

Testimony before the  
Senate Finance Subcommittee on Energy, Natural Resources, and Infrastructure

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“Honest and Accurate Tax Accounting for Oil & Gas”

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I. Introductory Remarks.

My name is Calvin Johnson. I have been a professor of law at the University of Texas Law School since 1981.<sup>1</sup> I help run the “Shelf Project,” which is a collaboration by tax professionals to develop and perfect proposals to raise revenue by defending the tax base.<sup>2</sup>

Uncle Sam is going to need significant revenue. The Congressional Budget Office estimates that the federal budget deficit for 2009 will total \$1.6 trillion, or 11.2% of gross domestic product.<sup>3</sup> Once the need for short term stimulus has passed, that deficit must be closed. In the impending revenue crisis, base-protecting revenue provisions that were not possible under ordinary politics become political necessities.

In raising revenue, it is better to go after the low tax and negative tax transactions before raising tax rates. A tax system does the least harm to the private economy if is broad, unavoidable and neutral between investment choices. A broad, healthy tax base allows us to raise the necessary revenue at the lowest feasible tax rates. A broad, least-damage tax would impose uniform effective tax rates on all alternative investment choice. Investment decisions should be governed, not by tax accounting, but by real nontax merits of the investments. We need to get the tax accounting right to describe real economic income, just as we need to keep our laboratory data honest and accurate, no matter how important the experiment.

Under the standards of a broad, unavoidable, and neutral tax base, we will need significant improvement in the tax accounting used for oil and gas. Tax accounting for oil and gas does not describe the economic income from the investment. Indeed, for a broad range of reasonable assumptions, oil and gas accounting delivers a negative tax or subsidy to profitable investments. With tax accounting so bad, even highly profitable investments in the oil and gas area cannot provide a source of revenue for our Uncle Sam.

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<sup>1</sup> A curriculum vitae, frequently updated, which includes links to publication is found at [http://www.utexas.edu/law/faculty/cvs/chj7107\\_cv.pdf](http://www.utexas.edu/law/faculty/cvs/chj7107_cv.pdf).

<sup>2</sup> The shelf project is described at *The Shelf Project: Revenue Raising Projects that Defend the Tax Base*, 117 TAX NOTES 1077 (2007) [ <http://www.utexas.edu/law/faculty/calvinjohnson/shelf-project.pdf> ].

<sup>3</sup> Congressional Budget Office, *The Budget and Economic Outlook: An Update* (Aug. 2009), [http://www.cbo.gov/ftpdocs/105xx/doc10521/2009BudgetUpdate\\_Summary.pdf](http://www.cbo.gov/ftpdocs/105xx/doc10521/2009BudgetUpdate_Summary.pdf)

For example, under reasonable assumptions, the combination of four tax preferences generates a subsidy that is a *negative* 42% of real income. The four preferences are the expensing of intangible drilling costs, the pool of capital doctrine, the percentage depletion allowance and the domestic manufacturing deduction. The subsidy from the combination means that an oil and gas investment can in reality lose over half of its cost of capital before tax and still make money after tax. Investments are not more virtuous because they lose money in absence of tax. Honest and accurate tax accounting for oil and gas would make taxable income describe the economic income from oil and gas and stop the tax subsidies.

No one has yet made a plausible case that a subsidy is needed for oil and gas beyond the wisdom of the laws of supply and demand. The price of oil and gas is high enough to provide sufficient incentive. If more incentive is needed, the price will adjust. Indeed, an increase in the price of oil and gas, if any, would help us conserve energy, and adjust to alternative energy sources and high energy prices in the future. The government should get out of the business of subsidizing oil and gas, especially via the tax system.

None of the tax advantages accorded to oil and gas have ever been subjected even to the care that we give to government spending. The competitive federal budget is the primary mechanism by which the government applies rationality to the alternative use of resources. Budgeted spending is subject to discipline because government spending is widely hated. When items are off budget, however, as when they are accomplished through the tax system, the subsidies avoid the budget competition for resources. When Congress allows tax advantages, they do not think of the burdens on the deficit as real money and the costs they incur, including the tax expenditures for oil and gas, therefore turn out to be irrational. Tax advantages are stealth subsidies, not understood to be real money by the people or the Congress that adopted them and they have never been justified by analysis or political legitimacy.

The following eight tax privileges now available to oil and gas should be repealed:

(1) Repeal Intangible Drilling Cost. Drilling for oil or gas is an investment, properly treated as a capital expenditure. But under current law, the investment is treated as a worthless expense, lost and deductible when made. Immediate expensing for an investment means that tax does not reduce the pre-tax internal rate of return from the investment. The economic or effective tax rate on a drilling investment has an expected value of zero.

(2) Repeal Pool of Capital doctrine. Under the pool of capital doctrine, a drilling enterprise may pay many of the costs of drilling by giving out an economic interest in the well, without either the enterprise or the provider of goods or services paying tax. An accounting system can describe real internal rate of return and impose tax at the statutory tax rates only if the adjusted basis of the investment is equal to discounted present value of the investment. Paying for royalties, goods and services with carried interests should be considered to be a taxable exchange of the underlying assets, both to the payor and to the recipient.

(3) Repeal of Working Interest Exemption from Passive Activity Loss Limitations. The Tax Reform Act of 1986 was able to reduce maximum tax rates from 50% to 28%, but only because the passive activity loss limitations so effectively attacked tax shelters as they were then

known. The Passive Activity Limitations remain the most effective of the anti-shelter tools. We need to end the exemption for working interests in oil and gas property from the limitations.

(4) Limiting Percentage Depletion to Basis. Percentage depletion allows the deduction of imaginary costs, because it continues even after real costs have been fully deducted. This accounting error was adopted because of an error in identifying “capital” to be recovered as the *value* of a gold mine when discovered, rather than its much lower cost.

(5) Repeal Exclusion as to Domestic Production. Six percent of income from oil and gas extracted in the U.S. or the continental shelf is excluded from tax. The exclusion is part of the reason why tax rate on oil and gas investments is negative and why money losing investments go forth for the tax benefits.

(6) Recover Geological and Geophysical Costs under Cost Depletion. Current law allows the geological and geophysical costs of identifying promising properties over two years, but a producing oil deposit found by the surveys can last for 30 years.

(7) Repeal LIFO inventory accounting. LIFO accounting allows taxpayer to keep in basis the oldest and lowest costs since the inventory accounts began. To reflect economic income, basis should come as close to fair market value as possible. FIFO should be mandated for oil and gas inventories.

(8) Repeal the tax credits. There is a 15% tax credit for Enhanced Oil Recovery Projects and a tax credit of \$3 per barrel for marginal wells. Neither credit is now available because the price of oil has risen high enough to give adequate incentive, under the terms of the statutory provisions. The credits need to be repealed, while they have no effect. Indeed the lesson extends beyond the credits: the price of oil is high enough to give adequate incentive. No tax advantages better than normal taxation are needed or appropriate.

