Big Oil, Targeted Taxes, and the Rule of Law

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Commerce and manufactures can seldom flourish long in any state which does not enjoy a regular administration of justice, in which the people do not feel themselves secure in the possession of their property, in which the faith of contracts is not supported by law, and in which the authority of the state is not supposed to be regularly employed in enforcing the payment of debts from all those who are able to pay. Commerce and manufactures, in short, can seldom flourish in any state in which there is not a certain degree of confidence in the justice of government.

— Adam Smith, Wealth of Nations, Book V, Chapter 3

In recent years, politicians have frequently directed harsh rhetoric toward particular corporate taxpayers that earn high profits. At times, this rhetoric has been accompanied by substantive policy proposals that single out a narrow set of profitable and unpopular taxpayers for disparate treatment. Perhaps the most notable example is the war against Big Oil. Congressional Democrats have repeatedly tried to impose on five companies — BP, Exxon Mobil, Shell, Chevron, and ConocoPhillips — unfavorable tax rules that do not apply to other companies. These efforts have succeeded in one instance, because section 167(h)(5) now prescribes a longer amortization period for some expenditures by the five oil producers. On May 17, 2011, the Senate rejected a bill that would have imposed several additional penalties on them. The Senate also rejected a similar bill on March 29, as this article went to press.

Throughout the debate, no coherent tax policy argument has been offered for singling out these five companies for tax rules different from those that apply to other corporate taxpayers. Instead, the proposed tax increases appear to be the result of political hostility driven by indignation at the oil producers’ high profits and by distress at high gasoline prices. Supporters of the tax increases complain that the companies have “too much” money and that the government is entitled to seize money from them if it believes it can spend the funds more wisely. In a free society, however, government collects revenue from companies and individuals under neutral tax rules, not based on an ad hoc determination that politically disfavored companies or individuals have too much money.

The debate on these targeted tax increases has been marked by several fallacies. One misconception is that oil producers can freely claim the foreign tax credit for royalties paid to foreign governments. Another fallacy is that the five large companies reap tax savings from percentage depletion, a tax break for which they have actually been ineligible since 1975. The most prevalent misconception, however, is that targeted tax increases on these companies would move the tax system toward neutrality. In reality, the proposals would move the tax system away from neutrality by imposing on five unpopular companies restrictions that do not apply to other companies.

It may be tempting to dismiss objections to these proposals. After all, the proposed tax increases are clearly not going to drive anyone into destitution. The five oil producers are indeed earning large profits, and the proposed tax increases would be a tiny fraction of those profits.
Yet, these targeted tax increases threaten the rule of law and pose significant risks to the economy at large. Societies governed by the rule of law can, should, and do tax those who are well off to support those who are in need. But they must not single out specific companies or individuals for additional taxes because of political or public hostility. Free societies can base taxes on income, consumption, wealth, or many other economic variables and can set either high or low tax rates. But they cannot base taxes on political unpopularity. There are strong empirical and theoretical reasons to expect that those violations of the rule of law can have harmful, indirect effects on economic growth that are disproportionately large relative to their direct impact.

In this article, we closely examine the oil issue to provide a history of the phenomenon of targeted tax increases. We begin by describing the barrage of proposals and laws in 2005 through 2010 that targeted the five large producers, and then discuss in greater detail S. 940, the bill that the Senate considered in May 2011. We conclude by discussing the implications of targeted taxes for the rule of law and economic growth.

Early Efforts to Target Big Oil

The large oil producers have repeatedly been targeted for adverse treatment in recent legislative proposals. We discuss only measures that were brought to the floor of at least one chamber of Congress and set aside the many bills that never reached the floor.1

On November 18, 2005, the Senate passed S. 2020, the proposed Tax Relief Act of 2005. The bill included two provisions targeting the large oil producers: a one-time inventory tax and a longer amortization period for some expenditures. Although the inventory tax never became law, a modified version of the amortization provision was later enacted, as discussed below.

S. 2020 would have imposed a one-time inventory tax on integrated oil companies2 with daily production volume greater than 500,000 barrels and gross receipts greater than $1 billion during the tax year. Each affected company using the last-in, first-out inventory method would have been required to revalue its crude oil inventory by $18.75 per barrel and its inventory of natural gas and petroleum products by $18.75 per barrel-of-oil equivalent at the close of its tax year ending in 2005. The company would have been required to reduce its cost of goods sold and thereby increase its gross income for the tax year by the amount of the revaluation. Section 6655 penalties for any failure to pay estimated taxes arising from the unexpected tax increase would have been waived. No similar tax would have applied to other oil producers or to other companies using the LIFO method.

One sponsor of the provision, Senate Finance Committee member Charles E. Schumer, D-N.Y., justified the provision as a base-broadening measure that would prevent the affected companies from reporting “artificially low” profits generated by LIFO when product prices had risen.3 He did not explain, however, why this logic applied to only the targeted companies or why the bill offered no relief for the artificially high profits that LIFO generates during periods of falling oil prices.

S. 2020 would also have eliminated amortization deductions for geological and geophysical (G&G) expenditures by integrated oil companies with production volumes greater than 500,000 barrels per day, effective for amounts paid or incurred after August 8, 2005. G&G expenditures are the costs of seismic shooting to determine whether to acquire acreage for oil production. Rather than amortizing those expenditures over a 24-month period, which other oil producers would have been allowed to continue doing, the affected companies would have been required to recover those costs through depreciation of any equipment involved or through cost depletion.

A modified version of that amortization provision became law on May 17, 2006, when Congress added section 167(h)(5) to the tax code.4 Section 167(h)(5)(A) provided that “major integrated oil producers” must amortize G&G expenditures over a five-year period, effective for amounts paid or incurred after May 17, 2006. Section 167(h)(5)(B) volume greater than 75,000 barrels per day. As explained below, integrated companies are ineligible for percentage depletion and may expense only 70 percent of intangible drilling costs.

