Internal Revenue Service

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Person to Contact:

Telephone Number:
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Refer Reply To:
CC:INTL:6 PLR-118948-98

Date:
DEC 18, 1998

LEGEND:

Parent: =
Sub 1: =
Sub 2: =

Country X =

Country Y =

Country Z =

Foreign Entity =

Company A =
Company B =

Tax Law =

Ordinance C =

Business a =

Bank	=
Date 1	=
Effective Date	=
Area 1	=
Area 2	=
Area 3	=
Amount a	=
Amount b	=
Amount c	=
Amount d	=
Amount e	=
Amount f	=
Amount g	=

Dear :

This letter is in reply to your letter dated October 1, 1998, requesting a ruling substantially identical to the private letter ruling, PLR 106079-97 issued to Parent on May 23, 1998. The subject of that ruling was the creditability under sections 901 and 903 of the Internal Revenue Code of amounts payable to Country X by Sub 2, under of a production sharing contract. Letters dated March 26, 1997, and July 23, 1997, were submitted with respect to this supplemental request. Specifically, Sub 2 has requested that the prior ruling letter be issued to Sub 2, in addition to Parent, and that the word “Parent” in the “Accordingly” paragraph on the bottom of page 12 of the prior ruling letter be changed to “Sub 2''. Additional conforming changes have been made.

The rulings contained in this letter are predicated upon facts and representations submitted by Parent and Sub 2 and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings. Verification of the factual information, representations, and other data may be required as part of the audit process. The information submitted for consideration is summarized below.

Parent, a domestic corporation, is the common parent of an affiliated group of corporations that join in the filing of U.S. consolidated income tax returns on a calendar year basis using the accrual method of accounting.

Sub 1 is a wholly-owned, domestic subsidiary of Parent and a member of Parent's consolidated group.

Sub 2 is a wholly owned, domestic subsidiary of Sub 1 and a member of Parent's consolidated group. Sub 2 is engaged in Business a in Country X.

Country X is the sovereign owner of land within Country X's territorial boundaries and all of that land's mineral and petroleum resources.

Foreign Entity is a corporation established under Ordinance C and authorized under the laws of Country X to exercise Country X's rights to explore, develop, exploit, produce, process, refine and market petroleum resources on Country X's land.

Company A and Company B are corporations organized under the laws of Country Y and Country Z, respectively, and engaged in Business a in Country X.

Sub 2 makes the following representations:

<u>The Production Sharing Contract Agreement</u>:

On Date 1, Parent entered into an agreement ("Agreement") with an Effective Date through Sub 2 to participate in an existing Production Sharing Contract ("PSC") between Foreign Entity, Company A, Company B, and Country X for the exploitation of Country X's petroleum rights in certain designated Contract Areas. Under the Agreement, Parent was admitted as an additional participant in the PSC and thus became a working interest holder in oil and gas concession interests acquired under the PSC. The term "petroleum" under the PSC includes all hydrocarbons (oil and natural gas). The nature of the oil and gas concession interests subject to the PSC are, as a practical matter such that natural gas or natural gas liquids ("NGLs") are the only commercially exploitable product in the Contract Areas, which areas are located offshore. Contractors' obligations and liabilities under the PSC are joint and several.

Contractors receive no compensation for services or reimbursement for their expenditures, other than their share of petroleum production from Areas 1 and 2, and bear all costs of exploration and development of the Contract Areas up to the point of commercial production. Title to all assets acquired and owned by Contractors in connection with PSC petroleum operations is transferred to the Foreign Entity, who becomes the owner of the assets, when the asset is landed in Country X (if purchased outside County X) or delivered to the Contract Area (if purchased within Country X), subject to Contractors' use during the contract term.

Contractors are obligated to make certain payments to the Foreign Entity under the PSC. A discovery bonus of Amount a is payable after each Commercial Discovery, followed by production bonuses of Amount a, Amount b, Amount c and Amount d, respectively, based upon defined incremental sustained production from the particular Contract Area. Contractors are required to make contributions towards research and development activities determined by the Foreign Entity and an annual service fee of Amount e. Contractors are also required to train Country X personnel in all aspects of the petroleum operations.

