax. The Cost of Living Council's ceiling price as of December 1, 1973 (CLC Reg. §150.353) was selected as the reference point for the base price. It is a known price and no new, separate or costly calculations will

have to be made. It also significantly exceeds historical oil price levels and it was the maximum price permitted on any domestic production until late August 1973.

Under the Windfall Profits Tax, the rates of tax on selling prices of oil in excess of base prices range from 10% to 85% under the following graduated rate schedule:

Table 4

Per 42-Gallon Barrel of Crude Oil

Amount in Excess of Base Price ($)	Bracket Rate (%)	Bracket Tax cents	Cumulative Tax cents
0-- .50	0	0	0
.51-- .75	10	2-1/2	2-1/2
.76--1.10	20	7	9-1/2
1.11--1.70	30	18	27-1/2
1.71--2.50	50	40	67-1/2
2.51--over	85		

In accordance with Treasury regulations to be prescribed, the top level of the lowest bracket (initially 0 to $0.50) and the bottom level of each higher bracket will be automatically adjusted upward monthly in the uniform percentage required to make the 10 percent rate of tax applicable after 36 months only to amounts in excess of the expected average long-run supply price of about $7 per barrel. Each higher bracket will be adjusted upward to apply to a constant number of cents per barrel above the next lower bracket. That portion of the price increase which remains after payment of the above Windfall Profits Tax is subjected to ordinary income tax.

As you can see from Table 5, the Windfall Profits Tax on the oil will be large if the oil shortage is severe enough to cause large price increases in oil and modest if the shortages and price increases are modest:

Table 5

Net Price Received by Oil Producer After Proposed Emergency Windfall Profits Tax (Base Price of $4.00 per Barrel)

	Month						
Price:	1	6	12	18	24	30	36
$10	$6.35	$6.47	$6.67	$6.94	$7.30	$7.80	$8.47
9	6.20	6.32	6.52	6.79	7.15	7.65	8.32
8	6.05	6.17	6.37	6.64	7.00	7.43	7.78
7	5.90	6.02	6.22	6.42	6.63	6.85	7.00
6	5.58	5.65	5.75	5.84	5.94	6.00	6.00

If we have underestimated the long-run supply price, the tax imposes little penalty. For example, suppose it turns out that three years hence a price of $8, rather than $7, is necessary to elicit a domestic supply equal to 85-90 percent of consumption at the then corresponding product prices. In that event, a tax would still apply but it would only be 22 cents a barrel, less than 3 percent of the price. Thus, producers who believe the $7 price is too low can nonetheless proceed on the basis of their own price judgments in the knowledge that when the windfall disappears and their investments become productive, the tax should also disappear, and that even if the tax does not then disappear, it will impose only a minor and vanishing penalty. This is to be contrasted with the situation which would result if prices were controlled. A $7 price ceiling would be equivalent to a 100 percent tax on prices above that amount, and if the long-term supply price should turn out to be higher than $7--or if producers expect it to be--we simply would not get the supplies we need.

However, the tax rates and bracket changes have been designed so that an owner of oil will be discouraged from withholding production until after the tax rate declines or the tax expires. The price of oil is or shortly will be as high as it is likely to be for the next five years (in terms of 1974 dollars) and will begin a gradual decline to the long-term supply price. Higher prices now increase the incentives to increase supplies, and gradually increasing supplies will gradually reduce prices. Accordingly, apart from the tax, the owner of oil must

attempt to produce the oil quickly to take advantage of the higher existing prices. Taking the rate of decline of the tax into account along with the expected price decline, we estimate that the gain from delaying production of oil to avoid the tax would be less than 1/2 of 1 percent per month on the average (see Table 6 below). Therefore, we believe that no sensible producer will fail to convert his oil to money since the value of the use of that money would be greater than the 1/2 of 1 percent per month he could gain by leaving his oil in the ground.

Table 6

Illustrative Effect of the Windfall Profits Tax on Net Proceeds Realized by Oil Producers, for Two Patterns of Oil Prices

	Number of Months after enactment	Hypothetical prevailing price of oil	Net producer proceeds	Average increase, per month
Pattern A:	1	$10.00	$6.35	
	12	9.00	6.52	0.24%
	24	8.00	7.00	0.59%
	36	7.00	7.00	0.00%
Pattern B:	1	9.00	6.20	
	12	8.00	6.37	0.25%
	24	7.00	6.63	0.33%
	36	7.00	7.00	0.45%

The combination of graduated rates and a scheduled upward adjustment of the brackets accomplishes three major purposes:

-- First, the graduated rates impose very high rates of tax on extraordinary price increases and "windfall" profits which are attributable more to an externally induced shortage in crude supplies than to long-run market conditions, but impose a lesser amount of tax on relatively small increases above the Cost of Living Council ceiling price.

-- Second, the automatic upward adjustment of the tax brackets recognizes that windfalls will be shortlived and that prices should peak in the near future and return to lower levels as they gradually result in greater supplies. Most important, it recognizes that if producers are to make the investments which will be required to make us independent, they must be able to count on an absence of burdensome special taxes on prices when those investments become productive several years hence.

-- Third, the phaseout of the tax as the windfall disappears assures that the tax will not cause higher prices for consumers, for the technical reasons I shall discuss later.

The tax will be imposed on the oil producer at the time of sale of the crude oil or at the end of the month in which produced if not sold. It is contemplated that the tax will be collected and remitted on a monthly basis as follows:

(i) The purchaser of crude oil will withhold and remit the amount of the tax from the sales price paid to the oil producer by the 15th day following the end of each month for all crude petroleum purchased during the month.

(ii) In the case of crude produced but not sold, as in the case of an integrated producer, the tax will be paid by the producer by the 15th day following the end of the month of production.