1One proposal that did not reach the floor merits a brief mention because it would have assigned the large oil producers an inferior constitutional status. On June 3, 2011, the House Judiciary Committee was marking up a proposed amendment to the U.S. Constitution that would have required a two-thirds vote of both chambers of Congress to raise taxes. Rep. Jerrold Nadler, D-N.Y., offered an amendment that would have waived the two-thirds rule for any measure that “repeals or reduces any exemption, deduction, or credit with respect to any producer of crude oil or natural gas with annual gross receipts in excess of ten billion dollars.” The Nadler amendment was rejected on a 12-7 vote. The proposed constitutional amendment has not been adopted.

2Integrated oil companies are defined by sections 291(b)(4) and 613A(d)(2) and (4) as oil producers that engage in retailing with sales greater than $5 million or that engage in refining with (Footnote continued in next column.)
classifies a producer of crude oil as a “major integrated oil producer” for a tax year if it satisfies three conditions: (1) It has an average daily worldwide production of crude oil of at least 500,000 barrels during the tax year; (2) it had gross receipts exceeding $1 billion in 2005; and (3) it engaged in the refining of crude oil with an average daily refinery run exceeding 75,000 barrels during the tax year. The legislation did not change the 24-month amortization afforded other oil producers.

Congress was not satisfied with the extent of this disparate treatment. On December 19, 2007, it amended section 167(h)(5) to increase the amortization period for G&G expenditures by major integrated oil producers to seven years, effective for amounts paid or incurred after December 19, 2007. All other oil producers were still allowed to retain 24-month amortization.

On February 27, 2008, the House passed H.R. 5351, the proposed Renewable Energy and Energy Conservation Tax Act, on a 236-182 vote. House Democrats supported the bill 219 to 8 while Republicans opposed it 17 to 174. Section 301 of the bill would have limited the ability of oil and gas producers to claim the section 199 domestic production activities deduction, effective for tax years beginning on or after January 1, 2009. As we discuss below, the section 199 deduction applies to companies that produce goods, although not those that produce services, and it is claimed by companies in numerous industries throughout the economy. For the five producers singled out by section 167(h)(5), the bill would have completely denied the deduction for any income from the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof. For other oil and gas producers, the bill would have reduced the deduction by one-third. The bill never reached the Senate floor and therefore did not become law.

On June 10, 2008, the Senate failed to invoke cloture on a motion to proceed to consideration of S. 3044, thereby killing the bill. S. 3044 would have repealed the section 199 deduction for the five large producers, effective for tax years beginning on or after January 1, 2009, and would have imposed a 25 percent windfall profit tax on the same five companies, effective for tax years beginning on or after January 1, 2008. The motion to invoke cloture failed for lack of the required 60 votes when 51 senators voted in favor and 43 senators voted against. Democratic senators supported the motion to invoke cloture 43 to 2 and Independents supported it 2 to 0, while Republicans opposed it 6 to 41.

On September 14, 2010, the Senate failed to invoke cloture on a motion to proceed to consideration of amendment 4595 to H.R. 5297, which had been introduced by Finance Committee member Bill Nelson, D-Fla., and which would have repealed the section 199 deduction for the five large oil producers. The motion to invoke cloture failed for lack of the required 60 votes when 56 senators voted in favor and 42 senators voted against. Democrats supported the motion 54 to 3 and Independents supported it 2 to 0, while Republicans opposed it 0 to 39.

A more sweeping proposal to single out the large oil companies was S. 940, which was defeated in the Senate in May 2011. As discussed below, the Senate considered a similar bill in March 2012.

The Latest Effort to Target Big Oil

On May 10, 2011, Finance Committee member Robert Menendez, D-N.J., joined by Sens. Sherrod Brown, D-Ohio, Claire McCaskill, D-Mo., and Jon Tester, D-Mont., introduced S. 940, the proposed Close Big Oil Loopholes Tax Act. S. 940 would have applied five restrictions to the “major integrated oil producers” identified by section 167(h)(5)(B) — and only to them. The press release announcing the introduction of S. 940 stated that it applied to BP, Exxon Mobil, Shell, Chevron, and ConocoPhillips, referred to as “the Big 5” or “Big Oil” throughout the press release. The Finance Committee held a hearing on May 12 at which executives from the five targeted companies were called to testify.

In a preliminary estimate, the Joint Committee on Taxation scored the bill as raising $21.2 billion of revenue in fiscal 2011 through 2021. Section 301 of the bill would have required that the revenue be used for deficit reduction. Of course, the provision would not have prevented Congress from later using the revenue for spending increases or tax cuts.

The five tax provisions were as follows. First, as further detailed below, the bill would have restricted the foreign tax credit claimed by the targeted producers in any country in which they received specific economic benefits from the country’s government (the dual capacity provision). The JCT scored this provision as raising $6.5 billion

6As we discuss below, Congress enacted legislation later in 2008 that reduced the section 199 deduction by one-third for all oil and gas producers.
8JCT, “Estimated Revenue Effects of S. 940, the ‘Close Big Oil Loopholes Act,’ Fiscal Years 2011-2021,” No. 11-2053 (May 12, 2011).
within the 10-year budget window. Second, the bill would have abolished the section 199 domestic production activities deduction for the targeted companies, in line with previous proposals in H.R. 5351, S. 3044, and Senate Amendment 4595. The JCT scored this provision as raising $12.8 billion. Third, the bill would have ended the targeted companies’ expensing of intangible drilling costs (IDCs), which the JCT scored as raising $1.8 billion. Fourth, the bill would have added a provision purporting to bar the targeted companies’ use of percentage depletion, which the JCT scored as having “negligible revenue effect.” As stated above and further explained below, this provision was a hoax because the targeted companies were already ineligible for percentage depletion. Fifth, the bill would have ended the targeted companies’ expensing of tertiary injectant costs, which the JCT scored as raising less than $0.1 billion.9

On May 17 a motion to proceed to consideration of S. 940 failed for lack of the required 60 votes when 52 senators voted in favor of the motion and 48 senators voted against it. Democrats supported the motion 48 to 3 and Independents supported it 2 to 0, while Republicans opposed it 2 to 45. Finance Committee member Olympia J. Snowe, R-Maine, and Sen. Susan M. Collins, R-Maine, joined most of the Democratic members in voting for the motion to proceed, while Sens. Mark Begich, D-Alaska, Mary L. Landrieu, D-La., and Ben Nelson, D-Neb., joined most of the Republican members in voting against the motion.

