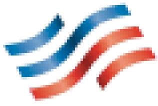

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April 15, 2015

The Honorable Orrin G. Hatch
Chairman
Committee on Finance
United States Senate
Washington, D.C. 20510

The Honorable Ron Wyden
Ranking Member
Committee on Finance
United States Senate
Washington, D.C. 20510

RE: AFPM's Comments to the Business Income Tax Working Group with the Senate Committee on Finance

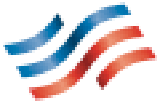
Dear Chairman Hatch and Ranking Member Wyden:

As the Senate Committee on Finance and the Tax Reform Working Groups explore modernizing the tax code, the American Fuel & Petrochemical Manufacturers (AFPM) supports reforms that will make all U.S. businesses more competitive, generate investment and economic growth in America, and most importantly, create good paying U.S. jobs. We believe these should be the key policy objectives for U.S. tax reform.

AFPM is a trade association representing high-tech American manufacturers of virtually the entire U.S. supply of gasoline, diesel, jet fuel, other fuels and home heating oil, as well as the petrochemicals used as building blocks for thousands of products vital to everyday life. AFPM's members operate in a highly competitive international market, where fractions of a penny on a per gallon basis can mean the difference between a refinery continuing operations or shuttering its doors.

In general, fuel and petrochemical manufacturing are capital intensive industries. Tax changes that enhance our ability to recover capital costs will result in more investment, more economic activity and more jobs in the U.S. Conversely, tax changes that increase our cost of capital or the costs of holding inventories will result in less investment, less growth and fewer domestic jobs. Tax policies that increase the costs of production will only make imported fuel and petrochemicals more attractive and U.S. exports less competitive. The result will be the loss of high-paying manufacturing jobs to other nations. Furthermore, an increased tax burden means increased pressure on the costs for the fuels and products AFPM members produce for all Americans, every day.

AFPM members already operate in a highly competitive marketplace and face significant challenges as a result of an increasing number of government regulations and mandates on the industry. Reducing the effective tax rate and regulatory burdens on U.S. refiners and petrochemical manufacturers, and all other domestic manufacturers, should be the touchstone of



U.S. tax reform efforts, as these changes will promote investment and high-quality, high-paying domestic jobs. AFPM supports a lower statutory tax rate, but it is important that overall efforts to simplify the tax code and reduce the statutory rate do not eliminate important and effective cost recovery measures that are critical to fuel and petrochemical manufacturers. Raising the tax burden on U.S. fuel manufacturers would only exacerbate the many challenges they face and potentially increase costs to U.S. consumers. Furthermore, such changes would not generate the economic growth, investment and jobs in the U.S that are the ultimate goals of tax reform.

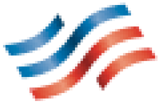
In addition to lower statutory and effective rates, AFPM also supports tax reform that produces a fairer, simpler tax code that does not pick winners or losers. At the same time, AFPM cautions against indiscriminate use of "base-broadeners" to achieve a lower statutory tax rate if the result is a higher effective tax rate on American manufacturers.

AFPM encourages policymakers to consider the impacts on domestic manufacturing jobs and investments, when considering base-broadeners and rate reduction in comprehensive tax reform. AFPM further requests that policymakers consider whether prior constraints/trade-offs are consistent with tax reform that would generate overall economic growth, investment and jobs. In particular, AFPM would like to point out the importance of the following tax code provisions in preserving such policy goals for U.S. fuel and petrochemical manufacturers:

"Last-In, First-Out" (LIFO)

LIFO is a 76-year-old GAAP-approved inventory accounting system used by an estimated 36 to 40 percent of all American businesses, including but not limited to manufacturers, wholesalers, retailers, and automobile and equipment dealers. LIFO does not meet the basic statutory definition of a tax expenditure. LIFO is commonly used to determine both financial and taxable income when companies anticipate inflation or rising prices of their inventory over the course of their operations. For refiners and petrochemical facilities, it is the most effective method of cost recovery that allows them to account for replacement costs, particularly as the cost of crude oil increases. However, LIFO is designed to react to price fluctuations and has a built in "toggle switch" that triggers tax when prices go down. The recent drop in crude oil is a good example of how this works. The significant drop in crude oil prices over the past year has cut the LIFO reserves of oil and gas companies. The significant drop in crude oil prices over the past year has cut the LIFO reserves of oil and gas companies. Generally, in this declining price environment, the tax deductions resulting from the cost of inventory sold under the LIFO method could significantly increase the tax paid by LIFO method taxpayers compared to FIFO method taxpayers for equivalent sales.