In computing percentage depletion, the amount of the Windfall Profits Tax is subtracted from gross income from the oil property before computing percentage depletion. The effect of this is to deny percentage depletion on the amount of the windfall which is taxed away.

Because the period of extraordinary profits is expected to be limited in duration, it is important that Congress reconsider the tax after several years of experience. Accordingly, the tax is to expire by its terms 60 months after the date of enactment.

Price Rollbacks Are Not a Reasonable Alternative to the Windfall Profits Tax

It would be a fundamental mistake--for everyone except foreign oil producers--to roll back oil prices to some former level. The reasons are several:

First, consumers will end up paying about the same prices in any event. The most they would be spared is a few cents a gallon for a few months. (A $1 reduction in the price paid for "new oil," for example, would translate initially into less than a one-half cent per gallon decrease in the price of gasoline and the market would quickly offset that initial decrease.) The principal effect would be to shift profits from the U.S. to abroad.

Second, the mere presence of ceilings of any sort will tend to dampen the new investment required to produce the increased oil we need. Investors are understandably wary of activities which come to be governed primarily by the laws of politics rather than the laws of economics.

Third, ceiling prices which are less than the prices producers think will prevail will deter them from investing--regardless of whether it is the price authority or the producers whose cost assumptions are correct. Judgments on complex matters like this always differ. Even supposing the government's price controllers could correctly guess the long-term supply price and use that as a ceiling, the ceiling would inhibit needed investment by producers whose judgments differ. In order to get to the long-term supply price, the ceiling would have to be set substantially higher.

Although it is plainly true, many observers fail to recognize that whatever we do with price controls cannot affect the price of the more than 30 percent of our oil we now import to satisfy our demands. The price of that oil fluctuates according to world demands and world supplies. Recognizing this, our Cost of Living Council rules permit refiners to pass through the foreign price they must pay. Thus, the prices of U.S. petroleum products are subject to controls, but the control system, in a sense, rides on top of the price of crude--and products go up in price when the world crude oil price goes up regardless of what we do to control the price of domestic crude oil. This means that the price levels at which no more petroleum products will be bought by consumers, the so-called "market clearing prices," cannot be controlled by controlling domestic crude oil prices. Consumers will eventually pay the same prices for petroleum products whether or not domestic crude prices are controlled. What we do when we control domestic prices at levels below world market levels is simply to permit our refiners to buy our domestic oil too cheaply--compared with world prices--and to bid higher for foreign oil to satisfy our consumers' demands. This, in turn, means that the larger amounts spent by consumers go not to domestic producers and to our government in taxes, but to foreign oil producers and foreign governments.

Of course, we could prevent this by denying U.S. consumers the right to buy the foreign oil products for which they are willing to pay or by not permitting cost pass-throughs for foreign oil prices. But if we do so, we will only be spiting ourselves since either of these measures will prevent foreigners from exporting oil to the United States at a time when we need it, before we have increased our degree of self-sufficiency.

Price rollbacks sound good to consumers until the consequences are appreciated. The consequences would be large transfers of dollars to foreigners and an ultimate reduction in oil for the U.S. consumers, all ironically incurred for price reductions which would be minor and evanescent.

Windfall Profits Tax Compared with Alternative Taxes

We believe that the Windfall Profits Tax will be considerably more effective and efficient than would either an excise tax or an excess profits tax.

The Windfall Profits Tax differs from an excise tax in that it will in fact operate to tax profits, as the portion of the price to which it will apply is above the level required to cover costs in all but exceptional cases. At the present price of $10 for new oil, the tax in its first month would exceed profits only if costs exceed $6.35 a barrel (see Table 5)--which is hardly likely for production planned months ago when prices were much lower. (Prices were controlled at levels below $4 until late August.) If in some small fraction of cases that should not be true, the tax could not exceed profits by more than a few cents per barrel.

An ordinary excise tax shares with the Windfall Profits Tax the virtue of simplicity but, in contrast, is not necessarily a tax on profits and is an undesirably blunt instrument to use in this case. Excise taxes are usually stated as so much per unit or as a percentage of the price of the unit. An excise tax stated as so many cents per barrel or gallon of oil would have to be paid regardless of the amount by which oil prices rose (or didn't rise). That is undesirable since the tax would not be related to the windfall. An excise tax stated as a percentage of the sales price would tax more heavily those who produce oil of higher quality and price than those who produce oil of lower quality and price, which is undesirable since, again, the tax would not be related to the windfall.

A classic excess profits tax of the type in effect during World War II or the Korean War would be a nightmare of complexity and uncertainty. It would be very difficult to design and administer a tax which would not impair the ability and incentive of oil producers to make the investment necessary to produce the additional oil needed to make us independent.

While prior excess profits taxes differed significantly, they contained the common elements of (i) a determination of profit in excess of some base amount, (ii) the application of a high rate of tax to the excess amount and (iii) complex exceptions designed to alleviate the penal nature of the high tax rate in situations in which the general rule determination of excess profits yielded an inequitable result. The following problems existed in prior excess profits tax laws:

. Determination of base period and fair rate of return. No period can be selected which was a normal period for all taxpayers. That is to say, during any taxable year or years selected, some taxpayers' rates of return on investment or profits will be higher or lower than others for many extraneous reasons, such as strikes, floods, etc. Two basic methods have been used to determine a normal profit for the base period. One method is to compute a rate of return on invested capital during the base period, treat that as a normal profit rate, and impose a tax on any profits realized in excess of that rate. The other is to treat the absolute amount of profits realized during the base period as normal profits and impose a tax on any profits realized in excess of that amount. Combinations of the two basic methods have also been used. The assumption of normality for any historical rate of profits or any absolute amount of profits for a particular taxpayer for a particular period is subject to challenge because of the infinite variations in taxpayers' situations. For example, during whatever base period is selected, some taxpayers' businesses were contracting, some expanding; some used heavy amounts of equity capital, some relied heavily on debt; some engaged in heavy research and development expenses, others maximized earnings by postponing research and development expenses, and on and on.

