

Energy and Taxes

Economic Growth and Tax Fairness



America's Oil and Natural Gas Industry

January 2017

For the latest report, please visit

<http://www.api.org/oil-and-natural-gas/energy-primers/energy-and-taxes> or

<http://www.energyandtaxes.com/>



Economic Growth and Tax Fairness

Working for All Americans.....	Page 1
Getting Tax Reform Right.....	Page 2
What the Tax	Page 3
Cost Recovery – A Pro Growth Tax Policy	Page 4
What Americans Are Thinking.....	Page 5
ONG and Other Industries	Page 6
Individual Impacts.....	Page 7



Affordable and available energy benefits consumers and supports a wide range of jobs for everyday Americans. Given the reliance of the U.S. economy on energy, tax policy targeting one type of energy, especially increasing its overall tax burden, over another puts the government into the marketplace and creates negative impacts and other unintended effects.

The goal of any well-structured tax system should be to raise revenue in a way that does the least amount of economic harm, while encouraging domestic investment and job creation, and allowing taxpayers to compete internationally for new opportunities. To achieve these goals, tax rules should not discriminate and should provide a level playing field for taxpayers engaged in similar activities.

Tax policy focusing on select energy investments or for limited periods, on the other hand, creates inefficient capital investment and confusion. Discouraging investment in the oil and gas industry could substantially undermine our economy, security and job creation – particularly good-paying job opportunities for minorities

and women that studies have shown are available. African American and Hispanic workers are projected to account for close to 25 percent of new hires in management, business and financial jobs through 2035. Of the women projected to be hired by the industry, more than half are expected to fill management and professional occupations.

“Energy production and lower consumer costs are best served by innovation and entrepreneurship; government should not pick winners and losers through the tax code or technological mandates.”

Getting Tax Reform Right



Recently, concerns have grown about the current U.S. tax system's impact on our competitiveness in an increasingly global economy. This has led to calls for reform, but beyond just doing something, it is important to do the right thing. Any tax reform should be based on commonsense, transparent policies, and tax rates should be lowered to support a tax structure that promotes investment and is competitive with other major trading partners.

Any tax reform will significantly impact how businesses look at the economics of their investments and any new tax rules that affect America's oil and natural gas industry could directly impact the amount of energy that is produced and supplied to the economy. It is critically important that any tax reform must be pro-growth and pro-job creation.

Since oil and natural gas reserves are depleting resources, substantial investments must be made on a recurring and continuous basis, and a stable and predictable cash flow is critical to the economics supporting U.S. projects. Oil and natural gas exploration and drilling investment analysis is very similar to the investments made by companies with a heavy concentration of research and development, where the technologies of tomorrow must be funded by the successes of today.

Therefore, any new pro-growth, pro-jobs tax system must incorporate competitive and robust capital cost recovery provisions that take both risk and economic development goals into account. While a lower statutory rate will likely impact the after-tax cash flow of all investments, when it comes to oil and natural gas there is not an exact "trade-off" between a lower corporate tax rate and the lengthening of cost recovery periods. Economy wide, a reduced tax rate can benefit existing investments (such as production from a factory already in place), but that lower rate may not provide for the continued after-tax cash flow necessary to drive new investments and projected reinvestments. This is especially true if the capital cost recovery rules are significantly changed in the tax reform process.

Energy is the foundation for our economy and standard of living, and oil and natural gas provide the majority of the energy that American's depend on every day – at home and at work. All industries will be impacted by any tax reform effort. But it is imperative that any new tax system not specifically target any one industry over another for additional tax benefits, burdens or costs. Using the tax code to pick winners and losers should be avoided. Specifically, within the energy sector we believe that any new tax system should not favor one form of energy at the expense of others or one type of taxpayer at the expense of others, particularly those engaged in the same activities. In a growing economy, all forms of energy production should be encouraged, and efforts to favor one form of energy over others should be avoided.



