AMERICANS FOR TAX REFORM ENERGY TAX ANALYSIS

MAY 2009

With President Obama's budget calling for hundreds of billions of dollars in the new, additional taxes, and several energy and climate proposals in the House and Senate; Americans for Tax Reform (ATR) created this packet which provides an outline for fiscally responsible energy provisions and analyzes the following specific niche issues with a energy-tax focus in mind.

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Americans for Tax Reform (ATR) is a non-partisan national coalition of taxpayers and taxpayer groups who oppose a federal, state, and local tax increases. ATR is a non-profit 501(c)(4) lobbying organization.

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ATR's Energy Points for 111th Congress

In every effort to avoid raising taxes (for the first time in thirteen years) and to provide comprehensive solutions to our energy needs, Americans for Tax Reform would like to offer the following fiscally responsible energy principles for this new 111th Congress:

Congress should oppose all efforts to reinstate a moratorium on OCS or shale oil. President Bush lifted the executive order banning offshore drilling and Congress allowed its natural expiration. The U.S. consumes approximately 7.5 billion barrels of oil every year. These previously untouchable reserves contain over 900 billion barrels of oil. This new access will create over 600,000 jobs and provide increased supply to reduce energy costs.

Congress should oppose the repeal and freezing of the Sec 199, the domestic manufacturers' deduction. This deduction is made available to all business that engage in domestic manufacturing; in laymen's terms, creating jobs. Recently, legislation was passed that specifically freezes this deduction at 6 percent only for energy companies, while all others will move up to nine percent in 2010. By specifically targeting energy producers, they are then less incentivized to create jobs in America and capitalize on domestic supplies.

Congress should support full expensing for all assets. As America becomes more and more productive, our need for energy increases. Allowing for the full expensing of all assets provides oil and energy producers with the incentive to produce more energy to meet our ever-expanding needs. Increased American supply to fill our growing demand will result in lower prices at the pump for all citizens.

Congress should oppose the federal renewable energy mandates such as renewable portfolio standards (RPS). Recent legislation has proposed that every utility in each state have 15% of its electricity come from a narrowly defined list of renewable energy sources. If a state cannot meet this requirement, the utility company will be forced to purchase credits from other states or the federal government. RPS is nothing more than a massive excise tax on rate paying consumers. These costs will not be absorbed by the utility company, but passed onto the consumer in the form of higher user fees and increased taxes.

Congress should continue to oppose legislation seeking to limit futures trading. Prices are determined by supply and demand – this is also true of the futures market. Companies hedge to guard against substantial losses during price contractions. If hedging is made illegal, the incentive to invest in crude will be greatly diminished. This will do nothing except lower supply and leave fewer companies in competition, driving prices higher and furthering market instability.

Congress should pass expedited leasing legislation and further restrain from interfering in the leasing of land for energy exploration. Leading economists estimate the U.S. will be reliant on oil and gas for at least the next 30 years. The federal governments continued interference in the leasing of land for exploratory purposes will ensure our dependence on *foreign* oil and gas over that time period. Instead, Congress must pass expedited leasing legislation that allows the Mineral Management Service to begin leasing immediately. In doing so, access to domestic energy can occur as early as late 2009.

Congress must offer 50-50 profit sharing for the states. The leasing and profits from the leasing of land for energy exploration off the states should occur in a joint-venture matter

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involving both the federal and state government. Congress should pass a 50/50 royalty sharing plan so that states will be allowed to keep and invest fifty percent of the revenue generated by energy exploration off their state shorelines. The Dept. of Interior estimated $1.4 trillion of revenue just from offshore drilling alone.

Congress must safeguard against legal malfeasance and abuse. In Feb. 2008, there were 487 leases issued in Alaska's Chukchi Sea (holding an estimated 15 billion barrels of oil.) However, due to frivolous lawsuits all 487 leases have been legally challenged and delayed. Currently, there are 748 leases between two major seas in Alaska, the Chukchi and Beaufort, and exploration in every single lease was legally challenged in May of 2008.

Congress should prioritize efficiency over protectionism by removing the subsidies on domestic ethanol and the tariffs on foreign ethanol. Congress currently mandates the use of expensive, inefficient corn ethanol (and promotes a generous ethanol tax credit) while taxing the importation of more efficient ethanol made from sugar cane. This both harms the consumer seeking to purchase ethanol and has the unintended consequence of increasing corn prices.

Congress should oppose using the alarmist rhetoric known as "price-gouging" which simply does not exist in a rational market. When a product, like gasoline, becomes scarce the price is raised by the producer as a warning to the consumer to curtail consumption. As a result, the consumer will respond to this scarcity by reducing their demand to meet the expected supply. Price gouging legislation, by introducing price controls, directly interferes with optimal market forces that, if left untouched, are perfectly able to appropriately regulate supply and demand imbalances.

Congress should oppose raising the average Corporate Average Fuel Economy (CAFE) standard, which impedes corporate production models and limits consumer choice. Historically, fuel economy programs failed and the ensuing price distortion and regulation resulted in supply shortages and consumer restrictions across America. Energy efficient standards have reached the point where the higher cost of the appliance outweigh the benefits from the electricity saved. Raising efficiency requirements forces the supplier to restrict production options and pigeonholes the consumer by limiting selection.

