

# Judge Wood Meets International Tax

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## INTRODUCTION

There is always a danger in having courts of general jurisdiction rule on issues involving the application of technical pieces of specialized legislation. Judges in these courts generally lack the background necessary to understand the interactions between the particular issue(s) under scrutiny and the larger legislative or regulatory picture. And unfortunately, the parties, usually operating under strict space constraints in their briefs, often fail to educate the judges about that larger picture. That is the situation Judge Diane Wood found herself in twenty-two years ago when it fell to her to write the opinion in *Amoco Corp v Commissioner of Internal Revenue*.<sup>1</sup> The question raised in the case was whether Amoco Corporation could claim foreign tax credits for taxes it “paid”<sup>2</sup> to a corporation owned and controlled by the Egyptian government,<sup>3</sup> the Egyptian General Petroleum Corporation (EGPC). Although EGPC passed Amoco Egypt Oil Company’s (Amoco Egypt) tax payment on to the Egyptian treasury, EGPC then claimed Amoco Egypt’s taxes as a credit against its own Egyptian income tax liability.<sup>4</sup> The Internal Revenue Service (IRS) took the position that this tax credit constituted an “indirect subsidy”<sup>5</sup> to

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<sup>1</sup> 138 F3d 1139 (7th Cir 1998).

<sup>2</sup> The way in which these taxes were “paid” is a large part of the underlying story. See notes 52–82 and accompanying text (discussing the US Treasury’s evolving position on the payment of foreign taxes in the context of production-sharing arrangements).

<sup>3</sup> “Egypt” is used to denominate the “Arab Republic of Egypt” or “ARE.”

<sup>4</sup> It is unclear exactly when EGPC began claiming (or stopped claiming) such credits. The Seventh Circuit case involved the tax years 1979 through 1982. See *Amoco*, 138 F3d at 1142–43 (presenting tables laying out suggested adjustments).

<sup>5</sup> US Treasury Department regulations forbade taxpayers from claiming foreign tax credits for taxes that were returned to the taxpayer. See Treas Reg § 1.901-2(e)(2) (“An amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven.”). Amounts paid or credited to another person that “[e]ngages in a transaction with the taxpayer” are treated as amounts paid to the taxpayer if the amount of the subsidy is determined by reference

Amoco Egypt, negating Amoco Egypt's original tax payment and its associated (US) foreign tax credits.<sup>6</sup> As a technical matter, the case turned on the question whether EGPC should be treated "as part of the Egyptian government" since "it made no sense to say that the Egyptian government was providing a subsidy to itself."<sup>7</sup> Although Judge Wood did an admirable job of confronting this narrow technical question, the opinion gives no hint that she understood the larger context surrounding the case. If she had, she likely would have found it far more interesting.<sup>8</sup>

## I. PROBLEMS IN THE TAXATION OF TRANSNATIONAL TRANSACTIONS

### A. The Theoretical Choices

At least until recently, the perceived problem with the taxation of transnational income—income earned in one jurisdiction by a taxpayer resident in a second jurisdiction—was the likelihood of "double taxation."<sup>9</sup> The fear was that taxpayers would find

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to the tax associated with the transaction. Department of the Treasury, Internal Revenue Service, Creditability of Foreign Taxes, 48 Fed Reg 46272, 46282 (1983). This regulatory position was later codified in IRC § 901(i). IRC § 901(i)(2); Joseph Isenbergh, 2 *International Taxation: U.S. Taxation of Foreign Persons and Foreign Income* ¶ 55:14 (Aspen 3d ed 2003) (stating that § 901(i) was enacted in 1986).

<sup>6</sup> The Egyptian tax authorities eventually decided that EGPC's tax credit claims were improper and adjusted its Egyptian tax liabilities accordingly. However, by the time the Egyptian tax authorities noticed the problem and made the appropriate adjustments, two tax years (1979 and 1980) had been closed by the statute of limitations, preventing the collection of additional tax with respect to those years. See *Amoco*, 138 F3d at 1142. The IRS sought to disallow the foreign tax credits claimed by Amoco with respect to those years. Since the taxes had been paid in Egyptian currency, it also sought to have the amount of the foreign tax credits claimed with respect to 1981 and 1982 recalculated to use the exchange rate prevailing in the year EGPC's tax credits were reversed and its deficiencies paid. See *id.* ("[T]he [IRS] . . . urges us to remand to the Tax Court to determine how much credit Amoco is entitled to, taking into account the changes in the foreign exchange rate (and presumably also the time-value of money). . . .").

<sup>7</sup> See *id.* at 1144.

<sup>8</sup> To be fair to Judge Wood and the Seventh Circuit, the Tax Court, which initially heard the case, see generally *Amoco Corp v Commissioner of Internal Revenue*, 71 Tax Ct Mem Dec (CCH) 2613 (1996), did not do much better. Although it traced the legal and political maneuvers that led to the construction of Amoco Egypt's concession agreement with EGPC and Egypt, the Tax Court failed to draw an explicit connection between the Treasury's rather tortured decision to allow Amoco Egypt's taxes to give rise to tax credits in the first instance and its later discussion of the credit issue in the case at hand.

<sup>9</sup> See Charles H. Gustafson, Robert J. Peroni, and Richard Crawford Pugh, *Taxation of International Transactions: Materials, Texts and Problems* 22 (West 4th ed 2011) ("A central focus of international taxation . . . is international double taxation."). More recently, the focus has shifted toward the phenomenon of undertaxation through the

their transnational income subject to income taxes levied by both the country of source and the country of residence. Given then-prevailing corporate tax rates,<sup>10</sup> such duplicative taxation could lead to government confiscation of virtually all, if not all (or even more than all) of the profits from transnational transactions, effectively shutting down all transactions that generated such income.<sup>11</sup> For example, suppose a US corporation operated a factory in France, earning \$1,000, at a time when the French government assessed a 40 percent, or \$400, income tax on this income. If the US government imposed its own 40 percent<sup>12</sup> tax on this \$1,000 of income on top of the French tax, the taxpayer's total corporate tax burden would have been \$800, or 80 percent of its total income. And this corporate level tax is before the imposition of a shareholder level tax on this income.<sup>13</sup> Such excessive taxation would obviously have a deleterious effect on the world economy—not to mention national economies—as opportunities for achieving economies of scale, exploiting comparative advantages, and incentivizing innovation would disappear.

An international consensus developed early on that source-country taxation should take precedence over residence-country

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creation of “stateless income” that falls through the cracks of every nation’s tax system. See Edward D. Kleinbard, *Stateless Income*, 11 Fla Tax Rev 699, 713 (2011) (“[T]he pervasive presence of stateless income tax planning changes everything.”).

<sup>10</sup> Although at present, the US corporate tax rate is 21 percent, see IRC § 11(b), the rates hovered in the mid-40 to low-50 percent range from 1953 through 1986, and remained in the mid-30 percent range until passage of the Tax Cuts and Jobs Act, Pub L No 115-97, 131 Stat 2054 (2017), codified in various sections of Title 26. See ProCon.org, *Federal Corporate Income Tax Rates* (May 21, 2018), archived at <https://perma.cc/B4WF-EVVQ> (providing a table of historical tax rates). Most foreign income tax rates (at least, in those countries that were both developed nations and not marketing themselves as tax havens) were similar until the early 1990s, when virtually all countries began reducing their statutory corporate tax rates. See Reuven S. Avi-Yonah and Yaron Lahav, *The Effective Tax Rates of the Largest U.S. and EU Multinationals*, 65 Tax L Rev 375, 375 (2012):

After the Tax Reform Act of 1986 lowered the U.S. rate from 46% to 34%, the United States had one of the lowest statutory corporate tax rates in the OECD. In the past twenty-five years, however, the U.S. rate has remained essentially unchanged . . . while most other OECD countries reduced their statutory rate. . . .

<sup>11</sup> See Eric M. Zolt, *Tax Treaties and Developing Countries*, 72 Tax L Rev 111, 115 (2018) (suggesting that double taxation could “result in relatively little cross-border activity”).