Under the PSC, Contractors are permitted to use, cost-free, petroleum (oil or natural gas) produced from the Contract Area for on-site petroleum production operations. Production in excess of such usage, or "net" petroleum production, is split between the parties to the PSC Agreement. Contractors are entitled to a disproportionate share of net petroleum production after a "cost recovery" allowance as limited by the cost recovery limitation. Profit production is split between Contractors and Foreign Entity according to type, i.e., oil, natural gas or liquid natural gas, and amount of petroleum production. Expenditures with respect to Area 1 are not recoverable from production in Area 2.

Total recoverable costs are limited depending upon whether oil, natural gas or natural liquid gas is produced, the location of such production and the estimated initial recovery amount. For example, where estimated initial recovery of natural gas exceeds Amount g, the maximum cost recovery is for on-shore gas and of other gas, e.g., off-shore gas. The maximum cost recovery for natural liquid gas is .

If the cost recovery amount in any given year exceeds the cost recovery limitation, this amount is carried over the succeeding year. If the cost recovery amount in any given year is less than cost recovery available in that year, this amount is reclassified as profit production. The parties may take their production share in-kind.

The PSC sets certain limitations upon the price of petroleum produced under the Agreement depending upon whether the production is oil, natural gas or natural gas liquids and whether it is sold for consumption within or without Country X. The value of oil from the Contract Area is tied to the price in world markets, based on prevailing market conditions in Area 3. Contractors are, however, required to sell up to of their share of profit oil at a discount price to meet internal demand of Country X.

Natural gas, which is sold for consumption within Country X, is priced according to a Marker Price, which is the arithmetic average of certain daily published quotes of High Sulfur Fuel Oil (HSFO") (based on thermal energy equivalents), fob Country X, for a rolling six-month period ending the last day, second month before the calendar quarter of the Marker Price. If no HSFO, the parties shall reset the price. Gas produced on-shore is set at of the Marker Price. Gas produced elsewhere is set at a price higher than the on-shore gas price (or of the Marker Price). The gas price is subject to a floor and ceiling price of and per metric tonne HSFO, respectively. The gas which may be produced in the Contract Areas is off-shore gas.

Natural gas in the form of natural gas liquids ("NGLs") may be exported for consumption without Country X. NGLs sold to third parties is to be priced at its fair market value at export point and such price must be preapproved by Foreign Entity. Contractors may purchase the Foreign Entity's share of NGLs at the same fair market value price less all processing and transportation costs.

Although Contractors are held harmless against certain taxes and duties imposed by Country X, Contractors agree, under the PSC, to be subject to and comply with Country X's Tax Law as it relates to filing returns and maintenance of books and records. Furthermore, the Foreign Entity agrees to assume, pay and discharge on behalf of Contractors each Contractor's Country X's Tax Law taxes out of the sums received by the Foreign Entity from the sale or other disposition of the Foreign Entity's share of petroleum under the PSC. For this purpose, the total taxable income of a Contractor for any calendar year shall be an amount calculated in accordance with Country X's accounting principles and Country X's Tax Law. The Foreign Entity's share of petroleum production from the Contract Areas includes an amount equal in value to the above assumed obligation. It is represented that the Foreign Entity will take amounts as a deduction and not as a credit for purposes of computing its tax liability. Contractors are, however, responsible for paying their own taxes on any income derived in Country X other than income from petroleum operations in the Contract Areas including, for example, income from processing or refining petroleum extracted from the Contract Areas.

Sub 2 has a letter from Country X (and countersigned by all other parties to the PSC) which effectively amends the PSC to provide Contractors with protection against changes in Country X law. The letter incorporates, as a matter of contract, the U.S. and Country Y bilateral investment treaties with Country X and also is a part of a natural gas purchase contract between Country X and Contractors.

Country X Tax Law:

The tax law of Country X is incorporated within its Tax Law. Residents of Country X pay tax under the Tax Law based upon worldwide income while nonresidents pay tax on income accruing (or arising) from or received in Country X. Taxable income under the Tax Law is computed according to various "heads" of income, including salaries, interest on securities, income from house property, agricultural income, income from business or profession, capitals gains and income from other sources (such as dividends, royalties and certain rents).

