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What's an Oil Subsidy?

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In his fiscal year (FY) 2012 budget request, President Obama proposed to end subsidies for oil companies by eliminating tax breaks, including accelerated depreciation options. A growing number of policymakers have echoed that call.

Though the President's anti-subsidy rhetoric is on track, there are several fundamental problems with the Administration's crusade. The President overreaches on what truly is a subsidy for oil and ignores the fact that the government does far more to hurt oil production than help it. He singles out the oil industry, which already faces a higher marginal tax rate at 41 percent compared to 26 percent for the rest of businesses in Standard & Poor's 500.

The President attacks oil subsidies while continuing to push for subsidies for renewable fuels, electric vehicles, wind, solar, clean coal, and even natural gas. According to the Congressional Research Service, President Obama's tax hikes on the oil and gas industry proposed in his FY 2012 budget would increase the price of oil and gas for American consumers.[1] A much better policy for taxpayers and consumers would be to define subsidies accurately and then remove all energy subsidies. Any repeal of tax breaks should be offset with a broad tax cut to avoid any net tax increase.

Oil Subsidies That Should Be Removed. First, let's take a look at oil subsidies that are obvious and unnecessary. Congress should eliminate the following subsidies:

- ***Government R&D.*** The Department of Energy (DOE) has spent taxpayer dollars on oil research and development, including funding for unconventional oil, gas, and coal. Although President Obama's FY 2012 budget request significantly cuts funding for the Office of Fossil Energy, decreasing its size by $417.8 million below the FY 2010 appropriation, it does not go far enough. The only funding in this area should maintain the Strategic Petroleum Reserve, for which the President's budget requests an appropriate $121.7 million. Eliminating all other fossil energy funding would save $399 million.
- ***Enhanced Oil Recovery (EOR) Tax Credit.*** Oil producers receive a 15 percent tax credit for costlier methods and technologies, such as injecting liquids and carbon dioxide into the earth. Many EOR processes are no longer in use, and the tax credit applies only when the price of oil falls below a certain level.
- ***Marginal Well Production Credit.*** Marginal wells produce 15 or fewer barrels of oil per day, produce heavy oil, or produce mostly water and fewer than 25 barrels of oil per day. The marginal well production credit is another safety-net tax provision. This is another preferential tax credit that Congress should repeal.

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Applied research of any kind—not just oil research and development—is better left to the private sector. The private sector should not be subsidized because of market conditions, as happens with the so-called safety-net tax credits that kick in if the price of oil falls below a certain level.

Broadly Available Tax Provisions Are Not Oil Subsidies. In many cases, what the President and anti-oil crusaders label an oil subsidy is neither a subsidy nor a tax treatment specific to the oil and gas industry. These are broad tax policies that apply to many industries. When the Administration takes aim at these provisions specifically in the oil and gas industry, it is essentially a targeted tax hike. These provisions include:

- ***Section 199 Deduction.*** This tax deduction, under Internal Revenue Code Section 199, goes to all domestic manufacturing. Producers of clothing, roads, electricity, water, and many other goods produced in the United States are all eligible for the manufacturer's tax deduction. The Section 199 deduction is unavailable to the service sector, and even that is a stretch, as the tax deduction includes music and movie production. Removing oil and gas production eligibility for this tax break is not removing a subsidy or closing a tax loophole but imposing a targeted tax hike. In fact, Congress already imposed a tax hike on oil and natural gas companies by freezing the deduction at 6 percent when other manufacturers receive a 9 percent deduction.
- ***Foreign Tax Credits and Deferral of Foreign Income.*** The foreign tax credit and deferral are two critical features of a worldwide tax system that prevent the U.S. corporate income tax from double taxing—and further crippling—the international competitiveness of U.S. companies. The President has proposed cutting deferral and limiting the applicability of the foreign tax credit. This would significantly increase taxes paid by U.S. businesses, subjecting more U.S. foreign income to double taxation and severely undermining the ability to compete abroad and grow at home. The President is charging in exactly the wrong direction. He should instead advance the competitiveness of American companies and workers by proposing to eliminate the U.S. tax on foreign source income. Foreign tax credits and deferral of foreign income are not unique to the oil industry, so the President's proposal is just another punitive, targeted tax hike.