It's a well-circulated myth that America's oil and natural gas industry receives federal subsidies. Subsidies are cash outlays from the U.S. Treasury, and the oil and natural gas industry doesn't get them. Similarly, there are no targeted tax credits currently being used by industry. Legitimate tax treatments used by oil and natural gas companies – similar to those used by other business sectors – regularly come under attack by those pushing for higher taxes on energy companies.

Here are the facts:

Domestic Manufacturer's Deduction – Section 199

- This deduction is available to all taxpayers engaged in manufacturing, producing, growing or extraction in the United States.
- While most industries are eligible for a deduction equal to 9 percent, the oil and natural gas industry is the only industry with a reduced deduction equal to 6 percent.
- *All other US manufacturing – even some you may not think of – qualify for the full 9 percent deduction.*

Intangible Drilling Costs (IDCs)

- This is a deduction for labor and related costs to drill a well.
- Independent producers can deduct these costs in year one while integrated oil companies can only deduct 70 percent in year one and amortize the

remainder over five years.

- *This treatment is similar to the research deduction, small business expensing, and the deduction of advertising costs in other industries.*

Last-In, First-Out (LIFO) Inventory Accounting

- This accounting mechanism is available to all industries as a way to value their inventory.
- There is no special LIFO provision for the oil and natural gas industry.
- *LIFO is commonly used by grocers, wineries and distillers, car dealers, and wholesalers.*

Foreign Tax Credit – Dual Capacity Rules

- In order to avoid double taxation, the U.S. tax rules allow taxpayers to credit foreign taxes paid on overseas income against U.S. taxes on that same income.
- Like all other taxpayers, the oil and natural gas industry must prove that the amounts it pays to foreign governments are actually income taxes in order to claim a corresponding credit.
- *The dual capacity rules impose additional steps, scrutiny and burdens – beyond those applied to other industries – to prove the amounts paid are creditable income taxes.*

Cost Recovery A Pro Growth Tax Policy



It is well understood that the cost of capital has strong and significant effects on business investment. U.S. businesses invest trillions of dollars each year in various assets such as equipment, structures and intellectual property. This type of investment that is a main driver of economic growth, technological advancement and jobs in the U.S. economy.

The U.S. tax system can impact the cost of capital in important ways. In particular, how those costs are recovered and depreciated is directly tied to a businesses' cost of capital analysis. For example, it has been estimated that the average cost of capital for equipment across all industries will increase by approximately 8.1 percent if current depreciation rules are eliminated. Further, even if coupled with a corporate tax rate reduction to lessen the impact of depreciation repeal, most studies show that the long-term effects would result in slower economic growth.

The oil and gas industry is very capital intensive – from well equipment to pipelines to refiner towers. The ability to continue to make substantial investments would be directly impacted by slower capital cost recovery provisions that increase the costs of such investments. Therefore, as tax policy is debated and tax reform is considered, it must be remembered that proposals increasing the cost of capital will have long-term, negative economic consequences as businesses adjust to the new tax regime.

What Americans Are Thinking on Energy Tax Increases

American energy leadership is a winner. 2016 election-night polling shows that no matter what their political stripe, U.S. voters highly approve of the ways increased domestic oil and natural gas development is strengthening our country – job creation, economic growth, energy cost savings to consumers and greater energy security.

There's certainly ready evidence of American energy's benefits, including hundreds of dollars in fuel cost savings for consumers and increased disposable income for U.S. households. Environmentally, American energy is leading as well, with increased use of cleaner-burning natural gas driving power-sector emissions to 25-year lows while helping make our air cleaner. This polling data shows U.S. voters' strong, bipartisan support for increased development to ensure a supply of abundant, affordable energy for everyone in our country, done in an environmentally responsible way. Americans support increased access to domestic oil and gas reserves and more energy infrastructure. They're concerned about the government increasing ethanol volume in gasoline, and they oppose tax hikes that could decrease energy investment and development.

Americans believe in American energy. They see it as the catalyst for economic growth, strengthened energy security and environmental progress – the foundation for forward-thinking energy policies to sustain and grow the benefits of America's energy renaissance.



