Phillips Petroleum Co. v. Commissioner, 104 T. C. 256 (1995)

Foreign taxes are creditable under U. S. law if they are imposed on net income and not as compensation for specific economic benefits.

Summary

Phillips Petroleum Co. contested the IRS's disallowance of foreign tax credits for Norwegian taxes paid on income from oil and gas operations in the North Sea. The case examined whether Norway's municipal, national, and special taxes qualified as creditable income, war profits, or excess profits taxes under IRC Section 901. The court analyzed if these taxes were based on net income and not compensation for specific economic benefits. Ultimately, the court ruled that all three Norwegian taxes were creditable: the municipal and national taxes as income taxes and the special tax as an excess profits tax, thereby allowing Phillips to claim these as foreign tax credits against their U. S. tax liability.

Facts

Phillips Petroleum Co. , through its subsidiary, extracted oil and gas from the Norwegian Continental Shelf under a license from Norway. They paid three types of charges to Norway: a municipal tax, a national tax, and a special tax on petroleum income. These charges were based on a "norm price" system, which aimed to reflect fair market value for oil transactions, particularly between related parties. Phillips claimed these charges as foreign tax credits on their U. S. tax returns, but the IRS disallowed the credits, arguing they were not income taxes but royalties for the right to exploit Norwegian resources.

Procedural History

Phillips filed a petition with the U. S. Tax Court challenging the IRS's deficiency notice. The court reviewed the case to determine whether the Norwegian charges were creditable under IRC Section 901. The issue was whether these charges were income, war profits, or excess profits taxes, or taxes in lieu thereof, as defined by U. S. tax law.

Issue(s)

1. Whether the Norwegian municipal tax is an income tax creditable under IRC Section 901?
2. Whether the Norwegian national tax is an income tax creditable under IRC Section 901?
3. Whether the Norwegian special tax is an excess profits tax creditable under IRC Section 901?

Holding

1. Yes, because the municipal tax is based on realized net income and not compensation for the right to exploit Norwegian resources.
2. Yes, because the national tax is based on realized net income and not compensation for the right to exploit Norwegian resources.
3. Yes, because the special tax is designed to tax net profits and capture excessive profits from the petroleum industry, and thus qualifies as an excess profits tax.

Court's Reasoning

The court applied a three-part test from the temporary regulations to determine if the Norwegian charges qualified as creditable taxes: they must not be compensation for specific economic benefits, must be based on realized net income, and must follow reasonable rules regarding jurisdiction. The court found that the norm price system was designed to approximate fair market value, and the Norwegian charges were computed based on net income after allowable deductions. The court rejected the IRS's argument that these charges were additional royalties, emphasizing that they were imposed under Norway's sovereign taxing power, not as compensation for resource rights. The court also noted that the special tax was specifically aimed at taxing excess profits from the petroleum industry, similar to U. S. excess profits taxes enacted during wartime.

Practical Implications

This decision clarifies the criteria for foreign taxes to be creditable under U. S. law, emphasizing the importance of the tax being based on net income rather than specific economic benefits. It impacts multinational corporations operating in countries with similar tax structures, allowing them to claim foreign tax credits and potentially reduce their U. S. tax liability. The ruling may influence how other countries structure their taxes on resource extraction to ensure they qualify as creditable under U. S. tax law. Subsequent cases have referenced this decision when analyzing the creditability of foreign taxes, particularly in resource-rich jurisdictions.