<sup>12</sup> This was the corporate tax rate prevailing during at least some of the years at issue in the *Amoco* case.

<sup>13</sup> Not to mention the possible imposition of state or provincial income taxes.

taxation,<sup>14</sup> but that was as far as the consensus went. There was no (and still is no) international agreement on exactly how residence countries should take source taxes into account when calculating the tax liabilities of their residents. Should foreign taxes be treated as an expense of doing business abroad, entitling taxpayers to a deduction when calculating the residence country's tax on the foreign income?<sup>15</sup> Or should the foreign taxes be treated as a prepayment of residence-country taxes, and credited against the residence-country tax obligation?<sup>16</sup> Should the residence country simply omit income subject to foreign-source taxes from their tax base?<sup>17</sup> Or should foreign-sourced income be included in residents' income after foreign taxation, but taxed at a lower rate of

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<sup>14</sup> This consensus can be traced to the work of T.S. Adams, an economics professor at the University of Wisconsin and Yale University who served as "the Treasury's principal advisor on issues of tax policy and administration" from 1917 to 1923. Michael J. Graetz and Michael M. O'Hear, *The "Original Intent" of U.S. International Taxation*, 46 *Duke L J* 1021, 1029 (1997). Adams was almost single-handedly responsible for the addition of the foreign tax credit to the Internal Revenue Code ("the Code") in the Revenue Act of 1918. See *id.* at 1043–54 (noting that the foreign tax credit was Adams's "first enduring contribution to international tax policy"). Even before the addition of the foreign tax credit, however, the United States allowed foreign-source taxes to be deducted as an expense of deriving foreign-sourced income. See *id.* at 1041. Though such a deduction is now considered to be on the less generous end of the methods for alleviating double taxation, it was more than many other countries offered at the time. See *id.* at 1046 & n 103 (listing other "limited unilateral relief measures that were in existence prior to the U.S. [foreign tax credit]").

<sup>15</sup> This would mean, in the example above, the United States would impose its 40 percent tax on the \$600 left after payment of the French tax, resulting in a US tax obligation of \$240 and a combined tax obligation of \$640—or 64 percent of the taxpayer's income. Allowing a deduction, rather than a credit, for foreign tax payments is said to achieve "national neutrality" because it ensures that the US Treasury's "total returns on capital . . . are the same whether the investment is made in the United States or abroad." Gustafson, Peroni, and Pugh, *Taxation of International Transactions* at 21 (cited in note 9).

<sup>16</sup> Under a credit system, the residence country subjects the entirety of the taxpayer's pretax foreign income to its own tax, but allows the taxpayer to credit foreign income taxes against this domestic tax liability. In the example above, the US taxpayer's (pre-credit) US tax liability of \$400 would be completely offset by credits generated from the \$400 French tax liability. Foreign tax credits are supposed to make investors indifferent (from a tax perspective) between investing in their country of residence or abroad, thereby furthering the goal of "capital-export neutrality." See *id.* at 20 ("Thus, the decision to invest in the United States or abroad is not affected by U.S. or foreign tax consequences.").

<sup>17</sup> Under this approach, no US tax would be imposed on the \$1,000 of foreign income. This approach is also described as "territoriality," because countries assert taxing jurisdiction only over income arising within their borders. It achieves (depending on who you talk to) "capital-import neutrality" since all capital imported into a jurisdiction is taxed at the same rate, or "national [ownership] neutrality," since the nationality of the owner of the capital has no effect on its tax rate. See *id.* at 21 (cited in note 9).

tax?<sup>18</sup> Different countries have opted for different approaches—or combinations of approaches.

The United States appeared (at least initially)<sup>19</sup> to have embraced the second option—of treating foreign-source taxes as a prepayment of the taxpayer’s residence-country tax liability for that foreign income by statutorily authorizing foreign tax credits.<sup>20</sup> The credit mechanism, at least in theory, places the same (worldwide) tax burden on the foreign operations of US taxpayers as is placed on their domestic operations, thereby eliminating the economic incentive to carry out operations in low-tax jurisdictions. Not only does equalizing these tax burdens make a given taxpayer’s choice between investing in the United States and abroad “tax neutral,” the tax credit mechanism ostensibly protects fully domestic competitors and the US economic base. It achieves “capital export neutrality.”

From its inception, however, the operation of the foreign tax credit mechanism raised difficult questions. As the next section of this Essay discusses, none of these questions had easy answers. And the imperfection of the answers provided in the Internal Revenue Code and Regulations gave rise to the *Amoco* case Judge Wood had to decide.

## B. Operational Dilemmas

The world is a complicated place. Many of those complications interfere with the ability of the foreign tax credit to achieve capital export neutrality.<sup>21</sup> The first complication stems from the

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<sup>18</sup> This approach has been championed by some academics, see, for example, Daniel Shaviro, *The Crossroads Versus the Seesaw: Getting a “Fix” on Recent International Tax Policy Developments*, 69 *Tax L Rev* 1, 21 (2015) (“[Foreign Source Income] should probably be taxed at an effective rate between zero and the full domestic rate.”), and some elements of it appear in the tax rules adopted in the Tax Cuts and Jobs Act of 2017, see IRC § 250(a)(1)(B) (allowing a deduction equal to 50 percent of the “global intangible low-taxed income,” effectively subjecting such income to tax at half of the normal corporate tax rate).

<sup>19</sup> The Tax Cuts and Jobs Act of 2017 has since significantly changed the US rules for the taxation of foreign income. The current rules for the taxation of foreign income include elements of territoriality and the “taxation at a lower rate” approach in addition to the capital export neutrality approach.

<sup>20</sup> Congress first adopted the foreign income tax credit in 1918. See Revenue Act of 1918, Pub L No 65-254, § 222(a), 40 Stat 1057, 1073, codified at IRC § 901.

<sup>21</sup> For purposes of this Essay, I assume that Congress’s commitment to capital export neutrality was real. There is reason to question that assumption. Until the adoption of the Tax Cuts and Jobs Act of 2017, the Code allowed taxpayers to defer paying the difference between their US tax liability on foreign-sourced income and their foreign-source tax liability by carrying out those foreign business activities through foreign subsidiaries. The

coexistence of both low-tax (relative to the United States) and high-tax countries.<sup>22</sup> The second is the difficulty of defining an “income tax”—or even explaining why the credit should be limited to foreign income taxes.

A true commitment to capital export neutrality would require the residence country to pay taxpayers any difference between source-country taxes paid and the domestic tax liability on that income. That is, if the US tax liability on \$1,000 of income was \$350 while the French tax liability on that income was \$400, the US Treasury would have to cut a \$50 check to the taxpayer to actually generate capital export neutrality.<sup>23</sup> No country, including the United States,<sup>24</sup> does that because it grants foreign governments an open check on their treasuries and erodes their ability to tax domestic income.<sup>25</sup> The United States limits the amount of foreign tax credits to the amount of the US taxpayer’s total tax liability multiplied by a fraction, the numerator of which is the taxpayer’s foreign taxable income and the denominator of which is its worldwide taxable income.<sup>26</sup> However, taxpayers swiftly

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United States has no jurisdiction to tax the foreign earnings of a foreign person, see Gustafson, Peroni, and Pugh, *Taxation of International Transactions* at 25 (cited in note 9) (“The separate legal personality of the Country X corporation is respected for U.S. tax purposes.”), so that unless a corporation’s income is subject to a special antideferral regime, payment of the tax differential is delayed prior to the income’s distribution to the US shareholders in the form of a dividend or sales proceeds, see id. (“[N]o U.S. tax can normally be imposed unless and until the foreign earnings of the Country X corporation are distributed as a dividend or otherwise to the U.S. parent corporation.”). Such deferral is economically equivalent to granting taxpayers an interest-free loan—or a reduction in their effective tax rate. See J. Clifton Fleming Jr, Robert J. Peroni, and Stephen E. Shay, *Worse Than Exemption*, 59 *Emory L J* 79, 94 (2009) (“[T]he general availability of deferral for CFC income reduces the effective rate of U.S. tax on foreign-source income.”).