A repeal of LIFO accounting for all taxpayers would amount to a multi-billion dollar tax penalty that would redefine the value of inventory on hand, resulting in a massive, retroactive tax on such inventory. Refineries keep large inventories in order to avoid product supply shortages that could lead to price spikes for consumers and keep an even flow of crude costs. Repealing LIFO would require companies to redirect cash or sell assets in order to cover the tax payment,



potentially devastating businesses and American jobs. There is no justification to enact a retroactive tax on American businesses and because LIFO is an accepted financial accounting method, AFPM believes that it should not be considered during comprehensive tax reform discussions.

Accelerated Depreciation

The U.S. tax code allows for the use of several cost recovery methods for businesses, known as depreciation. American manufacturers use accelerated depreciation through the Modified Accelerated Cost Recovery System (MACRS), which helps mitigate the harmful effects on businesses after-tax cost of investing in machinery and equipment needed to expand and grow their operations. Accelerated depreciation is especially important to fuel and petrochemical manufacturers who must invest billions of dollars in equipment for general operations and face a barrage of environmental regulations which require the addition of costly equipment. In an increasingly uncertain economy, where market demand and production costs can shift quickly, the rapid cash payback from MACRS depreciation substantially reduces the risk premium and hurdle rate to make new investments attractive.

Recent tax reform discussions have focused on the potential repeal of MACRS, and replacing it with a longer depreciation rate as a way to finance a reduction in the corporate tax rate. However, it is important to note that the ten-year budget window fails to accurately depict the consequences of using the repeal of accelerated depreciation as a long term revenue offset. According to a recent Quantria Strategies study, modifications to the depreciation rules may decrease deductions during the 10-year budget window, and thereby increase revenues during that period. However, those deductions will be available, and taken, beyond the budget window; therefore, these deferred deductions simply reduce revenues in future budget periods. In addition, accelerated depreciation plays an important role in stimulating investment and economic growth. Loss of these provisions would ultimately reduce the amount of new investment in the U.S. and result in lost jobs. [1]

Master Limited Partnerships (MLPs)

The Publicly Traded Partnerships (PTPs) which engage in active businesses, primarily in the energy industry, are commonly known as Master Limited Partnerships (MLPs). The MLP structure has been relied upon by the refining and petrochemical industries for over 30 years and has been extremely successful at encouraging investment in domestic energy infrastructure. MLP assets currently include over 400,000 miles of pipeline and are responsible for investing more than $193 billion in energy infrastructure since 2007 (including 2015 estimates).

MLPs do not pay corporate taxes; instead MLP income flows through and is taxed at the unitholder, or limited partner, level. The President's FY2016 budget proposal, as well as past

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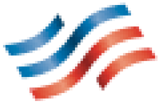
[1] Quantria Strategies study "Long-Run Revenue Effects of Changes in Cost Recovery Allowances"



proposals from some Members of Congress, has considered taxing these pass-through entities more like corporations. MLPs are extremely successful at encouraging investment in domestic energy infrastructure at levels that otherwise may not occur, as this level of investment allows for easier access to capital at a lower cost. The capital intensive nature of building and maintaining energy infrastructure projects that is somewhat ameliorated by the lower cost of equity capital associated with PTPs should not be discounted. We ask that the Committee retain the current treatment of PTPs within the Code.

Section 199

The American Jobs Creation Act of 2004 contains the "Section 199 Domestic Production Activities Deduction," often referred to as the "domestic manufacturing deduction." The Section 199 deduction applies broadly to income from property "manufactured, produced, grown, or extracted by the taxpayer" in the U.S., and further applies to qualified films, electricity, natural gas, or potable water produced in the U.S. and construction of real property in the U.S., including associated engineering or architectural services (see I.R.C. Section 199(c)). It provides needed tax relief for domestic production activities of all kinds, which support middle class jobs, including support to help stimulate domestic manufacturing activity. Petroleum refining and the production of domestic oil and natural gas resources are one of many sectors eligible for this credit, which incentivizes the expansion of U.S. refining capacity, energy supplies, and infrastructure. The deduction is needed to keep American fuel and petrochemical manufacturers competitive in an increasingly tough global marketplace. Since 2010, the oil and gas industry has received a discriminatory smaller deduction (6 percent) than every other manufacturer or producer (9 percent), including Hollywood film producers. This discrimination should be eliminated in any tax reform.

AFPM appreciates your consideration of our views. Please contact Lauren Sheehan, Manager of Government Relations, with any questions. She can be reached at lsheehan@afpm.org or 202-552-8487.

Sincerely,

Charles T. Drevna