## II. Fundamentals of Tax Economics for Oil and Gas.

Oil and gas transactions commonly benefit from a negative tax or subsidy, that is, the internal rate of return is higher for the investment after tax than before tax. This section presents a simple illustration that takes into account four tax preferences, i.e., expensing of intangible drilling cost, pool of capital doctrine, percentage depletion and domestic production exclusions, assuming that all are available. In the illustrative investment, tax *adds* 41% to the value of the investment and also allows investments to go forward that destroy over half their cost of capital. All of the tax advantages are subject to conditions and restrictions, which are discussed in the section which follows the simple illustration.

### A. Soft Money Investing means Tax Exemption for Drilling.

The ability to deduct an investment immediately ordinarily means that tax does not reduce the taxpayer’s pretax return from the investment. Getting into an investment with a deduction or exclusion is “soft money investing” and it means tax does not reduce the amount available for investment. “Soft money investing,” is ordinarily of the same value as exemption

from tax for the profit or gain from the investment. The thesis is routine to tax economists, but is not commonly evident in statutory or judicial decision making.

Assume, to illustrate the point, a taxpayer, described in Table 1, below, has \$100 income that will be invested in drilling for oil. The investment will triple in some unstated period of time. The assumed tax is a one-third, 33.3% tax rate. Exemption of the return is described in Column (A) of Table 1 and soft money investing is described in Column (B).

Column (A) describes the after tax result if the investment is capitalized, but the gain from the investment is exempt from tax. Capitalization of the investment is normal to an income tax because an investment is not a loss. Because of capitalization in column A, there is immediate tax on the \$100 income, which reduces the amount available for investment to two-thirds. The amount invested then triples to \$200. Our assumption in Column (A), however, is that there is no tax on the tripling so that the end result capitalization and exemption in Column (A) is \$200.

An income tax would also ordinarily tax the gain in Column A. Under normal income tax, the gain in the tripling, \$133.33, would be subject to a one third tax (or \$44.44), which would reduce the after tax proceeds to \$155.55. Tax of both the investing and the return is implied by our tax treating of debt financing, which gives both a deduction for interest and basis or exclusion for principal. Within in income tax, avoiding the tax on gain, which is shown in Column (A) is recognized as a benefit.

Table 1: Tripling is tax exempt		
	(A) Capitalized investment	(B) Soft Money Expensed or Excluded.
1. Income at \$100	\$100	\$100
2. Tax on row 1 at 35%	(\$33)	0
3. Investable amount (1.-2.)	\$67	\$100
4. Investment (3.) triples	<b>\$200</b>	\$300
5. Basis	\$67	0
6. Taxable amount	\$133	\$300
7. Tax at one-third of 6.	Tax Exempt	(\$100)
8. End result (4.-7.)	<b>\$200</b>	<b>\$200</b>

In Column (B), the \$100 is an intangible drilling cost and the taxpayer is able to deduct the entire cost immediately. Because of the deduction, none of the \$100 income is taxed. The full income of \$100 may thus be invested. In Column (B) there is no exemption for the tripling. Still, the result in Column (B) is the same, \$200, as in Column (A) with no tax on the profit. Therefore, the ability to expense the investment immediately is as valuable as a privilege of paying no tax on the gain.

Effective tax rate measures how much tax reduces the pretax internal rate of return from the investment.<sup>4</sup> The effective tax rate in Column (A) is zero because tax does not reduce the tripling before tax, and the effective tax rate in Column (B) is zero because tax has the same impact as in Column (A).

The results of Table 1 can be generalized by algebra, provided the tax rate at the start of the investment (row 2) is the same as at the end (row 7), the pretax return (tripling here) is the same on both columns, and the amount invested is sensitive to the upfront tax cost in row 2:

Terminal Value, Exempt Yield and Expensed		
Exempt income (col. A)	=	Expensed Investment (col. B)
$\$100 * (1-t) * (1+R)^n * (1-0)$	=	$\$100 * (1-0) * (1+R)^n * (1-t)$
Where \$100 is unit investment, t is tax rate, $(1+R)^n$ is compound growth at rate R over n, and (1-0) denotes no tax.		

The equivalence is an application of the commutative law of the multiplication, which says that it does not matter the order in which (1-t) and (1-0) appear. The equivalence of yield exemption and expensing is often called the Cary Brown thesis after its discoverer.<sup>5</sup>

The Column B model was set up to describe the portion of the investment qualifying as intangible drilling cost. Column (B), however, also describes the results of the pool of capital doctrine, or the results of a mixture of pool of capital doctrine and expensing of intangible drilling costs. The pool of capital doctrine, as discussed below, allows an enterprise to pay for goods and services put into a drilling venture by giving factor suppliers an economic interest in the well. If the supplier or royalty receiver is willing to take payment for value delivered in the form not of cash, but rather an interest in the outcome of the oil well, then there is no tax on the venture at row 2, before investment. Capitalized investments, under an income tax regime, requires a reduction by tax before the investment may be made (Row 2 of Column A, Table 1), but paying with untaxed interests allows enterprise to invest without tax (Row 2 of column (B)).

A corollary of the Cary Brown thesis is that you can deduce how much tax reduces the pretax interest or internal rate of return by looking to the ratio of adjusted basis to nontax fair market value.<sup>6</sup> Companies like Jet Blue and Macy's have a tax basis near or above their fair market value and thus they pay effective tax rates at or above statutory tax rates. Companies, including oil companies and software game development companies have a basis that is a small fraction of their value and so have modest effective tax rates. The impact of the differential real tax rates throughout the tax system is that tax warps the pretax value of an investment derived

<sup>4</sup> Effective tax rate =  $(IRR_{\text{pretax}} - IRR_{\text{post tax}}) / IRR_{\text{pretax}}$

<sup>5</sup> Cary Brown, *Business-Income Taxation and Investment Incentives*, in INCOME, EMPLOYMENT AND PUBLIC POLICY: ESSAYS IN HONOR OF ALVIN H. HANSON 300 (1948).

<sup>6</sup> Calvin H. Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles*, 121 TAX NOTES 1289 (2008). Briefly a soft money investment ("S")(eg in Col. (B) of Table 1) can be  $1/(1-T)$  the size of a capitalized investment ("H" for hard money), where T is the statutory tax rate. The effective tax rate is (pretax return – post tax return)/ pretax return or  $\{(H + S)*R - [H + S/(1 - T)] * R * (1-T)\} / (H + S)*R = H/(H+S)* T$   
H is basis and H+S is pretax value.

from real customer demand, and shifts investment to lower utility projects. The wide divergence in real tax rates, across the system, means that tax is damaging the allocation of capital unnecessarily.

