# IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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# SENATE TAX PROVISIONS FUEL CONTROVERSY

The U.S. House and Senate were unable to agree on a tax reconciliation package in 2005. Their efforts continue this year. Tax reconciliation legislation is a vehicle for extending some of the tax-relief provisions that were included on a temporary basis in the 2001, 2002, and 2003 tax acts.

The House and Senate have passed significantly different bills, with some of the key dissimilarities having to do with revenue raisers.[1] The Senate version of the legislation contains a number of proposed tax increases to partially offset the estimated revenue loss from the extenders; the House bill does not include the tax increases. According to Congress's Joint Committee on Taxation (JCT), the revenue raisers in the Senate's plan total $34 billion over the period 2006-2015, with $10.4 billion in 2006 alone.[2] A House-Senate conference will attempt to resolve the differences.

The tax increases in the Senate bill are controversial. The three that have attracted the most attention are aimed at the five largest integrated oil companies. The Senate bill does not explicitly name the five companies, but the statutory language singles them out.[3] They are U.S.-headquartered ExxonMobil, Chevron, and ConocoPhillips, and the U.S. subsidiaries of Royal Dutch Shell and British Petroleum. Two of the provisions would affect all five. One would hit only the U.S.-headquartered companies. The three oil-company-related provisions in the Senate bill appear to be linked to a Congressional hearing last November in which several Senators demanded to know from executives of the five companies why oil prices had shot up following hurricanes Katrina, Rita, and Wilma.[4]

Of course, the answer is that a drop in supply, other things equal, causes a rise in price. Because the hurricanes, especially Katrina, delivered a devastating blow to U.S. oil production and because the demand for oil is inelastic (it takes a big rise in price to reduce the quantity demanded significantly), one can predict from Economics 101 that the resulting price increase would be large. Political turmoil in the Middle East, concern about Venezuela (which accounts for a significant share of U.S. oil imports), and increased demand in countries like China and India placed further upward pressure on prices. Although the price spike following the hurricanes has been painful, it was unavoidable given the magnitude of the supply disruption, unless the United States were to resort to price controls and rationing. Price controls and rationing would have led to even worse problems, as previous experiences with such devices in this country and elsewhere have clearly shown.

The Senate version of the tax reconciliation bill contains a number of other tax increases. Those assorted revenue raisers also merit a closer look.

**Oil-Company-Related Provisions**

The Senate bill includes three provisions directed against some or all of the five largest integrated oil companies. One would prevent the three U.S.-headquartered companies from claiming foreign tax credits for some of the income taxes they pay to foreign governments. A second provision would force the five companies to make a one-time inventory revision that would increase their tax bills by an estimated $4.3 billion in 2006 and 2007. A

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third proposal would bar the five companies from using a provision in the Energy Tax Incentives Act of 2005 that allows two-year amortization for all U.S. oil and gas geological and geophysical expenditures.

*Foreign tax credit disallowance.* One proposal would prevent the three largest U.S.-based integrated oil companies from claiming foreign tax credits for many of the income taxes they pay to foreign governments. It would not affect Royal Dutch Shell and British Petroleum, which are non-U.S.-based companies whose foreign operations are not subject to U.S. tax law. If this change became law, it would hamstring the three major U.S.-based oil companies when they try to compete against foreign oil companies in international markets. The JCT estimates that the provision would collect added taxes of $800 million over 10 years.

The foreign tax credit has been part of the U.S. income tax system almost from the beginning. The credit was established by the Revenue Act of 1918 to address a double-tax problem experienced by Americans with foreign income. A basic rule of taxation, founded on considerations of sovereignty, is that the nation where income is earned has the primary right to tax it. The United States, however, imposes a worldwide income tax, meaning that the U.S. income tax does not stop at America's borders but lays claim to a share of the income that Americans earn in other countries. This exposes Americans who have foreign-source income to the danger that the income will be taxed first by the nation where the income is earned and second by the U.S. government.[5] If no relief were provided, this double taxation would produce cumulative tax rates far exceeding the U.S. rate and would often shut Americans out of foreign markets. A U.S. company that establishes a foreign operation and pays two income taxes on the operation's profits would have great difficulty competing against foreign businesses in the same market that pay only the foreign income tax.