<sup>22</sup> The problems multiply when countries tax different items of income at different rates—not that the United States has any right to complain about this!

<sup>23</sup> Alternatively, the same economic effect could be achieved by allowing the taxpayer to use the credit to offset the income taxes due on US source income. See Gustafson, Peroni, and Pugh, *Taxation of International Transactions* at 406–07 (cited in note 9) (allowing unlimited foreign tax credits “would be similar in effect to a refund of the ‘excess’ foreign taxes”).

<sup>24</sup> See IRC § 904 (imposing limits on creditability of foreign taxes).

<sup>25</sup> See Gustafson, Peroni, and Pugh, *Taxation of International Transactions* at 407 (cited in note 9) (“However, allowing a credit for foreign taxes in excess of the U.S. rate would result in an erosion of the core component of the U.S. tax base—U.S.-source income.”); Robert J. Peroni, J. Clifton Fleming Jr, and Stephen E. Shay, *Reform and Simplification of the U.S. Foreign Tax Credit Rules*, 101 *Tax Notes Intl* 1177, 1184 (2003) (“The United States would, in effect, be subsidizing the public sectors of high-tax foreign countries . . . result[ing] in a substantial diversion of funds from the U.S. Treasury to the treasuries of foreign countries.”).

<sup>26</sup> See IRC § 904(a).

learned how to game this limitation by “blending” or “cross-crediting” highly taxed foreign income with low-taxed foreign income, using tax credits generated with respect to highly taxed income to offset US taxes that would have been imposed on low-taxed income.<sup>27</sup> Such gaming undercut capital export neutrality because it led taxpayers earning income in high-tax countries to search out opportunities to earn additional low-taxed foreign income.<sup>28</sup> As a result of blending, taxpayers (not the US Treasury) benefited from low tax rates, exactly the opposite of what the foreign tax credit mechanism was supposed to accomplish.<sup>29</sup> Over the years, Congress has experimented with a number of different tweaks to the basic tax credit limitation mechanism to make blending less available, with varying degrees of success.<sup>30</sup>

To generate any foreign tax credits at all, however, a foreign jurisdiction must maintain an income tax. One of the perennial issues in foreign tax credit jurisprudence is how broadly to define that term.<sup>31</sup> This question has not been made any easier by uncertainty over why tax credits should be limited to income taxes—an uncertainty that strikes at the heart of the justification for the foreign tax credit regime.

The problem of double taxation is most apparent when both source and residence countries have similar tax regimes. However, the underlying problem—imbalances in the relative size of governmental burdens placed on transnational versus fully

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<sup>27</sup> See Fleming, Peroni, and Shay, 59 *Emory L J* at 132–37 (cited in note 21) (explaining cross-crediting).

<sup>28</sup> See Gustafson, Peroni, and Pugh, *Taxation of International Transactions* at 408 (cited in note 9) (“The goal of the international tax planner is to generate foreign-source taxable income subject to low or no foreign taxes to include in the numerator of the limitation fraction and thereby absorb the excess foreign tax credits arising from high foreign taxes imposed on other foreign-source taxable income.”).

<sup>29</sup> See Fleming, Peroni, and Shay, 59 *Emory L J* at 135 (cited in note 21) (explaining that cross-crediting makes the foreign tax credit system “more generous to taxpayers and economically distortive than a properly designed, non-elective exemption system for taxing foreign business income”).

<sup>30</sup> See Gustafson, Peroni, and Pugh, *Taxation of International Transactions* at 412–24 (cited in note 9) (explaining the evolution of limitation rules). A recently published article argues that the inefficacy of these limitations can serve a beneficial purpose—channeling most of the revenue losses suffered by less developed countries that have entered into tax treaties to foreign investors (thereby providing incentives to invest in those countries) rather than to treaty partner treasuries. See Zolt, 72 *Tax L Rev* at 137 (cited in note 11) (discussing the “appeal” to “directors in MNEs who seek to minimize the overall worldwide tax liability of the corporation”).

<sup>31</sup> See notes 57–59 and accompanying text (discussing the net gain requirement); notes 69–80 and accompanying text (examining the dual capacity taxpayers).

domestic enterprises—is not limited to situations in which taxing mechanisms obviously overlap. In addition, some countries may have very good reasons for preferring other revenue-raising mechanisms to an income tax. In particular, although developed countries have income taxes, lesser developed countries are less likely to have systems that measure up to US standards, or to apply them to only a limited number of taxpayers. Effective administration of an income tax system is expensive and requires sophisticated auditing staff.<sup>32</sup> The rationale for encouraging countries to use income taxes rather than other taxing mechanisms more suited to the local environment remains unclear.<sup>33</sup> And even some developed countries prefer to rely more on consumption taxes than income taxes.

More fundamentally, it is unclear why anyone would think that equalizing foreign tax burdens, let alone foreign income tax burdens, actually places US investors with foreign business operations on a more equal footing with US business operations. Paying taxes is not economically equivalent to throwing money away. Taxes are used (hopefully) to pay for government services, at least some of which may benefit the taxpayer. Low tax rates are often accompanied by low levels of government services. Businesses benefiting from low tax rates may well find themselves forced to provide for themselves many of the services that are provided to domestic US businesses “for free” by the US government.<sup>34</sup>

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<sup>32</sup> See Jordan M. Barry and Ariel Jurow Kleiman, *The Arbitrary Foreign Tax Credit* \*51 n 263 (UC San Diego Legal Studies Working Paper No 20-438, Mar 2020), archived at <https://perma.cc/M2FF-9237>, citing Michael Keen and Mario Mansour, *Revenue Mobilization in Sub-Saharan Africa: Challenges from Globalization* \*10 (IMF Working Paper No 09/157, July 2009), archived at <https://perma.c/U4Tq-HZ5L>, and S.M. Ali Abbas, Alexander Klemm, Sukhmani Bedi, and Junhyung Park, *A Partial Race to the Bottom: Corporate Tax Developments in Emerging and Developing Economies* \*3–4 (IMF Working Paper No 12/28, Jan 2012), archived at <https://perma.cc/3PDB-92EH>.

<sup>33</sup> There are several documented instances of foreign governments adopting income taxes—or declining to enact tax reforms—solely to ensure the availability of foreign tax credits. See Barry and Kleiman, *The Arbitrary Foreign Tax Credit* at \*45–46 n 237 (cited in note 32) (discussing efforts by Bolivia, China, and Costa Rica). It is worth noting that the federal income tax rules have sometimes seemed to encourage states in the United States to rely on income taxes rather than sales taxes by allowing individuals to deduct state income taxes—but not state sales taxes—for purposes of calculating their federal income tax liability. Sales taxes were added to the list of deductible taxes in 1964—and removed from the list in 1986. See Kirk J. Stark, *Fiscal Federalism and Tax Progressivity: Should the Federal Income Tax Encourage State and Local Redistribution?*, 51 *UCLA L Rev* 1389, 1415 (2004) (“Surprisingly, it does not appear that states reduced their reliance on the sales tax in response to the 1986 amendments.”).

<sup>34</sup> Some have argued that the existence of foreign tax credit incentivizes both the use of income taxes and beneficial increases in the size of government. See, for example,



Although such expenditures likely would be deductible for income tax purposes, a tax deduction is worth far less than a tax credit.<sup>35</sup> Equalizing the apparent tax burdens, in short, does not necessarily equalize the treatment of US investors operating in the United States and abroad once governmental spending patterns are taken into account. This is one reason many European countries, which are not known for their generosity in tax matters, have opted for explicitly territorial tax systems, exempting foreign business income<sup>36</sup> from the base of their income taxes. And in the earliest years of the operation of the tax credit system, neither the IRS nor courts seemed overly concerned about the match (or lack thereof) between foreign tax systems and either the US system or an “ideal” income tax.<sup>37</sup>

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Stanley S. Surrey, *The United States Taxation of Foreign Income*, 1 J L & Econ 72, 86 (1958) (discussing that foreign tax credits prevent “pressures on United States corporations to obtain tax concessions from underdeveloped countries”). It is probably true that building a sewage or water treatment plant that services the larger community is more socially beneficial than building one that services the needs only of the multinational enterprise located within the community. However, that is often not the choice: countries with weak government institutions may be incapable of using tax revenues to construct such a plant—or indeed of administering an income tax system to begin with. See note 32.