. Exceptions for abnormalties. Because of the problems referred to above and others, complex machinery has always been required to adjust the inevitable inequities arising from the selection of base periods and the calculation of base period profits. Administrative boards and courts become entangled for years over these questions. The World War II and Korean War excess profits tax cases spawned over 54,000 applications for over $6 1/2 billion of relief because of claimed abnormalties in the computation of excess profits. Thousands of lawsuits, the last of which has not yet been decided, required large expenditures of time and manpower for both government and taxpayer in complex economic arguments over how much was too much profit.

. Incentive for wasteful expenditures. Since the tax is conventionally imposed at a high rate and only on net profits, it has the effect of causing expenditures which would not otherwise be made and which are wasteful. For example, the corporate taxpayer at a 48% income tax rate must use 52 cents of its own money for every $1 expended. However, if the marginal tax rate is raised to 85% by the addition of an excess profits tax, only 15 cents of every $1.00 of excess profits spent by the taxpayer comes from its pocket--the other 85 cents will be taken in taxes if not spent. Experience teaches that this leads to wasteful practices and inefficiencies which increase or maintain product prices to consumers without creating corresponding benefits to society.

Applying an excess profits tax only to the net profit of oil production would be even more difficult, for the following reasons:

. Increased Coverage. The expected windfalls will accrue to all owners of oil, who include thousands of individuals, trusts, estates, specially taxed corporations such as insurance companies, and other corporations not generally associated by the public with oil companies. Accordingly, the windfall tax must apply to all owners of oil, not just to large oil companies, if it is to be effective. The World War II and Korean War excess profits taxes have applied only to corporate taxpayers. It is safe to say that as complex to administer as prior taxes have been, an excess profits tax affecting thousands of non-corporate taxpayers would be greatly more complex.

. Determination of excess profits. It would be necessary to determine the excess profits from oil production alone if the tax were to be confined to the windfall. Complex allocations of income and expense would have to be made. In the case of the numerous individuals, estates and trusts who keep minimum formal records, the allocation problem would be even more sizeable.

. Taxable income management. Taxable income management through wasteful expenditures would be easier to achieve for oil producers since their incomes are reduced currently through the deduction of most of the costs of new wells and percentage depletion. Wasteful drilling practices and wasteful expenditures for overhead items could reduce the impact of the tax to a large extent without corresponding benefits to society from productive new wells or research.

Other Aspects of the Windfall Profits Tax

The Windfall Profits Tax would tax only the person who has the windfall, the owner of crude petroleum. This can be illustrated by looking at gasoline price increases. From October 1, 1973, to late January 1974, average gasoline prices increased by 9.5 cents per gallon.

In the same period, average crude oil prices increased by between $3 and $3.50 per barrel or about 8 cents per gallon (there are 42 gallons to a barrel). The remaining 1-1/2 cents of the 10 cent increase was permitted to refineries and distributors by the Cost of Living Council to offset higher costs based on a thorough evaluation of their costs and profits. The windfall profit is reflected in the 8 cents which inured to the owner of crude oil and he is the person who must pay the tax if the windfall profit is to be taxed. Refiners, wholesalers, and retailers of petroleum products have been permitted only price increases under the Cost of Living Council rules which reflected, on a dollar-for-dollar basis, the actual costs they experienced.

It should also be noted that the Windfall Profits Tax will tax similarly those oil producers who are similarly situated. A producer who receives a $1 per barrel increase for low-priced oil with a base price of, say $3.00, is taxed the same as a producer who receives a price

increase of $1 per barrel for his higher quality and higher priced oil with a base price of, say $4.50. These relative base prices were previously established by market forces and are doubtless fairer than any which could be devised administratively.

The Windfall Profits Tax applies only to domestic production. It is not sensible to attempt to tax the windfall on imported oil for two reasons. First, anything which reduces the net price received by the foreign producer below what he would receive if the oil were sold in another country will only prevent imports from coming to the United States. The oil will tend instead to be sold elsewhere if the net price to producers is higher there because of a U.S. tax. Second, the amount of windfall realized by the company from which the imported oil is purchased is limited --the windfall will be realized primarily instead by the foreign government. This is easily seen by looking at increases in reference or posted prices of oil by foreign governments, which have increased radically and repeatedly in recent months to capture the windfalls from the operating companies. A tax or tariff on imported oil should be imposed only to discourage imports for national security or other reasons, which goes beyond what is appropriate at this time.

The Tax is Not Passed on to Consumers

The consumer currently receives government protection against unfair price increases through a combination of price controls and allocation policies. The Windfall Profits Tax complements these rules and will not have the effect some claim of increasing prices to consumers. Statements to that effect indicate a lack of understanding of how the tax operates. A tax which is less than the windfall profit will always fall on the oil producer.

Why isn't the tax passed on to the consumer? It is because the producers of oil are willing, even if reluctantly, to take less for the oil than the amount consumers are willing to pay and are in fact paying. Producers made their decisions to produce oil expecting prices below the current higher prices which are all that consumers will pay. (If consumers were willing to pay more, and were permitted by price controls to do so, producers would already be charging it.) If consumers will pay no more and producers are willing to take less, producers will absorb any tax which does not reduce their expected profit, i.e., reduce it by more than the windfall profit. On the other hand, if the tax is more than the windfall, the tax could fall on consumers in varying degrees, depending upon supply response (the greater the supply response, the more apt the tax is to fall on the consumer). The following example may be helpful.

. Suppose that producers are producing at full capacity and are willing to sell at a price of $x. For extraordinary reasons the price rises to $x+2, producing a "windfall" profit of $2. That represents the maximum price that consumers are willing to pay because if they were willing to pay more producers would be charging more.

