United States Senate

WASHINGTON, DC 20510

July 26, 2013

The Honorable Max Baucus
Chairman
Senate Finance Committee
Dirksen-219
Washington, DC 20510

The Honorable Orrin Hatch
Ranking Member
Senate Finance Committee
Dirksen-219
Washington, DC 20510

Dear Senators Baucus and Hatch:

We are writing in response to your letter of June 27th seeking input from Senators to your effort within the Senate Finance Committee to address comprehensive tax reform. We note that you plan to start with a "blank slate" that would exclude the list of tax expenditures as defined by the Joint Committee on Taxation, but also allow for the consideration of specific provisions that meet important objectives. You list those objectives as:

(1) helping grow the economy,
(2) making the tax code fairer, or
(3) effectively promoting other important policy objectives.

Though your letter focused on tax expenditures, you also invited comment on other issues in the context of tax reform.

We believe that focusing comprehensive tax reform on the goal of improving the economy is the correct approach. We also support an analysis of those provisions that have a proven record of economic benefit and supporting broader policy objectives. Additionally, we believe that developing a fairer tax code means applying these objectives consistently across a broad range of industries

With these points in mind, we believe that the provisions associated with oil and natural gas industry meet your objectives. From a broad perspective, existing provisions like the expensing of certain drilling costs, the ability to track inventory under the last in/first out method and the foreign tax credit mechanism help define the economics for an industry that supports over 9 million domestic jobs and makes up 7.7% of our nation's gross domestic product. As detailed in numerous studies and reports, the US oil and natural gas industry has been one of a few sectors of the economy instrumental in providing new jobs and spurring economic activity in various sectors of our economy. The contributions of the industry during the recent recession demonstrate that these provisions have proven ties towards developing a stronger economy.

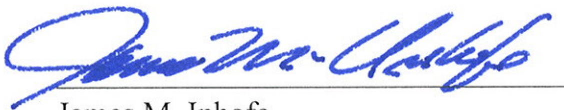
We note that these provisions are not always unique to the oil and natural gas industry in either application or policy. Therefore, a fair approach in comprehensive tax reform would be to review these provisions broadly taking into account similar provisions applicable to other industries or in the context of how other taxpayers are also treated. The impact of tax reform should also consider an industry's economic contribution to the overall economy as well as directly to the Federal Treasury. On that point, it should be noted that these provisions provide

certainty to an industry that is already paying, on average, $85M a day in taxes, rents and royalties to the federal government.

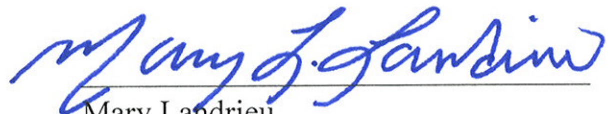
The US has seen a fundamental change to its energy future with the exploration and development of domestic oil and natural gas reserves. This investment will generate positive benefits for both consumers and businesses for the foreseeable future. This change will also have broader, even global impacts, in other US policy areas. Fundamental tax reform should not undermine this progress.

We understand that your staff may wish for additional input with respect to these provisions, which are described in more detail in the attachment. We respectfully urge you to consider the value of these provisions and the industry they are associated with as you work toward your goal of tax reform.

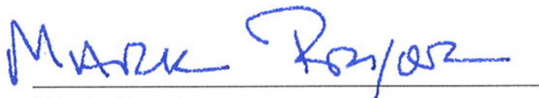
Sincerely,



James M. Inhofe
United States Senator



Mary Landrieu
United States Senator



Mark Pryor
United States Senator

Domestic Issues

One of the most significant economic drivers supporting investment by this industry is access to cash. Cash flow from operations drives the next investment and helps mitigate some of the industry's inherent risk – especially in the exploration and production stage – where upfront investments are extremely large. This model is not unique for this industry and drives many other capital intensive industries, which is an important consideration in the broader aspects of tax reform. Regardless of the industry, the integral component in the cash flow model is the ability to recover these substantial investment costs quickly for tax purposes.

The current tax code has a number of provisions reflecting this policy. Some are broadly applied and others are more specific to certain activities/operations but similar to other provisions applicable to different activities/industries. What these provisions all have in common is the stimulative benefit associated with quick cost recovery that allows cash to be reinvested into the economy.

