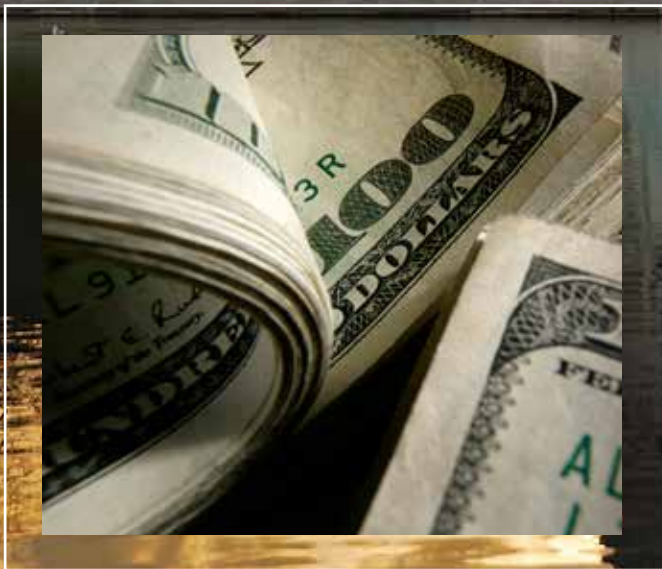


# Understanding

## Oil and Gas Tax Subsidies





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## Executive Summary

A century ago, the 16th Amendment to the Constitution established Congress's ability to impose individual and corporate income taxes. Just a few years later the oil and gas industry got their first tax breaks, and the subsidies for this industry have been with us ever since. In fact, over the years as changes were made to the code, new breaks or "tax expenditures" were added.

Today, the oil and gas industry is one of the largest and most profitable industries in the world. With the country facing more than \$17 trillion in debt and half a trillion dollars in annual deficits, it is past time to eliminate subsidies for highly profitable industries such as oil and gas. They don't need them and the country can't afford them. Furthermore, over time, subsidies have been layered over more subsidies and in the energy sector they are often working at cross-purposes. Subsidies to encourage renewable energy development are undercut by subsidies for fossil energy. A better way forward would be to adopt a "clean slate" approach that wipes out all the subsidies.

TCS wrote this report both to document how several of the most important oil and gas subsidies work, and to deconstruct the industry arguments in defense of the subsidies. This will be one of several pieces documenting wasteful corporate welfare, but we thought we would start with the oldest and least justified.

In Part 1, TCS takes on the notion that oil and gas companies pay high federal tax rates. In reality, the industry uses misleading wording that leaves the impression it pays a high federal tax rate, when what they are claiming includes local, state, federal, and international taxes, and they count taxes that won't be paid for years (if ever). The 2008-2012 **average tax that the three largest US based oil and gas companies paid to the US Treasury was actually 20 percent, which is 15 percent lower than the corporate rate of 35 percent.**

In Part 2, TCS evaluates seven tax treatments and accounting gimmicks for oil and gas companies. These range from the nearly century-old **intangible drilling cost deduction**, which allows companies to write off known equipment expenses as if they are research and development investments; to more recent efforts to evade taxes such as **Master Limited Partnerships**, which allow entities that are effectively corporations to be taxed as partnerships, thus avoiding corporate taxes. In September 2013, MLPs had a market capitalization of \$490 billion, and more than 85 percent of the MLPs were energy and natural resource related.

Other tax and accounting provisions include: **special percentage depletion allowance**, which can be used in some cases to claim tax deductions in excess of investment; **deduction for tertiary injectants**, which allows companies to deduct some costs immediately instead of capitalizing them and depreciating the cost over the life of the investment; **amortization period of geological and geophysical costs**, which for smaller companies is reduced to two years; **last-in, first-out accounting**, which allows companies to assume that the oldest (and presumably cheaper) barrels of oil remain in inventory reducing tax burdens; **domestic production activities deduction (Section 199)**, which allows an additional deduction from the tax rate for manufacturing in the US – roughly one-third of all US corporate activity qualifies for the deduction, including oil and gas production.



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# Understanding Oil and Gas Tax Subsidies

April 2014



## Introduction

The federal government has been subsidizing the oil and gas industry through the tax code for almost a century. During this time, the oil and gas industry has grown into one of the largest and most profitable industries in the world, while the federal government has accumulated more than \$17.5 trillion dollars in debt. The time has come to end federal tax subsidies to the oil and gas industry; it does not need them, and the federal government cannot afford them.

## Part I.

### Largest US-based Oil and Gas Companies

#### Do Not Pay Higher US Tax Rates than Other Industries

Although the oil and gas industry claims it pays more than other industries in taxes,<sup>1</sup> the largest US oil and gas companies actually pay a much lower federal tax rate than the standard corporate rate of 35 percent.

The explanation for this disparity between industry claims and actual taxes paid begins with the definition of “effective tax rate”(ETR). A company’s ETR sounds like it measures what a company is paying to Uncle Sam. What it actually measures is the total amount of tax a company expects to pay to all jurisdictions on a year’s worldwide income. The taxes taken into account include all local, state, national and foreign income taxes that are either owed currently or have been deferred to later years.