In creating the foreign tax credit, the U.S. government acknowledged the problem and recognized that foreign governments have first crack at taxing foreign income. Americans still have to pay U.S. income tax on their foreign-source income, but they can claim a U.S. tax credit for the foreign income taxes they have already paid on the same income. This arrangement does not entirely eliminate double taxation because of various limitations on claiming foreign tax credits, but it is vastly better than providing no relief.[6]

The Senate bill would prevent the affected taxpayers from claiming many of their foreign tax credits, and would instead require them to deduct those foreign income taxes as business expenses. A deduction has only about a third of the value of a credit and, so, would only protect against about one third of the double taxation.[7]

The way the provision would do this is by reopening issues that have already been dealt with through long-standing U.S. laws and regulations. The issues are how much credit to allow when foreign governments impose extra-high income tax rates on oil and gas companies, and how to distinguish between income taxes and taxes that are, in effect, a substitute for explicit royalty payments for mineral rights. Royalty payments should be deductible as business expenses, but they should not qualify for foreign tax credits.

The U.S. tax system imposes various tests to be reasonably certain that the amounts U.S. oil and gas companies claim as foreign income taxes really are income taxes. The Senate provision would apply much tougher tests to the three affected companies, with the result that many of the foreign income taxes they pay and that the U.S. government currently acknowledges are income taxes would suddenly no longer count as income taxes.

For example, some countries impose no general income tax on their own residents (sometimes for

reasons of religion or custom[8], sometimes due to an inability to collect such a tax because of primitive economic conditions or the lack of sophisticated accounting.) Under the Senate bill, the three targeted U.S. companies would not be able to claim any credit for a foreign income tax unless the host country in question imposes the income tax on its own resident individuals and businesses as well as on foreign companies. Furthermore, even if a host country has a general income tax, but imposes a higher income tax rate on certain industries, such as oil and gas, the Senate bill would limit the credit to the lower rate of the general tax for the three target companies.[9] These restrictions would not apply to any other U.S. firms operating in these countries, whether they are in other industries (soft drinks, automotive, financial services, transportation, hotels, communication, etc.) or are smaller oil and gas companies. This provision would also not apply to the oil and gas firms of foreign nations. In the many cases where foreign nations employ a territorial tax system, their oil and gas firms are only required to pay the host country tax, with no added taxation from the home country. Only the three major U.S.-based integrated oil companies would be hit.

This provision is awful tax policy because it attacks a needed feature of the tax code, singles out a few taxpayers, and would place American-based businesses at a tax disadvantage relative to foreign-based businesses. The restrictions would raise taxes on many energy projects currently in operation, a retroactive change in the rules. On many future projects to discover and develop energy resources around the world, the three major integrated U.S.-based oil companies would be consigned to the role of bystanders, instead of active participants. The U.S. firms would have a much harder time replenishing their inventories of oil and gas as drilling rights and access to reserves went to other nations' oil companies, which could afford to outbid the U.S. firms due to their lower tax burdens. By discouraging the major U.S.-based integrated oil companies from locating and developing energy resources abroad, the provision would reduce future energy supplies, which is hardly sensible energy policy. Foreign energy companies would fill part of the gap. However, if U.S. energy security is greater when American-based companies play a large role, rather than a small one, in global energy production, the provision would weaken this nation's energy security.

*Congressionally mandated understatement of inventory costs.* This proposal wins the trifecta for being bad tax policy, violating generally accepted accounting principles, and setting anti-U.S. energy policy. From an economic perspective, the best way to treat business costs, including inventory costs, is expensing, which means recognizing costs for tax purposes when they are incurred. If costs cannot be claimed until later tax periods, the delayed claims have a smaller present value than the actual costs, which creates a tax bias against undertaking the business activities and incurring the costs.[10] Expensing also has the virtue of simplicity.

The tax code generally does not allow inventory costs to be expensed, but it does provide several options for recognizing inventory costs. One of the least biased, especially during periods of inflation, is last in, first out (LIFO), which allows taxpayers to treat the last items added to inventory as the first ones sold. Introduced by the Revenue Act of 1939, this long-established method of inventory accounting is widely employed and generally accepted. Its use in tax calculations is considered entirely proper, not a tax dodge.

The Senate bill would require the five largest integrated oil companies to revalue their LIFO inventories held at the end of the 2005 tax year at $18.75 a barrel, which is a fictitious amount specified in the bill that is below replacement cost. This is dreadful in terms of tax principles because it would partially disallow a legitimate method of inventory valuation, force the affected taxpayers to use phony numbers, and single out a small group of taxpayers for punitive taxation. The phony numbers and the attack on an accepted accounting procedure

also explain why the proposal would be terrible accounting practice. This would be Enron-style accounting – mandated by the federal government.