### B. Finding Economic income.<sup>7</sup>

A tax system that imposed the same economic effective tax rate on all investments would reduce the harm that the tax system now does to the private economy. Investments decisions should be driven by the real demand and by costs outside of the tax system and not by differential tax treatment or tax accounting misdescriptions. “Effective tax rate” is as the measure of impact of tax on pretax internal rate of return:

$$\text{Effective tax rate} = (\text{IRR}_{\text{pretax}} - \text{IRR}_{\text{post tax}}) / \text{IRR}_{\text{pretax}},$$

where IRR stands for internal rate of return.<sup>8</sup> Internal rate of return is a universal yardstick for comparing diverse investments. It is the interest rate on a hypothetical bank account that is like the investment under examination. The impact of tax on that interest-like internal rate of return is measure of the real impact of tax, whatever the nature of the investment and whatever the manner or time of computation of the tax or the nominal, statutory tax rate. The formula for effective tax rate, above, asks how much tax has dropped the internal rate of return and then takes that drop as a percentage of the pretax internal rate of return. Imposing the same effective tax rate on investments across the economy prevents property from being worth more to high bracket taxpayers than low bracket taxpayers, and prevents tax from distorting the pre-tax choice of what is a good investment.

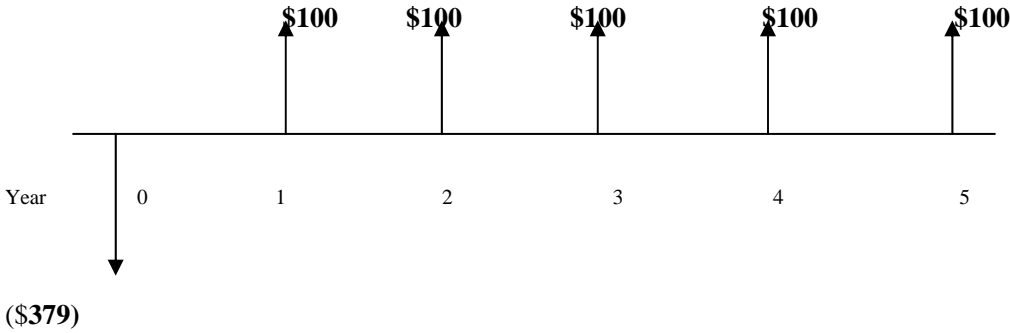
To impose a uniform effective tax rate, accounting must identify the interest-like internal rate of return from the investment and subject it to tax. If the tax accounting identifies the interest-like internal rate of return, it will simultaneously identify the amount that is like the bank account balance of that bank account that matches the investment under examination and will yield an adjusted basis for tax equal to that hypothetical bank account. Tax accounting identifying internal rate of return and bank account balance is forced, for instance, by our treatment of debt, which allows a deduction of interest and respect for the principal of the debt, which is the mirror image of treating the investment as a bank account. A neutral tax accounting that describes and taxes economic income would keep adjusted basis for an investment equal to the net present value of the investment, using internal rate of return as the discount rate to determined net present value.

Assume, for example, an oil and gas venture with cash flows set to give a 10% return over 5 years in absence of tax:

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<sup>7</sup> The section is based on Paul Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604 (1964).

<sup>8</sup> Effective tax is sometimes used to refer to total overall tax divided by overall income, in contrast to “marginal tax rate,” which looks to the tax on the next dollar of change in income.



The investment gives a 10% interest-like internal rate of return per year before tax, because the \$379 is the present value of the five \$100 cash flows at 10% under the standard formula for present value of an annuity:

$$(1) \quad \$379 = \$100 * \frac{1 - (1+10\%)^{-n}}{10\%}$$

using *i* (discount rate) of 10% and *n* (number of years) of 5.<sup>9</sup>

The Cary Brown thesis that expensing is equivalent to no tax reduction of the pretax return can be restated simply from equation (1) because expensing would both reduce the after tax cost of the \$379 investment by rate *T*, and tax would also reduce the \$100 revenue by *T*:

$$(2) \quad \$379 * (1-T) = \$100 * (1-T) * \frac{1 - (1+10\%)^{-n}}{10\%}$$

Equation (2), the expensing case, becomes identical to the pretax situation, equation (1), when the tax of  $(1-T)$  is factored out of both sides of equation (2). The return rate “*i*” is the same 10% both pretax (equation (1)) and post tax, (2).

If we are to tax the 10% return in the investment, by contrast, and reduce the interest by the statutory tax rate, we would need to identify the interest earned every period. Table 2, analyzes the illustrated investment as if it were a bank account, giving the 10% interest rate. All investments are measured as if they were bank accounts because that is the universal yardstick by which very diverse investments are measured. Interest on the bank account that is like the investment under examination is the internal rate of return from the investment and it is what we mean by income in the economic sense.

To identify the interest or internal rate of return, it is necessary simultaneously to identify the bank account balance on which the interest is calculated, and keep that balance as part of undeducted adjusted basis. Table 2 assumes an investment of \$379 in an oil and gas operation that returns pretax \$100 or 10% interest a year for five years.

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<sup>9</sup> The standard annuity formula is a short cut, derived by series analysis, from the separate discounting of each \$100 for different year, at the standard formula for present value, e.g.,  $\$100 / (1+i)^n$ .

Table 2. Economic Depreciation 5 Year, 10% Investment.						
	0	1	2	3	4	5
1. Revenue to give 10% IRR	(\$379)	\$100	\$100	\$100	\$100	\$100
2. Adjusted basis, also bank account balance, also net present value of future revenue at IRR	\$379	\$317	\$249	\$174	\$91	\$0
3. Interest at 10% on bank account (prior year row 2.), also income.		\$37.91	\$31.70	\$24.87	\$17.36	\$9.09
4. Withdrawal in excess of interest earned (a/k/a recovery of basis or depreciation) (row 1 minus rw 3.)		\$62.09	\$68.30	\$75.13	\$82.64	\$90.91
5. New bank account balance rw 2. minus rw 4.		\$317	\$249	\$174	\$91	\$0
6. Tax on rw 3 at 35%		\$13.27	\$11.09	\$8.70	\$6.07	\$3.18
7. After tax cash flow (rw 1.-6.)		\$86.73	\$88.91	\$91.30	\$93.93	\$96.82
7. Present value at found 6.5% {Rw 6./ $(1+6.5\%)^n$ }. Row 7. sums to zero @ 6.5%	-\$379.08	\$81.44	\$78.38	\$75.58	\$73.01	\$70.67

In Table 2, each year the bank account earns interest, at the built-in 10% interest rate (identified in row 3). But the interest is not enough to cover the withdrawals from the bank account, that is, the cash flow revenue in row 1, so some part of each withdrawal is reduction of the bank account balance by amount of row 4. The row 4 withdrawals in excess of interest reduce the bank account balance to zero at the end of the term. The bank account balance (row 2) is always net present value of remaining revenue at the 10% IRR. Depreciation or recovery of basis is the drop in the bank account balance shown by row 4. If we tax the interest income identified in row 2, at 35%, the tax system will reduce the IRR from 10% to  $10\% \times (1-35\%)$  or 6.5%, which is the right after tax income implied by a 35% tax on 10% interest income. The present values of the after cash flows (row 7) sum to zero showing that the investment, under the tax of row 6, is like a bank account giving IRR or interest of 6.5%. Different investments will have different row 1 pretax cash flows, but if the depreciation and adjusted basis describe the income from the investment, the adjusted basis will equal net present value of the future cash flows from the investment at the IRR.