<sup>35</sup> A tax credit, or at least a foreign tax credit, offsets the taxpayer’s US tax obligation on a dollar-for-dollar basis. A dollar of deductions, by contrast, reduces that tax obligation by that dollar multiplied by the taxpayer’s marginal tax rate. And as tax rates have declined, so too have the value of deductions. For example, a \$100 foreign tax credit reduces a US taxpayer’s US income tax obligation by \$100. A \$100 deductible expenditure by a US corporate taxpayer, given today’s 21 percent corporate tax rate, would reduce its tax bill by only \$21.

<sup>36</sup> See Zolt, 72 Tax L Rev at 126 (cited in note 11) (“Exemption systems are the most common approach.”). Most territorial tax regimes retain capital export neutral treatment for some types of income, particularly passive income and income associated with behavior defined as abusive, reducing the distance between the US tax regime and “territoriality.” See Shaviro, 69 Tax L Rev at 1, 1–2 n 4 (cited in note 18) (“First, the ‘worldwide versus territorial’ distinction greatly oversimplifies a reality in which countries’ international tax systems overlap substantially.”); Michael J. Graetz, *The David R. Tillinghast Lecture Taxing International Income: Inadequate Principles, Outdated Concepts, and Unsatisfactory Policies*, 54 Tax L Rev 261, 329 (2001) (“In practice, however, exemption systems used by other nations and our foreign tax credit system are quite close.”). After the Tax Cuts and Jobs Act of 2017, the US tax system now has an explicitly territorial element as well. See Stephen J. Pieklik, Nathan S. Catanese, and Cory C. Omasta, *Deducting Success: Congressional Policy Goals and the Tax Cuts and Jobs Act of 2017*, 16 Pitt Tax Rev 1, 21 (2018) (“The Tax Cuts and Jobs Act significantly changed the U.S. worldwide taxation system for corporations by changing the Code to become more like a territorial tax system.”).

<sup>37</sup> See Bret Wells, *The Foreign Tax Credit War*, 2016 BYU L Rev 1895, 1902 (“[E]arly cases and IRS rulings took an expansive view of credit eligibility, allowing the foreign country considerable latitude to define the manner in which a formulary tax arrived at the net income it intended to tax.”).

These operational problems or questions reached their apogee in the context of so-called “dual capacity taxpayers”—those receiving “specific economic benefit,” such as oil or other mineral extraction rights, in addition to general government services.<sup>38</sup> In such situations, it can be extremely difficult to determine whether a given payment represents royalties or extraction fees—which would normally be a deductible expense—or a tax. Both foreign governments and taxpayers benefit from maximizing the amount of such payments treated as creditable taxes.<sup>39</sup> In the 1960s and 1970s, the IRS raised no objection when foreign oil-producing governments “decided to forego charging higher royalties for the development of state-owned mineral interests and instead adopted special tax levies that had the effect of inflating the amount of U.S. foreign tax credits.”<sup>40</sup> Some of these “taxes” were levied at extraordinarily high rates, but remained creditable because the then-existing tax credit limitation rules provided ample opportunities for cross-crediting.<sup>41</sup>

The situation started to change after the “sharp increase in oil prices that began after 1973.”<sup>42</sup> It changed in two respects: first, the IRS became noticeably stickier about treating foreign exactions as taxes rather than royalties; and second, oil-exporting countries began changing the format of their agreements with foreign oil companies in ways that made government exactions look

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<sup>38</sup> Treas Reg § 1.901-2(a)(2)(ii) (defining “[d]ual capacity taxpayers”).

<sup>39</sup> See Joseph Isenbergh, *The Foreign Tax Credit: Royalties, Subsidies, and Creditable Taxes*, 39 Tax L Rev 227, 247–48 (1984):

Being ultimately indifferent to the color of the money it receives, a government that owns oil can cast as a tax amounts received from oil developers that would look much like a proprietor’s royalties in dealings between private parties. If the characterization as a tax holds up, U.S. oil companies operating in oil exporting countries derive a full reduction of U.S. taxes for amounts that would otherwise only be deductible as royalties.

<sup>40</sup> Wells, 2016 BYU L Rev at 1908 (cited in note 37). The IRS even issued a revenue ruling, Rev Rul 55-296, 1955-1 Cumulative Bull 386, stating that a Saudi Arabian surtax equal to a posted price per barrel of oil would be a creditable income tax. This ruling was later explained as a mechanism for surreptitiously granting foreign aid to Saudi Arabia, aid which was otherwise politically impossible. See Wells, 2016 BYU L Rev at 1908 n 32 (cited in note 37) (citing sources); Isenbergh, 39 Tax L Rev at 248 (cited in note 39) (“It has been suggested that pressure from the State Department, concerned with preserving good relations with oil producing countries in the Middle East, was behind this regime of benign neglect.”).

<sup>41</sup> See Isenbergh, 39 Tax L Rev at 249 (cited in note 39) (explaining cross-crediting options).

<sup>42</sup> *Id.*

less like income taxes. The taxpayer in the *Amoco* case decided by Judge Wood was one of the taxpayers caught in this crossfire.

## II. AMOCO'S EGYPTIAN TAX ADVENTURES

### A. The Saga of Dual Capacity Taxpayers

Amoco Egypt was a Delaware subsidiary of Amoco Corporation, the Indiana corporate successor to Standard Oil Company. Amoco Egypt began exploring and drilling for oil in the Arab Republic of Egypt (Egypt) in 1963.<sup>43</sup> Inasmuch as Egypt owned all the oil and other minerals located within its borders, foreign corporations could not undertake any oil exploration or production activities without entering into a concession agreement with the Egyptian government. Egypt created a wholly-owned—and controlled<sup>44</sup>—Egyptian corporation, the Egyptian General Petroleum Corporation (EGPC) as its interface with foreign oil companies, although all of EGPC's oil concession agreements had to be specifically authorized by the Egyptian Congress and enacted into statutory law.<sup>45</sup>

In the 1960s, oil companies entered into separate concession agreements with EGPC for each oil field.<sup>46</sup> The first such agreements with Amoco Egypt required Amoco Egypt to finance initial exploration activities.<sup>47</sup> Once satisfied that a field was worth exploiting, Amoco Egypt and EGPC shared equally in both the costs and the income generated from oil field operations.<sup>48</sup> Among the shared costs were Egyptian income taxes and oil royalties.<sup>49</sup> The original concession agreements obligated Amoco Egypt and EGPC to pay their respective shares of Egyptian taxes and royalties

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<sup>43</sup> Amoco Egypt entered into its first concession agreement, covering the "Western Desert" area, in 1963. See *Amoco Corp v Commissioner of Internal Revenue*, 71 Tax Ct Mem Dec (CCH) 2613, 2616 (1996). It entered into additional agreements covering other oil fields in 1964 and 1969. See *id.* (discussing "the Gulf of Suez Concession Agreement in February 1964, and the Western Desert and Nile Valley Concession Agreement in September 1969").

<sup>44</sup> By law, Egypt's president appointed the chairman of EGPC's board of directors while other members of the board were appointed by the prime minister in consultation with the minister of petroleum and mineral resources. *Amoco*, 138 F3d at 1140. Further, all of the board's resolutions had to be forwarded to the minister of petroleum and mineral resources for "ratification, amendment, or cancellation." *Id.*

<sup>45</sup> *Id.* at 1141.

<sup>46</sup> See *id.* at 1140–41.

<sup>47</sup> See *id.*

<sup>48</sup> *Amoco*, 138 F3d at 1140–41.

