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16 March 2009

ATR Obama Budget Analysis: Energy Tax Hike Series

Overall Budget Review

Current Law
In the 110th Congress, the federal bans on Outer Continental Shelf (OCS) and shale oil drilling were allowed to naturally expire. This created the natural potential for American businesses to utilize more domestic energy while creating jobs at the same time. Currently, energy prices are relatively low and stable, with no need for Congressional action.

Obama Proposal
What is Obama proposing?

- New taxes on all oil and gas from the Gulf of Mexico
- Increase amortization time for energy producers
- ...and repealing the following tax provisions that allow domestic U.S. energy production to create jobs and expand their domestic operations (as opposed to moving overseas):
    - enhanced oil recovery credit
    - marginal well tax credit
    - expensing of drilling costs
    - deduction for tertiary injectants
    - passive loss exception for oil and natural gas properties
    - percentage depletion for energy companies

ATR Analysis
If Obama would proceed with the offshore energy production plan, rather than repealing the ultra-deepwater oil and gas research and development projects and cutting tax incentives, the following **positive** things would happen:

- Access to the resources found will create $8 trillion in additional economic output (that's GDP growth)
- $2.2 trillion in total tax receipts
- 1.2 million NEW well-paying jobs EVERY SINGLE YEAR
- And $70 billion in additional wages driven into the economy each year

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LIFO Explained

Current Law

When companies purchase items to sell later, they are accumulating an "inventory." When a good is sold, the profit is the sales price minus the inventory cost. Since 1938, companies have had a choice when determining which parts of their inventory they report to calculate the profit on a good sold. Under "first-in, first-out" (FIFO), the oldest parts of the inventory are what are used to make this determination. Many companies, however, choose to use the "last-in, first-out" (LIFO) method, whereby the newest inventory purchased is what's used in the profit calculation.

The LIFO method is most valuable for companies that see the prices of their inventory rise over time. Let's say I have a $10 item I bought several years ago, and a $12 item I bought this year. I want to sell an item for $15. FIFO inventory gives me a profit of $5 ($15-$10). LIFO inventory gives me a profit of $3 ($15-$12). I would only pay taxes on $3 of profit, not $5.

The difference between the FIFO profit ($5) and the LIFO profit ($3) is $2. This $2 becomes part of a "LIFO reserve." Companies must keep track of this LIFO reserve, which in recent years has been the target of tax increase proposals by members of both political parties.

Obama Proposal

The FY 2010 Administration Budget calls for requiring companies to pay taxes on this "LIFO reserve." It's unclear how this would be accomplished, since the ten-year score for this tax increase is only $61.05 billion. Various estimates have scored full LIFO repeal at several multiples of this score.

ATR Analysis

<u>Companies should not have to pay taxes merely on inflation.</u> Yet that is exactly what forcing companies to use FIFO would do. <u>At the very least, companies using a long-standing and perfectly-reasonable inventory accounting standard should not be punished after the fact by being taxed on phantom "reserves."</u>

LIFO is used most often by energy companies. **Taxing LIFO reserves is a clear attempt to slap an unfair tax on energy manufacturers merely to exact a political price. The economic price will be borne by the American people, who will end up paying this "inventory tax" in the form of higher energy prices.** The most likely scenario is that taxing LIFO reserves and requiring FIFO going forward will be imposed strictly on energy manufacturers. It's the ultimate goal of tax increasers, though, to repeal LIFO altogether.

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IRS Sec. 199 Repeal

Current Law

The Internal Revenue Code (IRC) Section 199, the Domestic Production Activities Deduction, benefits all companies who produce goods on American soil – yet only energy companies are targeted for the cuts in deduction rates.

Prior to harmful energy legislation passed last Congress, businesses engaged in a qualifying production activity were eligible to take a tax deduction of 3% of the profits from this qualifying activity in tax years 2005 and 2006. The deduction increases to 6% in 2007, and 9% in 2010 and beyond.

However, the Pelosi-Reid energy agenda has implemented a Sec. 199 "freeze" at 6% - only for energy companies, thus further carving out their niche for non-traditional energy.