The adjusted basis that will identify economic income (IRR) can be calculated from net present value where future cash flows are assumed, as in the illustration, or when there is a broad market that sets a market price using estimates of fundamental value like the Table 2 analysis. More generally, however, the future cannot be known. Tax accounting thus must use conventions approximating fair market value basis to be administrable on a national basis with low audit rates. Still, the theoretical norm of what tax accounting would look like if we did tax



the economic income provides a purpose or goal for tax accounting. Accounting rules and conventions that leave the taxpayer with an adjusted basis closer to net present value of future cash flows are more accurate than accounting rules and conventions that leave the adjusted basis further away from net present value. The pool of capital doctrine and intangible drilling expense fail to reflect economic income because they drop the taxpayer's basis in the investment before the net present value of future cash flows.

C. Combining subsidies: Negative Tax.

Investments in oil and gas can sometimes qualify not only for the upfront, soft money investing benefits of expensing and pool of capital doctrine, but also for subsequent exclusions of revenue under percentage depletion and domestic production allowances. As discussed below, section 613 allows independent oil companies to exclude 15% of revenues from oil, and section 199, allows taxpayers to exclude 6% of earnings from domestic oil and gas production. Assume the same pretax investment discussed in Table 2, but assume soft money investing at the outset and the exclusions for percentage depletion and domestic production.

Table 3. Internal rate of Return after Four Tax Preferences (IDC, Pool of Capital, Percentage Depletion and Domestic Production).							
year:	0	1	2	3	4	5	
1. Pretax cash flows, set up to give 10% IRR.	(\$379)	\$100	\$100	\$100	\$100	\$100	
2. less 15% depletion allowance		\$85	\$85	\$85	\$85	\$85	
3. less 6% of rw 2 for domestic manufacturing exclusion		\$80	\$80	\$80	\$80	\$80	
4. Tax on row 3. at 35%		\$28	\$28	\$28	\$28	\$28	
5. Expensing of row 1. saving tax at 35%	(\$133)						
6. After tax cash flow. {rw 1 less rw 4 or rw 5.}	(\$246)	\$72	\$72	\$72	\$72	\$72	
7. Present value at found 14.2 % IRR. {Row 6./ $(1+IRR)^n$ } Row 7. sums to zero at found 14.2% rate	(\$246)	\$63	\$55	\$48	\$42	\$37	<u>sum:</u> \$0

The after tax cash flows, in row 6, have an internal rate return of 14.2% because 14.2% will sum the net present value of all the cash flows to zero. The 14.2% is the interest on a bank account that could give the cash flows equal to those in row 6. Tax has improved the investment from 10% pretax to 14.2% after tax. The improvement is a negative tax or subsidy of 42% of the original income.

Table 3 is undoubtedly a temporary advantage because competitors will move in like yellow jackets to sweet drinks when the return rate is so high. In equilibrium, returns drop on investments in a competitive economy, so that they have an annual return after tax equal to the cost of capital. Assume some competitor can borrow at 10% (same as return rate) and deduct the

interest so that after tax cost of interest is  $10\% \times (1-35\%)$  or 6.5%. Table 4, following, shows that given the tax benefits, the competitor can make as little as \$87 a year or 4.9% return and still have enough to bear the costs of interest. The investment in Table 4 makes 4.9%, hence loses 51% of its real interest cost at 10% in absence of tax. Tax has given sufficient incentive to allow a wasteful investment, losing over half of its capital costs.

Table 4. Break even Pretax Cash Flows Given Four Tax Preferences (IDC, Pool of Capital, Percentage Depletion and Domestic Production).							
year:	0	1	2	3	4	5	
1. Pretax cash flows with a found revenue to yield enough to pay interest cost.	(\$379)	\$87	\$87	\$87	\$87	\$87	
2. less 15% depletion allowance		\$85	\$85	\$85	\$85	\$85	
3. less 6% of rw 2 for domestic manufacturing exclusion		\$80	\$80	\$80	\$80	\$80	
4. Tax on row 3. at 35%		\$28	\$28	\$28	\$28	\$28	
5. Expensing of row 1. saving tax at 35%	(\$133)						
6. After tax cash flow. {rw 1 less rws 4 & 5.}	(\$246)	\$72	\$72	\$72	\$72	\$72	
7. Present value at debt cost 6.5% IRR. {Row 6./ $(1+IRR)^n$ } Row 7. sums to zero at 6.5% discount rate	(\$246)	\$63	\$55	\$48	\$42	\$37	<u>sum:</u> \$0

The pretax cash flows in row 1 yield a return of only 4.9% annually.<sup>10</sup>

Allowing an investment like that shown in Table 4 wastes capital. The assumed cost of capital is 10% and the annual return at 4.9% wastes 51% of the cost. Absent showing of special merit in the budget process, a pretax money-losing investment is a bad investment that should not be made.

If the advantage of low tax or subsidy from the oil and gas preferences is passed on to customers, then customers get a false sense of the true costs of oil and they adapt to the falsely cheap prices by over-consuming oil. Cheap oil to consumers is especially dangerous now because we rely on foreign sources from dangerous parts of the globe for our oil,<sup>11</sup> and because

<sup>10</sup> The 4.9% is the discount rate that makes costs and revenues have the same future value, hence 4.9% is the internal rate of return from the investment

$$(1) \quad \$379 = \$87.24 * \frac{1 - (1+i)^{-n}}{i}$$

using  $i$  (discount rate) of 4.9% and  $n$  (number of years) of 5

<sup>11</sup> See, e.g. William M Vandenburg, *Raise Federal Tax Now or Pay OPEC Later*, 122 TAX NOTES 532 (Jan. 26, 2009) (arguing for increased tax on oil and gas to reduce dependence on foreign oil).

the over-consumption of oil contributes to global warming. Cheap oil undercuts conservation and the development of alternative energy sources. Consumers need to start now to adapt to the future when oil will become very expensive, because the adaptation will take considerable time.

If the subsidy from tax preferences for oil is not passed on to customers, then the subsidy just contributes to the net worth of taxpayers holding oil interests. Given the impending desperate revenue needs, a basic sense of fairness suggests that those with equal ability to pay tax should pay equal taxes whether they are in oil or in some other industry.

Ending the tax-preference subsidies to the extractive industries would improve the efficiency of consumer choices because prices will then reflect real, unsubsidized costs. In general in a capitalist system, the decisions reached by supply and demand and evidenced in unsubsidized price are presumed to represent the best decisions as to use of our limited resources. If Congress decides to subsidize oil and gas investments, it should do so only by way of a competitive budget for government spending.

### III. Proposed Reforms of Oil & Gas Tax Preferences.

This section describes the most important tax preferences available for oil and gas investments under current law, the reasons for change, and then describes the remedy proposed here.