Before addressing the bill’s dual capacity, percentage depletion, and section 199 provisions at greater length, we briefly discuss its IDC and tertiary injectant provisions. Both provisions target tax preferences but do so in a highly selective manner.

Section 263(c) generally allows oil producers to expense IDCs, which include wages, fuel, repairs, and other costs necessary to drill wells and to prepare them for production. Although independent oil producers may expense all those costs, section 291(b)(1)(A) provides that integrated producers (including the five targeted companies) may expense only 70 percent of the costs and must amortize the remaining 30 percent straight-line over 60 months. Section 103 of S. 940 would have eliminated both expensing and 60-month amortization for the five targeted producers, effective for amounts paid or incurred in tax years beginning on or after January 1, 2012. They would generally have been required to recover the expenditures through cost depletion, with an immediate deduction if a well proves to be a dry hole.

Section 193 generally allows oil producers to expense qualified tertiary injectant costs, such as the cost of injecting carbon dioxide at high pressure into an oil field to prolong its life. Section 105 of S. 940 would have eliminated expensing of those costs for the five targeted companies, effective for amounts paid or incurred in tax years beginning on or after January 1, 2012.

Relative to a textbook income tax system, the expensing of IDCs and injectant costs is a tax preference, since it results in a zero effective tax rate at the corporate level. The risky nature of the payoff from the expenditures does not alter the conclusion. Of course, expensing is allowed for many other expenditures that are likely to be capital in nature, including periodical circulation expenditures (section 173), research and development (section 174), soil conservation costs (section 175), equipment and software investment by small companies (section 179), clean-fuel automobiles (section 179A), removal of barriers to access by the disabled (section 190), employee training (Rev. Rul. 96-62), and advertising (Rev. Rul. 92-38). S. 940 would not have changed the treatment of those expenditures.

Even within the oil industry, however, the provisions in S. 940 were ill targeted. The five large producers, which were already limited to 70 percent expensing of IDCs, would have been reduced to zero expensing while other integrated producers would have retained 70 percent expensing and independent producers would have retained 100 percent expensing. Similarly, the expensing of injectant costs would have remained in place for all producers other than the five targeted producers.

The two provisions discussed above accounted for less than one-tenth of the bill’s revenue yield. We now examine at greater length the other three provisions of S. 940, beginning with the dual capacity provision.10

Royalties, Foreign Taxes, and Dual Capacity

Some background on the FTC is necessary to understand the dual capacity provision of S. 940, which accounted for almost one-third of the bill’s revenue yield.

other business expenditures are deducted under section 162 or capitalized. At a 35 percent corporate income tax rate, a $1 credit is 2.86 times more valuable than a $1 deduction. The disparity in treatment creates an obvious incentive for companies to reclassify business expenditures as foreign income taxes. A company that purchases goods or services from a foreign government, such as an oil producer paying royalties for a concession to extract government-owned oil in a foreign country, has an incentive to reclassify its purchase costs as foreign income taxes if it can.

As one might expect, Congress and the IRS have adopted measures to prevent that reclassification. To begin, creditable payments must be structured as “income, war profits, and excess profits taxes” or taxes paid in lieu of those taxes, not as royalties.11 Under reg. section 1.901-2, income taxes are compulsory payments that are made under a foreign country’s authority to levy taxes and that have the “predominant character” of an “income tax in the U.S. sense.” The regulation requires, with much elaboration and many examples, that the foreign levy generally reach “net gain,” meaning that it is imposed on the occurrence of realization events and applies to gross receipts, reduced by the significant costs and expenditures attributable to those receipts.

The regulation further states that the credit may not be claimed for payments that are compensation for a specific economic benefit provided by the foreign government, such as a concession to extract oil. To enforce that restriction, reg. section 1.901-2A, which was finalized in 1983, imposes detailed rules on taxpayers that receive such a specific economic benefit (dual capacity taxpayers). Reg. section 1.901-2A(c)(2) allows a dual capacity taxpayer to claim the credit for any portion of a foreign levy that it demonstrates, based on the facts and circumstances, is not compensation for the taxpayer’s specific economic benefit. The taxpayer bears the burden of proof on this question. Alternatively, a dual capacity taxpayer may elect a safe harbor under reg. section 1.901-2A(d) and (e) allowing it to receive credit for part or all of the foreign levy based on the relationship between the levy and any general income tax imposed by the country.

Section 101 of S. 940 would have amended section 901 to add a sweeping provision preventing the targeted producers12 from claiming the FTC for any tax payment greater than the tax imposed by the foreign country’s “generally applicable income tax,” defined to include only an income tax that applies broadly to the country’s own residents. As a result, the targeted companies would be barred from using the facts and circumstances test. (In many cases, they would also be treated less favorably than under the current version of the safe harbor.) Most strikingly, the targeted producers would have received no FTC at all if the foreign government had no generally applicable income tax. The provision would have been effective for tax years beginning on or after the date of enactment but would not have applied to the extent that it conflicted with U.S. obligations under bilateral tax treaties.

The underlying premise of the provision is that no foreign government would ever subject large U.S. oil producers to less favorable income tax treatment than other taxpayers, so that any excess income tax apparently imposed on those producers must actually be a disguised royalty payment. In short, S. 940 assumes that no foreign government would adopt targeted income tax increases of the kind that S. 940 would itself adopt! The bill’s premise is self-refuting.