The worldwide ETR most commonly cited by the oil and gas industry does not show whether a company is paying its fair share of US taxes, whether it has left income offshore to avoid US taxes, or whether it has employed tax strategies that allow some income to escape taxation altogether. In other words, when it comes to how much a company or industry is paying in federal taxes, citing the global ETR is **misleading**. The more useful measure of a company’s US tax burden is how much federal income tax it owes as a percentage of its income from US operations.

According to their SEC filings, the three largest US-based oil and gas companies – Exxon-Mobil, ConocoPhillips and Chevron – reported a total of \$105.7 billion in US pre-tax income from 2008-2012. These three companies accrued a total of \$27.7 billion in US federal taxes on this income, giving them an average US ETR of 26.2 percent. Of the total amount these companies owed the federal government, they deferred payment of \$6.3 billion. On average, their “current” effective tax rate (excluding the amount deferred) was 20.3 percent.<sup>2</sup>

### US ETR of Three Largest US-based Oil Companies, 2008-2012 (\$m)

	Exxon Mobil	ConocoPhillips	Chevron	Total
Income	43,172	25,210	37,281	105,663
Current Tax	7,141	6,180	8,104	21,425
Deferred Tax	3,541	882	1,839	6,262
Total Accrued Tax	10,682	7,062	9,943	27,687
Expected Tax at 35%	15,110	8,824	13,048	36,982
ETR	24.7%	28.0%	26.7%	26.2%
Shortfall (expected - current)	7,969	2,644	4,944	15,557
Current ETR	16.5%	24.5%	21.7%	20.3%

**ExxonMobil:** Over the past five years, ExxonMobil's US pre-tax income was \$43.2 billion, which accounted for 13.4 percent of its total worldwide revenues of \$323.1 billion. It accrued \$10.7 billion in taxes to the federal government on its US income, giving it a federal corporate tax rate of 24.7 percent. ExxonMobil deferred 33.1 percent of the taxes it owes the federal government from this period. The taxes it actually paid to the federal government during the last five years equals 16.5 percent of its total US revenue. According to its 2012 balance sheet, ExxonMobil's accumulated net worldwide deferred tax liability of \$31.0 billion equals 19 percent of the company's total shareholder equity. It is almost triple the amount ExxonMobil owed in US taxes for 2008-2012. In addition to the significant amount of federal taxes it has deferred, the company has also “indefinitely reinvested” \$43 billion abroad, meaning it does not expect these earnings to ever be subject to federal taxation.

**ConocoPhillips:** ConocoPhillips's US pre-tax income was \$25.2 billion, which accounted for 31.3 percent of its total worldwide revenues from 2008-2012. It accrued \$7.1 billion in taxes to the federal government on its US income, giv-



ing it a federal corporate tax rate of 28.0 percent. ConocoPhillips deferred 12.5 percent of the taxes it owes the federal government from this period. The taxes it actually paid to the federal government during the last five years equals 24.5 percent of its total US revenue. ConocoPhillips's accumulated net worldwide deferred tax liability of \$13.5 billion equals 28 percent of the company's total shareholder equity, and almost double the amount it owed in current and deferred US taxes for 2008-2012. The company also "indefinitely reinvested" \$2.3 billion abroad, meaning it does not expect to ever subject these earnings to federal taxation.

**Chevron:** Chevron's US pre-tax income was \$37.3 billion, which accounted for 19.9 percent of its total worldwide revenues of \$187.7 billion. It accrued \$9.9 billion in taxes to the federal government on its US income, giving it a federal corporate tax rate of 26.7 percent. Chevron deferred 18.5 percent of its taxes from this period. The "current" rate was 21.7 percent of its total US revenue. According to its 2012 balance sheet, Chevron's accumulated net worldwide deferred tax liability of \$14.2 billion equals 10 percent of the company's total shareholder equity, and 143 percent of the amount it owed in US taxes for 2008-2012. In addition to the amount of federal taxes it has deferred, the company has also "indefinitely reinvested" \$26.5 billion abroad.

The largest US-based oil and gas companies are able to defer a significant amount of the taxes they owe. This is thanks to a variety of favorable provisions in the tax code, which are explained in more detail below. The three largest U.S.-based oil companies deferred a combined total of \$6.3 billion or 22.6 percent of the total amount of taxes they accrued during 2008-2012.





## Part II.

### Special Tax Treatment of Oil and Gas Industry

The largest US oil and gas companies do not pay higher federal tax rates than other industries. They are also able to defer large portions of their tax liabilities thanks to a suite of preferential tax provisions.

Under normal rules, taxpayers who make business investments in productive assets such as a plant or equipment can deduct these capital costs from their business income over a specified period of time, through a depreciation allowance. Small businesses, for example, are allowed to expense (write off in one year) a limited amount – \$1 million in 2013 – of capital investment. Oil and gas producers, however, enjoy significantly more generous capital cost write-offs than those available to other taxpayers, even small businesses. Many natural resource producers and royalty owners are even allowed to deduct more than the amount they have actually invested in an asset, unlike other taxpayers.

