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ATR Obama Budget Analysis: Energy Tax Hike Series

Passive Loss Exception Repeal

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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 Under no circumstances should this exception be repealed in the context of a net tax hike.

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