Additionally, if the proposal became law, it would hurt America's energy security. Although the legislation only calls for a one-time inventory revaluation, it would send the message that Congress views oil inventories with suspicion when prices increase sharply and may impose special taxes on the inventories. As any corporate finance textbook makes clear, business investment is governed by standard calculations of expected, risk-adjusted, after-tax rates of return. The normal response by energy companies to that inventory-related, made-in-Washington tax risk would be to hold smaller oil inventories than otherwise. Oil inventories cushion the effects of market shocks. A smaller inventory would increase America's vulnerability to oil-market shocks such as a demand spike due to unexpectedly cold weather, a drop in supply resulting from a natural disaster, or a supply disruption due to hostile actions in one or more oil producing nations. One wonders how the government can, on the one hand, be so concerned about the adequacy of oil inventories that it establishes and adds to the Strategic Petroleum Reserve and, on the other hand, treat private-sector oil inventories with such disdain that it seriously considers a special tax on them.[11]

<u>Slower, more complicated write-off of exploration costs.</u> A third proposal would bar the five largest integrated oil companies from using a provision in the Energy Policy Act of 2005 that allows all U.S. oil and gas geological and geophysical expenditures to be amortized over two years. The JCT estimates this provision would be a $300 million revenue raiser over 10 years. The two-year amortization provision in the energy legislation was intended to allow exploration costs to be claimed sooner, significantly simplify their tax treatment, and help expand U.S. energy supplies.[12] From a tax perspective, simplification is always welcome. The faster write-off, which moves in the direction of expensing, is also desirable. As explained above, a delay between when the costs of a business activity are incurred and when they can be written off for tax purposes creates a tax bias against the activity. By shortening the delay, two-year amortization is a step toward more neutral taxation. As energy policy, this provision is consistent with the goal of increasing U.S. oil and gas supplies. The requirement that the exploration be in the United States is based on energy policy; it is not neutral tax treatment.

If the Senate tax reconciliation bill becomes law, it would undo these gains in cases where the five major oil companies carry out the domestic oil and gas exploration. As tax policy, the Senate provision has the flaws that it would worsen tax complexity, intensify a tax bias, and single out a few businesses for hostile tax treatment. As energy policy, the Senate proposal conflicts with the objective of increasing U.S. oil and gas supplies and reducing this nation's dependence on foreign energy sources.

**Other tax increases in the Senate bill**

The Senate bill contains a long list of additional proposed tax increases. Several of the larger ones are examined below. Like the oil-company provisions, they have major shortcomings.

The Section of Taxation of the American Bar Association has sounded the alarm regarding several of the proposed changes.[13] The Tax Section objected that provisions related to the "economic substance" doctrine are complicated, ambiguous, would ensnare many legitimate business transactions, and are largely unneeded because of changes enacted as part of 2004 tax legislation. The JCT estimates that this troubling provision's tax bite would grow steadily over time, making it the largest revenue raiser in the Senate package over the period 2006-2015. The ABA section further warned that significant components of the 1998 Taxpayer Bill of Rights would be undermined by provisions in the Senate bill related to offers in compromise and to tax submissions the IRS views as frivolous.

A subtitle of the Senate bill titled "Provisions To Discourage Expatriation" would continue efforts in Congress to demand, in effect, a ransom from individual and business taxpayers wishing to go to other countries and leave the U.S. tax system. Such tax punishments resemble the financial exactions once deplored in this country when demanded from people wishing to emigrate from some Iron Curtain countries. Expatriation taxes tend to be ineffective and counterproductive.[14] They are often ineffective because, with advance planning, there are many legal and hard-to-block ways around them. They are counterproductive, especially at the business level, because they reinforce biases in the U.S. tax system that make it harder for U.S.-based multinationals to compete against foreign-based multinationals. A more fruitful approach would be to reform the horrifically complicated and increasingly uncompetitive U.S. corporate income tax.[15]

In the American Jobs Creation Act of 2004, Congress significantly tightened the tax treatment of certain types of leases. Recognizing that the changes could cause serious problems for some participants in existing leasing agreements and that a retroactive change in tax treatment would raise fairness questions, Congress kept the old rules for leases entered into before March 13, 2004 ("grandfathered" the old leases). Congress may also have recognized that altering the rules in midstream could discourage economically desirable leasing arrangements in the future by causing market participants to worry more about adverse, after-the-fact tax changes. Congress provided further transition relief by allowing some leases under development before March 13, 2004 to qualify under the old rules. A provision in the Senate bill would collect an estimated $4.5 billion in added taxes over the period 2006-2015 by removing the grandfathering protection in certain cases and by eliminating the transition relief for leases that had been under development. The restraint exercised in 2004 was good tax policy. The proposed revenue raiser in the current Senate bill would be bad tax policy.