**The largest US oil and gas companies do not pay higher federal tax rates than other industries.**

The benefit of the more generous expensing rules for oil and gas companies can be seen in the large amount of taxes these companies are able to defer. When an oil company deducts the full cost of designing and fabricating an oil rig and drilling a well, for example, it defers to later years the amount it would otherwise owe in a given tax year. Because they are able to defer significant amounts, year after year, large oil and gas companies are able to defer billions in total tax payments. At the end of 2012, ExxonMobil, ConocoPhillips, and Chevron had accumulated a total of \$58.7 billion in deferred taxes.

What follows is a brief description of some of the tax provisions that allow oil and gas companies such favorable expensing rules compared to other taxpayers:

#### Intangible Drilling Costs Deductions

Intangible drilling costs (IDC) include the costs of designing and fabricating drilling platforms as well as direct “wages, fuel, repairs, hauling, and supplies related to drilling wells and preparing them for production.”<sup>3</sup> IDCs can represent 60 to 80 percent of the costs of drilling a well.<sup>4</sup> The IDC deduction allows qualified natural resource developers to deduct all of these costs immediately.<sup>5</sup> Integrated oil and gas producers are required to capitalize 30 percent of their IDCs and recover them over a 60-month period.

**Intangible Drilling  
Cost deduction is not  
the same, or designed  
with the same purpose,  
as the Research  
and Experimentation  
deduction available  
to other industries.**

Non-oil and gas taxpayers who self-construct a plant, equipment or other productive property, by contrast, must capitalize all of the labor and supply costs for creating the property. These capital costs can be deducted from their business income over a specified period of time through depreciation allowances, based on the class of the asset (e.g. 5, 7 or 10 years). The book treatment of IDCs for oil and gas companies would be to recover these costs over the usable life of the well, which can be as long as 20 years or more. Not only is immediate expensing unique to the natural resource developers who can claim this deduction, this deduction is not subject to any maximum dollar limitation, unlike small business expensing rules, which cap the deductible amount.

The oil and gas industry characterizes the IDC deduction as the equivalent of the “research and experimental” (R&E) cost deduction and other business cost deductions that apply to all industries.<sup>6</sup> Research expenses are defined as reasonable costs incurred: “for activities intended to provide information that would eliminate uncertainty about the development or improvement of a product. Uncertainty exists if the available information does not establish how to develop or improve a product or the appropriate design of a product.”<sup>7</sup>

In fact IDC deduction is not the same, or designed with the same purpose, as the R&E deduction available to other industries. In the case of oil and gas wells, the principal uncertainty that exists is only whether oil and gas are present in commercial quantities. Indeed, producers repeatedly use the same or substantially similar equipment and processes on well after well. Little or no new information regarding development, improvement, or design occurs when this happens, but developers can still immediately deduct the costs of designing and fabricating these drilling platforms. At this point in the technological development of the industry, the IDC deduction only serves to subsidize the business generally by allowing certain taxpayers to avoid the capitalization rules applying to other taxpayers.

The Joint Committee on Taxation estimates the repeal of intangible drilling and development costs deduction for oil and gas wells will save taxpayers \$13.7 billion over 10 years.<sup>8</sup>

### **Special Percentage Depletion Allowance**

Depletion deduction is theoretically based on the principle that, as an income-producing asset is depleted, a company should be able to deduct from its income the cost of acquir-

ing the proportion of the asset that has been used. In other words, depletion is similar to the depreciation deduction for the capital cost of plant and equipment; the costs are deducted from income before the net income is taxed. This deduction should allow recovery of the cost of leases for oil and gas wells, as well as the cost of other natural resources and timber. The way the cost depletion formula works, the total deduction will never exceed 100 percent over the life of the well, so it approximates an accurate deduction of capital costs.

Eligible independent oil and gas producers and royalty owners, however, can claim “percentage depletion”.<sup>9</sup> While nominally designed to allow the oil and gas industry to deduct the cost of purchasing rights to oil and gas resources, the percentage depletion deduction bears no actual relationship to the cost of acquisition. It has been severed completely from the concept of recovering the capital cost of the resource; it effectively makes a certain portion of gross income tax-free without regard to capital costs. It allows independent producers a flat deduction of a percentage of gross income from each well. For instance at the 2012 average wellhead price of \$94.52 a barrel,<sup>10</sup> 1,000 barrels a day would produce an annual deduction of more than \$5 million on proceeds of over \$34 million.