Income from business or profession:

Profits and gains from any business or profession are expressly included in taxable income. Included in income under this category are recovery of previously written-off bad debts and similar items, gains on sale of machinery and equipment in excess of adjusted cost basis (i.e., original cost less depreciation), and recovery of certain previously expensed scientific research expenditures. Separate provisions apply to the taxation of insurance companies and to taxpayers involved in the exploration and production of petroleum and other mineral deposits. In the case of a corporation, the calculation of taxable income under the Tax Law is on an entity-by-entity basis.

The following deductions are allowed from income from a business or profession under the Tax Law: rents, repairs, interest, insurance premiums, depreciation (including investment allowances), local taxes, employee bonuses and commissions, bad debts, certain scientific research expenditures and any other expenditure (not in the nature of a capital expenditure) incurred for the purpose of the business or profession of the assessee. An assessee is the person by whom any tax is payable under the Tax Law. Salaries are deductible except the assessee is required to withhold tax at the time of payment against salary and, if such withheld tax has not been paid to Country X, the deduction on account of salary allowance is not allowable.

Profits and gains, calculated in the year a transfer of a capital asset takes place, are taxable and computed by subtracting the amount realized from the adjusted cost basis. Provisions are available whereby a capital gain may be deferred and reflected in a reduced cost basis of defined replacement property. The gain from a sale of Country X securities or shares of stock of public companies listed with a stock exchange in Country X are exempt from tax.

In general, losses in one category may offset income under another category, except that losses from any speculation business or capital losses may only offset gains from any speculation business or capital gain, respectively. Net losses from a business or profession not used to offset capital gain may, in general, be carried forward for six years to offset future income from that trade or business. Losses from any speculation business or capital losses may also be carried forward for six years, subject to certain limitations in the case of capital losses. There are certain conditions and limitations on the carryforward of losses, including rules which integrate the depreciation provisions with the loss carryover provisions.

Income from the exploration and production of petroleum and other mineral deposits:

Profits and gain from oil and gas exploration and production are taxable under the general rules of the Tax Law, as adjusted under a separate schedule ("Schedule") dealing with oil and gas taxation. The Schedule provides that where any person (including a corporation) carries on or is deemed under an agreement with Country X to carry on any business which consists of or includes exploration and production of petroleum, the profits or gains of such shall be computed separately from the income, profits or gains from any other business. Furthermore, the sum of payments to Country X and taxes on income subject to the provisions of the Schedule shall be as provided for in the agreement with the assessee.

In calculating gross income under the Schedule, the sale price of oil is deemed to be the oil's "well head value," which term has the same meaning as that assigned in the agreement between the assessee and Country X. It is unclear whether payments of a Contractor's PSC Tax Law liabilities by Foreign Entity is included within the gross income base of the Contractor.

The deductions, which are allowed other businesses and professions, are also permitted, subject to certain adjustments under the Schedule. The Schedule allows the following additional deductions:

(a) Unsuccessful exploration efforts - Subject to the agreement between the assessee and Country X, expenditures allocable to a surrendered area and to the drilling of a dry hole may be recovered in either of two ways:

(1) The loss may offset any category of income other than dividends of that year and, to the extent not utilized, may be carried forward for six years OR

(2) The loss may be carried forward to offset oil and gas income in the year commercial production commences, and, to the extent not utilized, may be carried forward for ten years.

Unsuccessful exploration expenses include dry hole and abandonment losses, except that, under the accounting procedures for the PSC, any interest expense relating to unsuccessful exploration or appraisal operations is not deductible.

(b) Pre-commercial production expenditures other than under (a) above - After commencement of commercial production, all expenditures not represented by physical assets and not previously recovered under (a) shall be allowed as a deduction, but not in an amount greater than ten percent of the unamortized amount per year.

Other pre-commercial production expenses include, inter alia, geological and geophysical costs as well as intangible drilling and developments costs on successful wells incurred prior to commencement of commercial production.

(c) Expenditures after commencement of commercial production - Expenses

> in connection with exploration and production shall be allowed as a deduction. If an expenditure is capital in nature allowance for depreciation shall be calculated subject to accordance with the provisions of the Third Schedule.

Expenses in this category may include intangible drilling and development costs on infill natural gas wells incurred after the commencement of commercial production. Lease operating expenses and post-commercial production interest expenses fall into this category as well as discovery and production bonuses paid by Contractors under the PSC.

