

Congress Should End Oil & Gas Tax Breaks

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House Speaker John Boehner's recent comment that Congress should "take a look at" repealing tax subsidies for large oil companies is well-founded.¹ These subsidies are a particularly poor use of taxpayer funds.

The oil and gas industry argues that their tax breaks encourage them to locate and extract more oil and gas, allowing the industry to increase supply and thus keep energy prices down below the level they would otherwise reach. But whatever one thinks of this argument, it totally falls apart when oil is selling at over \$100 a barrel. By any relevant measure, oil and gas companies are wildly profitable,² and have huge incentives to find and sell more oil. Repealing the tax subsidies that they enjoy will not change this.³

While these tax subsidies have increased oil and gas company after-tax profits to some degree, they have not changed the fact that very little of those profits are devoted to exploring for new sources. Their managers direct most of their profits to dividends and stock repurchases. Both of these actions drive up the companies' share prices, which also benefits managers, whose compensation depends in part on rising stock values.

Does ExxonMobil Need Tax Subsidies?

Over the past two years, ExxonMobil reported \$9,910 million in pretax U.S. profits. But it enjoyed so many tax subsidies that its federal income tax bill was only \$39 million — a tax rate of only 0.4 percent.

The facts speak for themselves: Among the largest five oil companies, less than 10 percent of after-tax profits went to exploration for new oil fields during the 2005-2009 period.⁴ Meanwhile, the percentage of net profits used to pay dividends and buy back stock was 58 percent in 2005, 73 percent in 2006, 72 percent in 2007, 71 percent in 2008 and 89 percent in 2009. These figures are high in comparison to other industries.

¹ Tax breaks for oil and gas companies are just one of the many types of subsidies the federal government provides through the tax code. For more general information on tax expenditures, see Citizens for Tax Justice, "Limiting Tax Expenditures Must Be Part of Congress's Efforts to Balance the Budget," April 22, 2010. <http://www.ctj.org/pdf/taxexpenditures.pdf>

² The measure of the industry's health is its return on investment which, at 21 percent annually, is quite high for the top oil companies. (Even this number understates their true profits because oil reserves are not "written up" for accounting purposes when the price of oil increases.) As a diversion, some oil executives say industry profits are not outsized because "only 9 cents of every dollar in oil sales is profit," which is below the average for American business. If profit margin were a reliable yardstick, all supermarkets would close, because they earn less than 1 cent per sales dollar. See Value Line Report, May 2010, Summary of supermarket chain financial results. By way of reference, the U.S. Treasury bond yields 4 percent, and the two top supermarket chains have average returns of 16 percent.

³ Oil and gas companies enjoy so much success that cutting their corporate welfare will have a negligible effect (less than 2 percent) on their annual after-tax profits.

⁴ According to the Security and Exchange Commission (SEC) Form 10-K filings of the top five oil companies, in 2005 to 2009 "exploration" expenses were about 5 percent of profits per year. The oil companies use a form of accounting called "successful efforts accounting," whereby a dry hole is expensed and a successful well is capitalized. Perhaps two thirds of exploratory wells are dry, so one can safely assume that the total amount of profits devoted to exploration (both unsuccessful wells that are expensed and successful wells that are capitalized) add up to no more than 10 percent.

For 2010, it makes sense to focus on four of the largest oil companies, leaving out BP because of its disastrous problems during the year. In 2010, these four companies spent 60 percent of their profits on dividends and stock repurchases, and just 18 percent on exploration.

In other words, the companies spent 3.3 times as much on dividends and stock buybacks as they did on exploration in 2010. The strategy works for oil company executives. For example, the value of the Exxon stock held by CEO R.W. Tillerson rose by \$32 million in just the last 12 months.

It's clear that the firms are more interested in boosting their share values than in finding new oil reserves. No amount of public advocacy advertising or Congressional lobbying can refute these numbers.

Congress Should Reform the Tax Code's Treatment of Oil and Gas Companies

President Obama's most recent budget plan proposes to close or reduce a number of the most expensive tax loopholes for the oil and gas industry. Here are some of the most significant of these proposals.

Bar large oil and gas companies from using the deduction for domestic manufacturing (often called the Section 199 deduction). Some might wonder why oil and gas companies could use a deduction for "manufacturing" in the first place. A few years ago, Congress actually redefined manufacturing for the purposes of this deduction so that it included oil and gas production, obviously at the behest of the energy industry. **The President's proposal to close this loophole would raise \$15.9 billion over ten years.**⁵

Repeal the deduction for "intangible" costs of exploring and developing oil and gas sources. The "intangible" costs of exploration and development generally include wages, costs of using machinery for drilling and the costs of materials that get used up during the process of building wells. Most businesses must write off such expenses over the useful life of the property, but oil companies, thanks to their lobbying clout, get to write these expenses off immediately. **The President's proposal to close this loophole would raise \$8.3 billion over ten years.**

Repeal "percentage depletion" for oil and gas properties. Most businesses must write off the actual costs of their property over its useful life (until it wears out). If oil companies had to do the same, they would write off the cost of oil fields until the oil was depleted. Instead, some oil companies get to simply deduct a flat percentage of gross revenues. The percentage depletion deductions can actually exceed costs and can zero out all federal taxes for oil and gas companies. The Energy Policy Act of 2005 actually expanded this provision to allow more companies to enjoy it. **The President's proposal to close this loophole would raise \$10.8 billion over ten years.**

⁵ Cost estimates were projected by the Congressional Joint Committee on Taxation for the 2012-2021 period.

Reduce the break for amortization of geological and geophysical expenditures. As already explained, most businesses write off the actual cost of property over its useful life (until it wears out). If a business can amortize (write off the costs) more quickly, that means it receives tax deductions earlier, making them much more valuable. The amortization over a two-year period of the costs of searching for oil was introduced in the Energy Policy Act of 2005 and is available even when oil and gas is discovered. The tax cut bill Congress passed in 2006 changed the rule to allow a five-year amortization. The President proposes to change the rule to allow seven-year amortization. **The President's proposal to reduce this loophole would raise \$1 billion over ten years.**

Modify Rules for "Dual Capacity" Taxpayers. Dual capacity taxpayers generally are corporations that make two types of payments to foreign governments. One type of payment is some form of corporate income tax, while another type is a royalty or fee or other type of payment made in return for a particular economic benefit. The U.S. tax code allows American corporations to take a credit for any corporate income taxes they pay to foreign governments, to avoid double-taxation of foreign income. The problem is that the current rules sometimes allow these corporations to, in effect, take foreign tax credits for non-tax payments they make to foreign governments. This of course has nothing to do with avoiding double-taxation, which is the sole purpose of the foreign tax credit. The President proposes to change the rules to end this practice, which is often used by oil and gas companies, as well as others (particularly mining companies). **The President's proposal to reform these rules would raise \$9.2 billion over ten years.**

Oil and Gas Companies Are Not Helping to Reduce Foreign Oil Dependence

Ironically, the stretched American taxpayer subsidizes one of the most profitable industries on Earth. The objective of the subsidy is to decrease dependence on foreign oil. Instead, the industry uses the subsidy to promote higher prices on its company shares and higher values on its executive stock options. Congress should repeal these subsidies.

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