IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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OIL INDUSTRY TAX HIKES

Senators Menendez (D-NJ), Brown (D-OH), and McCaskill (D-MO) have introduced a bill to eliminate certain tax provisions relating to the oil and gas industry for the five largest integrated U.S. producers. The bill would affect the global operations of United States-based ExxonMobil, Chevron, and ConocoPhillips, and the U.S. subsidiaries of BP and Royal Dutch Shell. These provisions are supposedly inefficient or unwarranted tax breaks or subsidies. In fact, the provisions are better described as offsets to what would otherwise be situations of double taxation, or cases in which the U.S. tax system would prevent U.S. firms from competing with foreign companies either here or abroad. These longstanding provisions have been re-examined many times over the years, and have always been left in place. That is because the competitive conditions and bizarre U.S. tax structure that made them necessary in the first place still exist.

The provisions affecting the "Big Five" U.S. oil companies

Targeting five specific taxpayers for punishment is corrupt tax policy. It has the odor of a bill of attainder, of the sort outlawed by the founding fathers in the U.S. Constitution in reaction to the evils of the practice prevalent in Britain.

For these five largest U.S. oil companies, the bill would:

- Prohibit royalty and other payments to foreign governments for drilling or production rights from being counted as income taxes for the purpose of the foreign tax credit; the payments could be taken as a deduction instead.
- Deny these companies the domestic manufacturing deduction.
- Eliminate their use of the deduction for intangible drilling costs (70 percent of which may be expensed instead of amortized). The big five would have to amortize the costs over time.
- End their use of the percentage depletion deduction (a deduction of a portion of revenue from oil and gas sales).
- Force the companies to amortize rather than expense tertiary injectants used to increase the amount of oil and gas that is recoverable from wells.

International issues

The United States has the second highest corporate income tax among the 34 developed nations in the OECD. Furthermore, the tax is imposed on the global income of U.S.-based companies, not just on the income they generate in the United States. The U.S. is the only major nation to utilize this global form of income tax. Other nations tax on a territorial basis, leaving income earned abroad to be taxed in the country in which it is generated.

To prevent double taxation of the foreign source income of U.S. businesses, the U.S. allows firms a foreign tax credit up to the amount of tax that the

U.S. would have imposed on the income. Since the U.S. is now often the higher tax-country, many businesses owe tax to the U.S. in addition to the foreign governments.

This higher tax burden hurts the competitiveness of U.S. firms in foreign markets. To ameliorate this disadvantage, the U.S. allows a deferral of tax on foreign source income of U.S. multinationals. Under deferral, the foreign income of U.S.-owned foreign businesses is not taxed in the U.S. until it is repatriated (nor are the foreign tax credits associated with the income allowed until the income is brought home).

As long as the U.S. retains its global tax system, these steps are essential if U.S.-based firms are to be able to compete for foreign markets on a remotely level playing field. They would not be necessary if the U.S. were to switch to a territorial tax system, or slashed its corporate tax rate to competitive levels.

Competition for energy resources

In particular, in the energy sector, European, Asian, and Latin American headquartered companies competing for drilling rights and production contracts in the Middle East and around the globe are not taxed on their foreign earnings. U.S. headquartered energy companies face potential U.S. taxes on their earnings abroad when they are repatriated. U.S. energy firms would find it harder to obtain foreign oil and gas reserves without tax deferral and the foreign tax credit. Control of the reserves would fall instead to companies from other nations.

In an ideal world, losing reserves to companies from other nations might not matter. In an ideal world, there would be no OPEC producers' cartel and no national oil companies under government control directing supplies to their home countries regardless of demand and supply conditions. All companies would be private, there would be many more of them, and they would compete to sell to the highest bidder without political considerations. But the world of energy is not ideal. Therefore, we would be wise to permit private U.S. multinational companies to compete for scarce resources.

Royalty issues

In the case of the oil and gas industry, the foreign tax credit may be allowed against royalties as well as business income taxes. Some foreign governments impose their tax take on the energy sector as royalties instead of as a corporate income tax (while they impose corporate income taxes on other industries). By any other name, it costs as much, and eats into the revenue stream from the operation as much as an income tax. The foreign competitors of U.S. energy companies are not forced to pay their home governments any tax on the earnings of their foreign operations or on the portion of their cash flow diverted to foreign royalties. Why should the U.S.-based firms have to bear that sort of disadvantage? In such cases, the royalty should be considered to be in lieu of the corporate income tax, and eligible for the credit.

The burden of the royalty restriction would fall mainly on the three large U.S. multinational companies, ExxonMobil, Chevron, and Conoco-Phillips. The U.S.-focused subsidiaries of BP or Shell would not be hurt, because their foreign-based parent companies handle operations outside of the U.S. and those foreign operations would not be affected by the U.S. tax provisions. This illustrates the advantage that foreign-based multinational companies have over U.S. multinational companies as a result of the dysfunctional U.S. tax system.

