The President's 2010 Budget: Reining in Oil and Gas Subsidies

The president's fiscal year 2010 budget repeals several long-standing oil and gas subsidies, saving an estimated $31.7 billion over the next ten years.[i] In addition, general tax and subsidy reforms will save $108.5 billion, largely from subsidies that benefit the oil and gas industries. For nearly a century, taxpayers have provided billions of dollars in subsidies to the oil and gas industry, this proposal takes the first step toward reining in decades of giveaways.

> **"The oil and gas subsidies are costly to the American taxpayer and do little to incentivize production or reduce energy prices."**
> ***President's FY10 Budget Request***

Details of the Proposed Oil and Gas Cuts

The president's budget proposal repeals the *Manufacturing Tax Deduction, Percentage Depletion Allowance, Expensing of Intangible Drilling Costs, Preferential Time Period Treatment for Geological and Geophysical Amortization, Passive Loss Exemption,* and *Deduction for Tertiary Injectants.*

In addition, the budget removes the *Enhanced Oil Recovery* and *Marginal Well* tax credits, cuts oil research and development funding, reforms abuses of the Foreign Tax Credit (FTC) and prohibits Last-In First-Out (LIFO) inventory accounting. Finally, the budget includes plans to impose an excise tax on offshore drilling.

The largest taxpayer savings will result from the repeal of the *Manufacturing Tax Deduction,* enacted under the American Jobs Creation Act of 2004. This tax loophole essentially allows oil and gas producers to deduct 6% of their taxable income from qualified activities in the United States.[ii] If this subsidy is repealed, savings over the next ten years will total $13.29 billion.[iii] The president's budget proposes this reform be applied to all industries in the U.S., not just the oil and gas industries.

The president's budget also creates $8.25 billion in taxpayer savings by eliminating the *Percentage Depletion Allowance* (PDA) for oil and gas companies. PDA was enacted in 1926 for depletable resources such as oil, gas and minerals.[iv] Rather than the typical cost-depletion method, based on exhaustion of property, the *Percentage Depletion Allowance* enables recovery of capital costs at a general rate of 15%, and potentially up to 25%.[v] Because the Percentage Depletion Allowance applies only to depletable resource property, producers can claim the depletion even after they recoup capital costs.[vi]

The repeal of the *Expensing of Intangible Drilling Costs (IDC)* loophole, enacted in 1916, will save the U.S. Government $3.35 billion over the next ten years.[vii] Under this tax break, oil and gas companies enjoy exemption from uniform capitalization rules that require the costs associated with

property to be considered inventory, or capitalized as part of the property basis. Alternately, oil and gas companies can choose to either expense IDCs immediately, or capitalize and amortize IDCs at an accelerated rate. Both alternatives lead to substantial tax benefits for the oil and gas industries.[viii]

The Administration's budget achieves $1.189 billion in savings by eliminating several other wasteful programs including the *Preferential Time Period Treatment for Geological and Geophysical Amortization* that allows oil and gas companies to write off costs incurred while searching for oil and gas deposits. The budget also ends the *Passive Loss Exemption*, established with the Tax Reform Act of 1986, that allows taxpayers to deduct losses on working investments in the oil and gas industry—so long as the taxpayer is not "materially involved" in the business' activity. Also cut is the *Deduction for Tertiary Injectants*, established as part of the Crude Oil Windfall Profit Act of 1980, which allows oil producers to deduct the cost of injecting fluids into oil reservoirs in order to remove very viscous oil. Eliminating these two programs will save a total of about $1 billion over the next 10 years.[ix]

> "…to transform our energy sector and, also, make a fairer tax code, the Budget proposes to cut unjustified tax loopholes that benefit oil and gas corporations."
> *-President Obama FY2010 Budget Request*

In addition, the 2010 budget request proposes a new excise tax on offshore oil and gas production—to address billions of taxpayer dollars that are being lost on royalty-free leases in the Gulf of Mexico under the Deep Water Royalty Relief Act (DWRRA). Due to a clerical error in lease negotiations in 1998-1999, many leases in the Gulf region pay no royalties.[x] Other leases issued in the late 1990's had price triggers to invoke royalties when gas prices reached above $36 /barrel.[1][xi] These leases were issued at a time when crude oil prices were only $18/barrel. With oil prices reaching well over $100 a barrel this last year, these leases should all be paying royalties. [xii] According to the Government Accountability Office, lost royalties on DWRRA leases could cost up to $53 billion in revenue over the next 25 years.[xiii] In order to correct this error and recover royalties, the president has proposed placing a 13% excise tax on oil leases in the Gulf of Mexico that are not currently paying any royalties.[xiv] This excise tax would raise $5.3 billion in tax revenues over the next 10 years, according to the updated budget summary from May 2009.[xv]

Notably, the budget eliminates both the mandatory and discretionary allotments for the Department of Energy's *Ultra Deepwater Oil and Gas R&D program*, worth $250 million over the next ten years.[xvi] The program was meant to encourage the development of technology to tap hard to reach oil reserves far off the coast. However, spending was encouraged by a handful of politicians and has been directed toward a select few oil and gas companies.[xvii] See the chart below for a breakdown of program eliminations and savings.