Immediate Expensing Should Be Complete and Permanent. Another non-subsidy target of the Administration is oil companies' ability to expense capital costs in the year of the purchases.

Immediate expensing allows companies to deduct the cost of capital purchases at the time they occur rather than deducting that cost over many years based on cumbersome depreciation schedules. Expensing is the proper treatment of capital expenditures. Depreciation raises the cost of capital and discourages companies from hiring new workers and increasing wages for existing employees. Immediate expensing for all new plant and equipment costs—for any industry or type of equipment—would allow newer equipment to come online faster, which would improve energy efficiency and overall economic efficiency.

Even President Obama has championed temporary 100 percent expensing for qualified capital because it lowers the cost of investment.[2] Congress should make immediate expensing permanently available for all business investments.

All companies, including oil and gas companies, should be able to expense their full capital costs immediately. Until that critical change in the tax code is made for all businesses, Congress should retain all provisions that move the tax code in the direction of expensing.

Special Tax Treatments That Deserve a Second Look. Special tax treatment can serve the same

1. Robert Pirog, "Oil and Natural Gas Industry Tax Issues in the FY2012 Budget Proposal," Congressional Research Service Report for Congress, March 3, 2011, at *http://www.nationalaglawcenter.org/assets/crs/R41669.pdf* (May 13, 2011).
2. Press release, "Obama Administration Releases Report Outlining Benefits of Expensing Proposal in Encouraging Business Expansion, Hiring Now," The White House, October 29, 2010, at *http://www.whitehouse.gov/the-press-office/2010/10/29/obama-administration-releases-report-outlining-benefits-expensing-propos* (May 12, 2011).

purpose as a subsidy by uniquely favoring the oil and gas industry. There are cases where this type of treatment should be considered carefully:

- ***Percentage Depletion Allowance.*** A depletion allowance is analogous to depreciation and is appropriate when the quantity of the potential resource is unknown, such as the amount of recoverable oil from a well. Independent oil and gas producers use a depletion allowance to recover capital investments over time. This is also available to producers involved in mining, timber, geothermal steam, and other natural deposits. The depletion allowance for independent oil and gas producers is 15 percent of the producer's gross income from its average daily production, up to 1,000 barrels of oil. While there is nothing wrong with percentage depletion in theory, the question is whether at 15 percent it is overly generous or, possibly, not generous enough and should be raised. Congress should have an independent organization determine this.
- ***Exemption from Passive Loss Limitation.*** Passive activities occur when a landowner collects income or incurs losses without physically participating in activity on his land. For example, someone could own farmland but not operate the equipment or plant the crops. In oil and gas operations, passive activities include the cost of development and the operation of the property. Typically, taxpayers can deduct passive activity losses only against passive activity income; however, taxpayers with working interests in oil and gas are exempt from the passive loss limitation rules, allowing losses incurred from exploration in oil to offset non-oil income. Congress should repeal all passive loss limitation exemptions.

End Real Oil Subsidies, but Don't Gratuitously Punish Companies. Ending all energy subsidies, including those for oil and gas, would be good for American taxpayers and consumers. However, Congress should not punish the oil and gas industry with targeted tax hikes, nor should it reward other parts of the energy industry favored by the Administration.

Immediate expensing is not a subsidy; it is good policy that can encourage new investments and benefit all businesses. There are, however, special treatments that should end. Congress should repeal passive loss limitation exemptions and enhanced oil recovery and marginal well production tax credits. Congress should then use any resulting revenue to reduce tax rates and eliminate DOE spending for fossil fuel research.

Finally, Congress and the Administration should also remove the regulatory shackles that hinder additional drilling for oil and gas onshore and offshore—work that is vital to ensure access to abundant, affordable energy for American families and businesses.

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