Impact of the FairTax on Oil and Gas

The Industry

The U.S. oil and gas extraction industry is comprised of nearly 34,000 enterprises, which reported $8.4 billion in net income and $94 billion in gross receipts in 1996. The industry paid $1.9 billion in taxes in 1996.[1]

Item	Oil and Gas[2]
Gross Receipts	$ 94.0
Net Income	$ 8.4
Taxes Paid	$ 1.9
Effective Tax Rate (on net income)	22.6%
Net Income as Percentage of Gross Receipts	8.9%

Oil and gas is a high-risk enterprise. The price of oil and gas is largely determined in international commodities markets. It is also a capital-intensive industry, with traditionally long-term fixed costs.

Disadvantages of Current Tax Law

Current tax law disadvantages the oil and gas industry because the industry's high risk, highly capital-intensive character is adversely affected by unfavorable capital cost recovery rules, the alternative minimum tax and other rules. Some taxpayers may elect to use the relatively favorable "percentage depletion" method with respect to certain exploratory costs.[3] Intangible oil and gas geothermal well drilling and development costs are also capital expenditures.[4] Many oil and gas firms are also subject to the alternative minimum tax. The alternative minimum tax treats both the excess of percentage depletion over cost basis[5] and excess intangible drilling costs as preference items.[6]

Disadvantages for Firms Operating Abroad

A significant fraction of oil and gas firms operate abroad. The internal tax provisions of the income tax, besides being inordinately complex and expensive to comply with, contain several adverse provisions directly targeted at the oil and gas industry. For example, oil related income of controlled foreign corporations is specifically targeted for

[1] $843 million in federal corporate taxes (after credits), $561 million in foreign taxes and $494 million in estimated individual income taxes paid by S corporation owners, IRS Statistics of Income, Returns of Active Corporations, 1996, Table 6 and Corporations with Net Income, Form 1120S, 1996, Table 15.
[2] Ibid. All dollar figures are in billions.
[3] See IRC §613.
[4] However, the law allows amortization (i.e. cost recovery) over a period of five years. See IRC §291(b).
[5] Except for independent oil and gas producers. See IRC §57(a)(1).
[6] See IRC §57(a)(2).

imputation to the parent company, and the imputation is currently taxed to the parent.[7] In addition, the foreign tax credit is aggressively limited with respect to oil and gas income.[8]

Benefits of the FairTax

The FairTax will be advantageous to the oil and gas industry in several respects. First, oil and gas will benefit, as will all domestic industries, from sustained growth in the economy. All known economic studies predict growth as a result of replacing the income tax with a consumption tax; indeed, economists typically estimate additional growth 10 to 12 percent greater within a decade.[9] Because the economy will grow, industrial production, travel, construction (bigger houses) and the like will grow, and demand for crude oil and gas will increase.

No More Corporate Income Taxes

The oil and gas industry will benefit by never again having to pay U.S. corporate income taxes on either domestic or foreign production. Business-to-business transactions will fall out of the taxing net. The retail sale of gas and oil products will be subject to sales tax, just like all other retail goods. However, given the increase in consumers' after-tax income due to the repeal of the income and payroll taxes, and the increased demand resulting from a growing economy, demand for oil and gas will increase.

More Favorable Interest Rates

The industry will also be advantaged by more favorable interest rates. Interest rates are expected to be reduced by between 25 to 30 percent under a national sales tax.[10] Although the costs of borrowing will no longer be *deductible*, interest expense will be paid from pre-tax earnings. Interest will also not be taxed to the recipient. As a result, investors will no longer need to charge a tax premium to achieve a particular after-tax rate of return, and interest rates fall toward the current tax-exempt rate.[11]

Reduction of Compliance Costs

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[7] Oil related income of controlled foreign corporations (CFCs) is generally treated as subpart F income and taxed currently to the parent even if the parent received no dividend or other income from the CFC. IRC §954(a)(5) and §954(g).

[8] See IRC §901(f) and §907.

[9] Dale W. Jorgenson, Harvard University, "The Economic Impact of the National Retail Sales Tax," report to National Tax Research Committee, November 25, 1996, estimates a 10.5 percent GDP increase; Laurence J. Kotlikoff, Boston University, "Replacing the U.S. Federal Tax System with a Retail Sales Tax – The Macroeconomic and Distributional Impacts," report to National Tax Research Committee, December, 1996, estimates a 12 percent increase in GDP.

[10] For a more detailed discussion of the impact of a national sales tax on interest rates, see John E. Gobb, *Economic Review*, Federal Reserve Bank of Kansas City, "How Would Tax Reform Affect Financial Markets?" Fourth Quarter, 1995. He estimates a 25-35 percent drop (p. 27).

[11] This is sometimes described as removing the "tax wedge" from interest rates – the tax serves as a wedge between the gross or pre-tax return and the after-tax return.

Oil and gas will enjoy a substantial reduction in transactional and compliance costs. For example, oil and gas companies who engage in international transactions will no longer need to be concerned with foreign sourcing rules, whether a foreign charge is an income tax, or the calculation of the foreign tax credit. Companies will no longer need to be concerned with disfavorable capital cost recovery or alternative minimum tax rules. They will no longer need to spend resources complying with complex employee benefit taxes, pension taxes, and similar tax rules. They will no longer have to endure the unnecessary record-keeping requirements, tax accounting, and audit costs associated with the corporate income tax.

Family-Owned Businesses

Finally, some oil and gas companies are family-owned. A national sales tax, like the FairTax, will dramatically reduce the burden on family-owned businesses by repealing the estate and gift tax. This will eliminate the need for family-owned small businesses to be sold out of the family to pay the estate tax, as well as the need to engage in expensive estate planning (including paying estate planning professionals and purchasing expensive life insurance products designed to fund the estate tax).