<sup>49</sup> *Amoco*, 71 Tax Ct Mem Dec (CCH) at 2616.

directly to the Egyptian treasury. In addition, each entity was required to pay an additional “surtax” to Egypt if the combination of its royalty, income tax, and other required payments to Egypt fell short of 50 percent of the entity’s net profit, to bring the total of such payments up to that 50 percent figure.<sup>50</sup> If an entity’s (pre-surtax) payments exceeded 50 percent of its net profits, it was allowed to apply such excess as a credit against its future obligations to Egypt.<sup>51</sup>

In 1970, however, Egypt decided to employ a new format for concession agreements to increase the government’s share of oil revenues: the “production-sharing” format.<sup>52</sup> Under this new format, EGPC would receive a stated percentage of oil produced from fields covered by the concession agreement, out of which it would pay the Egyptian treasury all amounts due as taxes or royalties.<sup>53</sup> The foreign contractors received the remainder of the oil in return for bearing all the costs of exploration, development, and production of the oil.<sup>54</sup>

American oil companies, including Amoco Egypt, immediately objected to the terms of these proposed agreements. Their concerns went beyond the economic costs of giving the EGPC a larger share of the oil and accompanying profits. They were at least as worried that the US tax authorities would conclude that the payments made under such agreements would be treated in their entirety as royalties, and thus that they would be left owing US income tax on their oil-related income without any offset for foreign tax credits.<sup>55</sup> The oil companies had good reason to be concerned. Despite the recital in the proposed agreements that EGPC would pay the oil companies’ Egyptian income tax obligations, there was nothing in the agreement as originally drafted to

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<sup>50</sup> *Id.*

<sup>51</sup> *Id.* The EGPC was also required to distribute its “after-tax surplus” to the Egyptian treasury on an annual basis. *Amoco*, 138 F3d at 1140.

<sup>52</sup> *Amoco*, 138 F3d at 1141 (claiming Egypt was “[e]ager to secure for itself a greater share of the benefits from its oil”). See also *Amoco*, 71 Tax Ct Mem Dec (CCH) at 2620 (finding that the Egyptian government estimated that the change to the new format would generate an additional \$2.4 billion from the Amoco Egypt leases over a twenty-year period).

<sup>53</sup> *Amoco*, 71 Tax Ct Mem Dec (CCH) at 2616.

<sup>54</sup> *Amoco*, 138 F3d at 1141.

<sup>55</sup> See *Amoco*, 71 Tax Ct Mem Dec (CCH) at 2616–18 (discussing the history of negotiations between Egypt, EGPC, and Esso Middle East, a division of Exxon Corporation). The amounts at issue were substantial; Amoco noted that “the lack of a creditable Egyptian income tax could result in reduced corporate earnings on the order of several hundred million dollars annually in the near future.” *Id.* at 2621 (quotation marks omitted) (citing Amoco’s statements).

differentiate between oil transferred to the EGPC for payments of royalties (a deductible expense) and for income taxes (a creditable expense).<sup>56</sup> And from an economic perspective, nothing about the initially proposed production-sharing agreement corresponded to the economics of income tax payments. The amount of oil transferred to the EGPC would not change as the oil companies' profits rose or declined, or be tied in any way to the amount of the foreign oil company's net income. Indeed, to argue that a portion of the payments made to the EGPC constituted payment of an income tax requires accepting that the amount received by EGPC as recompense for royalty payments would decline as oil company profits went up and rise as profits declined, which is surely at odds with how any reasonable royalty arrangement would be structured if the royalties and taxes were payable to separate parties. The share of the oil received by EGPC remained the same whether or not the oil company made any profit at all. This was not an incidental feature of the production-sharing arrangements; one of the reasons Egypt gave for switching to production-sharing agreements was to eliminate the revenue uncertainty that came with collecting part of its revenue from an income tax.

These were not defects that the US tax authorities could be counted on to overlook. By the mid-1970s, the IRS had begun disallowing credits for foreign taxes which "arise[ ] under an overall arrangement in which payments are sometimes made in the absence of any net gain," deeming such taxes as deductible "privilege" taxes or "royalties" rather than creditable income taxes.<sup>57</sup> The IRS had litigated (and won) several cases against taxpayers attempting to claim foreign tax credits for alleged income taxes, which failed to allow taxpayers deductions for reasonable costs of earning income, and thus could not be said to be levied on "net income."<sup>58</sup> And the IRS had started to go after oil company arrangements that violated the net-income standard.<sup>59</sup>

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<sup>56</sup> Indeed, the first version of the production-sharing agreement presented to Esso explicitly provided that Esso "shall be exempted from the Income tax in the A.R.E." Id at 2617.

<sup>57</sup> Isenbergh, 39 Tax L Rev at 238 & n 28 (cited in note 39).

<sup>58</sup> See id at 236-42 (discussing *Keasbey & Mattison Co v Rothensies*, 133 F2d 894 (3d Cir 1943); *New York & Honduras Rosario Mining Co v Commissioner*, 168 F2d 745 (2d Cir 1948); *Commissioner v American Metal Co*, 221 F2d 134 (2d Cir 1955); and *Inland Steel Co v United States*, 677 F2d 72 (Ct Cl 1982)).

<sup>59</sup> See Barry and Kleiman, *The Arbitrary Foreign Tax Credit* at \*14-15 (cited in note 32) (tying "heightened U.S. scrutiny" of foreign levies to "rising oil prices and economic stagnation in the mid-1970s" and a "Congressional investigation of U.S. oil

American oil companies, including Amoco Egypt, worked with Egypt and EGPC to include language in their production-sharing agreements that they hoped would satisfy the US tax authorities. Amoco Egypt succeeded in getting EGPC to provide in its Merged Concession Agreement<sup>60</sup> (MCA) that Amoco Egypt would be entitled to up to 20 percent of the crude oil produced “as a reimbursement for the costs of exploration, production, and related operations” in addition to a further payment of 13 to 15 percent of the remaining 80 percent of the oil.<sup>61</sup> Any oil not allocated to Amoco Egypt under the MCA went to EGPC, which remained responsible for paying all royalties, and both its own and Amoco Egypt’s Egyptian income tax liability to the Egyptian treasury.<sup>62</sup> The MCA specifically stated that:

1. AMOCO [Egypt] shall be subject to Egyptian Income Tax Laws and shall comply with the requirements of the A.R.E. Law in particular with respect to filing returns, assessment of tax, and keeping and showing of books and records.

...

3. EGPC shall assume, pay and discharge, in the name and on behalf of AMOCO [Egypt], AMOCO [Egypt]’s Egyptian Income Tax out of EGPC’s share of the Crude Oil produced and saved and not used in operations under Article VII. All taxes paid by EGPC in the name and on behalf of AMOCO [Egypt] shall be considered taxable income to AMOCO [Egypt].<sup>63</sup>

The addition of this language did not in any way change the underlying (nontax) economic deal. The production split contained in the final MCA was identical to that outlined in the production-sharing agreement originally proffered to Amoco Egypt by Egypt and EGPC. Amoco Egypt’s share of the underlying oil production was the same under both the initially proffered agreement and the MCA. This share remained net of any associated

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companies’ payments to oil-exporting countries”); Isenbergh, 39 Tax L Rev at 250 (cited in note 39) (“Once the Treasury began scouring this landscape [of oil payments], it became difficult to find a stopping place. The problem of oil payments soon brought the entire question of creditable taxes under scrutiny.”).

<sup>60</sup> Unlike the prior production agreements, which were entered into on a field-by-field basis, Amoco Egypt’s 1975 MCA covered all the oil concessions granted to Amoco Egypt. See *Amoco*, 71 Tax Ct Mem Dec (CCH) at 2618–19.

<sup>61</sup> *Id.* at 2619.

<sup>62</sup> *Id.*

<sup>63</sup> *Id.* (alterations in original). This provision was further elaborated in “Annex E to the MCA.” *Id.*

royalty or Egyptian income tax payments. However, the MCA explicitly constructed a circular flow of funds between Amoco Egypt and EGPC to make it look like Amoco Egypt was bearing its own tax liability. The EGPC's payment of Amoco Egypt's tax liability was treated for Egyptian tax purposes as an additional payment to AMOCO, thereby raising Amoco Egypt's Egyptian income and the associated Egyptian (and also US) tax liability. Although this deemed income inclusion affected the amount of the tax due to Egypt (and with it, the potential US foreign tax credits), it had no effect on Amoco Egypt's actual cash (or cash-equivalent) flows as EGPC was responsible for paying this additional liability. The amount of oil actually distributed to Amoco Egypt under the MCA remained unchanged.