Americans for Tax Reform (ATR), encourages you and your colleagues to use these and other free-market solutions to better serve consumers. For more information, contact Federal Affairs Manager Brian M. Johnson at bjohnson@atr.org.

Onward,

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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 raising taxes by $1.1. billion once phased in.**

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.

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…"

> 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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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 and will increase taxes by $3,100 on every American family.

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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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 **$61.05 billion in new taxes on this "LIFO reserve."** Various estimates have scored full LIFO repeal at several multiples of this score.

ATR Analysis

Companies should not have to pay taxes merely on inflation. Yet that is exactly what forcing companies to use FIFO would do. 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."

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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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 million, 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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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 three 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.

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

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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, **passing a $13.3 billion tax onto every American family.**

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.

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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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Superfund Explained

Current Law

Superfund excise taxes were imposed in years before 1996. They included a tax on domestic crude oil and imported petroleum products at a rate of $9.7 per barrel; a tax on hazardous chemicals at a varying rate of $0.22 to $4.87 per ton; and a tax on imported substances that use hazardous materials in their production.

The Superfund Environmental Income Tax refers to a corporate environmental income tax imposed before January 1, 1996 at a rate of 0.12 percent for corporations whose incomes exceeded $2 million.

The revenue from these taxes was assigned to the Hazardous Substance Superfund Trust Fund. Money from the Superfund Trust Fund was available for expenditures related to hazardous substances released into the environment.

Obama Proposal

The Obama budget reinstates the **Superfund taxes which are expected to cost approximately $17 billion over 10 years.**

ATR Analysis

Superfund was initially conceived as a way to target companies as potential victims of trial lawyer activists. Companies who have been accused of alleged improper hazardous waste disposal are not only targeted by bureaucrats, but trial lawyers milking the Superfund with extraneous lawsuits, trolling for potential "victims" of the alleged environmental violation.

Not only are the owners of said company liable for alleged damages, so is anyone who was operating or working at the site at the time, any worker or non-employee who took part in arranging the alleged improper disposal, or any person who transported any material to the site.

Simply put, if you are the unfortunate worker who happened to be transporting materials or signed a shipping order on the day the trial lawyers show up, not only could you lose your job, but face a massive EPA-backed lawsuit.

Superfund is nothing more than a slush-fund for trial lawyers by which they use the tools of the government to identify potential "victims".

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Review of Waxman-Markey

U.S. Representatives Waxman (D-CA) and Markey (D-Mass.) recently introduced the "Clean Energy Act". This bill sets the unrealistic goal of decreasing the CO2 emissions rate 83% below the 2005 level by 2050. The bill seeks to lower CO2 emissions through several provisions that are riddled with tax increases and costly federal mandates. Below are just some of ATR's concerns:

- The Markey-Waxman "Cap-and-trade" program imposes a tax on producers' carbon emissions that will have devastating economic effects.
    1. The Heritage Center for Data Analysis projected that in 2016 the Cap-and-trade program will cost the loss of 200,000 to 900,000 American jobs.
    2. **ATR strongly opposes** Cap-and-Trade because it is the largest tax increase since the proposal of income tax and will cost the average American household an extra $1,600 annually.
- The Markey-Waxman Federal Renewable Electricity Standard is a mandate requiring electric providers to derive a certain amount of their production from renewable resources.
    1. From 2012- 2015, the annual percentage of renewable resources providers must use will be 6% to 8.5%; 2016- 2020: 11% to 17.5%; 2021- 2024: 17.5% to 23%; 2025 to 2039: 25%.
    2. The high costs this mandate inflicts on providers will be passed onto their customers, drastically raising energy prices.
- The Low Carbon Fuel Standard (LCFS) requires the EPA to establish a low carbon fuel standard for transportation fuels.
    1. The LCFS penalizes energy companies by not counting their "low carbon" efforts since 2007 mandates, which required producers to use blends of biofuels that met stringent government-mandated standards which.
    2. **ATR strongly opposes** this regressive energy policy.
- The bill's mandated increase of Corporate Average Fuel economy (CAFE) for vehicles increases costs and diminishing consumer choices.
    1. CAFE forces automakers to produce smaller and lighter cars. The National Highway Traffic Safety Administration (NHTSA), estimated that these lighter cars will increase American traffic fatalities by almost 40,000.
    2. **ATR strongly opposes** this standard because it will cost both lives and money. CAFE will cost American drivers more than $6.71 billion between 2010 and 2011.
- Subtitle B – "Lighting and Appliance Energy Efficiency Programs" is an invasive, unrealistic, federal mandate that requires manufactured homes, appliances, and lighting to be "energy efficient".
- The "Smart Grid Advancement" inclusion of "Smart-Grid Features in Appliances Rebate Program" writes a blank check from taxpayers' wallets to fund the rebate program, and contains no definitive monetary language to restrict federal spending.
- The "Proposed Allowance Allocation" of Markey-Waxman claims to "protect consumers from energy price increases" but the marginal percentage of allowances given to "Low-and moderate-income" households pales in comparison to the overall cost of the Markey-Waxman "Clean Energy Act".