With respect to the oil and natural gas industry, the main domestic tax provisions of interest that may be discussed in this effort are as follows:

Treatment of Intangible Drilling Costs (section 263(c) of the Code): Given the large capital investment for exploration and production, it is not unusual for producers to invest more cash than they take in from operations. To allow for this reinvestment in operations to continue, taxpayers have the ability to elect to accelerate the recovery of the labor and other operating costs associated with the day-to-day drilling of domestic oil and gas wells.[1] Similar to the deduction for research and development costs, the ability to deduct these expenses recognizes the various risks associated with spending huge amounts of capital and the need to develop domestic sources of energy. A recent Wood Mackenzie study[2] has found that the elimination of this election could have an impact on the US production of oil and natural gas of almost 4 million barrel of oil equivalents a day by 2023. The repeal could have an almost immediate reduction in domestic capital investment of $33B and the loss of almost 190,000 good paying domestic jobs. A delay in recovering these costs would decrease the amount of rents, royalties and (ultimately) taxes flowing to individuals and governments that are currently derived from these operations. The elimination of this election, therefore, would run counter to the promotion of a sound domestic energy policy and the goal of a strong domestic economy that should be a part of any tax reform effort.

LIFO (section 472 of the Code): Taxpayers with inventory are required to track the cost of their inventory in order to calculate taxable income. For decades, the last-in/first-out method has been deemed for tax and accounting purposes as a way to track costs between items sold in the current

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[1] API Submission to Ways and Means Energy Tax Reform Working Group, March 26, 2013, pp 27-36.
[2] Impacts of Delaying IDC Deductibility, Wood Mackenzie (2013)

year and a taxpayer's ending inventory. This method is elected by the taxpayer and must be maintained until the taxpayer no longer has inventory or consent is given by the IRS to allow the taxpayer to change methods. Revenue generated from the repeal of LIFO would come from the deemed sale of a taxpayer's ending inventory in the current year and generate fictitious profits – requiring taxes to be paid without any additional operational income. As a result, companies would experience a significant cash drain that would impact capital investments, new projects, employment and ongoing operations.[3]

Production Activities Deduction (section 199 of the Code): Section 199 of the Code was established to broadly support domestic manufacturing activity through a deduction calculated as a percentage of a taxpayer's qualifying domestic production income.[4] This was meant to broadly apply to a number of different manufacturing operations. However, since enacted, the amount of the qualifying deduction has been limited solely for the oil and natural gas industry (6% versus 9%). Any tax reform efforts impacting section 199 should avoid further targeting industries and look to the need and scope of the provision as a whole. Consideration of 199 by manufacturing activity or manufacturer provides unneeded complication to the Code and is likely to lead to more unfairness among taxpayers.

Percentage Depletion (section 613 and 613A of the Code): The rules under section 613A generally limit the amount of percentage depletion that can be claimed for oil and natural gas production and then further limit the deduction to only small producers, marginal well production and royalty owners. However, the U.S. relies upon these small producers and marginal wells (which are usually plugged in other countries) for a significant portion of its oil and natural gas production. Approximately 80 percent of oil wells in the U.S. are marginal wells that produce 20 percent of U.S. oil, and 67 percent of natural gas wells are marginal and produce 12 percent of U.S. natural gas. The percentage depletion deduction is essential to keeping marginal wells in operation and a change in existing law to deny percentage depletion for oil and natural gas production could make many wells unprofitable and result in shutting down that production. A substantial decline in marginal well activity in the United States would compromise domestic oil and natural gas production that is otherwise expected to be a necessary part of a promising energy future. Further, America's royalty owners are farmers, ranchers and families that benefit from their ownership of mineral assets and use these royalties to supplement retirement income and their farm and ranch incomes.