**The special percentage depletion enables oil and gas producers to claim tax deductions in excess of their investment.**

The percentage depletion deduction was first adopted in the 1926 Revenue Act.<sup>11</sup> At that time, the deduction was set at 27.5 percent for oil and gas wells, and limited to 50 percent of the net income from the well. It has since undergone a few modifications, with the most significant occurring in 1975.<sup>12</sup> The oil and gas percentage depletion deduction was reduced to 15 percent and the limitation was set at 65 percent of net income and 1,000 bpd.<sup>13</sup> The most notable change was that integrated oil companies – those that operate refineries as well as producing oil and gas from drilling – were restricted from using the percentage depletion deduction. In 1990, the limitation was revised again to allow percentage depletion deductions of up to 100 percent of net income from marginal wells.<sup>14</sup>

Setting the limit at 100 percent means the deduction may offset the entire net income – a producer may pay zero tax on the income from a marginal well. Even this limit was suspended for 1998 through 2007 and 2009 through 2011, meaning a producer could deduct more than 100 percent of the net income from a marginal well.<sup>15</sup> The special percentage depletion allowance enables producers to claim tax deductions in excess of their investment. No other taxpayer has such a benefit. The Joint Committee on Taxation has estimated the repeal of percentage depletion allowance for oil and gas companies would save taxpayers in excess of \$12 billion over 10 years.<sup>16</sup>

# A CENTURY OF SUBSIDIES FOR BIG OIL

The oil and gas industry has been getting subsidies from U.S. taxpayers for almost a century. We can't afford special treatment for profitable companies. The time has come to end taxpayer subsidies for the oil and gas industry.

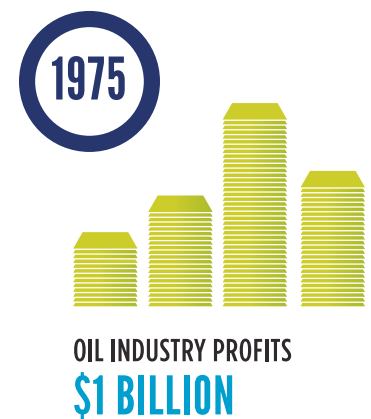
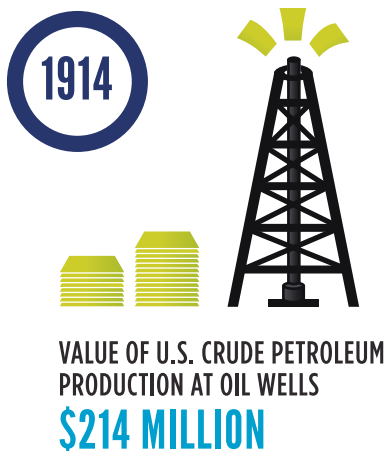
1980 Deductibility of Intangible Drilling Costs

1939 Last-In, First-Out Accounting

1926 Special Percentage Depletion Allowance

1916 Intangible Drilling Costs

1915



## Sources

By eliminating *just* the oil industry subsidies below, we can save taxpayers *at least*:

**\$65B OVER 10 YEARS**

**2005** Amortization Period for Geological and Geophysical Costs

**2004** Domestic Production Activities Deduction

ion for Tertiary Injectants

• 2015

1998



**\$62M+**  
LOBBYING  
DOLLARS



**631**  
INDUSTRY  
LOBBYISTS

2007

**EXXON**

MAKES RECORD PROFITS OF  
**\$40.61 BILLION**  
or almost  
**\$1,300 PER SECOND**

2013



**\$144M+**  
LOBBYING  
DOLLARS



**756**  
INDUSTRY  
LOBBYISTS

The most profitable company in history *still* gets subsidies!

The tax code lets companies deduct tertiary injectants immediately even though they may support production from a well for several years.

### Deduction for Tertiary Injectants

“Tertiary recovery,” sometimes called “enhanced oil recovery,” includes a variety of methods to increase the productivity of an oil and gas reservoir. Tertiary injectants increase the amount of oil or gas that is recovered and extend the life of a well. As oil and gas is withdrawn from a geological formation, the pressure inside the reservoir declines, making it more difficult to remove the hydrocarbons inside, requiring tertiary recovery. The principal means of tertiary recovery involves injecting materials into the formation to increase the reservoir pressure, increase the mobility of the remaining

hydrocarbons within the formation, or to increase separation between injected fluids (used for secondary recovery) and the remaining hydrocarbons.

The oil and gas industry has suggested the deduction for tertiary injectants is simply a standard cost recovery provision.<sup>17</sup> If tertiary injectants were useful only in the year when they were injected, they could be deducted as an expense under other ordinary business provisions of the tax code. But the industry’s argument ignores the fact that tertiary injectants may support production from a well for a period of time, and not simply in the year they are used. Section 193 allows oil and gas companies to deduct the cost immediately, and avoid capitalizing and depreciating the cost over the life of the injectants’ usefulness. Producers may also deduct the cost of tertiary injectants without limitation.<sup>18</sup>

### Amortization Period for Geological and Geophysical Costs

Geological and geophysical (G&G) assessments are activities that oil and gas companies engage in to determine where oil and gas may be located, and in what amounts, and also to determine where drilling may be most appropriate. The activities may include seismic surveys, electromagnetic surveys, other types of remote sensing, shallow test drilling, and bottom sampling.<sup>19</sup> The Energy Policy Act of 2005 specified that the tax deduction for geological and geophysical assessments by smaller oil and gas companies should be recognized over an amortization period of just 24 months.<sup>20</sup> For major integrated oil companies, the amortization period is seven years. Even this longer period is not tied to the actual usefulness of the information generated from G&G assessments.