Tax accounting issues — expensing vs. deductions

In a neutral, unbiased tax system, all costs would be expensed in the year they occur, and all revenue (less the expensed costs) would be taxable in the year it occurs. The income tax does not allow expensing, relying instead on depreciation and amortization over time. A deduction delayed is a deduction devalued by the time value of money and by inflation. The result is to overstate income over the life of the asset, and to overtax it.

All capital and resource intensive industries suffer from these delays in reporting their costs under the income tax. In the case of risky start-up businesses, industries on the cutting edge of technology with high R&D costs, or highly competitive international industries, the effects can be especially devastating. That is why, in some areas, Congress has mitigated the tax bias against investment with things like the manufacturer's credit, the R&D credit, and a number of expensing and depletion allowances.

The manufacturer's deduction — 9 percent off taxable income — lowers the top effective corporate and non-corporate business tax rates from 35 percent to 31.85 percent. It can also be thought of as an alternative to a more rapid and more complete write-off of plant and equipment for the more capital intensive sectors of the economy (and those most subject to foreign competition). The U.S. oil industry is under as much or more competitive pressure from abroad as any other business. There is no reason to deny its major firms the manufacturer's credit.

Expensing and depletion provisions available to energy businesses are best thought of as offsetting situations of double taxation under the income tax. Delaying the acknowledgement of lease payments and costs of drilling would result in overstatement of income and over-taxation. Depletion can be thought of as reducing the over-statement of taxable income that would otherwise result from delayed write-offs. Depletion may be greater than the value of the oil in a particular field, but that field may be only part of the picture. The firm may have sunk hundreds of dry wells in other places, and the cost of the drilling rights and the dry wells would not have been fully allowed as expenses under standard income tax rules.

Loss of access to the expensing and depletion provisions would raise reported income for the five affected firms, and reduce their incentive to explore and produce in the U.S. They would have an incentive to sell their domestic assets to firms not burdened with these penalties. It would also increase the excess U.S. tax payments of the three U.S. multinationals on their foreign earnings, increasing the companies' tax disadvantage relative to foreign firms competing abroad (including the foreign parents of BP and Shell).

All these provisions would become moot under a neutral cash flow tax with full expensing of all costs. All of these issues are present in other industries as well, to some degree. A true and comprehensive tax reform, with a net reduction in the tax bias against capital formation and a shift to territorial taxation, would be the best policy. Until then, Congress should blame itself for any complexity that results from having to reduce the sting of a bad tax system where it threatens to do the most damage.

Effect on U.S. economy, jobs, consumers

Another argument against the tax increases on the industry is the fear that they would be passed on to consumers. In one sense, all taxes are passed on to consumers. Business can only pay out what they take in, and can only pay taxes out of revenues. The oil industry is subject to world oil prices and competitive pressures. If some firms are subject to higher taxes, and others are not, they will not immediately be able to pass the taxes on to consumers unless world supply and prices are affected. What will certainly happen instead is that the firms subject to the higher taxes will experience a lower return on investment, and will shrink and surrender market share to the firms not subject to the taxes. The big five would lose U.S. market share to independents, and to foreign-owned companies such as CITGO, Lukoil, CNOOC, Total, Petrobras, etc. These replacement sources would presumably be a bit less efficient than the suppliers driven from the market by the higher taxes, and prices would rise.

Later, as global production suffers from the decline in energy production by the big five, some rise in energy prices would occur. There would be some partial offsetting increase in output by other producers here and abroad (including BP and Shell overseas), and some rise in OPEC's pricing power.

If the price effects are a bit uncertain as to timing and size, the effects on U.S. energy production are not. Clearly, net energy exploration, production, and refining activity by U.S. companies at home and around the world would decline. U.S. jobs would be lost, and with them would go federal, state, and local tax revenue. The taxes would not bring in the expected windfall to the U.S. Treasury. Foreign treasuries would gain.

Conclusion

The recommended tax increases on the five largest U.S. oil and gas companies are an ill-advised attempt to raise revenue with minimal voter anger by targeting an unpopular subset of taxpayers. These discriminatory proposals would not improve the tax system. Rather, they would remove from part of the industry some relief from double taxation currently enjoyed by the industry as a whole, when what is really needed is to extend similar relief (expensing) to all business taxpayers through real tax reform.

The proposals would reduce exploration and production of oil and gas in the United States, and make the country more dependent on foreign suppliers. Much of the presumed U.S. tax take would be lost to reduced U.S. energy output and a global shift in ownership of production assets and reserves to foreign producers. Foreign production and tax revenue would increase. The extent of price effects for consumers would depend on the extent of the reduction in global production, but there would certainly be a drop in energy industry employment in the United States relative to current law.

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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.