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# The 110th Congress Should End Tax Subsidies for Big Oil

Over the last couple of years, Americans have faced rising gasoline prices — affecting their everyday lives as well as the economy in which they try to make a living — even as oil and gas companies enjoy record profits. Some suspect that the energy industry is becoming so consolidated that it does not face the sort of competition that would normally keep oil prices down to reasonable levels. Some progressives have argued that this is reason to impose a new tax on large oil and gas companies, perhaps even a new version of the windfall profits tax that was in place in the 1980s.

A better policy, at least in the short-term, would be to simply close the absurd loopholes that currently allow Big Oil to avoid paying its fair share. If the public debate revolves around whether or not Big Oil needs to be subsidized through the tax code at a time when oil prices are at an all-time high, it will be much more difficult for the energy companies to win the debate. As a practical policy matter, it makes sense for Congress to get energy companies to simply pay the taxes they would owe without special loopholes, before considering adding a new tax on their excess profits.

The Bush administration, which claims to support free-market policies, may find it difficult to oppose a proposal to stop using the tax code to subsidize large energy companies. This is particularly true of the latest round of energy tax breaks, which were added in the Energy Policy Act of 2005. These were so embarrassing that even President Bush (hardly an enemy of Big Oil) opposed them and only signed them into law when it was clear that they were necessary to get a bill passed through Congress.

## Tax Loopholes and Solutions

Several bills were proposed in the recently adjourned 109th Congress that would have ended many of the biggest tax subsidies going to large energy companies. Democratic leaders in the Senate proposed the Clean Energy Development for a Growing Economy (Clean EDGE) Act, which would shift money away from tax breaks for large oil and gas companies and towards encouraging the use of alternative energy sources. Several other proposals were made along similar lines in the House and Senate. Here's a breakdown of the biggest tax breaks going to Big Oil, as well as a review of legislation proposed to repeal them.

## The Biggest Three Tax Breaks for Big Oil

The following are the three largest tax breaks going towards oil and gas companies according to the bipartisan Congressional Join Committee on Taxation.[1]

[1]For a longer and more complete list of the tax subsidies oil and gas companies enjoy, see Friends of the Earth, "Big Oil, Bigger Giveaways: Ending Tax Breaks, Subsidies and Other Handouts to the Oil and Gas Industry."

**1. Deduction for intangible costs of exploring and developing oil and gas sources.**
**($5.4 billion over 5 years)**

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 Clean EDGE Act would repeal this tax break when oil prices are high.

**2. Percentage depletion for property from which oil and gas are derived.**
**($4.7 billion over 5 years)**

Percentage depletion for oil and gas properties is a particularly glaring feature of our energy tax policy. Most businesses must write off the actual costs of the 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.

**3. The five-year amortization of geological and geophysical expenditures.**
**($611 million over 5 years)**

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.

These three loopholes, along with others, would have been closed by S. 2670, introduced by Senator John Kerry (D-MA), and its companion in the House, H.R. 5300. Senator Susan Collins (R-ME), also sponsored a bill that would take these tax breaks away from large oil and gas companies and put the money towards encouraging alternative fuels and energy efficiency.

## Another Big Energy Tax Break — and Another Proposed Solution

**4. Expensing of equipment used to refine liquid fuels.**
**($700 million over 5 years)**

According to the Joint Committee on Taxation, a provision allowing companies to deduct 50 percent of the costs of certain equipment used in refining liquid fuels will cost $700 million over five years. This provision was created in the 2005 act and serves as another example of the sort of "incentives" Congress claimed were necessary for the oil industry at a time when the price of oil was topping $55 a barrel.

The Clean EDGE Act would repeal this "incentive" when oil prices are high. Senator Kerry's bill would repeal the provision entirely. Also, in the 109th Congress, Congressman John Larson (D-CT) sponsored a bill, H.R. 5234, that would repeal this section of the 2005 act, along with the provisions on geological and geophysical expenditures and the expansion on the percentage depletion deductions.

## Not Targeted Solely To Big Oil, But Loved By Big Oil Nonetheless

### 5. Domestic manufacturing tax deduction.
### ($700 million a year spent on oil and gas companies)

One tax break that is enjoyed not just by Big Oil but the broader business community is the manufacturing tax deduction. A legislative slight-of-hand in the tax breaks enacted in 2004 redefined manufactured goods to include oil and gas so that energy companies could enjoy this tax break. (The deduction is 3% of the cost of domestic manufacturing activities this year, rising to 6% in 2007 and 9% in 2010.) This tax break was actually created to replace a program that was found in violation of international trade laws. The fact that the program being replaced didn't have anything to do with the oil industry did not seem to trouble Congress at the time.

The Clean EDGE Act would repeal this gift to Big Oil, as would a proposal sponsored by Congressman Jim McDermott (D-WA) in the House (H.R. 5218) and John Kerry (D-MA) in the Senate (S. 2672). The Joint Committee on Taxation estimated that this would save $700 million a year.[2]

## Not Quite as Large, But Still Unnecessary and Unfair

### 6. Special accelerated depreciation for natural gas distribution lines.
### ($386 million over 5 years)

Our tax code already allows capital investments to be written off faster than they actually wear out. This means that if a business owner buys a machine to use in the course of business, the cost of it can be deducted over a period of time that probably ends before the machine is no longer useful. This provision, introduced in the 2005 Energy Policy Act, allows natural gas distribution lines to be written off over an even shorter period than already allowed. Now these pipelines can be depreciated over 15 years — far less than their actual useful life.