. If a tax of $1 is imposed it will not affect supply, since by definition the supply is the same at any level above $x. If producers could previously have added $1 to the price they would have done so already. If they now try to add $1 to the price, demand will simply fall. Thus, the price to consumers will not change and the oil producers will have to pay the $1 to the tax collector.

. However, if there is no windfall profit in the price, a tax will affect the amount which oil producers are willing to supply and some part of the tax will inevitably be passed on in the form of a price increase, as a lesser supply will result in price increases. The greater the supply response (i.e., the greater the contraction in supply), the closer to the amount of the tax the price increase will tend to be.

Proposals Relating to Domestic Incentives

Among the tax proposals which I presented to you in April 1973 were several which affect incentives for domestic exploration for and production of oil and gas. They are the proposals for the Exploratory Drilling Credit, for a Minimum Taxable Income and for a Limitation on Artificial Accounting Losses.

I said to you in April:

> "...the need is for new exploration in the United States which will add to the national wealth of known oil and gas reserves for the future and assure the continued availability at reasonable prices at home--not abroad--of adequate fuel supplies."

To that end we proposed a new investment credit for exploratory drilling. This credit operates in much the same way that the investment credit operates, and we expect it to be similarly effective in encouraging new exploration.

The tax law now contains incentives for oil and gas production in the form of the percentage depletion allowance and the deduction for intangible drilling costs. Of these, the provisions for intangible drilling costs are the more effective incentive for new production because they relate to the drilling operation itself and because the deductions may be taken whether or not the drilling is successful. Percentage depletion, on the other hand, relates only to production, and is a more diffused incentive because its benefits are available only if the drilling is successful and then only over a period of years.

The new exploratory drilling credit is concentrated on the activities which are most needed, namely, the discovery of new fields and reservoirs. And since it provides a major and immediate benefit for drilling activity, it should have a significant incentive effect on that activity.

The existing incentives provided by percentage depletion and the immediate deduction of intangible drilling costs would be lessened respectively by the Administration's proposals with respect to Minimum Taxable Income (MTI) and Limitation on Artificial Accounting Losses (LAL). These reductions in existing incentives, which are not large in relation to aggregate investment in the industry, are necessary for other reasons and are more than offset by the somewhat larger and more efficient incentives which would be provided by the proposed Exploratory Drilling Credit.

The purpose of both the MTI and LAL proposals is to stop the spectacle of high income taxpayers paying little or no federal income tax and thus to remove an element which tends to corrode the indispensable public confidence in our tax system. The Internal Revenue Code contains many preferences designed to provide incentives for particular activities. We believe that Congress should review them individually from time to time so that those which have become outmoded and unnecessary can be revitalized or eliminated. However, the pressing need at this time is to see that such provisions, in total, do not give rise to the public impression that tax laws apply unfairly in favor of the wealthy, who are the persons most likely to respond to the incentives. Thus, the Minimum Taxable Income proposal deals with existing incentives (leaving their reexamination to another day) and proceeds on the philosophy that while individual incentives may be good, there may be too much of a good thing. The Minimum Taxable Income proposal would place a limit on the aggregate amount of certain incentives which may be used by a particular taxpayer. Stated very roughly, the concept is that a taxpayer should not be permitted to use such incentives in an aggregate amount which exceeds half of his "economic" income. Just as the Code now places limits on particular incentives--such as the 50 percent of income limitation on the charitable deduction--the Minimum Taxable Income proposal would place a limitation on aggregate incentives.

In designing the Minimum Taxable Income provision, we were mindful that it would affect the use of percentage depletion in cases where percentage depletion in combination with other covered items exceeded half of the taxpayer's economic income. We concluded after careful consideration that, while individual taxpayers would complain, the proposal's effect on percentage depletion would be minimal in the aggregate and would not significantly affect capital investment for increased production of oil and gas. Whatever slight adverse effect the proposal might have in that regard, we believe it is the necessary price of preserving public confidence in the tax system generally.

The LAL proposal also lessens somewhat the incentives provided by the immediate deduction of intangible drilling costs. In the case of producing wells, such deductions often create accounting losses even though the well is in fact profitable. Under the proposal such losses

could be used only to offset income from oil and gas properties, and not to offset other income. The purpose of the proposal is to prevent high income taxpayers from eliminating their current taxable income from other sources by using deductions which do not represent economic losses. Drilling expenses incurred in connection with holes which turn out to be dry are not artificial losses and are unaffected by the proposal. While the proposal limits the use of such artificial losses, it does permit their utilization against oil and gas income and in that sense provides an incentive to oil and gas investment which partially offsets the disincentive.

Looking at the April 30 proposals as a package, the proposals for MTI and LAL would reduce to some degree the existing incentives for investment in oil and gas, but the proposal for an exploratory drilling credit would, in terms of dollar benefits to taxpayers, more than offset the dollar detriments arising from those proposals. Thus, when both proposals are considered together, the dollar tax incentives offered for investment in oil and gas remain essentially unchanged--but a significant portion of those dollar incentives has been rechanneled to operate in a much more efficient way to produce new oil and gas reserves.

Thus, we urge your Committee to act promptly on the proposed exploratory drilling credit, but to keep in mind that it must be considered in the total context of the proposals for Minimum Taxable Income, to which we hope you will also accord a high priority.

Proposals Relating to Foreign Operations

As a part of the program to make our nation independent in energy resources, we believe it desirable, within the limits of fairness, economic efficiency, and national security to emphasize incentives for domestic exploration as distinguished from foreign exploration. With that in mind, we presented to you last April a proposal relating to the recovery of foreign losses that are deducted against United States income. We now have two additional proposals relating to foreign operations which we ask that you consider.

The Foreign Tax Credit.

All of these proposals require an understanding of the international system for avoiding double taxation of income earned in one country by a citizen of another country.