The policy issues in this area are complex because the FTC has dubious intellectual underpinnings. As Daniel Shaviro has observed, the credit draws a sharp distinction between foreign income taxes and other overseas business outlays, even though foreign income tax payments have no special significance from the standpoint of U.S. economic welfare. He powerfully argues that the credit is an inferior way to lower the U.S. tax burden on companies’ overseas operations, relative to a lower tax rate on those operations accompanied by deductibility of foreign income taxes.13 We believe that the optimal tax rate on overseas operations might well be zero (at least to a rough approximation), which would obviate the issue of the treatment of foreign income taxes. In any case, the current tax system treats foreign income taxes as creditable and

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11Section 901(i)(1) also denies the credit for any foreign income taxes “used (directly or indirectly) by the country imposing such tax to provide a subsidy by any means” to the taxpayer or a related party. On a more specific note, section 901(f) denies the credit for foreign income taxes paid “in connection with the purchase and sale of oil or gas extracted in such country” if “such purchase or sale is at a price which differs from the fair market value.” Section 907(a) also limits the credit for foreign oil and gas taxes to 35 percent of foreign oil and gas income, preventing those taxes from being cross-credited against taxes on other types of income and thereby placing an upper bound on the tax savings from any efforts to increase creditable oil and gas taxes.

12Because BP and Shell are foreign corporations, they are unaffected by restrictions on the FTC, except to the extent that their U.S. subsidiaries pay foreign income taxes.

other features of the international tax rules, including the tax rates on overseas income, have been set based on that premise.

Within that context, no serious case has been made for repeal of the facts and circumstances test, although changes to some aspects of the safe harbor should perhaps be considered. In a comprehensive report on the dual capacity issue, Pamela Olson, Brian Jenn, and Grant Aldonas emphasize that the taxpayer bears the burden of proof in applying the facts and circumstances test. They point out that reg. section 1.901-2A has curbed previous abusive practices, dating to the 1950s, in which U.S. oil producers were allowed to freely reclassify royalties as income tax payments. They also describe numerous instances in which countries have chosen to tax oil producers at higher rates than other industries for reasons that have nothing to do with trying to exploit the U.S. FTC and note that the United States has itself chosen to tax oil producers at higher rates than other industries. A common motivation is the desire by governments to tax the profits that oil producers earn when oil prices rise.14

The two cases in which the Tax Court applied the facts and circumstances test, both of which were decided in favor of the taxpayer, illustrate the manner in which the test operates. In each case, a U.S. company was unexpectedly subjected to a windfall profit tax imposed by a foreign government after it had started extracting oil, with the company receiving no additional extraction rights or other privileges after the tax was imposed. Unsurprisingly, the Tax Court found in each case that the tax was not a payment for a specific economic benefit, even though the U.S. company was paying a tax that was limited to oil producers and was therefore paying a higher tax rate than most of the foreign country’s other taxpayers.15

The repeal of the facts and circumstances test would prevent a targeted company from claiming credit for a foreign tax that singled out oil producers, even if the producer indisputably paid market-rate royalties to the foreign government. It is hard to see the justification for that result. Of course, if such a policy were justified, it should apply to all dual capacity taxpayers, including banks, casinos, and construction companies that receive specific economic benefits, not to only five companies.

Much of the rhetoric on this issue has been highly misleading, featuring baldfaced assertions that oil producers are allowed to freely claim tax credits for royalties paid to foreign governments. In an April 2011 press release, for example, Finance Committee Chair Max Baucus, D-Mont., announced that he supported a “reduction in the foreign tax credit for royalty payments to foreign governments.”16 The Tax Notes story covering that press release stated without comment that “the foreign tax credit for royalty payments to foreign governments” was in Baucus’s sights.17 A 2009 editorial in The Economist asserted that “American oil companies earn a credit at home for royalties (of up to 80 percent in some cases) paid on oil extracted abroad.”18 A distinguished federal judge similarly asserted that oil producers “are permitted to deduct royalties they pay to foreign governments, on the ground that royalties paid to a government are really a tax.”19 Of course, oil producers are allowed to deduct royalties because they are a business expense. The apparently intended statement, that producers are allowed to claim credits for royalties, is false, unless the royalties are disguised in ways that avoid the regulatory restrictions. A New York Times story asserted that “another subsidy, devised by the State Department in the 1950s, allows U.S.-based oil companies to reclassify the royalties they are charged by foreign governments as taxes,” ignoring the fact that reg. section 1.901-2A was adopted in 1983 to curb the practices of the 1950s.20

Unfortunately, the misleading rhetoric about dual capacity pales in comparison to the widespread misinformation about the large oil producers’ nonexistent use of percentage depletion.

**The Percentage Depletion Hoax**

Section 104 of S. 940 purported to abolish the percentage depletion allowance for the five targeted

14Pamela F. Olson et al., “Economic and Foreign Policy Implications of the Administration’s ‘Dual Capacity’ Taxpayer Proposals” (July 2010), Doc 2010-16675, 2010 TNT 144-20.


oil producers, ostensibly effective for tax years beginning on or after January 1, 2012. That provision was a brazen hoax, however, since Congress had denied percentage depletion to those companies (and other integrated oil producers) 36 years earlier.

Percentage depletion is an egregious loophole that allows companies to deduct a percentage of their income as a cost. Professor Calvin Johnson of the University of Texas has aptly said, “Percentage depletion, while posing as a capital recovery mechanism, is a deduction of part of revenue without regard to costs. Percentage depletion continues the exclusion after the taxpayer has recovered its costs.” 21 As Johnson observes, percentage depletion was adopted in the 1920s in response to the odd fallacy that producers should be allowed to recover the market value, rather than the cost basis, of wells and similar investments. Atlanta accountant Jay Starkman has further detailed the bizarre history of this loophole. 22

Although percentage depletion once offered large tax savings to the big oil producers, that era abruptly ended when Congress added section 613A on March 29, 1975. 23 Effective for amounts paid or incurred on or after January 1, 1975, section 613A(a) provides that percentage depletion is unavailable for oil and gas wells, except as otherwise provided. Section 613A(c) permits 15 percent depletion on up to 1,000 barrels of oil per day, but section 613A(d) denies even that allowance to integrated producers. As a result of this provision, the five large companies (and other integrated oil producers) do not receive percentage depletion and must instead use cost depletion. Percentage depletion is available only to independent producers and royalty owners, and even their use of the tax break is subject to the 1,000-barrel-per-day limit.