While G&G does not directly yield income, the investment in G&G contributes to the income an oil and gas company may receive from the property assessed, throughout the life of the company's use of the property. As such, the results of G&G investment are a capital asset whose cost should be recognized over the period of the usefulness of the data.

Seven years is not an unreasonable estimate of the period that such information may be most useful, though in fact some information from the assessments may be used for decades. The size of the company conducting the G&G assessment is not itself relevant to determining the period that G&G data may be useful, so the current provision simply provides a tax subsidy to smaller companies. The Joint Committee on Taxation has estimated that changing this amortization period to uniform 7 years would save taxpayers \$1.25 billion over 10 years.<sup>21</sup>

### Last-In, First-Out Accounting

Last-in, first-out (LIFO) is a method for estimating the value of a company's inventory against the value of goods sold in a given year. A taxpayer's gross profit from the sale of goods is determined by subtracting the cost of goods sold from gross receipts. Taxpayers for whom the production, purchase, or sale of merchandise is a material income-producing factor must maintain inventory records to determine the cost of goods sold during the taxable period. Cost of goods sold generally is determined by adding the taxpayer's inventory at the beginning of the year to the purchases made during the year and subtracting the taxpayer's inventory at the end of the year. The methods used to account for inventory include the first-in, first-out ("FIFO") method, which assumes the items in ending inventory are those most recently acquired by the taxpayer, and the LIFO method, which assumes the items in ending inventory are those earliest acquired by the taxpayer.

**Last-in, First-out accounting doesn't reflect reality. LIFO can be used to artificially reduce the value of inventory to reduce tax liability. Barrels of oil don't stay in inventory for decades.**

LIFO is the conceptual offspring of the "base stock method," which traces its origins back to the United Kingdom more than a century ago. The base stock method assumes a company always maintains a minimum quantity (base stock) of inventory, which should be treated as a fixed asset valued at its original acquisition cost. The US Supreme Court struck down the base stock method for tax purposes in 1930. Congress enacted LIFO in the Revenue Act of 1939.

The following example illustrates the advantage created by LIFO when costs are rising. Assume that a producer has 1,000 units in inventory costing \$100 each, produces an additional 1,500 units at a cost of \$120 during the year and sells 1,200 units for \$150. Gross receipts are \$180,000.

Under the FIFO method, the producer is treated as having sold the 1000 units with a cost of \$100 each and 200 of the newer units with a cost of \$120. Its cost of goods sold is \$124,000 and total income from the sales is \$56,000. In contrast, income under the LIFO method is only \$36,000 since cost of goods sold is computed by treating the 1200 units sold as all being from the most recent production costing \$120 a unit. The difference in income is deferred until production drops below sales so the old units are treated as sold or costs decline below the costs at which the oldest inventory was produced.

LIFO allows companies to defer payment on increases in the value of their goods even if those increases have nothing to do with general inflation – the express purpose of LIFO. The price of oil is affected by a variety of factors – such as security issues and global shifts in demand – that have increased the cost of oil far more than the general rate of inflation. From 2005 to 2013, the wellhead price of domestic oil rose nearly 130 percent, compared to a 32 percent rise in the producer price index for all manufacturing and a 21 percent rise in consumer prices.<sup>22</sup> But because oil and gas companies use LIFO, there is no distinction between an increase in inventory values as a result of inflation or other factors.

LIFO also creates demonstrably false assumptions about an oil company's inventories. Under LIFO, as long as a company's sales do not exceed its purchases (and it maintains a constant or growing inventory), its inventory is considered to have never been sold. A company that has used LIFO for many years and maintained its inventory levels will theoretically have oil in its inventory dating back to when it started using LIFO, which could have been as long as 75 years ago.

The Joint Committee on Taxation estimates the repeal of last-in, first-out method of inventory for oil, natural gas, and coal companies would save taxpayers \$20.2 billion over ten years.<sup>23</sup>

### **Section 199: Domestic Production Activities Deduction**

The net income from business activities is generally taxed at rates as high as 39.6 percent for individuals and 35 percent for corporations. For income from qualified domestic production activities, the code allows a deduction equal to 9 percent of income derived from this activity. The deduction is designed to be approximately a 3-percentage-point reduction in the tax on eligible activities. In the case of oil and gas production activities, Con-



gress limited the special deduction to 6 percent in 2008.

The US previously provided incentives for the export of manufactured goods through exclusion for extraterritorial income (ETI).<sup>24</sup> This subsidy was found to be illegal under World Trade Organization (WTO) rules and was repealed in 2004. The Section 199 domestic production deduction<sup>25</sup> was included in the American Jobs Creation Act of 2004 in an effort to replace the benefit that US exporters were losing in a manner permissible under WTO rules. Compared to the ETI, Section 199 significantly broadened the range of activities that could qualify for the benefit and no longer required that qualifying activities result in products for export.