The major nations of the world have a network of systems designed to avoid excessive double taxation of income. Those systems vary in detail but fall into two general categories. Under some systems, income earned abroad is simply not taxed in the home country. France,

and the Netherlands, for example, have systems which generally follows that basic concept. Other countries, including the United States, Great Britain, Germany, Canada, and Japan--our major trading partners--have tax credit systems.

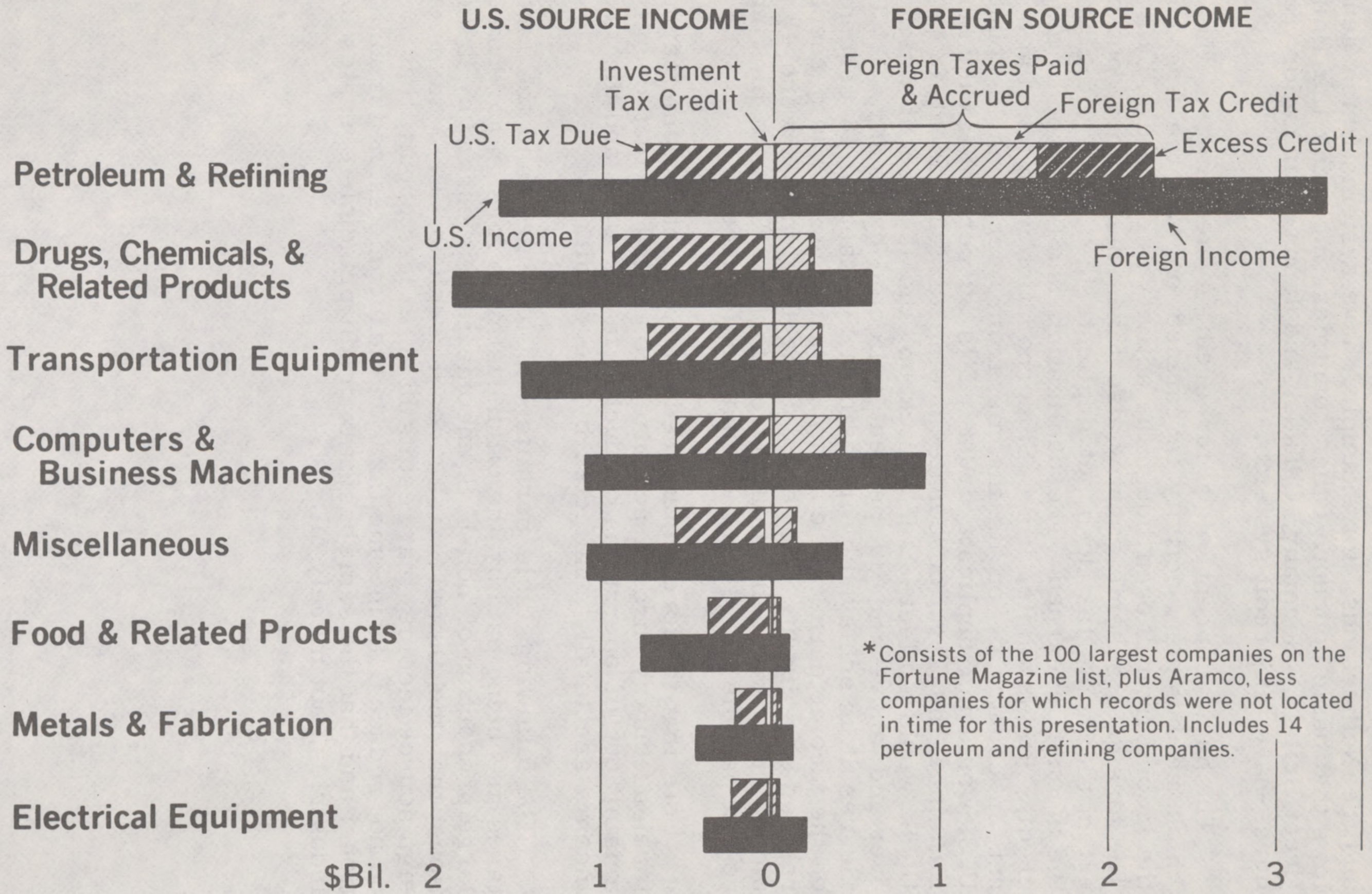
The basic concept of a tax credit system is that the country in which the business activity is carried on has the first right to tax the income from it even though the activity is carried on by a foreigner. The foreigner's home country also taxes the income, but only to the extent the home tax does not duplicate the tax of the country where the income is earned. The duplication is eliminated by a foreign tax credit. For example, if a U.S. corporation were taxed at a 30 percent rate in country X on its income from operations in country X, the U.S. would not duplicate country X's 30 percent tax on that income. But since the U.S. corporate income tax rate is at 48 percent, the U. S. would collect--i.e., "pick-up" the 18 percent which remained over and above the 30 percent collected by country X. Technically the result is achieved by imposing a hypothetical 48 percent U.S. tax on the income earned in country X, with the first 30 percentage points rebated by a credit. However, if the foreign rate were 48 percent or more, there would be nothing left for the U.S. to pick up and thus no tax payable to the U.S. on that foreign income.

Note that the foreign tax credit only affects income earned in some foreign country through activities conducted in that country. Income arising out of operations conducted in the U.S. and the taxes on that income are totally unaffected by the credit.

The following table permits one to understand the fact that high taxes are being paid by the oil industry to foreign governments on the large proportion of non-U.S. income that is earned by these corporations; that the United States gives a credit for U.S. taxes on the foreign source income that results in an excess credit; that these credits do not reduce U.S. income taxes on the income earned from U.S. operations; and that the same basic tax credit principle operates for all U.S. industries, not merely oil.

Table 7

INCOME AND TAXES PAID, OF THE 79 LARGEST U.S. COMPANIES,* 1970



*Consists of the 100 largest companies on the Fortune Magazine list, plus Aramco, less companies for which records were not located in time for this presentation. Includes 14 petroleum and refining companies.