Transition relief included in the 1975 legislation allowed 22 percent depletion for natural gas sold under a fixed-price contract in effect on February 1, 1975, and for some natural gas sales made at regulated prices before July 1, 1976. Legislation adopted in 1978 allowed 10 percent depletion for some natural gas from geopressured brine produced from wells for which drilling began from 1978 through 1983. 24

Although percentage depletion has been abolished for Big Oil and sharply limited for Little Oil, it continues to ride high in other industries. In those industries, no industry segment is disqualified from using percentage depletion and there is no limit on the quantity of production to which the tax break can be applied.

Subject to minor qualifications, section 613(b)(1) provides 22 percent depletion for sulphur, uranium, anorthosite, clay, laterite, nephelinite syenite, asbestos, bauxite, celestite, chrome, corundum, fluor spar, graphite, ilmenite, kyanite, mica, olivine, quartz crystals (radio grade), rutile, block steatite talc, zircon, and ores of antimony, beryllium, bismuth, cadmium, cobalt, columbium, lead, lithium, manganese, mercury, molybdenum, nickel, platinum and platinum group metals, tantalum, thorium, tin, titanium, tungsten, vanadium, and zinc. Section 613(b)(2) provides 15 percent depletion for silver, copper, iron ore, and some oil shale. Section 613(b)(3) provides 14 percent depletion for metal mines, rock asphalt, vermiculite, ball clay, bentonite, china clay, and sagger clay. Section 613(b)(4) provides 10 percent depletion for asbestos, brucite, coal, lignite, perlite, sodium chloride, and wollastonite. Section 613(b)(5) provides 7.5 percent depletion for some types of clay, shale, slate, bromine, calcium chloride, and magnesium chloride. Section 613(b)(6) provides 5 percent depletion for gravel, peat, pumice, sand, scoria, and some types of shale and stone. To round things out, section 613(b)(7) provides 14 percent depletion for “all other minerals,” with several specified exceptions (of course, one exception is for oil and gas) and sets forth a non-exhaustive list of more than 30 eligible minerals.

Percentage depletion should be repealed for all industries, as Johnson has proposed. That, of course, is exactly what S. 940 did not do. Because none of the five producers targeted by S. 940 receive percentage depletion, the bill would have done nothing to address that loophole. Adding this meaningless provision to S. 940 allowed the sponsors to bask in the glory of purporting to address an egregious loophole while actually leaving it completely intact.

Little wonder, then, that the JCT scored the provision as having negligible revenue effect. Presumably, the JCT’s reference to “negligible” rather than zero was intended to capture the remote possibility that some percentage depletion is still being claimed by the five targeted companies under the transition provisions described above. The JCT treated the revenue from this provision as zero when it summed the revenues from the various provisions to compute the bill’s total revenue yield.

The Congressional Research Service similarly explained why the provision would have no economic effects:

The percentage depletion allowance was repealed for the major oil companies by the Tax Reduction Act of 1975 (Pub. L. No. 94-12). Percentage depletion remains generally in effect only for the independent oil companies. As a result the percentage depletion allowance should no longer be a factor in investment, output and pricing decisions by the five major oil companies.

The denial of a tax benefit to taxpayers who are already ineligible to receive it should indeed have no effect on their investment, output, or pricing.

While the revenue and economic effects of the sham provision were negligible, the political effect was substantial. Numerous media stories reported without explanation, elaboration, or contradiction that S. 940 would deny percentage depletion to the large oil companies.

The press release issued by the bill’s sponsors said that “firms that extract oil and gas” are permitted to choose between cost depletion and percentage depletion and that the bill would repeal percentage depletion for the Big Five. Of course, the Big Five firms have not been permitted this choice since 1975. During floor debate, Sen. Jeff Merkley, D-Ore., asserted that “firms that extract oil and gas are permitted to deduct 15 percent of the sales to recover their capital investment” and that “the value of that deduction often exceeds the value of the original capital investment,” ignoring the fact that none of the firms affected by S. 940 had been permitted to do such a thing for the preceding 36 years. Sen. Dianne Feinstein, D-Calif., similarly stated that the bill would repeal percentage depletion.

We were surprised and disappointed to see that Tax Notes did not expose or challenge the hoax. The story on the introduction of S. 940 reported without comment that the summary of the bill stated that it would repeal percentage depletion for the five firms. A story on the bill’s defeat asserted that it “would have rolled back…section 613A percentage depletion for oil and gas wells.”

A story on the introduction of a similar bill by Rep. Earl Blumenauer, D-Ore., asserted that it “would repeal provisions benefiting large oil and gas producers such as…section 613 depletion for oil and gas wells.”

In his tax policy blog, professor James Edward Maule of Villonova Law School said, “Two deductions available to oil companies that need to be questioned are those for percentage depletion and for intangible drilling costs. Both are among the tax breaks that would be repealed by the Close Big Oil Tax Loopholes Act.” Far from repealing percentage depletion, the bill would have left the loophole unscathed, because the bill would not have applied to a single company that actually uses it. In her blog, professor Linda Beale of Wayne State University Law School said that “oil company executives from BP, Chevron, Shell, ConocoPhillips, and ExxonMobil were called to Congress…to talk to the Senate Finance Committee about their tax breaks—like the oil depletion allowance.” In reality, as discussed above, the executives noted at the hearing that the depletion allowance was not their tax break, since they had been disqualified from it 36 years earlier.

A recent New York Times editorial said that “the oil industry…has long enjoyed a web of arcane and unnecessary tax breaks—deductions for well depletion and intangible drilling costs. They are unique to the industry…Congress should end the subsidies to Big Oil.”