#### A. Soft Money, Upfront Benefits.

##### 1. Intangible Drilling Cost.

Under current law, a taxpayer may deduct the costs of drilling for oil, as if it were a worthless or lost cost as soon as it is made, even when the drilling program is highly successful.<sup>12</sup> The deduction arises from a congressional resolution adopted to reverse a decision by the Fifth Circuit holding that intangible drilling costs were indeed investments and capital expenditures.<sup>13</sup> Costs eligible for expensing under section 263(c) must be costs that cannot be salvaged when the drilling is over.<sup>14</sup> An integrated oil company must reduce its expensed intangible drilling costs by 30% and amortize that 30% over five years.<sup>15</sup> In computing alternative minimum tax, the intangible drilling cost is amortized over five years.<sup>16</sup>

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<sup>12</sup> IRC §263(c).

<sup>13</sup> FHE Oil Co. v. Commissioner, 147 F.2d 1002 (5th Cir.) reh'g denied, 149 F.2d 238, second reh'g denied, 150 F.2d 857 (1945). See BORIS I. BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶26.1.1 (2009).

<sup>14</sup> Harper Oil Co. v. United States, 425 F.2d 1335 (10th Cir. 1970) (Blackmun, J.) (drilling casings held not intangible drilling cost); Standard Oil Co. v. Commissioner, 77 T.C. 349 (1981) (accord); Exxon Corp. v. United States, 547 F.2d 548 (Ct. Cl. 1977) (construction of offshore platforms held not intangible drilling cost).

<sup>15</sup> IRC §291(b).

<sup>16</sup> IRC §56(g)(4)(D)(1), §312(n)(2)(A).

Immediate expensing for an investment, as noted, means that tax does not reduce the pre-tax internal rate of return from the investment. Combined with other preferences the tax rate is negative or subsidy. The subsidy has never been subjected to a competitive budgeted process for government spending, which is the primary process by which government evaluates its costs. The deduction creates a tax expenditure estimated to be worth \$3.5 billion for 2007-2011.<sup>17</sup>

The price of oil provides the necessary incentive for oil and gas exploration. If the price is not sufficient to induce supply, the price will go up. In the impending revenue crises, the best source of revenue is the tax exempt and negative tax investments, such as those in oil and gas.

The proposed remedy would capitalize the costs of drilling for oil and allow recovery of the cost by cost depletion as the barrels of oil are extracted. Costs of an entire program would be capitalized, and recovered as oil from the entire program is extracted. Regulations would define the program unit, but the program needs to be defined as broadly as possible so that basis comes as close to value as possible. Costs of the entire program would be capitalized even if some of the wells within the program are dry. Costs would be recovered by cost depletion as oil from the program is extracted.

## 2. Pool of Capital doctrine.

Oil and gas ventures benefit from a low effective tax rate in part because they are able to pay many of the costs of the drilling without capitalizing their costs. As noted, the ability to make an investment out of untaxed soft money is a privilege ordinarily equivalent to zero tax on the investment profit. Under the pool of capital doctrine, a drilling enterprise may pay many of the costs of drilling by giving out an economic interest in the well, without either the enterprise or the provider of goods or services paying tax. In 1941, the IRS ruled that when the venture pays the landowner for the rights to explore and develop the deposit, pays the drillers, equipment suppliers, and the investors who contribute materials and services in connection with the development of a mineral property by giving them an economic interest in such property, the receipt of the economic interest does not result in realization of compensation or income. The contributors are viewed as not performing services for compensation or selling goods or inputs, but as making a contribution to a common pool and receiving an interest in that pool in return.<sup>18</sup> The venture is not considered to have disposed of assets of value by giving up the economic interest in the successful deposit. Absent the pool of capital doctrine, receipt of the interest in payment for goods and services would be ordinary income immediately, measured by the value of the interest.<sup>19</sup> Absent the pool of capital doctrine, the developer paying with a property interest would also need to recognize gain on the property transferred, measured by appreciation

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<sup>17</sup> JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES 2007-2011, (JCS 3-07) at 47.

<sup>18</sup> G.C.M. 22730, 1941-1 C.B. 214.

<sup>19</sup> The general rule is that a taxpayer who receives any oil interest as compensation must include the fair market value of the interest as ordinary income. See, e.g., *Leland J. Allen v. Commissioner*, 5 T.C. 1232 (1945) acq 1946-1 C.B. 1.

of its cost in the transferred asset over its value.<sup>20</sup> Under the pool of capital doctrine, paying with economic interests results in recognition to neither the transferor nor the recipient.

In 1971, the IRS ruled that the pool of capital doctrine was limited to services and capital related directly to the drill site for which an economic interest was given.<sup>21</sup> The tax planners responded by giving out profits interests in partnerships, called carried interests.<sup>22</sup> Giving partnership income interests continues the privileges of nonrecognition to both the transferor and recipient that was allowed under the pool of capital doctrine.<sup>23</sup>

To impose an income tax at the statutory tax rates on extractive industries, costs would have to be capitalized until the taxpayer's basis is equal to the fair market value of its investment, determined using internal rate of return as the discount rate to calculate future cash flows. "Income" in financial economics is the interest on a bank account that matches the investment under examination. An income tax can identify the interest from an investment, and reduce it by the statutory tax rate, only if the bank account balance of the bank account that describes the investment is equal to the taxpayer's adjusted basis. Alternatively stated, a tax system can reduce an investment's pretax income by the statutory tax rate if and only if the taxpayer has an adjusted basis at the end of each year equal to the value of the investment.<sup>24</sup>

The remedy proposed here would be to treat the exchange of economic interests for goods, services and for the right to drill as taxable to both sides, so that adjusted basis of the investment reaches its value. Paying for royalties, goods and services with carried interests should be considered to be a taxable exchange of the underlying assets. Treating the exchange of goods and services for oil interests as taxable is a reform that needs to be extended outside of the oil industry into the imitators who picked up the carried interest idea from the oil patch. But the nontaxation of paying for necessary goods and services started in the oil patch and it can be fixed first in the oil patch.

### 3. Working Interest Exemption from Passive Activity Loss Limitations.

The Tax Reform Act of 1986 was a treaty across the aisle to reduce tax rates and end tax shelters as they were then known. Both in reducing rates and attacking shelters, the Act

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<sup>20</sup> Rev. Rul. 83-46, 1983-1 C.B. 16; Rev. Rul. 77-176, 1977-1 C.B. 77.

<sup>21</sup> Rev. Rul. 77-176, 1977-1 C.B. 77.

<sup>22</sup> Frank M. Burke, Jr., *Oil and Gas Taxation from 1972 to 1992: A Study in Questionable Tax Policy and Administration*, 57 TAX NOTES 871 (Nov. 12, 1992).

<sup>23</sup> Rev. Proc. 2001-43; 2001-2 C.B. 191 (transfer of a profits interest for services is taxable to neither new partner nor partnership); Notice 2005-43; 2005-24 I.R.B. 1221 (saying that IRS intends to issue proposed regulations that will exempt receipt of partnership interest if the recipient would receive nothing in liquidation if the partnership were liquidated immediately).