The change may have had a minor effect on EGPC's cash flow. EGPC, after all, had to pay the Egyptian treasury the full, grossed-up amount<sup>64</sup> of Amoco Egypt's tax liability, as well as all royalties and its own income tax liabilities. Although the additional tax payment<sup>65</sup> was expressly allowed as a deduction against EGPC's own income for purposes of its Egyptian income tax obligation,<sup>66</sup> thereby reducing its taxable income, the tax savings created by this additional deduction would not have been equivalent to the amount of the additional tax paid. The tax savings would have equaled the additional tax multiplied by EGPC's marginal tax rate.<sup>67</sup> Whether this had any real effect on EGPC's finances is unclear since EGPC was required to pay the Egyptian treasury on a yearly basis not only taxes and royalties, but also its "net surplus." It is quite possible that increased tax payments were

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<sup>64</sup> Amoco Egypt's Egyptian tax liability increased (or was "grossed up") because its income included not just the oil it received, but also the tax payments made on its behalf by EGPC.

<sup>65</sup> That is, the tax imposed on the income created by EGPC's payment of Amoco Egypt's Egyptian tax liability.

<sup>66</sup> The right to this deduction was specifically provided for in the MCA. See *Amoco*, 71 Tax Ct Mem Dec (CCH) at 2619 (citing to ¶ 6 of the MCA).

<sup>67</sup> For example, suppose the Egyptian tax rate was 30 percent, and EGPC's payment of Amoco Egypt's tax liability increased Amoco Egypt's taxable income by \$1,000. Amoco Egypt's Egyptian tax liability would increase by \$300 and EGPC's income for tax purposes would decrease by \$300, decreasing its tax burden by \$90. EGPC's net payment to the Egyptian treasury would increase by \$210. Note: the \$300 increase in Amoco Egypt's Egyptian tax liability in turn would increase its deemed income when EGPC paid this amount to the Egyptian treasury, further increasing Amoco Egypt's income and Egyptian tax liability. This iterative process can be simplified through the use of a mathematical expression  $[1000/(1-.30)]$ . In this case, the formula would generate a total "grossed up" Egyptian tax liability and Amoco Egypt income inclusion of \$1,428.57.

offset by decreases in “net surplus” payments, leaving EGPC’s economic position unchanged as well.<sup>68</sup> But it is also possible that EGPC regularly spent every penny that came in, never generating a surplus, so that this change in contractual terms engendered some reallocation of money between EGPC and the Egyptian treasury.

The ink had barely dried on this new MCA when, in 1976, the IRS issued a revenue ruling disallowing foreign tax credits for taxes paid under an Indonesian production-sharing agreement which was remarkably similar to the EGPC–Amoco Egypt MCA.<sup>69</sup> Worried that the issuance of this ruling signaled a threat to its own ability to claim foreign tax credits for Egyptian taxes, Amoco Egypt tried to obtain Egypt’s agreement to amend the MCA to allocate a greater share of the oil production to Amoco Egypt in return for Amoco Egypt making its tax payments directly to the Egyptian treasury.<sup>70</sup> Such a rearrangement would have altered the underlying economic deal with EGPC because there would have been no guarantee that the taxes made payable by Amoco Egypt would exactly offset the value of the additional oil allocated to it under a revised agreement. Egypt and EGPC refused to countenance such changes.<sup>71</sup>

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<sup>68</sup> Much of the language in the MCA was copied from a production-sharing agreement entered into between Egypt, EGPC, and Esso, another US oil company. EGPC had expressed concern in the context of the Esso negotiations that its payment of royalties, Esso’s grossed-up income tax payments, and its own tax payments would leave it with insufficient cash to operate. See *Amoco*, 71 Tax Ct Mem Dec (CCH) at 2617. Esso assuaged EGPC’s complaint by pointing out that “EGPC had not deducted taxes paid on behalf of Esso in its sample calculations . . . [and that with this tax amount and] royalty expensed EGPC would have a net income.” *Id.* EGPC insisted on the addition of a provision enshrining its ability to deduct royalties and Esso’s tax payments for purposes of calculating EGPC’s income tax obligation, see *id.* at 2616–18, language which was carried over into Amoco Egypt’s MCA. EGPC’s initial misconception regarding the deductibility of these amounts indicated a basic misunderstanding of the operation of an income tax, and perhaps illustrates the dangers of attempting to force the use of such a mechanism on foreign countries.

<sup>69</sup> Rev Rul 76-215, 1976-1 Cumulative Bull 194 (holding purported payments of Indonesian income tax under a production-sharing agreement non-creditable). Indonesia subsequently changed production-sharing and tax arrangements “[a]fter two years of three cornered negotiations among the taxpayer, the Service, and the Indonesian government,” Isenbergh, 39 Tax L Rev at 254 (cited in note 39), and the IRS issued a new revenue ruling blessing the new arrangements. See Rev Rul 78-222, 1978-1 Cumulative Bull 232 (holding taxes paid under Indonesian production-sharing agreement creditable).

<sup>70</sup> See *Amoco*, 71 Tax Ct Mem Dec (CCH) at 2620–21 (discussing changes advocated by Amoco Egypt in light of the Indonesian revenue rulings).

<sup>71</sup> *Id.* at 2621–22.



Fortunately for Amoco Egypt, these changes were rendered unnecessary once the Treasury issued temporary regulations in 1980 making clear that taxes paid by a foreign national oil company on behalf of a US oil company could generate foreign tax credits.<sup>72</sup> These temporary regulations stated in no uncertain terms that arrangements, like Amoco Egypt's MCA, providing a "straight split of oil" generated foreign tax credits "so long as the host government was willing to make a computational accommodation for the taxpayer" by providing for an explicit computation of the host country tax liability payable out of that split.<sup>73</sup> The fact that such a straight split (regardless of the "computational adjustment") had all the economic indicia of a royalty—in that the amount payable did not vary on account of the amount of income derived from the extraction activities—was ignored. These temporary regulations were succeeded by final regulations in 1983, which "were greeted with near ecstasy by the oil industry"<sup>74</sup> because they further loosened the requirements for creditability.

The 1983 regulations relaxed the standards for treating a foreign tax as an income tax. Failures to allow deductions for all costs of generating income would be ignored as long as the "predominant character" of the tax provided for cost recovery.<sup>75</sup> Further, more extensive deviations from US realization concepts were deemed acceptable.<sup>76</sup> Perhaps most importantly, though, the 1983 regulations provided a mechanism for "the splitting into tax and nontax components of payments made by taxpayers who receive specific economic benefits from foreign governments."<sup>77</sup> These regulations provided a method for determining the amount of "taxes" paid by "dual capacity taxpayers" pursuant to production-sharing arrangements. The "safe harbor method" allowed taxpayers to reconstruct, and claim tax credits for, the amount that would have been paid under the foreign country's general

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<sup>72</sup> Id at 2622 (referencing Temporary Income Tax Regs, § 4.901-2, 45 Fed Reg 75647, 75648 (Nov 17, 1980)). In their briefs, the attorneys for Amoco pointed to an example in those regulations specifically allowing credits to be granted for tax liabilities assumed by a foreign government. See Brief of Appellee, *Amoco Corp v Commissioner of Internal Revenue*, No 96-3632, \*7-8 (7th Cir filed Mar 25, 1997) (referencing Treas Reg § 1.901-2(f)(2) (Example 3)).

<sup>73</sup> Isenbergh, 39 Tax L Rev at 269 (cited in note 39).

<sup>74</sup> Id at 284.

<sup>75</sup> Id at 272-73.

<sup>76</sup> See id at 271-72 (providing examples of more generous regulations).