The Tax Law provides that only the assessee who owns a fixed asset is entitled to depreciation on that asset. Since title to fixed assets used in petroleum operations under the PSC belongs to the Foreign Entity, Contractors are not allowed to depreciate such assets. The taxing authorities for Country X have issued to Sub 1 an opinion that there is no bar to claiming the costs of these assets as revenue expenditures. But, in such a case, Foreign Entity may not claim depreciation for not using the assets and for having zero cost in their hands, although they become the owners of the asset. Sub 2's tax accountants, however, doubt whether for tax purposes Sub 2 can claim the cost of assets as revenue expenditure, despite clearance from Country X's taxing authorities, because under the PSC the costs of assets transferred to the Foreign Entity are recoverable in Sub 2's production share and therefore not a real cost to Sub 2.

(d) Deductions in (b) and (c) in excess of income - If the deductions under section 29 of the Tax Law and under (b) and (c) above exceed gross receipts from the sale of petroleum, such excess shall be offset against other income, other than a dividend, and carried forward in the manner and subject to the limitations concerning set-off of losses, carry forward of business losses and conditions and limitations of carry forward of losses. Generally, losses may be carried forward for six years under these provisions.

The Third Schedule also provides for a depletion allowance of 15 percent of the gross receipts representing the well head value of the production from the business, limited to 50 percent of the profits or gains computed without regard to the depletion deduction.

Law and Analysis:

Overview:

Section 901 of the Internal Revenue Code allows a foreign tax credit for "the amount of any income, war profits, and excess profits taxes ('income taxes') paid or accrued during the taxable year to any foreign country." A foreign levy is an income tax if and only if (1) it is a tax, and (2) the predominant character of that tax is that of an income tax in the U.S. sense. Treas. Reg. § 1.901-2(a)(1). Furthermore, section 903 of the Code provides that the term "income, war profits, and excess profits taxes" includes a tax paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by a foreign country. A foreign levy is a tax in lieu of an income tax if and only if it is a tax within the meaning of section 1.901-2(a)(2) of the regulations and it meets the substitution requirement set forth in section 1.903-1(b) of the regulations. Treas. Reg. § 1.903-1(a).

Section 1.901-2(f)(1) of the regulations provides that only the person by whom the tax is considered paid for purposes of sections 901 and 903 of the Code is the person on whom foreign law imposes legal liability for such tax, even if another person remits such tax. For purposes of sections 1.901-2, 1.901-2A and 1.903 of the regulations, the person on whom foreign law imposes such liability is referred to as the "taxpayer." Treas. Reg. 1.901-2(f)(1). Moreover, section 1.901-2(f)(2) of the regulations provides that a tax is considered paid by the taxpayer even if another party to a direct or indirect transaction with the taxpayer agrees, as part of the transaction, to assume the taxpayer's foreign tax liability.

For the purposes of sections 901 and 903 of the Code, whether a single levy or separate levies is imposed by a foreign country depends upon U.S. principles and not on whether foreign law imposed the levy or levies in a single or separate statute. Treas. Reg. § 1.901-2(d)(1). If a foreign law imposing a levy is modified for one or more persons subject to the levy by a contract entered into by such person or persons and the foreign country, then foreign law is considered for purposes of sections 901 and 903 of the Code to impose a separate levy for all persons to whom such contractual modifications of the levy applies, as contrasted to the levy as applied to all persons to whom such contractual modification does not apply. Treas. Reg. § 1.901-2(d)(2).

Section 1.901-2A(a)(1) of the regulations provides separate levy rules for dual capacity taxpayers as defined by section 1.901-2(a)(ii)(A) of the regulations. Under these rules, if the application of a foreign levy is different, either by the terms of the levy or in practice, for dual capacity taxpayers from its application to other persons, then unless the only such difference is that a low rate (but not the same base) applies to dual capacity taxpayers, such difference is considered to be related to the fact that dual capacity taxpayers receive, directly or indirectly, a specific economic benefit from the foreign country and, thus, to be a difference in kind, and not merely of degree. Treas. Reg. § 1.901-2A(a)(1). In such cases, notwithstanding any contrary provision of section 1.901-2(d) of the regulations, section 1.901-2A(a)(1) of the regulations provides:

1. the levy as applicable to such dual capacity taxpayers is a separate levy within the meaning of section 1.901-2(d) from the levy as applicable to such other persons; and

2. each of the levy as applied to dual capacity taxpayers and the levy as applied to other persons must be analyzed separately to determine

whether it is an income tax within the meaning of section 1.901-2(a)(1) and whether it is a tax in lieu of an income tax within the meaning of section 1.903-1(a).