<sup>24</sup> The argument arises from Paul Samuelson, *Tax Deductibility of Economic Depreciation to Insure Invariant Valuations*, 72 J. POL. ECON. 604 (1964). *See.e.g.*, Calvin H. Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles*, 121 TAX NOTES 1289 (Dec. 15, 2008), <http://www.utexas.edu/law/faculty/calvinjohnson/effective-tax-ration.pdf>].

improved the economic efficiency of the tax system. The Tax Reform Act of 1986 would not have been able to reduce maximum tax rates from 50% to 28%, except because the passive activity loss (“PAL”) limitations of new section 469 of the Code so effectively contained the use of the artificial accounting losses in tax shelters.<sup>25</sup> The PAL limitations suspend losses from an activity outside the taxpayer’s normal business until the taxpayer reports gain from that and similar activities or until the taxpayer abandons the investment so that the cash in and out can be totaled without relying on artificial accounting. The rule is based upon skepticism that normal accounting rules are able to ensure that losses are not artificial. If, however, the taxpayer “materially participates” in the activity, spending more than roughly a quarter of a full time working year on the activity, then the activity is no longer considered to be a “passive activity” subject to the PAL limitations.<sup>26</sup>

On enactment in 1986, Congress gave an exemption from the PAL limitations to working interests in oil and gas.<sup>27</sup> A working interest qualifying for the exemption must be burdened with the obligation to share in the expenses of drilling and operations of the oil and gas extraction.<sup>28</sup> The investment vehicle must be a general partnership or co-venture that does not limit the liability of the taxpayer.<sup>29</sup> Under the working interest exemption, the taxpayer may use the artificial losses generated by the intangible drilling costs without putting in any of the time that material participation would need. The exemption allows outsiders with income they need to shelter, but without any oil mud on their hands, to buy into the artificial losses from oil and gas.

Tax accounting in the oil and gas area, as illustrated, can generate artificial loss deductions even for ventures that are in fact profitable. The PAL limitations remain the most effective over-riding limitations on the use of artificial accounting losses. The PAL limitations are not draconian: They allow losses to be used against the first income from any passive activity including unrelated projects. The PAL limitations also allow all losses proved up by counting cash at the end of the transaction to be deducted against salary and other normal sources of income. The limitations are neither draconian nor are they pure of theory, but they have unexpectedly effective for the last 23 years. The exemption from PALs for working interests was never consistent with the necessary rationale for PAL limitations. It is proposed to repeal section 469(c)(3) so that oil and gas working interests would be subject to the normal PAL limitations rules.

#### 4. Rapid Write-offs for Geological and Geophysical Costs.

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<sup>25</sup> See, e.g., Calvin H. Johnson, *Why Have Anti-Tax Shelter Legislation?*, 67 TEXAS L. REV. 591 (1989).

<sup>26</sup> Treasury Reg. § 1.469-5T(a)(1).

<sup>27</sup> IRC §469(c)(3)

<sup>28</sup> STAFF OF THE JT COMM. ON TAXATION, GEN. EXPLANATION OF THE TAX REFORM ACT OF 1986, at 251 (1987).

<sup>29</sup> *Id.*

Under current law, a taxpayer may write off the geological and geophysical (“G&G”) costs of identifying promising properties over two years.<sup>30</sup> The large integrated oil companies, however, must write off G&G costs over seven years. As a matter of economics, however, the deposits located by the G&G costs can last for 30 years. Using a 3 year straight line depreciation schedule for a G&G investment on that assumption that it lasts for 30 years means that the effective tax rate (IRR-reducing tax) for the G&G investment drops from the normal 35% down to 9.45%.<sup>31</sup> Using a 7 year straight line schedule for G&G costs that last 30 years reduces the effective tax rate from 35% statutory tax rate down to 15.4%.<sup>32</sup> In combination with other benefits accorded to oil and gas, the short amortization schedules contribute to an increase in the negative tax subsidy inappropriately awarded to oil and gas.

Under the proposal, geological and geophysical costs would be allocated to the deposits of oil and gas successfully discovered by the taxpayer and affiliates over the following three years, according to the relative size of the proven reserves. No deduction would be allowed for the three years after the geological and geophysical costs are incurred, and the costs would allocated to proven reserves of oil at that time. The point of exploration costs is not the dry wells, although they happen, but rather the successful wells. An exploratory or wild cat program might hit oil in only one out of 10 drillings and yet the costs are well justified by the deposits that

<sup>30</sup> IRC § 167(h)(1).

<sup>31</sup> The following spreadsheet assumes a \$100 investment that gives annuity with 10% return over 30 years (row 1). The columns for years 5 through 29 are dropped out of the presentation but they are identical to the column for year 4 (except for present value).

Impact of 3-year Amortization on Effective tax Rate						
year:	0	1	2	3	4 ...	30
1. Pretax cash flows, set up to give 10% IRR.	(\$100)	\$10.61	\$10.61	\$10.61	\$10.61	\$10.61
2. less amortization of cost over three years		(\$33.33)	(\$33.33)	(\$33.33)	0	0
3 Taxable income		(\$22.73)	(\$22.73)	(\$22.73)	\$10.61	\$10.61
4. Tax on row 3. at 35%		(\$7.95)	(\$7.95)	(\$7.95)	\$3.71	\$3.71
6. After tax cash flow. {rw1 less rws 4}	(\$100)	\$18.56	\$18.56	\$18.56	\$6.90	\$6.90
7. . Present value at found 9.05% IRR. Sum=0.	(\$100)	\$17.02	\$15.61	\$14.31	\$4.87	\$0.51

The present values in row 7 sum to zero, proving that 9.05% is the after tax discount rate on the investment. The statutory tax rate (row 4) is 35%, but a tax that reduces the internal rate of return from 10% to 9.05% has an effective tax rate of  $(IRR_{\text{pretax}} - IRR_{\text{post-tax}})/IRR_{\text{pretax}}$  or here,  $(10\% - 9.05\%)/10\%$  or  $0.95\%/10\%$  or 9.5%). The logic is the same as shown in, *supra*, Table 3.

<sup>32</sup> The spreadsheet like that in *supra* note 31, but for 7 year amortization, allows \$14.29 deduction in row 2 for seven years, rather than \$33.33 for three years. The found return after tax is 8.46%, which represents a 15.4% reduction in IRR from the given pretax 10%.

are found. The costs allocated to a deposit would be recovered by cost depletion which allows the recovery as barrels are extracted.

A simplification would be to allow the taxpayer to elect to recover the costs over 50 years or 2% of geological and geophysical costs per year. This is a longer period than the deposits found might well last, but taxpayers should be able to achieve simplicity as long as simplification is achieved without shifting the tax burden onto other taxpayers.