WHAT VOTERS *are* THINKING ON ENERGY ISSUES

✓ **78%** OF VOTERS CONSIDER IT IMPORTANT THAT THE U.S. IS DOING BETTER THAN OTHER MAJOR ECONOMIES IN EUROPE & ELSEWHERE IN REDUCING GREENHOUSE GASES

OF VOTERS SUPPORT NATURAL GAS' ROLE IN REDUCING U.S. GREENHOUSE GASES **77%** ✓

✓ **92%** OF VOTERS CONSIDER IT IMPORTANT THAT GASOLINE & DIESEL FUELS ARE HELPING REDUCE AIR POLLUTION

OF VOTERS SUPPORT INCREASED U.S. PRODUCTION OF OIL AND NATURAL GAS **80%** ✓

✓ **86%** OF VOTERS AGREE THAT INCREASED ACCESS TO DOMESTIC OIL AND NATURAL GAS RESOURCES COULD LEAD TO MORE AMERICAN JOBS

OF VOTERS OPPOSE HIGHER TAXES THAT COULD DECREASE ENERGY PRODUCTION **72%** ✓

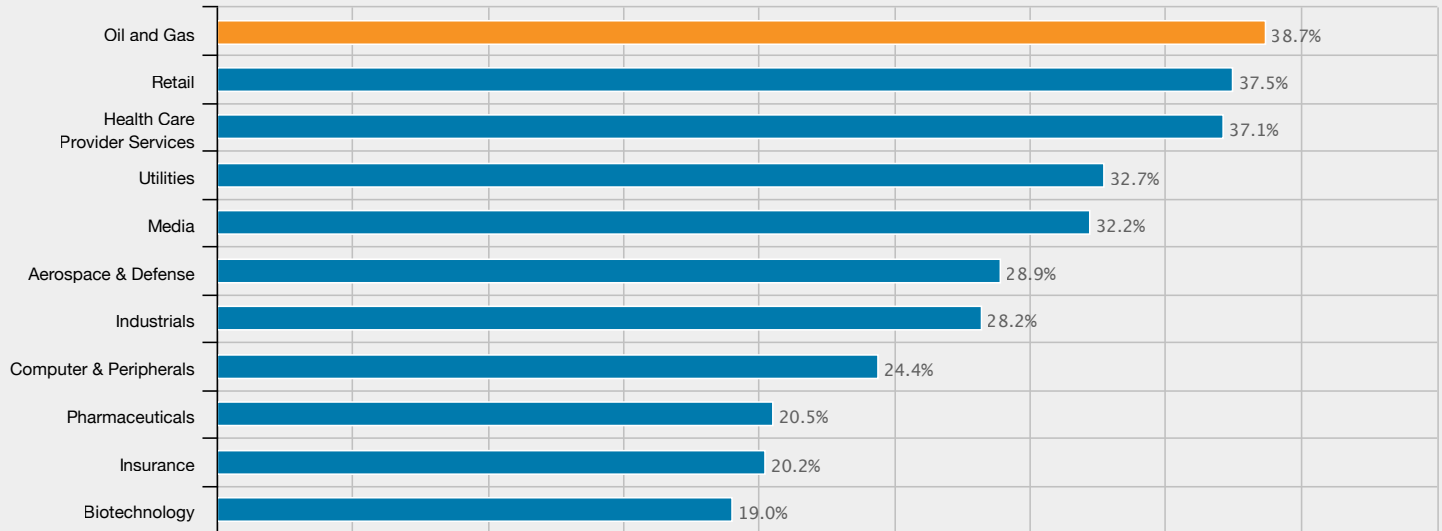
✓ **75%** OF VOTERS ARE CONCERNED ABOUT GOVERNMENT MANDATES TO INCREASE ETHANOL IN GASOLINE

OF VOTERS SUPPORT INCREASED ENERGY INFRASTRUCTURE **81%** ✓

✓ **77%** OF VOTERS SUPPORT A NATIONAL ENERGY POLICY THAT ENSURES A SECURE SUPPLY OF ABUNDANT, AFFORDABLE AND AVAILABLE ENERGY FOR THE AMERICAN PEOPLE IN AN ENVIRONMENTALLY

Effective Tax Rates Among Industries

(averaged over 2010–2015)



Tax rate is total income taxes, which include income taxes imposed by federal, state, and foreign governments, divided by pretax income.