Roughly one-third of all US corporate activity now qualifies for this deduction, including mining, oil extraction, farming, construction, architecture, engineering, and the production of software, recordings and films.<sup>26</sup> Manufacturing activities performed in the US may only need to account for up to 20 percent of the costs in order to be eligible for the deduction. The benefit is available to activities that would occur in the absence of the benefit, or activities that could not reasonably be exported. Construction of real property in the US, for example, is eligible for the deduction, including the construction of residential or commercial buildings, swimming pools, parking lots, roads, and sidewalks.<sup>27</sup> Electrical, plumbing, heating and air-conditioning contractors qualify. Qualifying production activity does not need to result from, or in, exports.

**The level of domestic manufacturing appears unaffected by the introduction of the production activity deduction.**

And like other qualifying activities, the nature of oil and gas production is such that the jobs associated with the production of oil and gas from domestic wells cannot be moved abroad in the way that jobs producing consumer goods might. The jobs associated with qualifying production activity income do not need to be skilled or high-wage jobs. Non-production activities that create substantial economic benefit and high-skilled jobs, such as medical research, do not qualify for the subsidy. Producers are not required to demonstrate that any new jobs were created by the activity. Indeed, if (within limits) a producer is able to increase net income by cutting wages and benefits or replacing workers with machines, the result would be an increased production activity deduction.

The level of domestic manufacturing appears unaffected by the introduction of the production activity deduction. Almost a decade after enactment, the level of domestic manufacturing has continued its steady decline from the 1950s. The Bureau of Labor Statistics reports the manufacturing sector accounted for only 8.1 percent of domestic jobs in 2010, and will further decline to 7 percent by 2020.<sup>28</sup>

The Joint Committee on Taxation estimates the limitation on deduction for income attributable to domestic production of oil, natural gas, and their primary products would save taxpayers \$21.8 billion over 10 years.<sup>29</sup>

## Master Limited Partnerships

A Master Limited Partnership (MLP) is a partnership, or a limited liability company (LLC) with interests that are traded on a public exchange or an over-the-counter market, like stock in a corporation. Investors in an MLP purchase "units" rather than stock. MLPs have all of the characteristics commonly associated with corporations. Unit interests in MLPs are freely transferable on public markets. MLPs are subject to the same accounting and reporting rules as public companies and to the securities regulations that apply to publicly-traded companies. Yet, investors are shielded from personal liability for the acts or omissions of the MLP; their only risk is the loss of investment.

For an MLP to qualify for this tax-advantaged partnership treatment under the tax code 90 percent of its income must come from qualified sources, including specified natural resources activities. The definition of qualified income has resulted in the oil, gas, and coal industries dominating the use of tax-advantaged MLPs. At the end of September 2013, nearly 130 MLPs had a combined market capitalization of \$490 billion.<sup>30</sup> Energy and natural resource MLPs accounted for 86 percent of this total. In terms of market capitalization, three-fourths of all MLPs are engaged in mid- and downstream activities, including gathering and processing; refining; compression; transportation by pipeline, ship or truck; storage; marketing, and distribution (other than retail).<sup>31</sup>

Although similar to corporations in many ways, MLPs, unlike corporations, are taxed as partnerships, eliminating the corporate income tax for these publicly traded entities and creating a significant advantage for them in accessing capital investment. While the depletion and intangible drilling cost subsidies benefit upstream activities (exploration, development, and production), MLPs effectively eliminate corporate taxes on many mid- and downstream activities for oil and gas companies.

## Conclusion

The tax code is littered with tax breaks – tax expenditures – for a wide range of parochial interests. The whole code needs comprehensive reform. Certain long-standing subsidies for profitable industries like oil and gas should be eliminated. The subsidies worked. These are some of the most profitable industries in the country, and they don't need any more taxpayer handouts.

## Glossary of Terms

**Book accounting:** Accounting used on a company's audited financial statements. Balance Sheets (assets, liabilities, and equity) and income statements should be reported using U.S. GAAP.

**Capitalize:** An accounting method used to delay the recognition of expenses by recording the expenses as long-term assets. In general, capitalizing expenses is beneficial [for book purposes] as companies acquiring new assets with a long-term lifespan can spread out the cost over a specified period of time. Companies take expenses that they incur today and deduct them over the long term without an immediate negative effect against revenues.

**Current taxes:** Current taxes are the income taxes paid or payable (or refundable) for a year on the taxable income (or loss) for that year. For simplicity these are described as "paid" even though final cash settlement of liabilities may occur in a subsequent year.

**Expensing:** Money spent or costs incurred that are tax-deductible and reduce taxable income.

**Deferred tax:** A liability recorded on the balance sheet that results from income already earned and recognized for accounting, but not tax, purposes. Also, differences between tax laws and accounting methods can result in a temporary difference in the amount of income tax payable by a company. This difference is recorded as deferred income tax.

**Sources:** Investopedia, Internal Revenue Service

## Appendix A: ETR Methodology and Impairments

The analysis is based entirely on each company's annual SEC filings (Form 10-K) for the years 2008 through 2012.