## B. Unwarranted Exclusions.

### 1. Percentage Depletion Allowance.

Under the percentage depletion allowance, the holder of an economic interest in oil may exclude from tax 15% of its revenue from the extraction of oil. Percentage depletion is disguised as a means for recovery of capital, but the exclusion depends on revenue not cost or basis, and the 15% percent exclusion continues even after all the taxpayer's basis has been fully recovered. Moreover, in oil and gas drilling, the taxpayer's basis in the economic interest for which percentage depletion is allowed has commonly already been fully recovered or mostly recovered because of prior expensing of intangible drilling costs, pool of capital doctrine and short period amortization. Percentage depletion is commonly a double deduction of costs already deducted. Farmers and ranchers rarely have any basis for recovery against their royalty incomes because their cost of land can be allocated against royalties only if they bought the land knowing of and paying for the oil deposits.<sup>33</sup> Service providers who receive interests not taxed under the pool of capital doctrine have no basis in the economic interest they receive for their services. A 15% exclusion would not be a generous rule if tax basis reflected the true cost of drilling,<sup>34</sup> but a continuing 15% exclusion is important part of the negative tax subsidy for oil extraction because of the already low basis and because the exclusion continues after basis has been fully recovered.

The percentage depletion allowance arose out of an early misperception that the "capital" that had to be recovered to calculate income was the discovery value of an oil deposit rather than its cost. Senator David Reed of Pennsylvania was the floor manager of the 1925 act that created percentage depletion, and he argued on the floor of the Senate on behalf of percentage depletion that if "[I discovered a gold mine, basing depletion on cost] would not allow me an adequate return on my 'real capital.'" <sup>35</sup> "Real capital" meant to Reed, the extraordinary value of the gold mine when discovered, not the invested costs in the gold mine. Reed's error also fit within an existing conceptual framework early in the income tax, under which it was commonly thought that to compute income, one had to subtract the *value* of property as of the commencement of the period under consideration, rather than just its cost.<sup>36</sup> In fact to reflect

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<sup>33</sup> See, e.g., *Plow Realty Co. v. Commissioner*, 4 T.C. 600 (1945).

<sup>34</sup> On one set of assumptions, cost depletion would be better than percentage depletion if basis equaled all investment costs, only if the deposit lasted for more than almost 67 years. Calvin H. Johnson, *Percentage Depletion of Imaginary Costs*, 122 TAX NOTES 1619, 1623 (Mar. 30, 2009)

<sup>35</sup> 67 CONG. REC. 3766 (Sen. David Reed, R. Pa.).

<sup>36</sup> Calvin H. Johnson, *supra* note 31, at 1620-21.



income, only costs need to be subtracted. Percentage depletion in excess of cost allows deductions for imaginary costs. One should not be confident of the wisdom of congressional engineering when the decision to allow percentage depletion was based upon erroneous understanding of “capital” and upon imaginary costs.

The OPEC oil embargo of the 1970s quadrupled oil prices, and Congress in reaction restricted access to percentage depletion. Since 1975, the integrated oil companies that refine and retail oil must use cost depletion, which is a sensible accounting method that reasonably allocates costs to the related revenue as oil and gas are extracted. Percentage depletion is also not available for foreign production.<sup>37</sup> Independent domestic oil drilling, however, continues to be able to use percentage depletion, up to a level, now at about \$24 million per taxpayer per year.<sup>38</sup>

The proposal would amend section 612, which authorizes depletion, to limit total depletion deductions, whether under percentage or cost depletion, to the taxpayer’s adjusted basis. Percentage depletion in excess of cost are no more justified for minerals other than oil and gas, so the proposal would affect all depletion allowances, not just oil and gas.

## 2. Exclusion as to Domestic Manufacturing.

Current law allows a deduction of 6% of income from domestic oil and gas production.<sup>39</sup> While the deduction is 6% in 2009, it is scheduled to rise to 9% of domestic income in 2010.<sup>40</sup> The deduction is limited to taxable income in the year and so does not carryover to past or future tax years. The deduction is also limited to 50% of the domestic wages reported on W-2 forms,<sup>41</sup> but that ceiling is primarily of symbolic value, because it will come into play only if domestic wages are under roughly 1.2% of total costs.<sup>42</sup>

The deduction of 6-9% of domestic production contributes the negative tax subsidy accorded to oil and gas. The market price of oil will give sufficient incentive to the production of oil because it always meets supply at the market clearing price. If more incentive is needed, price will increase. The increase in price will give incentives to conservation of fuel and alternative non-fossil energy sources. Government should get out of the job of oil and gas

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<sup>37</sup> Tax Reduction Act of 1975, P.L. 94-12, § 501, 89 Stat. 36.

<sup>38</sup> IRC § 613A(c) (exemption) and (c)(3) (limitation of exemption to 1,000 barrels a day or 365,000 barrels a year). At \$75 per barrel for oil, the exemption allows the full 15 percent percentage depletion on up to \$24million in revenue per year.

<sup>39</sup> IRC §199(a)(2).

<sup>40</sup> IRC §199(a)(1)(A).

<sup>41</sup> IRC §199(b).

<sup>42</sup> For example assume a 10% income per year, so that \$100 will produce \$10 income. The 6% of income exclusion is 60 cents. If the taxpayer pays domestic wages reported on W-2 form of \$1.20, the ceiling of half of domestic wages will allow the full 60 cents to be deducted. The \$1.20 is only 1.2% of the \$100 invested cost.

subsidies because it gives incentive to waste of capital on investments that cannot be justified in absence of a subsidy.

Subsidy of domestic production, moreover, means that we drain domestic supply before we use cheaper oil overseas. A smart program on homeland security would punish domestic production to preserve domestic supply for some future emergency and use cheaper overseas oil while is available to us.

The proposal would end the section 199 deduction for domestic oil and gas production.

### 3. Repeal LIFO inventory accounting for oil and gas.

Inventory accounting allows the deduction of the cost of units that have been sold or lost by the taxpayer, but not the costs of units taxpayer retains on hand at the end of the year. Whether the costs are still in basis or are sold or lost deductible costs is determined by counting the units still on hand in closing inventory.

Oil and gas units extracted or bought at different times have different costs, but since the units are fungible, it makes no difference outside of the accounting whether the taxpayer is considered to have sold the old cheap units or kept the oldest and cheapest units. Costs are assigned by an arbitrary ordering convention, usually FIFO or LIFO.

The First In First Out ("FIFO") convention treats the oldest costs as sold first, so that there are no old costs are left in closing inventory. FIFO accounts leave the basis of the closing inventory at levels approximately equal to the current market value that it would take to replace the inventory.

The Last In- First Out ("LIFO") convention, by contrast, identifies the most recent, usually higher costs with the units that are sold and deductible and identifies the lowest costs with the units that have been retained and remain as nondeductible basis. LIFO maximizes unrealized appreciation, and minimizes tax, often quite dramatically.

A taxpayer that employs LIFO carries its closing inventory at the cost of units of the oldest purchases, starting when taxpayer first adopted inventory accounting and adopted the LIFO convention. If, for instance the taxpayer started a business 50 years ago in 1959, it would carry its oldest inventory at \$3 a barrel (the 1959 price), notwithstanding that the taxpayer is now selling oil at \$72 a barrel.<sup>43</sup> The \$69 difference is treated as unrealized appreciation and not taxed until the taxpayer shrinks its inventory to use up the last of the old costs. Shrinking inventory back to oldest price will happen only when the corporate taxpayer is contracting at the end of its life. Avoiding tax on the \$69 appreciation is the point of LIFO convention. LIFO has no nontax purpose.