### 7. Foreign tax credit for energy companies that generally are not paying foreign taxes.
### ($325 million over 5 years)

American companies with branches doing business in other countries are supposed to pay taxes on their income from those branches *except* when it is already taxed by the foreign government. Corporations receive a tax credit for foreign taxes paid in these situations. The principle behind this is that it is fair for all the income from a corporation to be taxed by a national government one time. However, because there are questions of whether large oil companies claiming this credit really are paying foreign income taxes, modifications to the credit were proposed last year but not acted upon. The change would have repealed the credit for large oil companies for branches in foreign countries that do not have a generally applicable income tax. The Congressional Joint Committee and Taxation calculated that this provision would have saved $325 million over 5 years.

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[2] http://www.house.gov/mcdermott/pr060515.shtml

Senator Kerry's bill deals with both of these loopholes, repealing accelerated depreciation for natural gas distribution lines and denying the foreign tax credit for income made by large oil companies in countries that have no general income tax. The latter provision is also included in the Clean EDGE Act and in Representative Larson's bill.

# Long-Term Goals — New Taxes for Energy?

Nothing discussed up to this point concerns increasing tax rates. Instead, the reforms discussed above would simply remove loopholes in the tax code that give unfair preferences to energy companies that don't need tax subsidies from the taxpayers. But some environmental and social justice advocates (and even some economists) would like Congress to pursue a more ambitious — and controversial — agenda. They would impose new taxes on the energy industry both to restrain the power of Big Oil and also to "internalize" the negative effects of using too much energy. Assuming the loopholes discussed above are closed, what further steps could Congress then take?

### 1. Windfall profits tax.

If we believe that the market is failing to bring Big Oil's profits down to reasonable levels, that may be an argument for a new tax on Big Oil's profits. Organizations such as Public Citizen have argued that this is the only way to give back to Americans what large oil companies are able to take away by using their near-monopoly over the industry.[3] The Government Accountability Office has documented that mergers in the oil industry have led to market concentration and to increased gasoline prices.[4]

In the energy crisis of the late 1970s, such a windfall profits tax was imposed on oil companies, and it raised a significant amount of money over its temporary existence. To be sure, there are issues in administering a windfall tax (the prior tax, for example, applied to each barrel of oil and each barrel was a assigned to a specific "tier" with a separate rate). But those issues can be addressed if Congress finds a windfall tax attractive. A more serious concern about a non-temporary windfall tax is that it may eventually become a tax on consumers, thus defeating its main purpose.

### 2. Carbon tax?

The majority of scientists agree that global warming caused by greenhouse gases is a threat to our environment and that carbon dioxide emissions are the greatest contributor to the problem. Should fuels that cause such emissions be subject to a "carbon tax" to try to encourage more environmentally friendly forms of transportation and manufacturing?

The biggest problem with such a tax is its likely regressive effects. Even assuming that such a tax is not imposed directly on consumers but on industries that extract fossil fuels such as oil

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[3] Slocum, Tyson. Washington DC Examiner. Op-Ed: America Needs Oil Company Windfall Profits Tax. http://www.citizen.org/cmep/energy_enviro_nuclear/electricity/Oil_and_Gas/articles.cfm?ID=14648

[4] Government Accountability Office. Energy Markets: Mergers and Other Factors that Affect the U.S. Refining Industry. July, 2004. http://www.gao.gov/new.items/d04982t.pdf

or coal, the tax will probably be passed on to consumers in higher prices. Gasoline prices, for example, would be higher for motorists, most of whom cannot easily curtail the amount of the driving they do in the short-run. The same goes for utility prices in areas with coal-generated electricity. The effects, then, could be similar to those of any sales tax. Wealthier people end up paying a relatively small proportion of their income towards the tax while low-income families are hit especially hard. Like food, gasoline and electricity are goods that people cannot easily cut back on (at least in the short-run), so the tax cannot be avoided by those with less money to pay it.

It is possible that the regressive effects of such a tax could be remedied to a degree. For example, other taxes could be reduced in a progressive way. Such a program would probably have to include direct payments (or refundable tax credits) for the many families who owe no income tax because of their low incomes (or any payroll tax because they are retired, disabled or unemployed). Even under such a program, however, there would be substantial regional differences that would be hard to mitigate. Moreover, such rebates or other offsets may be vulnerable to budget-cutting efforts down the road. So any exploration of a carbon tax should be undertaken cautiously.

## Reasons for Optimism

The 110th Congress will have a very different attitude than the 109th regarding tax policy and environmental policy. The basic acknowledgment that oil companies are making huge profits and do not need tax subsidies is itself an enormous shift. The next Congress has many options to close unnecessary and wasteful energy-related tax loopholes as it tries to come up with ways to curtail the budget deficit or fund new initiatives (including programs to encourage conservation and alternative energy sources). Longer-term environmental strategies may involve more ambitious proposals such as a windfall profits tax or a carbon tax — but these ideas have pitfalls that should be considered very carefully.