The editorial’s subtle movement between references to “Big Oil” and to “the oil industry” conceals from readers that Big Oil does not receive percentage depletion. Of course, the statement that percentage depletion is “unique to the industry” is false, given that section 613(b) provides that treatment for roughly 100 minerals, metals, and other substances.

The list of inaccurate statements could be multiplied. Even news stories that did not repeat the myth that the five producers receive percentage depletion could be cited. The list of inaccurate statements could also be multiplied. Even news stories that did not repeat the myth that the five producers receive percentage depletion could be cited.

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26 See press release, supra note 7, at 2.
27 Congressional Record, May 17, 2011, at S3001 (Merkley) and S3035 (Feinstein).
28 Meg Shreve and Drew Pierson, “Senate to Consider Bill to Repeal Oil Industry Tax Breaks,” Tax Notes, May 16, 2011, p. 646.
depletion generally failed to challenge it, simply passing over it in silence. For what it’s worth, the prevalence of misinformation did not necessarily reflect political bias, because even some opponents of S. 940 accepted the sham provision at face value.  

Of course, sham provisions are not used only by Democrats. The House recently approved a Republican-sponsored measure that purported to deny food stamps to taxpayers with assets or incomes exceeding $1 million, an unnecessary restriction since 7 U.S.C. section 2015 requires that food stamp recipients have incomes below 130 percent of the poverty level. This gambit drew media ridicule and did not win Republicans plaudits for combating millionaire food stamp recipients. In contrast, supporters of S. 940 won widespread praise for combating the nonexistent use of percentage depletion by Big Oil, even as they steadfastly protected the loophole's actual beneficiaries. The media were silent precisely when the public most needed information, because Americans are much more likely to know that millionaires don’t receive food stamps than to know that integrated oil producers don’t receive percentage depletion.

We now turn to the bill’s provisions on section 199, which account for about three-fifths of its revenue gain. 

**Big Oil, Adult Movies, and Section 199**

Section 102 of S. 940 would have denied the section 199 deduction to the five targeted companies, effective for tax years beginning on or after January 1, 2012. As discussed above, previous bills had also attempted to deny this deduction to the five companies.

Section 199, which was enacted in 2004, allows taxpayers to deduct from taxable income a percentage of the net income attributable to qualified domestic production, generally defined to include the production of goods but not services. Taxpayers were allowed to deduct 3 percent of net income in 2005 and 2006, 6 percent in 2007 through 2009, and 9 percent in 2010 and thereafter. In general, the activity must consist of the sale, lease, rental, license, exchange, or other disposition of tangible personal property or computer software that was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States.

This tax break originally applied to oil and gas production on the same terms as the production of other goods and services. On October 3, 2008, however, Congress enacted section 199(d)(9), which, starting in 2010, reduced the allowable deduction by 3 percent of income “attributable to the production, refining, processing, transportation, or distribution of oil, gas, or any primary product thereof.” This provision reduces the deduction for oil and gas income from 9 percent, the value applicable to other industries that produce goods, to 6 percent.

By no stretch of the imagination can section 199 be considered a special subsidy to large oil producers or to the oil industry in general. The deduction does reflect an economically arbitrary preference for goods over services. But oil is treated no more favorably than other goods — because of the 2008 legislation, it is actually treated one-third less favorably. As Gary Hufbauer recently commented, “There is no reason Section 199 should not be available for refining and processing petroleum products.”

Strikingly, S. 940 would have placed production by large oil companies in the same category as adult movies. Although film production in the United States is generally eligible for the deduction, section 199(c)(6) denies the deduction to films that are subject to the record-keeping and performer age provisions of 18 U.S.C. section 2257. Under S. 940, a similar denial would have applied to the five targeted oil producers. Their treatment would have
been more onerous than the treatment accorded to producers of firearms, coal, tobacco, and alcohol, all of which would have continued to benefit from the deduction.

One argument for removing oil and gas production from the section 199 deduction is that such production did not receive benefits under the export subsidies that the 199 deduction was adopted to replace. But broadening the scope of the deduction to all goods is a move toward neutrality. Extending it to also include services (or equivalently, replacing the deduction with an economy-wide tax rate cut) would be a further move toward neutrality.

The Big Picture

The dominant theme in the debate over S. 940 is undisguised hostility toward the large oil companies, a hostility that seems to be driven by distress over high gasoline prices and resentment of the companies’ size and profitability. The political mindset seems to treat high profits and prices as tantamount to criminality. Referring to the summoning of the five executives to the May 12, 2011, Finance Committee hearing, one media source commented, “It’s a tradition in Washington: the annual Capitol Hill version of the perp walk for Big Oil.”

The hostility seems to increase when gasoline prices are high. For example, Energy Department data show that the price of regular gasoline peaked around $3.96 per gallon when S. 940 was being considered. Of course, as New York Times columnist Joe Nocera notes, “oil is a commodity,” and “the companies have about as much to do with setting the price of oil as farmers do with setting the price of corn.” Indeed, when they argued that the bill would not increase prices at the pump, supporters of S. 940 frequently stressed that oil prices are set in world markets.

A relentless theme in the debate was the claim that the five producers make too much money. Section 2(a)(11) of S. 940 cited the fact that the major oil companies had accumulated more than $1 trillion in profits over the preceding decade. During the floor debate, McCaskill said, “Instead of making $125 billion... Big Oil is going to have to suffer the floor debate, McCaskill said, ‘Instead of making more than $1 trillion in profits over the preceding decade. During the floor debate, McCaskill said, ‘Instead of making $125 billion... Big Oil is going to have to suffer the floor debate, McCaskill said, ‘Instead of making more than $1 trillion in profits over the preceding decade. During the floor debate, McCaskill said, ‘Instead of making $125 billion... Big Oil is going to have to suffer the floor debate, McCaskill said, ‘Instead of making same proportion of IDCs while independent producers expense 100 percent.