Another provision would make a one-year change in individual estimated tax rules to shift $5 billion of tax revenue forward a year. Congress currently requires that individuals prepay their income taxes during the year and imposes an estimated tax penalty if they do not prepay enough. A problem for taxpayers trying to meet this requirement is that they often do not know their incomes and tax liabilities accurately until well after the year has ended. One way individuals can be sure of avoiding the estimated tax penalty is to make prepayments totaling at least 100% of their previous year's tax liability, jumping to 110% of their previous year's tax liability if their adjusted gross income exceeds $150,000. The Senate bill would further raise the safe-harbor threshold for upper-income individuals to 120% in 2006. That change would force most upper-income individuals who want to qualify for the safe harbor to go to the expense and inconvenience of substantially overpaying their taxes in 2006 and receiving extra large refunds in 2007. This is a gimmick to shift some tax revenues from 2007 to 2006, not an action based on sound tax principles. Current law's 110% threshold for upper-income taxpayers can already be criticized as soak-the-rich taxation. The Senate bill's proposal would worsen the bias.

**Conclusion**

The Senate version of the tax reconciliation bill contains a number of revenue raisers that depart from good tax practice, rational energy policy, and sensible economics. The provisions that seek to punish major oil companies for responding to the forces of supply and demand are particularly egregious. If the Senate really wants to help Americans obtain ample energy supplies at reasonable prices, it should pursue a more effective strategy: fight for legislation to remove a number of current statutory restrictions that artificially limit oil and gas production in the United States.

The House has produced a generally superior tax reconciliation bill. The House bill omits the tax increases. While the House bill therefore looks like it would cost the government more tax revenues than the Senate bill, the actual revenue difference would be much less. Two of the biggest provisions in the House bill, entirely absent from the Senate version, are extending the 15% rate on capital gains and dividends. Those provisions would lessen the tax system's bias against saving and investment and are highly pro-growth. Because the official revenue estimates rely on the unrealistic static assumption that tax changes never have any effect on total economic activity, they miss the positive revenue feedback from those extenders and, thus, greatly overestimate their cost. Because of the unrealistic static assumption, the official revenue estimates also miss the negative growth effect of the Senate's proposed revenue raisers and, hence, paint too rosy a picture of their revenue impact.

The country will be served well if the tax reconciliation bill that emerges from the House-Senate conference closely resembles the House bill.

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## *Endnotes*

1. The House passed its version on December 8, 2005 (The Tax Relief Extension Reconciliation Act of 2005, H.R. 4297). The Senate included tax reconciliation in a bill it passed on November 18, 2005 (S. 2020). This year, the Senate took up the House bill (H.R. 4297), struck the House language, substituted its own language, and passed it on February 2, 2006.

2. Joint Committee On Taxation, "Comparison Of The Estimated Revenue Effects Of The Tax Provisions Contained In H. R. 4297, "The 'Tax Relief Extension Reconciliation Act Of 2005,' As Passed By The House, And H. R. 4297, The 'Tax Relief Act Of 2005,' As Amended By The Senate," JCX-10-06, February 9, 2006. This is also the source for the revenue estimates mentioned later in the paper.

3. For example, one of the provisions (sec. 461 on a government-ordered understatement of inventory costs) would apply to an "an integrated oil company ... which has an average daily worldwide production of crude oil of at least 500,000 barrels for the taxable year and which had gross receipts in excess of $1,000,000,000 for its last taxable year ending during calendar year 2005."

4. U.S. Senate, Joint Hearing of the Energy and Natural Resources Committee and the Committee on Commerce, Science and Transportation, "Energy Pricing And Profits," November 9, 2005.

5. The U.S. income tax already applies multiple layers of tax to certain uses of income, especially saving and investing. Income is taxed when earned (layer 1). If the income is saved, the returns on saving are taxed (layer 2). If the income is saved and invested in corporate equity, the returns are also taxed at the corporate level (layer 3). And if a substantial amount remains at death, it may additionally be taxed by the estate and gift tax (layer 4). The potential double tax on foreign-source income discussed here is *in addition to* all these other layers of tax.

6. An alternative to worldwide taxation that is seen in many countries is territorial taxation. Under a territorial tax, a country taxes income within its borders but does not tax income derived in other countries. A territorial income tax avoids the double tax problem created by a worldwide income tax and, therefore, also avoids the need for a foreign tax credit.