Office of the Secretary of the Treasury,
Office of Tax Analysis

January 31, 1974

It is also important to note that the satisfactory functioning of this credit system depends upon reciprocity among nations. Thus, the U.S. reciprocally has the first right to tax income of foreigners arising out of operations in the U.S., and the home foreign countries either give those foreigners a credit for the U.S. tax or they exclude the U.S. income entirely from the home country's tax base.

When Congress wrote the basic tax credit provisions in 1918 and when the question of oil country taxes first became controversial twenty-odd years ago, circumstances were different from what they are today. Most foreign countries today have income tax rates nearly as great or greater than the U.S. tax rate. Thus, after our companies have paid their tax abroad, there is little or nothing left for the U.S. to "pick-up" on that foreign income unless we wish to impose a tax which duplicates the foreign tax. It has been the broad position of our government, under this and previous administrations, that the avoidance of double taxation is a sound principle and that we should continue to participate in the international system designed to avoid it. If we were now to withdraw from the system, we would invite retaliation and discrimination from other nations and would be required to rethink and renegotiate international arrangements. Excessive tax burdens would be imposed on U.S. companies operations abroad and their international competitive position would be severely affected.

In summary, the basic foreign tax credit must be understood not as a tax loophole or positive incentive to foreign investment, but rather as part of a system designed to allocate primary taxing jurisdiction to the government within whose borders the income is earned. The system does not reduce the total tax bill of U.S. companies below the amount they would have paid to the U.S. if the income had been earned here. They are excused from paying U.S. tax on foreign income only to the extent that they have paid an equivalent tax on that income to a foreign government. We must accept the fact that other countries now impose taxes comparable to ours, so that the U.S. now collects little or no tax from operations conducted by its corporations in most major foreign countries.

There still remain, however, certain "tax haven" countries which impose little or no tax, and there exist also some countries where the tax rates are much higher than U.S. tax rates. Much of the complication in the present system arises out of the desire of taxpayers either to average or not to average (depending upon the circumstances) the income and taxes of high tax and low tax countries.

At the present time, the oil producing countries impose taxes at very high rates. If these taxes were expressed as a percentage of taxable income as defined by our rules, they would be in the neighborhood of 90 percent. But if they were only as high as our corporate income taxes, namely 48 percent, the U.S. would still collect no

tax on earnings in those countries. However, the difference of 40-odd percentage points between those rates and U.S. rates produces very large "excess tax credits" which, under existing rules, can be used to eliminate the tax that the U.S. would otherwise "pick up" in the low tax, tax haven countries. One of the proposals I shall discuss later deals with an aspect of that fact.

Recovery of Foreign Losses

The April proposal with respect to the recovery of foreign losses is directed to a situation that arises because a taxpayer with losses in a foreign country can deduct those losses against income earned in the U.S. in the year of the loss. When the foreign operation becomes profitable in a later year, the foreign country often collects tax on the profits without regard to the prior loss, and if that tax is as large as our 48 percent tax, the resulting credit will absorb any U.S. tax on those foreign earnings. The result is that the United States shoulders the burden of the start-up deductions, but the foreign country collects the tax when the operation becomes profitable. Such losses often arise in connection with the exploration for oil or gas deposits abroad, involving large intangible drilling and development costs.

The April proposal would modify the foreign tax credit provisions to require that where a United States taxpayer has deducted foreign losses against United States income, such losses would be taken into account to reduce the amount of foreign tax credit claimed by such taxpayer on foreign earnings in later years. This would eliminate the present situation which permits the current deduction of intangible drilling costs and other start-up expenses in a foreign country against United States source income and then permits a foreign country to claim the full income taxes on the profits, with a United States tax credit for such taxes when production begins. The proposal, by restricting this possibility, would eliminate a present United States tax benefit for commencing foreign drilling operations. The estimated revenue gain from this proposal is $100 million annually after five years.

Elimination of Percentage Depletion in the Case of Foreign Oil and Gas Production

Percentage depletion was first allowed in 1926. Through the years it has been retained as an incentive for exploration for new reserves.

Percentage depletion has been available regardless of whether the producing property is located in the United States or in a foreign country. However, from time to time adjustments have been made

in rates and rules, and under existing law percentage depletion is unavailable, or available at a lower rate, for foreign production of a number of minerals other than oil and gas. In the case of oil and gas the depletion deduction is and has always been available abroad to the same extent as in the U.S.

In recent years, percentage depletion on foreign oil and gas has not produced a benefit in many, if not most, cases because of the generally high foreign taxes imposed abroad. (The precise amount of the hypothetical U.S. tax is irrelevant if the foreign tax is in any event higher, so that the foreign tax credit eliminates the U.S. tax.) However, there is a potential benefit for production in countries with lower tax rates.

It is now apparent that our primary aim should be to encourage the exploration for new sources of oil and gas in the United States. There is no longer any policy support for giving special encouragement to oil and gas exploration and production abroad. Thus, we now propose that the Internal Revenue Code be amended to provide that percentage depletion shall not be allowed with respect to oil and gas wells located in foreign countries. The percentage depletion allowance for oil and gas would be limited to wells located in the United States, in its possessions, in the Commonwealth of Puerto Rico or on the outer continental shelf.

Because the taxes of the major countries where oil and gas is now being produced by U.S. companies are now imposed at rates equal to or in excess of those which would be imposed by the U.S., no major revenue effect is expected from this change, although it may have a significant effect on some producers. The estimated revenue gain is $50 million.

We are not now proposing any change in the percentage depletion deduction available for other natural deposits located in foreign countries. However, that question should be examined from time to time and adjustments made when appropriate.