Tax Law and PSC Tax Liabilities:

Pursuant to sections 1.901-2(d)(2) and 1.901-2A(a)(1) of the regulations, the Tax Law as applied to income from business or profession ("General Tax Law levy") and the Tax Law as applied to petroleum operations within Country X, as modified by the PSC, ("PSC Tax Law levy") constitute separate levies.

Sub 2 has represented that it will elect to apply the safe harbor provisions pursuant to sections 1.901-2A(c)(3) and 1.901-2A(d) of the regulations in determining the amount of the separate levy that is an income tax under section 901 or 903 of the Code.

First, it must be determined whether the PSC Tax Law levy is a creditable tax under section 901 or 903. The predominant character of the General Tax Law levy is that of an income tax because the levy is likely to reach net gain in the normal circumstances in which it applies and satisfies each of the realization, gross receipts, and net income requirements of section 1.901-2(b) of the regulations and is a tax. In addition, the General Tax Law levy is not a soak-up tax within the meaning of section 1.901-2(c) of the regulations.

The PSC Tax Law levy, however, raises certain issues concerning whether, judged on the basis of predominant character, the PSC Tax Law levy satisfies the gross receipts and net gain requirements of section 1.901-2(b) of the regulations. As to the gross receipts test, an issue is raised whether the market value for natural gas and oil sold for consumption without Country X satisfies the gross receipts requirements of section 1.901-2(b)(3)(i) of the regulations because there has not yet been production.

Issues are also raised as to whether, judged upon the basis of predominant character, the PSC Tax Law levy satisfies the net income requirements of section 1.901-2(b)(4)(i) of the regulations because of disallowed interest expenses attributable to exploration and appraisal.

These issues are raised, but not answered, here because it is determined that the PSC Tax Law levy qualifies as a tax "in lieu of an income tax" under section 903 of the Code and the attendant regulations to the extent such levy constitutes a tax within the meaning of section 1.901-2(a)(2) of the regulations. The PSC Tax Law levy is imposed in substitution for, and not in addition to, the General Tax Law levy, which levy qualifies as a creditable income tax under section 901 of the Code, and is not dependant (by its terms or otherwise) on the availability of a credit for the foreign tax against income tax liability to another country.

Accordingly, based on the information submitted and representations made, it is held:

> To the extent that Sub 2 establishes (by use of the facts and circumstances or safe harbor method) the amounts paid and accrued by the Sub 2 under Country X Tax Law, as applied to petroleum operations and modified by the PSC Agreement, which are paid with respect to the distinct element that constitutes a tax, such amounts will be considered payments of a creditable tax paid "in lieu of" an income tax within the meaning of section 903 of the Code.

No opinion is expressed as to the actual amount, if any, paid by Sub 2, as a dual capacity taxpayer, pursuant to the Country X's tax law, as modified by the PSC, that is not paid in exchange for a specific economic benefit.

No opinion is expressed as to the amount, if any, which is "paid or accrued" (within the meaning of sections 1.901-2(e) and 1.903-1(a)) by Sub 2.

Our analysis and conclusions are based upon a translation of the Tax Law provided by Parent and on representations about those laws made by Parent and Sub 2. This ruling is conditioned on the accuracy of that translation and those representations. The Internal Revenue Service has made no independent verification of the accuracy of the translation of the foreign law supplied.

Except as specifically ruled upon, we express no opinion on the application of any other section of the Code or regulations to the facts submitted.

A copy of this ruling should be attached to all relevant income tax returns.

This ruling is directed only to the taxpayer who requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely yours,

Phyllis E. Marcus
Chief, Branch 2
Office of the Associate Chief Counsel
(International)

Prior Written Determination Number 9835008