[1] Price is given in 2008 dollars. The original threshold was $28.

Table 1: Repealed Oil and Gas Subsidies and Tax Breaks in the 2010 Budget Request

Subsidies and Credits	Taxpayer Savings
Repeal Enhanced Oil Recovery Credit*	
Repeal Marginal Well Tax Credit*	
Repeal Expensing of Intangible Drilling Costs	3,349,000,000
Repeal Deduction for Tertiary Injectants	62,000,000
Repeal Passive Loss Exemption for Working Interests in Oil and Natural Gas Properties	49,000,000
Repeal Manufacturing Tax Deduction for Oil and Natural Gas Companies	13,292,000,000
Eliminate Preferential Time Period Treatment for Geological and Geophysical Amortization Period for Independent Producers	1,189,000,000
Repeal Percentage Depletion for Oil and Natural Gas	8,251,000,000
Terminate Oil Research and Development Program	5,000,000
Terminate Ultra-Deepwater R&D Program	250,000,000
Levy Tax on Certain Offshore Oil and Gas Production	5,300,000,000
Total	*31,747,000,000*[xviii]

**Due to regulatory stipulations, the Enhanced Oil Recovery Credit was completely phased out for taxable years beginning in 2008 and the Marginal Well Tax Credit has been phased out since becoming effective in 2005.*

Other Tax Proposals that Impact Oil and Gas

The president's budget tackles the *Foreign Tax Credit* (FTC), another tax loophole that benefits oil and gas companies. The FTC was established to prevent U.S. businesses—and U.S. citizens living abroad—from being double-taxed on income earned in foreign countries. The credit allows U.S. companies to deduct foreign income taxes and expenses from taxes owed in the U.S. [xix] Unfortunately, the FTC contains a loophole that allows companies to make deductions for foreign business they don't actually owe U.S. taxes on, leading to a larger tax credit than they should really receive. The president's budget proposes reforming the FTC by requiring companies to pool and report on all of their foreign profits, not just those on which they owe U.S. taxes, making it more difficult for companies to cross-credit tax deductions. In addition, the budget includes a "dual capacity" provision that will prohibit companies that do business in countries that don't charge income taxes from receiving a domestic tax credit. The president's budget would also discourage companies from deferring U.S. tax payments by requiring that companies repatriate taxes *before* they can receive a tax credit.[xx] In total, these reforms to the Foreign Tax Credit will save $47.5 billion over the next 10 years (CBO has not calculated what portion of these savings will come directly from the oil and gas industries).[xxi]

Last-in, first-out (LIFO) accounting methods are also repealed for all industries in the budget request. Because of inflation and general rising costs, LIFO allows companies to move the most expensive inventory off of their balance sheets, and thereby reduce their taxable income, even though the actual movement of inventory occurs on a first-in, first-out (FIFO) basis in most industries. LIFO is already prohibited by International Financial Reporting Standards. The repeal of LIFO applies to all industries, including oil and gas, and will create savings of $61 billion over the next ten years.[xxii]

Table 2: General Business Reforms

Subsidies and Credits	Taxpayer Savings
Determine the Foreign Tax Credit on a pooling basis	24,492,000,000
Prevent splitting of foreign income and foreign taxes	18,542,000,000
Modify tax rules for dual capacity taxpayers	4,490,000,000
Foreign Tax Credit total	*47,524,000,000*
Last-in, first-out accounting (LIFO)	61,054,000,000
Total:	***108,578,000,000****

**Note: these savings are across all industries in the U.S., not the oil and gas industry exclusively.*

Drilling Down on Oil and Gas Subsidies

We are pleased to see the Administration taking a strong stance against subsidies to the oil and gas industries. As stated in the budget request "The oil and gas subsidies are costly to the American taxpayer and do little to incentivize production or reduce energy prices…Oil and, to a large extent, gas are internationally traded commodities and their prices are determined on the world market. As a result, domestic oil and gas production subsidies generally do not significantly reduce the prices that consumers pay for products such as gasoline or home heating oil, resulting primarily in higher returns to the industry."[xxiii]

We applaud the Administration for proposing the repeal of the above loopholes, tax breaks and subsidies. However, more must be done to end the billions in other wasteful subsidies to the fossil fuel industry as well as other mature energy industries. The Administration is taking the first steps in ending the long-standing flow of U.S. taxpayer dollars to an industry that does not need handouts. Taxpayers for Common Sense supports the removal of these subsidies and urges Congress and the Administration to take action to repeal other existing subsidies to the fossil fuel industry.