Excessive Foreign Tax Rates

Using artificially high posted prices for oil and high tax rates, many oil producing countries now collect "income taxes" on petroleum profits which greatly exceed income taxes normally collected by governments on other business activities. This has created what we believe to be a distortion in the normal and equitable operation of our foreign tax credit system.

We continue to support the principle of avoiding double taxation through a tax credit system. But like other basically sound principles, it can be subject to distortion and abuse in particular situations. The special problem that we are dealing with arises particularly where the taxing authority and the ownership of the oil are embodied in one and the same entity, which thus has the power to extract payments

from oil producers in the form of taxes or in some other form, at its discretion. The high artificial posted prices on which the taxes of a number of oil producing countries are based have created legitimate concern over whether the payments treated as creditable tax are "income taxes" or taxes "in lieu of a tax on income." It is argued that these payments, at least in part, more realistically represent some other business expense.

Business expenses are excludible or deductible from gross income, but they may not be credited against U.S. income tax. Foreign income taxes, on the other hand, may be either deducted from income or credited against U.S. tax, at the option of the taxpayer. Thus, if the tax law allows payments which in substance are not income taxes to be treated as income taxes, taxpayers will receive larger credits than they should. When the amount of the "tax" payment on foreign oil production exceeds the U.S. tax on the same income, the excess payment gives rise to an excess foreign tax credit which may be used as a credit against U.S. tax on income from other operations in that country, or on income from other foreign countries, depending on whether the foreign tax credit is computed on the per-country limitation or the overall limitation.

In the case of oil production, foreign producing countries generally base their tax on the "posted price" for crude oil. The posted price is a fictitious price which may or may not have any relationship to the market value of the oil. It is, however, almost always higher and has moved dramatically higher in recent months. As the posted price has risen, the foreign taxes have gone higher. This has led to greatly increased excess credits for taxes paid the oil producing countries.

Under the tax credit system, as the foreign tax rate goes up, the U.S. tax goes down, until the foreign rate becomes 48 percent and the U.S. rate becomes zero. Thereafter any increases in the foreign rate have no further effect on the U.S. rate on the foreign income but simply create "excess credits," which most companies cannot use. However, companies electing the "overall limitation" on the foreign tax credit, may average foreign tax rates so that "excess credits" in one country may, in effect, be used to pay U.S. taxes with respect to income earned in another foreign country which imposes little or no tax. While we believe this result to be satisfactory in general, we believe it leads to a distortion of the credit mechanism in the case of oil companies under present circumstances.

The total amounts of these payments to the foreign producing countries, and the effective rate of taxes have grown so large that, whether or not they technically qualify as "income taxes," we do not think that we should continue to treat them entirely as an income tax for tax credit purposes since they exceed normal levels of taxation and can

affect very significantly the U.S. treatment of other foreign source income of U.S. oil companies. For a number of years, the existence of increasingly large excess tax credits was of minor importance because there was no U.S. tax payable in any event, and the companies simply accumulated excess credits which they could not use. It now appears, however, that major international oil companies are beginning to engage more heavily in foreign operations other than oil extraction, including operations such as shipping, which are subject to little or no foreign tax. The number of companies electing the overall tax credit limitation appears to be increasing, and the income from these low-taxed foreign operations is thus shielded from U.S. tax by using the excess credits resulting from the extremely high "taxes" paid to the foreign governments on the foreign oil and gas income.

Our proposal would continue the foreign tax credit mechanism substantially as it has existed over the years, and it would not tamper with the basic definition of an income tax. We do not underestimate the ability of foreign oil producing countries to design the structure of their levies to correspond to any definition of an income tax that we require. But under our proposal only a reasonable part of the foreign income tax would be treated as a creditable tax. The balance would be treated as an expense. We propose to use U.S. tax levels as a standard in determining what is a reasonable level of foreign tax to be creditable. Thus in the case of these foreign taxes on oil and gas production, we would treat as creditable only an amount equivalent to the U.S. tax on the same income--i.e., in most cases the 48 percent general corporate rate or, the lesser 34 percent rate for Western Hemisphere Trade Corporations, as the case may be.

Since the expense part of the tax is deductible in determining taxable income, the determination of the creditable portion must be made by an algebraic formula. The explanatory material in the Appendix sets forth this formula and shows how it is derived. Its practical result is that foreign oil production will no longer generate excess foreign tax credits.

For purposes of applying these rules, the foreign oil taxable income of the taxpayer and the foreign tax paid with respect to that income would be determined separately for each foreign country, and the proposed new limit on creditable taxes would be computed separately for each foreign country. After application of the limit, the creditable taxes would be aggregated with other creditable taxes and subjected to the normal per-country or overall limitation on the foreign tax credit. Excess tax credits accumulated in taxable years beginning before the effective date of this proposal could be carried over to years beginning after the effective date of this proposal as under present law, but would be denied to the extent that they could not have been utilized had this change not been enacted. The proposal would become effective with respect to taxes paid during, or accrued with respect to, taxable years ending after December 31, 1973.

It is not possible to estimate the revenue gain from this proposal with precision because its enactment will cause taxpayers to change their operations in ways which we cannot predict. If more companies were to devise ways to use the excess credits generated under the present system, the revenue loss could be in excess of $1 billion a year. The proposal would foreclose that possibility. If the proposal were applied to existing patterns of operations we would expect it to produce revenues of about $400 million a year over current levels. However, taxpayers can be expected to change their procedures to reduce that amount substantially.

It has been suggested that the proper approach to this problem is to deny the foreign tax credit entirely with respect to the existing taxes on oil income. We believe that our proposed limitation is far more desirable. The result of denying the credit would be to subject U.S. companies to higher tax burdens than their foreign competitors. The step of denying any tax credit should not be taken unless it is determined that United States oil companies should not participate in foreign oil and gas production.