Obama Proposal

The Obama budget proposes a full repeal of Sec. 199 – but only for energy companies.

ATR Analysis

According to Paul Schlather, a senior tax partner with PricewaterhouseCoopers, "Every small business in the manufacturing industry should be looking at this as a tax deduction. While Section 199 comes with a very complex set of rules, chances are small businesses will qualify for the deduction much easier than the rules depict."

34 Senators and 172 Congressmen have signed the Taxpayer Protection Pledge. In so doing, they promised to their constituents and the American people that they would "oppose any net reduction or elimination of deductions or credits…"

Repealing the Section 199 deduction IS A CORPORATE INCOME TAX INCREASE and is therefore a PLEDGE VIOLATION *unless* the increase is offset completely with other income tax cuts.

Note: Budget neutrality (which is concerned with deficits) has no role in determining applicability of the Pledge. Rather, tax revenue neutrality (as scored by the JCT) is the only relevant metric for the purposes of the Pledge.

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Renewable Portfolio Standards (RPS)

Current Law

A Renewable Portfolio Standard (RPS) mandates that electric utilities and other retail electric providers supply an arbitrary government-specified minimum amount of customer load with electricity from eligible renewable energy sources (defined by the Federal government – not the states). RPS requirements and goals have been established in thirty-two states without a federal government top-down mandate.

Obama Plan

The Obama calls for a mandatory portfolio standard that would force the country to derive 10 percent of its electricity from renewable sources by 2012 and 25 percent by 2025 (however plans before Congress call for a much higher percentage).

ATR Analysis

According to a recent study, Global Energy Decisions (GED) reveals that twenty-seven states will not meet the Bingaman RPS requirements.[1] If a state cannot meet this requirement, the utility company will be forced to purchase credits from other states or the federal government. GED estimates that the **total national cost of these fees will be $175 billion by 2030.**

What is renewable for one state may not be renewable for others. A top-down mandate is not the answer. In this system, hydroelectric power doesn't count (the low head hydro or other forms that don't require any water storage do not provide adequate energy). Biomass is not allowed if it comes from federal lands – like the brush that is cleared from national forests to keep them from burning to the ground. Neither is municipal solid waste. Right now the country gets just under 3 percent of its electricity from "renewable energy" as defined by the bills before Congress, yet the President wants to force states to comply with an arbitrary RPS that cannot realistically be met. The reality is that the administration is well aware that this standard cannot be met, and is looking forward to the additional revenue.

For more information, contact tax policy director Ryan Ellis at rellis@atr.org or federal energy policy analyst Brian Johnson at bjohnson@atr.org

[1] Global Energy Decisions. "Setting Renewable Targets is Easy, Getting Results is Not." 2007. www.globalenergy.com

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Gulf of Mexico Energy Taxation

Current Law

Despite the increase from the last presidential administration in royalties (money paid to the U.S. Treasury by the energy producers for the right to access energy) by fifty percent on energy produced in the Gulf of Mexico, there is no current additional taxation levied on energy produced in the Gulf.

Obama Proposal

The Obama budget proposal for FY 2010 implements the first ever tax on energy produced from the Gulf of Mexico. Currently, 25 percent of total U.S. production of oil and 15 percent of total U.S. production of natural gas comes from the Gulf of Mexico.

ATR Analysis

History tells us if we want less of something, tax it.

The Obama proposal will increase the tax on energy production by $5.3 billion and will result in less production, fewer jobs, and will increase the cost of energy for all consumers.

Access to domestic energy is vitally important for both our economic security and stability. The President's budget does nothing but further his personal agenda to force Americans off of traditional forms of energy and onto expensive and underdeveloped alternative forms of energy.

At a time of economic uncertainty, this is not the moment for the President to use the budget as a personal vehicle to play with the nation's infrastructure development needs by levying the highest tax ever on domestically produced energy.

