Oil & Natural Gas Industry Tax Reform Principles

Introduction

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 be non-discriminatory among industries and should provide a level playing field for taxpayers engaged in similar activities.

Recently, concerns have grown about the current U.S. tax system, (i.e., that the rules limit U.S. competitiveness in an increasingly global economy), leading to calls for tax reform. Any tax reform should be based on sound, transparent policies, and tax rates should be lowered to support a tax structure that promotes investment and is competitive with other major trading partners.

We recognize that tax reform will be a substantial undertaking and will significantly impact how businesses look at the economics of their investments. We also highlight that any new tax rules addressing America’s oil and natural gas industry could directly impact the amount of energy that is produced and supplied to the economy. Therefore, in order to help frame the debate on how to approach tax reform with respect to energy, we raise the following considerations.

Domestic Pro-growth/Pro-job Considerations

The U.S. oil and natural gas industry currently supports 9.8 million jobs in the economy. The industry as a whole accounts for 8 percent of the nation’s Gross Domestic Product (GDP). One of the main reasons for this significant impact is the size and scope of the domestic capital investments which are necessary to produce and refine the energy demanded by U.S. consumers. For example, the top 50 exploration and production companies spent $173 billion on acquiring access to various U.S. properties for future development. In addition, according to the U.S. Census Bureau, oil and natural gas extraction, support activities, refining, distribution and transportation accounted for nearly 18 percent of all new structure and equipment investment in 2013 – over $235 billion1,2

Since oil and natural gas reserves are depleting resources, these substantial investments must be made on a recurring and continuous basis for the industry to maintain and continue to grow production and refining in the U.S., and to meet the economy’s energy demands. Because investment needs to occur on a continuous basis, a stable and predictable stream of cash flow is critical to the economics supporting domestic projects. Given the risks inherent in the oil and gas business, and the level of the expenditures required, these costs must be recovered quickly in order for the industry to continue to reinvest in the next project or to hire new employees. The industry’s oil and natural gas exploration and drilling investment analysis is very similar to the investments made by companies with a heavy

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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 regime 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, we have found that in our industry there is not an exact “trade-off” between a lower corporate tax rate and the lengthening of cost recovery periods. We would note that, 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.

Given the size of the oil and natural gas industry, we understand it will be impacted by any tax reform effort. But we believe 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.\(^3\) In a growing economy, all forms of energy production should be encouraged, but efforts to favor one form of energy over others should be avoided.

**International Tax Reform – Territorial**

We recognize that the taxation of foreign operations by a home country is a very complex area to address in tax reform. However, the industry's main focus in reforming international tax provisions is fairly simple: rules ensuring that foreign source operating income of U.S. based companies is not subject to double taxation are essential for supporting the competitiveness of U.S. companies internationally.

As an extractive industry, we must operate where the resource is located rather than where the tax rate is the lowest. In fact, the industry pays substantial income taxes on its foreign operations, which often causes the industry’s effective tax rate to be over 40 percent. The industry is currently able to repatriate a substantial amount of international cash back to the U.S. economy\(^4\) under the foreign tax credit mechanism, which allows U.S. taxes on foreign sourced income to be offset by foreign taxes paid on those operations. This tax system generally alleviates the double taxation concerns.

Therefore, in general, the industry can support a territorial system provided it is competitive with the tax laws of the other major developed countries and allows U.S. based oil and natural gas companies to compete internationally with non-U.S. oil and natural gas companies. For example, any move to a territorial system must insure that all active operating and related income would qualify for exemption, and that all industry specific tax restrictions are eliminated. Of course, until such time as a new system is implemented, a fully functioning and competitive foreign tax credit system must remain in place.

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\(^3\) The U.S. oil and natural gas industry is the only industry in which the tax rules apply differently to significant members of that industry based on size (or involvement in additional business lines such as retail marketing of gasoline or refining). Pro-growth tax reform and an efficient tax system require that tax provisions be nondiscriminatory and evenly applied among taxpayers within an industry.

\(^4\) Over $70 billion was repatriated by the industry in 2009 according to IRS data.
Additional Comments & Considerations

The industry recognizes the value of a lower corporate tax rate and supports movement in that direction. However, further base broadening measures used to support a lower tax rate could significantly impact the cash flow for domestic projects. As such, we are concerned that such measures could result in less domestic energy investment and ultimately undermine the goal of pro-growth tax reform. We would encourage the development of proposals that can achieve both of these objectives—lower rates and robust pro-growth capital cost recovery mechanisms.

Any new tax regime will be difficult for businesses to immediately adopt. Therefore, we support the development and implementation of fair and equitable transition rules. Establishing transition rules that provide adequate time for implementation and that take into account prior reliance on the current tax code as manifested in existing agreements, practices, and other requirements is essential for the success of any new tax system.

Finally, we recognize the difficulty in tackling truly comprehensive tax reform. Subject to addressing the above tax reform principles and considerations, phased corporate or individual tax reform could be a way to facilitate the process for broad tax reform. However, in all cases, targeted, isolated, or piecemeal changes should be avoided.