Source: S&P Research Insight; NB. Average rate for ONG was brought down by 25.6 percent in 2015

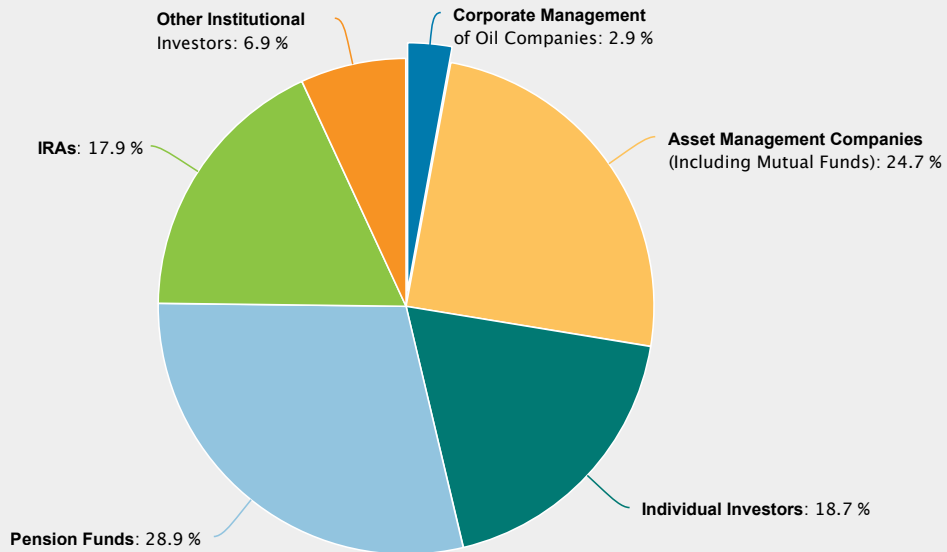
U.S.-based oil and gas companies must structure their operations and invest substantial capital where the resource is found rather than where the best tax regime is located. As a result, U.S.-based oil and gas companies' overseas income is often subject to very high effective tax rates. In addition, operations in the U.S. generate separate state and federal income tax obligations or payments, causing the industry to have an effective tax rate above the federal statutory rate of 35 percent.

Retailers are placed in a similar situation as they must naturally align their locations with customers, which can lead to higher effective tax rates. Other industries, however, may have greater flexibility on where they locate their physical capital or other operations to meet their customer needs. As a result, they may be able to establish activities in locations with lower effective tax rates.

Tax Policy and Effects on Americans' Investments

Who Owns "Big Oil?"

(holdings of oil stocks, 2014)



Source: Who Owns America's Oil and Natural Gas Companies, SONECON, October 2014.

No discussion of taxes and the U.S. oil and natural gas industry is complete without acknowledging the potential impact of higher taxes on regular Americans – the true owners of “Big Oil.” If you have a mutual fund account, and 57 million U.S. households do, there’s a good chance it invests in oil and natural gas stocks. If you have an IRA or personal retirement account, and 46 million U.S. households do, there’s a good chance it invests in energy stocks. If you have a pension plan,

and 61 million U.S. households do, odds are it invests in oil and natural gas. A strong oil and natural gas industry is a vital part of the retirement security for millions of Americans. A common misconception is America's oil and natural gas companies are owned – and therefore benefit – a small group of insiders. In fact, just 2.9 percent of industry shares are owned by corporate management. The rest are owned by tens of millions of Americans, many of them middle class.

For more information, please visit
www.energytomorrow.org
www.api.org



AMERICAN PETROLEUM INSTITUTE