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Cap and Trade

Current Law

When world economies engage in global trade, there must be production of goods. This production of goods emits carbon. Under the Kyoto Protocol, several countries have implemented a method of cap and trade. Cap and trade is a system by which the government sets an arbitrary level, or "cap", on the amount of carbon that companies are allowed to emit. Companies must then purchase credits from the government that represent the right to emit a specific amount. Companies that wish to increase their emissions must buy credits (the "trade") from those who produce less.

In an effort to maintain United State competitiveness and productivity, there is not a current cap and trade system in effect. Every cap and trade system proposed in the U.S. Congress has been rejected by not only members, but the general public as well.

Obama Proposal

The Obama FY 2010 budget proposal will implement a cap and trade system on all American businesses.

ATR Analysis

The implementation of a cap and trade program on American businesses will result in a tax increase of $646 billion dollars over 10 years as called for in the Obama budget.

When fully phased in, this will be a $100 billion per year tax on American businesses. This tax will decrease U.S. competitiveness and increase consumer costs.

Cap and trade systems punish businesses for being successful. As companies become more successful and employ more Americans, their production of goods increases. Along with this production, comes the natural byproduct from increased energy use. The purposeful taxation of this success by forcing an arbitrary cap on production emissions is counterproductive to a prosperous economy. Every family in America will pay this cap and trade tax in the form of higher energy prices.

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Passive Loss Exception Repeal

Current Law
A generation ago, "tax shelters" were popular and legal tax-avoidance strategies. The most common form a tax shelter took back then was for someone to become a limited partner in a partnership that had losses year after year. These losses would be passed along to the partner-investor, who would use them to offset other income. There were few restrictions on this practice.

That all changed in 1986 with the passage of the Tax Reform Act. Congress required "passive losses" (losses incurred by businesses in which the taxpayer didn't have any material participation) to be carried forward, not used against other income. The losses from the passive activity now can only be realized if the activity eventually turns a profit, or when the investor sells his interest in the activity. This legislative change drove a stake through the heart of the tax shelter industry.

Congress made several exceptions to the passive loss rule, though. One of these was a working interest in an oil or gas property. For these investments, the rules are much like they were before 1986.

Obama Proposal
The FY 2010 Administration Budget repeals the passive loss exception for working interests in oil and gas properties starting in 2011. This has a ten-year cost of $49 billion, and when fully phased in will increase taxes annually by $6 billion.

ATR Analysis
This is a clear and blatant attempt to increase taxes on America's energy manufacturing sector. **The policy rationale behind the passive loss exception in current law is debatable, but repealing it should only be done in the context of further tax reform.** If the federal government is going to be a full partner in your profitable years, and a deferred partner in your losing years, then you ought to at least get lower tax rates out of the deal. Under no circumstances should this exception be repealed in the context of a net tax hike.

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Amortization Period Increase

Current Law

According to IRS Publication 535, "Business Expenses", the current law states: You can amortize the cost of geological and geophysical expenses paid or incurred in connection with oil and gas exploration or development within the U.S. These costs can be amortized ratably over a 24-month period beginning on the mid-point of the tax year in which the expenses were paid or incurred. For major integrated oil companies (as defined in section 167(h)(5)) these costs must be amortized ratably over a 5-year period for costs paid or incurred after May 17, 2006 (a 7-year period for costs paid or incurred after December 19, 2007).

Obama Proposal

The Obama FY 2010 budget proposal will increase the amortization period to seven years **for only energy producing companies**.

ATR Analysis

Raising taxes on oil companies by increasing the amortization period of geological and geophysical (G&G) expenditures makes U.S. oil and natural gas exploration projects less competitive globally, thereby discouraging new U.S. production and increasing the nation's reliance on imported oil. Almost all large oil and gas companies are publicly-traded entities, whose shares are owned by millions of investors through their 401(k) plans, retirement plans and pension funds. Taxing away the earnings of those companies negatively impacts the ability of hard-working Americans to achieve a more financially secure future.

Increasing the amortization period results in A CORPORATE INCOME TAX INCREASE and is therefore a PLEDGE VIOLATION *unless* the increase is offset completely with other income tax cuts.

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