Many of the statements about taxation of oil production reflect a fundamental misunderstanding of what it means for a tax provision to be a subsidy. The tax system subsidizes a specific economic activity, such as oil production by a particular firm, and artificially causes it to expand if that activity receives more favorable tax treatment than the treatment given to alternative activities. In that comparison, the greatest weight should be placed on those alternatives that are the closest substitutes to the activity in question. The mere fact that the activity receives treatment more favorable than that prescribed by an arbitrary benchmark does not necessarily establish that the activity is being subsidized. Instead, the determination of whether a

John D. Rockefeller IV, D-W.Va., said, “Why focus on them? Because they are a symbol. They are the top of the heap... They can always get what they want. Everybody always caves to them because they are so big, as they fly around in their shiny jets.”

At the May 12 Finance Committee hearing, Schumer argued that homeland security, veteran benefits, and college aid were higher priorities than preserving tax breaks for the five companies. But, the importance of those programs has no bearing on whether the five companies should be targeted for discriminatory treatment. If the programs merit additional resources, the resources can be obtained by raising taxes under neutral tax rules.

Other supporters of S. 940 pulled back from the claim that the targeted producers’ profits were excessive and confessed to simply be seeking tax neutrality by removing tax subsidies from the companies. But it is hard to see how a bill that applies special rules to five companies could be a step toward neutrality. That is particularly true when the bill’s most important provision denies the five companies a deduction that is available to manufacturing, agriculture, and construction firms throughout the economy. And, it is even truer when the five companies have already been singled out for unfavorable treatment. Under section 167(h)(5), they face a longer amortization period for G&G costs than other taxpayers. Along with other integrated oil producers, the five companies are denied the percentage depletion that is available on a limited basis to independent oil producers and on an unlimited basis to other extractive industries. Along with other integrated oil producers, the five companies are allowed to expense only 70 percent of IDCs while independent producers expense 100 percent.

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subsidy exists is inherently a relative one, since it depends on how the activity is treated in comparison with alternative activities. By the same token, the selective removal, from some activities but not from others, of treatment that is more favorable than an arbitrary benchmark need not move the tax system toward neutrality and need not genuinely reduce subsidies. Many supporters of S. 940 maintained that the five producers were subsidized by the tax system, merely because the companies were taxed more favorably than they might be taxed under some arbitrary, generally unspecified, benchmark. In reality, no conclusion about subsidization can be drawn without an examination of how the treatment of the five companies compares with the treatment of other oil producers, other extractive industries, and other industries. As discussed above, such an examination seriously undermines the subsidy argument. At the May 12 hearing, the executives of the five targeted companies emphasized this point and repeatedly affirmed their willingness to relinquish the benefits of provisions like section 199 if the provisions were also repealed for other industries.

Another argument holds that the denial of tax preferences to fossil fuels serves environmental goals. Indeed, the G-20 group of nations has pledged to reduce those tax preferences. Of course, a hodgepodge of punitive measures on selected fossil fuels and subsidies to an array of selected alternative fuels is a poor substitute for a coherent policy such as a carbon tax. For example, it is hard to see why oil and gas are targeted while coal is not. In any event, these concerns would not justify singling out the five large producers for unfavorable treatment. A barrel of oil produced by a Big Oil company has the same environmental effects as a barrel produced by a Little Oil company. If fossil fuel preferences are to be curtailed, they should be curtailed for all producers.46

The actions against these few taxpayers are a classic case of time-inconsistent policy and follow almost exactly the negative scenarios suggested in pioneering work by Finn Kydland and Edward Prescott, part of the work for which they received the Nobel Prize in economics.47 They pointed out that opportunistic governments may change their policies over time. A government can, for example, promise low capital taxes to stimulate investment and generous patents to promote the creation of intellectual property, but then renege on its promises once the capital or the intellectual property has been brought into existence. The problem, Kydland and Prescott wrote, is that investors will anticipate these broken promises unless the government can find a credible way to ensure that it will keep its promises.

By focusing a barrage of punitive policies on oil companies that have committed the cardinal sin of profitability, Congress runs the risk of signaling to investors who might have outsized success in the future that they too will be the focus of targeted hostile legislation. This chilling effect could, in principle, be quite widespread because Congress is practically flying a banner over the Capitol celebrating time-inconsistent policies.48

These concerns are not just theoretical. As Kydland and Prescott anticipated, the effect of the rule of law on the economy has been well established in the empirical literature over the last couple decades. Early research by Robert Barro found strong evidence that economic growth is enhanced by respect for the rule of law.49

Barro’s results have been confirmed by more recent work. A number of studies that have examined the relationship between economic freedom and economic growth have used the Economic Freedom of the World Index, published by the Fraser Institute, to measure nations’ economic freedom. This index measures the degree of economic freedom in five broad areas: size of government expenditures, taxes, and enterprises; legal structure and security of property rights; access to sound money; freedom to trade internationally; and regulation of credit, labor, and business.50

Economists James Gwartney, Randall Holcombe, and Robert Lawson use this index to assess the relationship between economic freedom and a country’s growth and income level. They find that

46President Obama’s budget proposals have taken this approach, calling for neutral tax treatment within the oil industry. For example, the president proposed to actually repeal percentage depletion for oil and gas production, a measure that would have affected independent producers that still receive the tax break but not the integrated producers that are ineligible for it. Nevertheless, the administration did issue a statement supporting the passage of S. 940 when it came to the Senate floor.