Read more about the subsidies to be repealed as well as continuing subsidies in the TCS oil and gas subsidy analysis.

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For more information, contact Autumn Hanna at (202) 546-8500 or autumn@taxpayer.net

[i] Office of Management and Budget, “Terminations, Reductions and Savings: Budget of the U.S. Government, Fiscal Year 2010,” 26 February 2009, <http://www.whitehouse.gov/omb/budget/fy2010/assets/trs.pdf>
[ii] The Staff of the Department of the Treasury, “General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals,” May 2009, <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>
[iii] Office of Management and Budget, “Terminations, Reductions and Savings: Budget of the U.S. Government, Fiscal Year 2010,” 26 February 2009, <http://www.whitehouse.gov/omb/budget/fy2010/assets/trs.pdf>
[iv] Staff of the Joint Committee on Taxation, "Description and Technical Explanation of the Conference Agreement of H.R. 6, Title XIII, The Energy Tax Incentives Act of 2005, JCX-60-05, 28 July 2005, Joint Committee on Taxation, <http://www.house.gov/jct/x-60-05.pdf>
[v] The allowance applies to independent producers and royalty owners. Only marginal wells – wells whose daily production is less than 15 barrels per day, or wells that produce only heavy oil – qualify for a depletion allowance greater than 15%.
[vi] The Staff of the Department of the Treasury, “General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals,” May 2009, <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>
[vii] Office of Management and Budget, “Terminations, Reductions and Savings: Budget of the U.S. Government, Fiscal Year 2010,” February 26, 2009, <http://www.whitehouse.gov/omb/budget/fy2010/assets/trs.pdf>
[viii] The Staff of the Department of the Treasury, “General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals,” May 2009, <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>
[ix] Office of Management and Budget, “Terminations, Reductions and Savings: Budget of the U.S. Government, Fiscal Year 2010,” 26 February 2009, <http://www.whitehouse.gov/omb/budget/fy2010/assets/trs.pdf>
[xi] Rogers, David. Billions could be lost in Gulf oil leases. Politico, May 27, 2008. http://www.politico.com/news/stories/0508/10633.html
[xii] Energy Information Administration. “Short-Term Energy Outlook”. September 9, 2009. http://www.eia.doe.gov/steo#Global_Crude_Oil_And_Liquid_Fuels
[xiii] Government Accountability Office. Oil and Gas Royalties: Litigation over Royalty Relief Could Cost the Federal Government Billions of Dollars GAO-08-792R June 5, 2008. http://www.gao.gov/products/GAO-08-792R
[xiv] Dogget, Tom, “US Treasury Secretary Attacks Oil, Gas Tax Breaks,” *Reuters India*, 5 March 2009, <http://in.reuters.com/article/oilRpt/idINN0454844120090304>
[xv] [xv] Office of Management and Budget. “Budget of the U.S. Government, Fiscal Year 2010: Updated Tables”. May 4, 2009. Pp 22. http://www.gpoaccess.gov/usbudget/fy10/pdf/summary.pdf
[xvi] The $5 million R&D savings is not counted in the $26 billion loophole termination, probably because it does not directly affect the industry. Office of Management and Budget, “Terminations, Reductions and Savings: Budget of the U.S. Government, Fiscal Year 2010,” 26 February 2009, <http://www.whitehouse.gov/omb/budget/fy2010/assets/trs.pdf>
[xvii] Peterson, Laura. “Big Oil Yields Ultra Deep Influence”. Center for Public Integrity: December 20, 2004. http://projects.publicintegrity.org/oil/report.aspx?aid=436
[xviii] Office of Management and Budget, “Terminations, Reductions and Savings: Budget of the U.S. Government, Fiscal Year 2010,” 26 February 2009, <http://www.whitehouse.gov/omb/budget/fy2010/assets/trs.pdf> and Office of Management and Budget. “Budget of the U.S. Government, Fiscal Year 2010: Updated Tables”. May 4, 2009. Pp 22. http://www.gpoaccess.gov/usbudget/fy10/pdf/summary.pdf
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[xx] Tax Policy Center. “Reform U.S. International Tax System”. May 2009. http://www.taxpolicycenter.org/taxtopics/2010_budget_other.cfm
[xxi] Office of Management and Budget. “Budget of the U.S. Government, Fiscal Year 2010: Updated Tables”. May 4, 2009. Pp 21. http://www.whitehouse.gov/omb/budget/fy2010/assets/summary.pdf
[xxii] The Staff of the Department of the Treasury, “General Explanations of the Administration’s Fiscal Year 2010 Revenue Proposals,” May 2009, <http://www.treas.gov/offices/tax-policy/library/grnbk09.pdf>
[xxiii] Office of Management and Budget, “Terminations, Reductions and Savings: Budget of the U.S. Government, Fiscal Year 2010,” 26 February 2009, <http://www.whitehouse.gov/omb/budget/fy2010/assets/trs.pdf>