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<sup>43</sup> For 1959 price, Financial Trend Forecaster, [http://www.inflationdata.com/inflation/Inflation\\_Rate/Historical\\_Oil\\_Prices\\_Table.asp](http://www.inflationdata.com/inflation/Inflation_Rate/Historical_Oil_Prices_Table.asp). For current price <http://www.bloomberg.com/energy/> (accessed Aug. 25, 2009).

Notwithstanding the LIFO convention, the oil firms have long ago pushed 1959 oil out of their system and they have no 1959 oil left. They sold their \$3 oil for cash and realized their accession to wealth that resulted from the increase in real prices. Accession to wealth turned into cash would normally be taxed. For a firm, for instance, with \$10 billion in oil and gas inventory the difference between LIFO and FIFO ordering convention is material. One estimate put the difference between LIFO and FIFO for publically traded companies at \$600 billion of taxable income.<sup>44</sup>

The function of LIFO is said to be used to adjust for inflation so that that fictive inflationary gains are not taxed.<sup>45</sup> Inflation is mostly just an excuse in LIFO for oil and gas because oil and gas has benefited from such real price improvements in realized wealth. The 1959, \$3 price, for example, would be adjusted to \$20.22 to account for inflation,<sup>46</sup> leading to an exclusion of \$17.22, not an exclusion of \$69, which is actually allowed. Oil and gas have had real increases in value since 1959, to the extent of 75% of the gain. The LIFO convention excludes real gains from tax, on the basis of the argument that 25% of the gain is inflation caused.

Inflation, moreover, cannot coherently be adjusted for some kinds of investments but not others without creating distortions in the allocation of resources. Interest deductions, moreover, must symmetrically be taken away to the extent the interest just offsets inflation; to the extent of inflation, interest paid is not even a cost. Inflation exclusions for assets without adjustment as to liabilities creates artificial losses in the tax accounting.

As noted, moreover, tax accounting can identify the real interest from an investment, and make the economic effective tax rate equal to the statutory tax rate only if the adjusted basis for assets is equal to the present value of the assets.<sup>47</sup> Reporting basis – the bank account -- at 3/72 or 4% of its real value is tantamount to an effective tax rate that is only 4% of the statutory tax rate.<sup>48</sup> No justification has ever been offered for tax rates on oil gain that is that trivial a percentage of the statutory tax rate.

The proposal would require additions to closing inventory be calculated by the current replacement cost of oil and gas. Existing inventory would also be restated at current fair market value prices, but the gain on existing inventory, so long delayed already, would be brought into income over four years.

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<sup>44</sup> Edward Kleinbard, et. al. *Is it Time to Liquidate LIFO*, 113 TAX NOTES 237 (Oct. 16, 2006).

<sup>45</sup> See, e.g., *Amity Leather Products Co. v. Commissioner*, 82 T.C. 726, 732 (1984); *Hamilton Industries, Inc. v. Commissioner*, 97 T.C. 120, 130 (1991).

<sup>46</sup> Financial Trend Forecaster, [http://www.inflationdata.com/inflation/Inflation\\_Rate/Historical\\_Oil\\_Prices\\_Table.asp](http://www.inflationdata.com/inflation/Inflation_Rate/Historical_Oil_Prices_Table.asp)

<sup>47</sup> Section IIB. Finding Economic Income, text after *supra* note 5.

<sup>48</sup> Calvin H. Johnson, *The Effective Tax Ratio and the Undertaxation of Intangibles*, 121 TAX NOTES 1289 (Dec. 15, 2008).

### C. Repeal the Tax Credits Made.

Congress has in recent years provided two subsidies for oil drilling for special cases where it was perceived that market price alone might not provide sufficient incentive. In 1990 Congress enacted a 15% tax credit giving subsidy for enhanced oil recovery techniques, including preparation of Alaska natural gas, and the injections of various liquids into the deposit to help extract oil.<sup>49</sup> In 2004, Congress enacted a tax credit of \$3 subsidy per barrel of oil for marginal wells.<sup>50</sup>

Both credits disappear when the market price is high enough to give sufficient incentive to undertake the higher cost drilling. The enhanced recovery credit is phased out over a \$6 per barrel range when the price of oil exceeds a threshold originally set at \$34 per barrel,<sup>51</sup> but with inflation adjustments now at \$41 per barrel.<sup>52</sup> With oil now at \$72 a barrel,<sup>53</sup> the enhanced recovery credit is now unavailable. The marginal well credit has never been available because the price of oil shot up above its phase out level before it could come into effect.<sup>54</sup>

The price of oil provides a sufficient free-market incentive to explore for and extract oil and gas, not just when the price exceeds the phase out line for marginal wells and enhanced recovery, but in every case. No further subsidy is needed beyond the wisdom of supply and demand.

The tax credits were never a good idea even when they were available. The decision making process for tax credits and other tax expenditures is not good enough.<sup>55</sup> Congress apparently does not consider the money in tax expenditures for oil and gas to be real money.

### IV. Conclusion.

Congress needs to adopt best tax accounting practices for oil and gas that will make taxable income describe real economic income. To make tax accounting for oil and gas investments describe economic income, it is proposed that Congress repeal (1) the intangible

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<sup>49</sup> IRC §43 added by Omnibus Budget Reconciliation Act of 1990, P.L. 101-508 §11511.

<sup>50</sup> IRC §45I added by American Jobs Creation Act of 2004, P.L. 108-357 §341

<sup>51</sup> IRC §43(b)(1) .

<sup>52</sup> U.S. TREASURY DEP'T., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 60 (May 2009).

<sup>53</sup> <http://www.bloomberg.com/energy/> (accessed Aug. 25, 2009)

<sup>54</sup> U.S. TREASURY DEP'T., GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2010 REVENUE PROPOSALS 60 (May 2009). IRC §45I(b)(2)(A) set the phase out to begin at \$18 but with inflation adjustments.

<sup>55</sup> For a recent criticism of the decision making process with respect to tax subsidies, see Edward Kleinbard, *How Tax Expenditures Distort our Budget and Our Political Processes*, 123 TAX NOTES 925 (May 18, 2009).

drilling expense deduction (2), the pool of capital doctrine, and (3) the exemption from passive activity loss limitations for working oil and gas interests. Congress should (4) limit percentage depletion to basis, (5) repeal the domestic production exclusion, (6) allow recovery of geological and geophysical costs under cost depletion, (7) repeal LIFO for oil and gas inventories, and (8) repeal the enhanced oil recovery and marginal wells tax credits.

The government should get out of the business of giving tax preferences for oil and gas investments. The free market laws of supply and demand will give all the incentives that are needed.

\* \* \*

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