It has been suggested that the problem in this area is that the international oil companies are paying absurdly low taxes, sometimes alleged to be on the order of 2 or 3 percent, and that those taxes should be raised to the level of other U.S. companies. This is a simplistic way of looking at the problem. The fact is that these companies are paying high taxes on their foreign production. It is true that these taxes are not being paid to the U.S., but it is also true that there is no reason under the international system that they should be paid to the U.S. If a U.S. company can go to Saudi Arabia, find and produce oil, take it to Japan or Western Europe, sell it at a profit, pay reasonable taxes to the countries concerned, and repatriate the after-tax profits to the U.S., U.S. policy-makers should not be dismayed; they should be pleased.

We are all upset because the price of oil is high, but the reaction should not be to strike out blindly at the most available target. The approach of our proposal is not a vindictive one. We are not trying to penalize oil producers. Nor are we trying to restrict U.S. companies to U.S. business. What we are suggesting is a technical change which will remove the possibility of the oil producers obtaining an undue benefit from changed circumstances.

* * * *

In conclusion, let me emphasize our conviction that all of these proposals, together with those which we made last year, are of great importance to our nation's welfare. We urge that you give them a high priority. The Treasury Department will be pleased to assist in every way it can.

APPENDIX

Determination of Creditable Portion of Foreign Income Taxes on Oil and Gas Production

Many countries collect income taxes on oil and gas production at excessive levels. The Treasury proposal would characterize part of those income taxes as deductible expenses.

The method of dividing foreign income taxes between a portion which would be creditable against U.S. taxes, and the remainder, which would be characterized as an expense, may be described in three steps:

(1) The creditable portion of the tax would be equal to the U.S. tax rate applicable to corporations times foreign source petroleum income defined according to U.S. law. (The rate would be 48 percent for corporations other than Western Hemisphere Trade Corporations and also for individuals, trusts and estates, but would be 34 percent for Western Hemimsphere Trade Corporations.)

(2) Foreign source petroleum income defined according to U.S. standards would be equal to the fair market value of the petroleum, less royalties, lifting costs, and other allowable expenses, and less that portion of foreign income taxes which is characterized by the U.S. as an expense.

(3) The portion of the foreign income tax characterized as an expense would be equal to the total foreign income tax less that portion of the foreign income tax which is creditable against U.S. taxes.

Each step in the apportionment of foreign income taxes depends on some other step. Thus, to determine the creditable portion of the foreign tax, it is necessary to express the principle as an algebraic formula. The general statement of the principle is that the maximum creditable portion (M) of the foreign income tax (T) is equal to the U.S. tax rate (R) times the excess of foreign petroleum taxable income computed without deducting any portion of the foreign tax (I) over the deductible portion of the foreign tax (T - M). This may be expressed as the equation:

$$M = R\,[I - (T - M)]$$

This equation may be simplified into the form:

$$M = \frac{R}{1-R}\,(I - T)$$

In most cases R will equal 48%, and the equation may be further simplified into (approximately): $M = .923\,(I - T)$.

In the case of a Western Hemisphere Trade Corporation, R = 34%, and the equation becomes (approximately) M = .515 (I - T).

In practical terms, under the proposal, foreign petroleum ventures would no longer generate "excess" foreign tax credits. This is illustrated by the following table:

	Present Law	Proposal
Calculation of Foreign Tax		
Posted price, per barrel	$ 11.65	$ 11.65
Royalty (12.5%)	-1.46	-1.46
Lifting, etc., costs	-0.20	-0.20
Income as defined by foreign government	9.99	9.99
Foreign income tax (55%)	5.49	5.49
Calculation of U.S. Tax		
Fair market value	7.65	7.65
Royalty	-1.46	-1.46
Gross income	6.19	6.19
Depletion allowance (22% of $6.19)	-1.36	-0-
Lifting, etc., costs	.20	.20
Portion of foreign income tax recharacterized	-0-	-5.03
Taxable income for U.S. purposes	4.63	0.96
U.S. income tax (48%)	2.22	0.46
Calculation of Credit		
Maximum credit for foreign income tax	2.22	0.46
Excess foreign tax credit	3.27	-0-
Portion of excess disallowed because of depletion deduction	-0.65	-0-
Available excess credit	2.62	-0-

Under the proposal, excess foreign tax credits carried forward from years prior to the effective date of the proposal would still be characterized as excess credits available in the future to the extent they would have been used if the proposal had not become law. The excess foreign tax credits from such years would not be converted into deductions. If they were deductible from taxable income, the result would be a substantial revenue loss. The additional deduction would typically exceed taxable income before the deduction leaving the companies with a loss which they could offset against taxable income from U.S. sources.

For example, assuming that the figures shown in the table apply in 1973 and 1974, an excess credit of $2.62 from 1973 would more than offset the taxable income for U.S. purposes of $0.96 for 1974, leaving a net loss in 1974 of $1.66. This loss could be used to offset U.S. source income of an equivalent amount, on which the U.S. government would lose the tax of 48 percent or $0.80.

Treatment of a portion of the foreign income taxes as deductible cannot result in a reduction of U.S. taxes on U.S. income except in the unlikely case in which the foreign income taxes together with the costs associated with the petroleum exceed the value of the foreign petroleum. This case is particularly unlikely under our proposals because of the denial of a deduction for percentage depletion.

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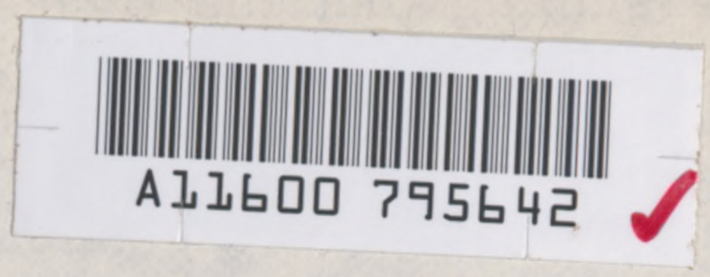
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