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DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Attachment 1

CC:INTL:Br3:MArndt

ACTION ON DECISION

SUBJECT: Exxon v. Commissioner, 113 T.C. 338 (1999) (Dkt. Nos. 23331-95, 16692-97)

Tax: Petroleum Revenue Tax (PRT)
Years: 1984-1988

Issue:

Whether the U.K. Petroleum Revenue Tax (PRT) is a creditable income tax under section 901.

Discussion:

The U.K. granted licenses to Exxon for exploitation of petroleum resources in the United Kingdom's segment of the North Sea. Under those licenses, Exxon paid the U.K. in excess of £16 billion in royalties. In addition, Exxon paid up-front fees and annual fees. Subsequent to the grant of those licenses, the U.K. enacted and Exxon became subject to a modified version of the U.K. corporate income tax and the PRT with respect to its oil production.

The PRT is imposed on income relating to extraction of oil and gas from the North Sea, income earned by taxpayers providing transportation, treatment, and other services relating to oil and gas resources in the North Sea, and income relating to the sale of North Sea oil and gas assets. In computing the PRT liability, all significant costs and expenses of producing taxable income relating to North Sea petroleum resources are currently deductible, except interest expense. Deductions consisting of amounts equal to 35 percent of most capital expenditures relating to a North Sea field ("uplift") are provided in lieu of a deduction for North Sea related interest expense. In addition, the PRT provides for other special allowances such as oil, tariff receipts, and safeguard.

In determining the creditability of the PRT under section 901, the Court considered two issues: (1) whether the PRT satisfies the net income requirement under Treas. Reg. § 1.901-2(b)(4); and (2) whether the PRT was paid in exchange for a specific economic benefit under Treas. Reg. § 1.901-2(a).

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Net Income Issue (1):

With respect to the net income issue, the Court found that the PRT allowances effectively compensated for the nondeductibility of interest expense and that the PRT, in its predominant character, constituted a tax in the nature of an income or excess profits tax in the U.S. sense. In reaching this holding, the Court relied on “representative industry data” presented at trial by Exxon. The Court found that aggregate uplift allowances received by oil companies significantly exceeded aggregate amounts of disallowed North Sea-related interest expense. The Court rejected the Service’s arguments that quantitative data should not be considered alone without an independent showing that the allowances were designed and intended to compensate for nondeductible expenses and that if a quantitative analysis approach is to be used, it should be done on a return-by-return basis. Under a return-by-return analysis of representative industry data, a majority of the companies operating in the North Sea did not have uplift allowance greater than or equal to nonrecoverable interest expense for a majority of the years surveyed.

While we generally believe that quantitative data should not be used exclusively to establish whether the net income requirement is satisfied, we agree that the exclusive use of such data may be appropriate in situations involving specialized taxes that apply to a limited number of taxpayers, such as the PRT. However, we disagree with the Court’s approach in analyzing the quantitative data in this case because it analyzed the industry data on an aggregate basis, rather than also on a return-by-return basis. We believe that aggregate industry data is inherently unreliable and can produce skewed results. Therefore, we acquiesce in result only to the Court’s holding that the predominant character of the PRT is that of an income or excess profits tax in the U.S. sense.

Specific Economic Benefit Issue (2):

With respect to the specific economic benefit issue, the Court held that all of the PRT paid by Exxon for the years in question constituted taxes, not payments for specific economic benefits. As a dual capacity taxpayer, to prove what portion of the PRT, if any, was paid as tax, Exxon chose to rely on the facts and circumstances method under Treas. Reg. § 1.901-2A(c)(2). In finding that all of the PRT paid by Exxon constituted a tax, the Court cited Phillips Petroleum Co. v. Commissioner, 104 T.C. 256 (1995). Like Phillips, the Court relied on the fact that Exxon acquired its licenses to extract oil from the North Sea before the PRT was enacted and that it received no new or additional benefits as a result of paying the PRT. In addition, the Court based its holding that the PRT paid by Exxon was not paid in exchange for a specific economic benefit on the following: (1) the royalties and other fees paid by Exxon represented substantial and reasonable compensation; (2) the U.K.’s purpose in enacting the PRT was to take advantage of the increase in oil prices and to assure itself of a share of those excess profits; and (3) the PRT had all of the characteristics of a tax and was

intended to be a tax. In sum, examining all the facts and circumstances of the PRT paid by Exxon during the years at issue, the Court concluded that all the PRT constituted taxes, not payments for specific economic benefits.

In the case of a levy that applies only to dual capacity taxpayers, the section 901 regulations contemplate that all or a portion of that levy is a compulsory payment in exchange for a specific economic benefit. Treas. Reg. § 1.901-2A(b)(1). In our view, the PRT is directly tied to the concessions to extract government-owned petroleum because it only applies to those having licenses to extract petroleum, and therefore the Court should have recognized that even though the PRT had the characteristics of a tax, all or a portion of the PRT paid by Exxon was paid in exchange for a specific economic benefit. Therefore, we acquiesce in result only to the Court's holding that no portion of the PRT was paid in exchange for a specific economic benefit.

Recommendation:

The Court's holdings that the PRT satisfies the net income requirement and that Exxon satisfied its burden of proof with respect to the specific economic benefit issue were decided as factual issues. We do not believe that an appellate court would find that the Court's factual findings are clearly erroneous. Thus, we do not recommend appeal. In addition, the Service will only follow this opinion in disposing of cases involving the PRT where the facts are substantially similar to those in this case.

Net Income Issue (1): Acquiescence in result only.

Specific Economic Benefit Issue (2): Acquiescence in result only.

Reviewers:

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