<sup>77</sup> Isenbergh, 39 Tax L Rev at 274 (cited in note 39) (considering the splitting rules the "pièce de résistance of the 1983 regulations").

income tax given the amount the taxpayer retained under the production-sharing agreement after payment of production-related expenses.<sup>78</sup> Only payments in excess of the computed tax amount would be treated under the regulations as (merely deductible) license fees or royalties.<sup>79</sup> This method of splitting the tax share off from the royalty component of a fixed production split, of course, effectively reduces the taxpayer's deemed royalty payments as the taxpayer's income and income tax obligations increase, and increases the royalty payments as the taxpayer's income declines, which, as discussed earlier, defies economic rationality.<sup>80</sup> It was a back door to territoriality.

These new regulations allowed oil companies to guarantee source-country governments a stable financial return—a split of oil production that did not depend on the profitability (or not) of the foreign enterprise—without sacrificing their own access to foreign tax credits for US tax purposes.<sup>81</sup> Oil companies could make payments that had the economic characteristics of royalties while claiming at least a portion of these payments as creditable foreign income taxes. This greatly reduced the difficulties involved in negotiating production-sharing agreements with foreign governments because it eliminated the conflict between those governments' desire for a stable share of revenues and the taxpayers' desire to qualify for foreign tax credits. But by allowing credits for payments that were part of a larger transfer of money designed to remain the same in the face of changes in taxpayers' net income, the regulations showed that the United States' commitment to granting credits only for income taxes—and hence capital export neutrality—was a pretense. It certainly did not apply to taxpayers engaged in foreign extractive industries. Their treatment for tax purposes came much closer to territorial, or capital import neutral, tax treatment.<sup>82</sup>

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<sup>78</sup> *Id.* at 276–80 (describing the “safe harbor method”).

<sup>79</sup> *Id.* at 276.

<sup>80</sup> See notes 59–60 and accompanying text. This generosity had political roots. See Isenbergh, 39 *Tax L Rev* at 269 (cited in note 39) (“Practically from the moment of taking office, the Reagan administration promised new regulations on the foreign tax credit. It was widely assumed that these would abandon the prior policy of treating taxes on oil profits in their entirety either as royalties or as true taxes.”).

<sup>81</sup> Isenbergh, 39 *Tax L Rev* at 269–74.

<sup>82</sup> Although these regulations allowed dual-capacity taxpayers to claim foreign tax credits in a broader set of circumstances, the value of these credits was decreased by Congress's revision of the tax credit limitation rules to limit blending opportunities for over-taxation. See IRC § 907 (limiting income with which extraction income could be blended

## B. The IRS's Attempt at a Second Bite

While the 1983 regulations made it easier for taxpayers like Amoco Egypt to treat part of its payments to foreign governments as creditable income tax payments rather than deductible royalties, Amoco Egypt faced one last obstacle: proving that these tax payments remained with the government ostensibly collecting them. Payments made to a foreign government that are promptly returned to a taxpayer are not considered “paid.”<sup>83</sup> Determining what constitutes a “return” or a “refund” can be quite difficult. A straightforward return of cash to the taxpayer is one thing, but what if the government uses the funds (or other funds since actual cash often cannot be traced) to provide benefits that aid the taxpayer or its business activities? The principle cannot be (and is not) to treat all governmental benefits received by a taxpayer as a return of taxes paid, for doing so would undermine a government’s ability to provide services to its constituents. And indeed, the regulations treat only the receipt of a “specific economic benefit”<sup>84</sup>—economic benefits “that [are] not made available on substantially the same terms to the population of the country in general”<sup>85</sup>—as a return or refund. The 1983 regulations, though, prevented the specific economic benefit received by Amoco Egypt (the right to extract oil) from being treated as such a return or refund, even though, as an economic matter, such taxes effectively did reduce the amount of royalties paid by the taxpayer. It was EGPC’s treatment of the taxes deemed received from Amoco Egypt that provided the basis for the challenge to their creditability in the case before Judge Wood.

EGPC claimed tax credits for the taxes it paid on behalf of Amoco Egypt against its own Egyptian income tax liability.<sup>86</sup>

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for limitation purposes); Wells, 2016 BYU L Rev at 1909 (cited in note 37) (“In 1982, Congress modified section 907 to ensure that the maximum amount of creditable taxes for foreign oil and gas extraction income would not exceed the maximum U.S. tax rate.”); Isenbergh, 39 Tax L Rev at 282–83 (cited in note 39) (discussing § 907(a) limits on credits allowable for foreign “oil and gas extraction taxes”).

<sup>83</sup> Isenbergh, 39 Tax L Rev at 244 (cited in note 39) (“A foreign tax that is refunded to the taxpayer—however impeccably the tax base might initially have reflected U.S. notions of net income—has fairly clearly not been ‘paid,’ and cannot sustain a credit.”).

<sup>84</sup> Treas Reg § 1.901-2(a)(2)(i).

<sup>85</sup> Treas Reg § 1.901-2(a)(2)(ii)(B).

<sup>86</sup> EGPC may have begun doing this as early as 1975, but by 1980, it was insisting in negotiations about potential changes to the MCA that language it claimed authorized such credits be retained. See *Amoco*, 71 Tax Ct Mem Dec (CCH) at 2621–22 (recounting negotiations).

Instead of deducting the tax payments as an expense for purposes of computing its own income tax liability, as at least the English version of the MCA explicitly provided,<sup>87</sup> EGPC claimed those taxes as a dollar-for-dollar<sup>88</sup> credit against its own tax liability. And the IRS had ruled that tax credits claimed by, or governmental subsidies provided to,<sup>89</sup> a contractual partner of a US taxpayer would negate payment of the tax, and thus the US taxpayer's right to claim foreign tax credits based on them, to the extent those credits or subsidies were measured by the amount of taxes paid by that US taxpayer. This position was reiterated in later Treasury regulations<sup>90</sup> and eventually statutory law.<sup>91</sup> A number of courts upheld IRS disallowances of tax credits due to the existence of such indirect subsidies.<sup>92</sup> Although the Egyptian tax authorities eventually decided that EGPC was only entitled to claim deductions for the Amoco Egypt tax payments,<sup>93</sup> and recalculated EGPC's Egyptian tax payments accordingly, the IRS argued that Amoco Egypt should not qualify for tax credits for tax payments made in the two tax years for which the Egyptian statute of limitations had passed by the time of this redetermination (and for

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<sup>87</sup> At least, the English version of the MCA so provided. See note 66. There was some dispute as to whether the Egyptian/Arabic version of the agreement authorized EGPC to claim these credits. See *Amoco*, 138 F3d at 1142 (emphases in original):

This brief excursion into Arabic helps to explain why, in later years, EGPC took the position that Article IV(f), para. 6, allowed it to *credit* against its Egyptian taxes the full amount of the taxes it was paying on Amoco's behalf, even though the English version of the text sounds as if Amoco's Egyptian taxes were to be taken as a *deduction* against EGPC's income.

<sup>88</sup> Since the tax payments were made in Egyptian currency, it was actually pound for pound.

<sup>89</sup> See Rev Rul 78-258, 1978-1 Cumulative Bull 239 (discussing how Brazilian borrowers received a subsidy equal to 85 percent by withholding taxes paid by US lenders).

<sup>90</sup> See Treas Reg § 1.901-2(e)(2)(i) ("An amount is not tax paid to a foreign country to the extent that it is reasonably certain that the amount will be refunded, credited, rebated, abated, or forgiven."); Isenbergh, 2 *U.S. Taxation* at 55:14–55:19 (cited in note 5) (discussing the history of these regulations).

<sup>91</sup> See IRC § 901(i) (denying treatment "as a tax" for the amount of any tax "used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means to the taxpayer, a related person . . . or any party to the transaction or to a related transaction" if "such subsidy is determined (directly or indirectly) by reference to the amount of such tax"). Section 901(i) was added to the Code in 1986. See Isenbergh, 2 *U.S. Taxation* at 55:14 (cited in note 5).

<sup>92</sup> Isenbergh, 2 *U.S. Taxation* at 55:18–55:19 (cited in note 5) (listing cases).