48One of us made this point when S. 3044 was under consideration. See Kevin A. Hassett, “Oil Tax Exposes Democrats’ Economic Illiteracy,” Bloomberg.com (June 2, 2008).


countries with institutions and policies more consistent with economic freedom both grow more rapidly and achieve higher income levels. Moreover, they show that institutional quality influences economic growth by affecting both the rate of investment and the productivity of resource use.51

Economists Hugo Faria and Hugo Montesinos expand on the research done by Gwartney, Holcombe, Lawson, and many others by using an instrumental variable approach to cement the channel from economic freedom to prosperity. Faria and Montesinos find that the index can explain both differences in growth levels, which are more transitory and driven by policies, and income levels, which are driven by long-run economic performance and are likely dependent on the institutional framework of the country. This research supports the hypothesis that increasing economic freedom through better policies can lead to increased prosperity in a country.52

Other scholars have added to our understanding of the role that reliable institutions can play in fostering growth. Using a clever technique, Daron Acemoglu, Simon Johnson, and James A. Robinson exploit differences in mortality rates faced by European colonists to estimate the effect of institutions on the economic performance of former colonies. The key idea is that the colonies that were inhospitable to Europeans were set up with extractive infrastructures, whereas hospitable colonies were subject to the same type of favorable institutions to which Europeans were accustomed. The authors find that variation in institutions accounted for fully three quarters of the income variation across these countries, highlighting the key role that organized rule of law can play in creating the foundations of economic growth.53

In another study, Dani Rodrik, Arvind Subramanian, and Francesco Trebbi attempt to disentangle the effects of geographic location, trade integration, and institutional environment on economic development. They find that solid institutions trump the other factors in determining a country’s income level.54 Similarly, Stephen Knack and Philip Keefer find that respect for property rights is crucial to investment and economic growth. When they control for investment, the effect on growth remains, which suggests that security of property rights affects growth through other channels besides capital formation.55

A significant legal tradition also condemns targeted taxation in the context of the press. In 1936 the U.S. Supreme Court unanimously struck down under the First Amendment a Louisiana license tax equal to 2 percent of newspapers’ gross advertising receipts, applicable only to newspapers with weekly circulation exceeding 20,000. Because of the circulation threshold, only 13 newspapers, published by only nine publishers, were subject to the tax while the state’s 124 other newspapers were exempt. The Court acknowledged that newspaper publishers were subject to “the ordinary forms of taxation for support of the government,” but held that the unprecedented Louisiana tax was not ordinary and that its form was “suspicious” because it was “measured alone by the extent of the circulation of the publication in which the advertisements are carried, with the plain purpose of penalizing the publishers and curtailing the circulation of a selected group of newspapers.”56

In 1983 the Court struck down 8 to 1 a Minnesota tax on the purchase of ink and paper by newspapers, with an exemption for the first $100,000 of ink and paper consumed by each publication. As a result of this exemption, in 1974 the tax applied to only 14 newspapers published by 11 publishers, and in 1975 to only 16 newspapers published by 13 publishers, with the Minneapolis Star Tribune bearing roughly two-thirds of the total tax burden. The Court opinion, written by Justice Sandra Day O’Connor, stated:

The effect of the $100,000 exemption...is that only a handful of publishers pay any tax at all, and even fewer pay any significant amount of tax...Whatever the motive of the legislature in this case, we think that recognizing a power in the State not only to single out the press but also to tailor the tax so that it singles out a few

members of the press presents such a potential for abuse that no interest suggested by Minnesota can justify the scheme. . . . When the exemption selects such a narrowly defined group to bear the full burden of the tax, the tax begins to resemble more a penalty for a few of the largest newspapers than an attempt to favor struggling smaller enterprises.57

Of course, the legal issues are not fully comparable. The Constitution expressly guarantees freedom of the press, but not the freedom to extract oil. Nevertheless, the Supreme Court’s decisions in the two cases demonstrate its recognition of the dangers of targeted taxation.

Conclusion

The effort to target the large oil companies has not yet ended. On March 19, 2012, Menendez introduced S. 2204, the proposed Repeal Big Oil Tax Subsidies Act. The bill includes the same provisions targeting the five large oil producers as those in S. 940, along with provisions extending or expanding tax preferences for alternative energy sources. The JCT has scored the oil tax provisions as raising $24 billion in fiscal years 2012 through 2022, with $14.4 billion from the denial of the section 199 deduction, $7.5 billion from the dual-capacity provision, $2 billion from the repeal of IDC expensing, and almost nothing from the repeal of tertiary injectant expensing. The revenue gain would be partly offset by an $11.7 billion revenue loss from the tax breaks for alternative energy. The revenue estimate lists “No Revenue Effect” for the percentage depletion hoax, a more emphatic statement than the “Negligible Revenue Effect” listed in the JCT’s preliminary revenue estimate for S. 940.58 Regrettably, the Tax Notes stories about the bill again accepted the hoax at face value, stating without comment that the bill would deny percentage depletion to the targeted companies.59 On March 29 the Senate failed to invoke cloture on S. 2204, thereby killing the bill. The motion to invoke cloture failed for lack of the required 60 votes when 51 senators voted in favor and 47 senators voted against. Democratic senators supported the motion to invoke cloture 47 to 4 and Independents supported it 2 to 0, while Republicans opposed it 2 to 43.

Some commentators misunderstand the principles at stake in this debate. In an editorial discussing the May 12, 2011, Finance Committee hearing, The New York Times commented, “With profits at near-record levels it is hard to feel sympathy for the oil industry. Yet sympathy is what the C.E.O.’s of the five biggest companies asked for.”60 But an insistence on equality before the law is quite different from a request for sympathy. And recognition of equality before the law should not rest on a feeling of sympathy.

To be clear, we do not call for the kind of equality that Anatole France memorably satirized, “The law, in its majestic equality, forbids the rich as well as the poor to sleep under bridges, to beg in the streets, and to steal bread.”61 We do not challenge, nor did the five executives, the existence of a tax system under which affluent Americans, including the stockholders of the large oil companies, make large tax payments to cover the costs of government services and to provide aid to Americans who are in need.

We firmly believe, however, that the rules of that tax system should not be manipulated to penalize disfavored companies whose profits Congress deems excessive. The acceptance of that principle across the ideological spectrum would help protect economic freedom and prosperity for all Americans.

57 Minneapolis Star & Tribune Co. v. Minnesota Commissioner of Revenue, 460 U.S. 575, 591-592 (1983). As an alternative ground for its decision, the Court concluded that the state had not justified imposing use tax on ink and paper rather than sales tax on newspapers.
61 Anatole France, The Red Lily Chapter 7 (1894).