The US ETRs listed are calculated by dividing the sum of the current and deferred federal income tax liabilities for each year (as reported in the income tax note to the financial statements) by the US income reported. If the income tax notes did not report income, then income from continuing operations before tax as reported in the Income Statement was used. This method may overstate the US ETR on US-source income for some of the companies because it takes into account any residual US tax paid or accrued on foreign source income. The foreign ETR was calculated using a similar methodology.

Under industry accounting rules, the costs of oil and gas properties are capitalized and recovered as income is received from the properties. For tax purposes, many of these costs are expensed. This difference in treatment means taxable income is lower than book income in the year of investment but higher than book income in later years. The amount due with respect to the current year earnings is reported current tax while the reduction in tax that results from expensing is recorded as a deferred tax liability.

The capitalized cost of an oil and gas property is carried as an asset on the company's balance sheet. Generally, under oil and gas accounting rules, if the value of a property declines below that carried on the balance sheet the company must write off the loss in value as an "impairment." The value of a property may decline (be impaired) by significant declines in commodity prices or by factors specific to the individual property.

When an impairment is recognized, a book expense is recorded. Current tax is unaffected; however, since potential future book expenses have been reduced, an appropriate reduction in deferred taxes is required. The deferred tax liability reduction is reported as a negative deferred tax expense.

During the period 2008-2012, most of the top 20 oil and gas companies recorded impairments to the value of oil and gas properties. These were primarily attributable to dramatic drops in wellhead prices for natural gas and crude oil in 2008. In an examination of effective tax rates, these impairments can create seeming contradictions such as:

- Current tax payments in years with book losses,
- Extraordinarily high ETR when book income is reduced to a small amount by the impairments without a comparable impact on taxable income, and

- Negative accrued taxes in years with positive income when deferred tax liabilities exceed accrued current taxes.

## Endnotes

- <sup>1</sup> According to the oil industry: "We pay our fair share – and then some. From 2006 to 2011, the oil and natural gas industry paid **an effective tax rate of 44.3 percent**, higher than any other industry." (original emphasis) American Petroleum Institute, *Oil & Natural Gas: Supporting the Economy While Paying Our Fair Share*, 2013 <http://www.api.org/~media/Files/Policy/Taxes/Oil-Gas-Industry-Pays-Its-Fair-Share-Taxes.pdf>
- <sup>2</sup> Current taxes are the income taxes paid or payable (or refundable) for a year on the taxable income (or loss) for that year. For simplicity these are described as "paid" even though final cash settlement of liabilities may occur in a subsequent year.
- <sup>3</sup> Internal Revenue Service. *Department of the Treasury*. "Publication 535 (2013), Business Expenses." Chapter 7 pp. 23. Available at: <http://www.irs.gov/pub/irs-pdf/p535.pdf>
- <sup>4</sup> The Congressional Research Service reports that "Since 1986, major integrated oil companies have been able to expense 70% of their intangible drilling costs and capitalize the remaining 30% over a 60-month period." CRS Report R42374. "Oil and Natural Gas Industry Tax Issues in the FY2014 Budget Proposal." 30 October 2013. Available at: <http://www.fas.org/sgp/crs/misc/R42374.pdf>
- <sup>5</sup> "Capital expenditures." U.S. Code, 2012 Edition. Title 26. Section 263(c). Hereafter cited as 26 U.S.C. 263(c). Available at: <http://www.gpo.gov/fdsys/pkg/USCODE-2012-title26/pdf/USCODE-2012-title26-subtitleA-chap1-subchapB-partIX-sec263.pdf>
- <sup>6</sup> American Petroleum Institute fact sheet: "This is a deduction, not a credit or government spending outlay and is no different than the policy behind and treatment of R&D costs vis-à-vis the R&D deduction available for other industries." API. "Why Oil & Gas Treatments Are Not Unique or 'Subsidies'." February 2012. Available at: <http://www.api.org/~media/Files/Policy/Taxes/Oil-Gas-Tax-Treatments-Not-Subsidies-Feb-2012.pdf>
- <sup>7</sup> Internal Revenue Service. *Department of the Treasury*. "Publication 535 (2013), Business Expenses." Chapter 7 pp. 22. Available at: <http://www.irs.gov/pub/irs-pdf/p535.pdf>
- <sup>8</sup> Joint Committee on Taxation. JCX-11-13. "Estimated Budget Effects Of The Revenue Provisions Contained In The President's Fiscal Year 2014 Budget Proposal." 10 May 2013. Pp. 3. Available at: <https://www.jct.gov/publications.html?func=startdown&id=4520>
- <sup>9</sup> 26 U.S.C. 613A. Available at: <http://www.gpo.gov/fdsys/pkg/USCODE-2012-title26/pdf/USCODE-2012-title26-subtitleA-chap1-subchapI-partI-sec613A.pdf>
- <sup>10</sup> U.S. Energy Information Administration. "Domestic Crude Oil First Purchase Prices by Area." Data available at: [http://www.eia.gov/dnav/pet/pet\\_pri\\_dfp1\\_k\\_a.htm](http://www.eia.gov/dnav/pet/pet_pri_dfp1_k_a.htm)
- <sup>11</sup> United States Statutes at Large. Volume 44. Part 2. Chapter 27. (26 February 1926). Commonly cited as 44 STAT. 9. Available at: [http://www.law.uc.edu/armstrong/stat/044/United\\_States\\_Statutes\\_at\\_Large\\_Volume\\_044\\_Part\\_2.pdf](http://www.law.uc.edu/armstrong/stat/044/United_States_Statutes_at_Large_Volume_044_Part_2.pdf)
- <sup>12</sup> Tax Reduction Act of 1975. Public Law 94-12, Section 501. 89 Stat. 47 (Mar. 29, 1975). Available at: <http://www.gpo.gov/fdsys/pkg/STATUTE-89/pdf/STATUTE-89-Pg26.pdf>
- <sup>13</sup> 26 U.S.C. 611, 613, 613A. Available at: <http://www.gpo.gov/fdsys/pkg/USCODE-2012-title26/pdf/USCODE-2012-title26-subtitleA-chap1-subchapI-partI.pdf>
- <sup>14</sup> Omnibus Budget Reconciliation Act of 1990. Public Law 101-508, Section 11522. 104 Stat. 1388 (Nov. 5, 1990). Available at: <http://thomas.loc.gov/cgi-bin/query/F?c101:4:./temp/~c101gFLMby:e1587687:> (Marginal wells are defined as those that produce very little oil or only heavy oil.)
- <sup>15</sup> 26 U.S.C. 613A(c)(6)(H). Available at: <http://www.gpo.gov/fdsys/pkg/USCODE-2012-title26/pdf/USCODE-2012-title26-subtitleA-chap1-subchapI-partI-sec613A.pdf>