<sup>93</sup> The Egyptian tax authorities made this redetermination, and the associated tax adjustments, beginning in 1990. By 1992, adjustments were made for the tax years ending in and after June 1981. See *Amoco*, 138 F3d at 1142.

which tax adjustments therefore could not be made)<sup>94</sup> and that later payments should not be treated as paid until those adjustments had taken place.<sup>95</sup>

It is theoretically possible for a tax credit granted to a party in the position of EGPC to redound to the benefit of a contractual partner like Amoco Egypt. The party receiving a tax credit or subsidy could pass its benefit to its contractual counterparty in the form of a lower contract price.<sup>96</sup> There was, however, no indication that the benefit of EGPC's tax credit passed to Amoco Egypt. The percentage of oil retained by Amoco Egypt was in no way affected by EGPC's Egyptian tax liabilities, nor did EGPC's computation of its tax liabilities in any way affect Amoco Egypt's computation of its own Egyptian tax liabilities. The benefit (or not) of the credit redounded entirely to EGPC, and from the perspective of Amoco Egypt, reflected simply a dispute over the revenue split between parts of the Egyptian government. Nonetheless, several courts have held that a bright-line rule could be defended as a prophylactic device because the economic incidence of a tax is fiendishly difficult to discern,<sup>97</sup> and in her opinion in the *Amoco* case, Judge Wood concurred with that judgment.<sup>98</sup>

However, all of those cases and rulings involved situations in which the refunds or credits were provided to third parties, not to the government levying the tax. When a government cedes tax revenues (whether through a cash payment or a tax credit) to another arm of the government, it does not diminish the amount of tax received by the government. It merely transfers money from

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<sup>94</sup> See *id.* at 1142–43 (tax years 1979 and 1980).

<sup>95</sup> *Id.* at 1142:

[T]he Commissioner concedes that some credit should be granted [for 1981 and 1982 taxes], but urges us to remand to the Tax Court to determine how much credit Amoco is entitled to, taking into account the changes in the foreign exchange rate (and presumably also the time-value of money) between the time these taxes were credited against Amoco's U.S. taxes and the time when EGPC eventually revised its Egyptian tax filings, in 1992.

<sup>96</sup> A crafty US taxpayer could arrange a three-cornered setup in which the foreign government “extracts” an exceptionally large tax (generating large US foreign tax credits), which would be transferred to the contractual partner in the form of a tax credit or subsidy, which would then flow through to the US taxpayer in the form of a price reduction on the contracted for items or services.

<sup>97</sup> See, for example, *Northwest Corp v Commissioner of Internal Revenue*, 69 F3d 1404, 1408–09 (8th Cir 1995); *Continental Illinois Corp v Commissioner of Internal Revenue*, 998 F2d 513, 519–20 (7th Cir 1993).

<sup>98</sup> See *Amoco*, 138 F3d at 1145 (“The fact that Amoco may have received no economic benefit from the credits EGPC enjoyed (which appears to be the case) is of no importance.”).

one governmental pocket to another. Even the Treasury had promulgated a regulation<sup>99</sup> providing that a taxpayer would remain eligible for tax credits when a government assumed the taxpayer's tax liability pursuant to a contractual obligation. Under this regulation, Amoco Egypt's position would have been unassailable had it entered into a production-sharing agreement with Egypt. The question faced by Judge Wood was whether the interposition of EGPC made a difference, or if EGPC should be treated as a part of the Egyptian government for foreign tax credit purposes.

Judge Wood's opinion parses the relationship between EGPC and the Egyptian treasury, stressing not only the degree of political control exercised by the central governmental authorities, but also its tight financial connection. Although EGPC had its own budget, she found that it was not run as a "distinct economic enterprise" because "EGPC's profits go straight to the treasury, and it would never feel any losses, because the treasury would absorb them."<sup>100</sup> As a result, she reasoned,

The government of Egypt can receive a greater amount of EGPC's taxes today (if EGPC deducts Amoco's tax payment) and a smaller amount of profit at the end of the year, or it can receive slightly less today (if EGPC takes a credit) and more profit at the end of the year.<sup>101</sup>

She found that a payment to the EGPC was, for US tax purposes, exactly the same as a payment to the Egyptian treasury and therefore that Amoco was entitled to foreign tax credits for any Egyptian taxes deemed paid to EGPC in the year in which those payments were made.

That determination was absolutely correct, and her reasoning clear enough for her opinion to be included in at least one casebook on the taxation of international income.<sup>102</sup> However, the opinion fails to note that the Treasury's dual-capacity taxpayer regulations actually did exactly what the IRS feared EGPC's claimed tax credits might do. The safe-harbor mechanism, in the context of a production-sharing agreement like Amoco Egypt's MCA, effectively allows taxpayers to reduce their royalty

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<sup>99</sup> See Treas Reg § 1.901-2(f)(1), (2)(i). For an example of this regulation, see Treas Reg § 1.901-2(f)(2)(ii)(Example 3).

<sup>100</sup> *Amoco*, 138 F3d at 1148.

<sup>101</sup> *Id.* at 1149.

<sup>102</sup> See Gustafson, Peroni, and Pugh, *Taxation of International Transactions* at 347–61 (cited in note 9).

payments in tandem with increases in income tax “payments.” Another way of putting it is that some portion (and perhaps all) of Amoco Egypt’s deemed income tax payments were actually being refunded to it in the form of reduced-royalty payments—but because of the Treasury’s own regulations, not because of EGPC’s tax credits. This makes the IRS’s decision to prosecute Amoco nothing short of bizarre. Why did it view one form of an (alleged) subsidy or refund as more objectionable than another? Or was the real story that the IRS was at odds with the Treasury over the substance of the dual-capacity taxpayer regulations?

I do not know the answers to these questions, and I am sure Judge Wood did not either. The scope of her inquiry, and her opinion, was necessarily blinkered by the briefs presented to the court and the lower court’s opinion—neither of which raised these issues—and her limited knowledge of the international tax landscape.

But perhaps the larger lesson of the case is less about the limits of generalist courts and judges than about the limits of law in general. The dual-capacity taxpayer regulations provided a politically favored industry *sub silentio* with something close to a territorial tax treatment by granting tax credits for something other than actual income tax payments.<sup>103</sup> There is currently another set of US taxpayers eagerly pushing for another exception to the rules limiting foreign tax credits to foreign income taxes. Foreign countries have begun subjecting Facebook, Google, and other digital companies to gross-income-based taxes,<sup>104</sup> which clearly fall outside the current regulatory definition of creditable taxes.<sup>105</sup> It will be interesting to see if they have as much political

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<sup>103</sup> As more payments made by taxpayers to foreign governments are denominated as creditable foreign taxes, the room left for the imposition of a US residence-country tax is eliminated. If few, if any, situations trigger the imposition of residence-country tax liability, the distinction between a purportedly capital export neutral tax system and a territorial system disappears.

<sup>104</sup> See Barry and Kleiman, *The Arbitrary Foreign Tax Credit* at \*20 (cited in note 33) (“As of October 2019, Austria, France, Hungary, Italy, and Poland had all either approved or implemented a digital services tax. Many other jurisdictions, including Belgium, Canada, the Czech Republic, Slovenia, Spain, Turkey, Uganda, the United Kingdom, and the European Commission have all put forward serious proposals.”) (citation omitted).

<sup>105</sup> See *id.* at \*21 (“[B]ecause [digital services taxes] are assessed based on gross revenues, they do not constitute income taxes in the U.S. sense.”). One critic of the current tax credit rules points out that it is unclear whether the current US income tax rules would meet the regulatory definition of an income tax. See Wells, 2016 BYU L Rev at 1926 (cited in note 37) (“[T]he regulatory predominant character standard fails to reflect the evolution in the U.S. income tax laws that has occurred since 1983 and consequently utilizes

power today as the oil companies did in the 1980s. It will be just as interesting to see if Congress proves willing to extend any relief it grants to those taxpayers to similarly situated ones—as well as its definition of “similarly situated.”

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standards that no longer accurately identify an income tax in the U.S. sense.”). He also points out several instances in which the IRS seems to be waffling on whether to allow credits for other “innovative foreign formulary tax levies” which clearly violate the 1983 Treasury regulation’s requirement that their “predominant character” be a tax on net income. See *id.* at 1895–96.