7. For example, suppose a U.S.-based business has a foreign operation with $100 of foreign-source income. Also suppose the U.S. income tax rate is 35% and the foreign government's income tax rate is 30%. Given these assumptions, the foreign government will assess an income tax of $30. If the United States allows a full foreign tax credit, it will charge an additional income tax of $5 ($35 - $30), for a combined total of $35. The combined tax rate

of 35% matches the U.S. rate on domestic income. However, if the United States only allows a deduction for the foreign tax as a business expense, the U.S. income tax will be $24.50 (35% of $70), for a combined total of $54.50. The cumulative tax rate of 54.5% will be far above the U.S. rate on domestic income.

8. Some Islamic countries impose a tax that resembles a tithing arrangement on their citizens, but impose a Western style income tax on foreigners and foreign businesses to roughly the same effect. Denying U.S. firms a foreign tax credit simply because the form of taxation adopted by a sovereign foreign government is not identical to that in the United States is unfair to the U.S. firms and smacks of imperialism.

9. Under current law, the U.S. firm may always use the foreign general income tax rate as a "safe harbor" for distinguishing income taxes from royalty payments. However, the firm may claim credit for the higher, actual income tax payments imposed on oil and gas firms if it can show "facts and circumstances" that prove it to be an income tax (such as its clear structure as an income tax and separate payments for royalties in amounts that are usual for the industry). The Senate bill eliminates this option.

10. As a simplified example, suppose a $1,000 inventory expense cannot be claimed for tax purposes until 3 years from now and the interest rate is 10%. The discounted value of the write-off is $751, which understates its true cost by $249. Because income is a net concept – revenues minus expenses incurred in generating the revenues – this understatement of inventory costs causes any income generated by the inventory to be overstated in present values terms by $249. As a result of the exaggeration of income, too much income tax will be owed, which produces a tax bias against keeping inventories. This type of example is usually employed to show the income tax bias against investment when investment costs cannot be expensed, but it is also valid in the case of inventories. (An alternative to expensing is neutral cost recovery, which delays the recognition of costs, but uses the discount rate to scale up the nominal amounts that can eventually be deducted so that they retain their present value.)

11. For an interesting discussion of the Strategic Petroleum Reserve (SPR) and how it compares to private inventory reserves, see Jerry Taylor and Peter Van Doren, "The Case Against The Strategic Petroleum Reserve," *Policy Analysis*, No. 555, Cato Institute, November 21, 2005, accessed at http://www.cato.org/pubs/pas/pa555.pdf. Taylor and Peter Van Doren identify a number of problems with the SPR in theory and practice. They raise questions about whether private inventories, as set by market forces, are suboptimal. Even if inventories are suboptimal, they conclude that government subsidies encouraging private-sector companies to carry larger inventories would yield better results than having the government acquire the inventories itself, especially given the reluctance government officials have exhibited in the past to dip into the SPR. Of course, if the Senate provision were to become law, the perverse result is that the federal government through the tax code would be pressuring energy companies to hold *smaller* inventories.

12. See House Of Representatives, 109th Congress, 1st Session, Report No. 109-45, "Enhanced Energy Infrastructure and Technology Tax Policy Act of 2005," April 18, 2005, pp. 34-36. The two-year amortization provision, which is described in that report, was later folded into the Energy Policy Act of 2005.

13. Section of Taxation, American Bar Association, Letter sent to Chairmen and Ranking Members of House Ways and Means Committee and Senate Finance Committee, January 4, 2006, accessed at http://www.abanet.org/tax/pubpolicy/2006/060104s2020.pdf.

14. For a brief and insightful explanation, see Gary C. Hufbauer, "Corporate Inversions," Testimony before the Committee on Ways and Means, United States House of Representatives, Washington, DC, June 6, 2002, accessed at http://www.iie.com/publications/papers/paper.cfm?ResearchID=470.

15. In recognition of the facts that capital is very sensitive to after-tax returns and is internationally mobile, many foreign countries have dramatically reduced their corporate taxes since the early 1990s. The United States has not. This nation now has one of the highest effective corporate tax rates in the world. See Chris Edwards, "The U.S. Corporate Tax and the Global Economy," *Tax & Budget Bulletin*, No. 18, Cato Institute, September 2003, accessed at http://www.cato.org/pubs/tbb/tbb-0511-28.pdf.

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*Note: Nothing here is to be construed as necessarily reflecting the views of IRET or as an attempt to aid or hinder the passage of any bill before the Congress.*