- <sup>16</sup> Joint Committee on Taxation. "Estimated Revenue Effects of S. 3080/HR. 5745, the 'End Polluter Welfare Act'." Fiscal Years 2012-2022
- <sup>17</sup> American Petroleum Institute. "API Key Tax Issues." <http://www.api.org/policy-and-issues/policy-items/taxes/api-key-tax-issues>
- <sup>18</sup> 26 U.S.C. 193. Available at: <http://www.gpo.gov/fdsys/pkg/USCODE-2012-title26/pdf/USCODE-2012-title26-subtitleA-chap1-subchapB-partVI-sec193.pdf>
- <sup>19</sup> Bureau of Ocean Energy Management. BOEM Report 2014-001. "Atlantic OCS Proposed Geological and Geophysical Activities: Mid-Atlantic and South Atlantic Planning Areas, Environmental Impact Statement." February 2014. Pp. 3-3. Available at: <http://www.boem.gov/BOEM-2014-001-v1/>
- <sup>20</sup> 26 U.S.C. 167(h); Energy Policy Act of 2005. Public Law 109-56, Section 1329. 119 Stat. 594 (Aug. 8 2005). Available at: <http://www.gpo.gov/fdsys/pkg/PLAW-109publ58/pdf/PLAW-109publ58.pdf>
- <sup>21</sup> JCX-11-13. "Estimated Budget Effects Of The Revenue Provisions Contained In The President's Fiscal Year 2014 Budget Proposal." 10 May 2013. Pp. 4. Available at: <https://www.jct.gov/publications.html?func=startdown&id=4520>
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- <sup>23</sup> Joint Committee on Taxation. "Estimated Revenue Effects of S. 3080/HR. 5745, the 'End Polluter Welfare Act'." Fiscal Years 2012-2022
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- <sup>25</sup> 26 U.S.C 199. Available at: <http://www.gpo.gov/fdsys/pkg/USCODE-2012-title26/pdf/USCODE-2012-title26-subtitleA-chap1-subchapB-partVI-sec199.pdf>
- <sup>26</sup> Congressional Research Service. Report number: R41988. "The Section 199 Production Activities Deduction: Background and Analysis." 27 February 2012. Pp. 6. Available at: [http://www.taxpayer.net/images/uploads/articles/CRS\\_Report-The\\_Section\\_199\\_Production\\_Activities\\_Deduction.pdf](http://www.taxpayer.net/images/uploads/articles/CRS_Report-The_Section_199_Production_Activities_Deduction.pdf)
- <sup>27</sup> Karnis, Daniel. "Maximizing the Section 199 Deduction." *Journal of Accountancy*. September 2010. Available at: <http://www.journalofaccountancy.com/Issues/2010/Sep/20102727.htm>
- <sup>28</sup> Bureaus of Labor Statistics. *U.S. Department of Labor*. "Employment Projections, Table 2.1: Employment by major industry sector." 19 December 2013. Available at: [http://www.bls.gov/emp/ep\\_table\\_201.htm](http://www.bls.gov/emp/ep_table_201.htm)
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- <sup>31</sup> National Association of Publicly Traded Partnerships (NAPTP). "Master Limited Partnerships 101: Understanding MLPs." 4 October 2013. Slide 35. Available at: [http://www.naptp.org/documentlinks/Investor\\_Relations/MLP\\_101.pdf](http://www.naptp.org/documentlinks/Investor_Relations/MLP_101.pdf)