MACRS Recovery (section 168 of the Code): Modified Accelerated Cost Recovery System (MACRS) is a depreciation mechanism that allows taxpayers to recover the cost of investing in machinery and equipment needed to expand and grow their operations. Accelerated depreciation

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[3] Reasons Why the LIFO Method Should Not Be Repealed in The Context of Business Tax Reform, The LIFO Coalition, March, 2011 (updated July, 2012).
[4] General Explanation of Tax Legislation Enacted in 108th Congress, Joint Committee on Taxation, page 170.

is especially important to energy and fuel producers who must invest billions of dollars in equipment for general operations, as well as to comply with changing environmental regulations. Studies have shown that U.S. depreciation rates are similar to those used by our trading partners and altering that schedule (even with an associated tax rate reduction) could harm the ability for domestic manufacturing firms to compete for capital and markets. Studies have shown that repealing MACRS to finance a rate reduction will increase the cost of capital, which could reduce the amount of new investment in the U.S. and result in lost jobs.[5]

Ability to Recover Geologic and Geophysical Costs (section 167(h) of the Code): Congress enacted section 167(h) with the belief that it would provide a substantial simplification for taxpayers[6], significant gains in taxpayer compliance, and reductions in administrative cost by establishing a clear rule. Prior to the provision, the treatment and recovery of these costs was a consistently audited and contentious issue. Adoption of section 167(h) eliminated these concerns in the form of an amortized recovery schedule that was a compromise between taxpayers and the IRS. Therefore, the provision, as it stands, meets one of the criteria outlined in your letter and any further consideration of this provision in tax reform needs to recognize the balance struck and try to maintain it.

Ability to Recover the Cost of Tertiary Injectants (section 193 of the Code): Similar to the treatment of geological and geophysical costs, the provision allowing taxpayers to quickly recovery the expense associated with tertiary injectants is a clarification provision.[7] Section 193 was added in 1980 to clear up audit issues on the various methods being used to recover these costs at the time. Since it represents a simplified solution, it already meets one of the criteria outlined in your letter and any further consideration of the provision needs to recognize the balance struck and try to maintain it.

Passive Loss Exception for Working Interests (section 469): The passive loss exception for working interests was enacted in 1986 to clarify a situation created from separating investment income into two baskets – active and passive. The passive loss exception formally recognizes the long standing practice that working interest holders in oil and natural gas leases are materially involved in the ongoing operations on that lease. Unlike passive investors, working interests holders directly bear a portion of the actual costs of exploring for, developing and producing the oil and natural gas resources associated with that interest. Working interest owners can deduct only those expenses that have actually been incurred by them and for which they are entirely liable as a result of those operations. As long as there is a distinction between active and passive investment income, clarification of the active involvement of working interest

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[5] The Tax Treatment of Capital Assets and Its Effect on Growth: Expensing, Depreciation, and the Concept of Cost Recovery in the Tax System. See also, "Tax Reform 2013: What Price For a Corporate Rate Reduction?", Ernest S. Christian, Gary A. Robbins, and George J. Schutzer, Tax Notes p. 187 (1/14/13).
[6] General Explanation of Tax Legislation Enacted in 109th Congress, Joint Committee on Taxation, page 51.
[7] General Explanation of the Crude Oil Windfall Profits Tax Act of 1980, Joint Committee on Taxation, page114.

owners in oil and natural gas investments is needed. Since most US wells are drilled by small and independent companies that rely on sharing costs and inherent risks with other working interest holders, the retention of this clarification is vital to the cash needed to continue our growth in domestic energy production.

Master Limited Partnerships (section 7704 of the Code): Master Limited Partnerships (MLPs) are limited partnerships engaged in active business operations and whose "units" are traded on public exchanges. As a partnership, MLP income flows through and is taxed only at the level of the unitholder, who are often domestic individuals, such as seniors and individuals close to retirement. This treatment is available for various qualified income including income from oil and natural gas infrastructure investments. As a result, the MLP vehicle allows for easier access to capital and is extremely successful at encouraging investment in domestic energy infrastructure at levels that otherwise may not occur. Since 2007, MLPs have invested $113 billion in the U.S. economy and are expected to invest $25 billion more in 2013 to build and maintain the U.S. energy infrastructure. Repealing MLP treatment would have the impact of double-taxing investments and thus disincentivizing these investments. With our economy's need to invest in infrastructure and energy development, imposing double taxation on more entities is the wrong way to improve the code.

International Issues

As noted above, access to cash is an integral part of growth in the oil and natural gas industry and all the ensuing economic benefits. Part of this cash flow has come from repatriated foreign earnings, which have been earned in an active business and taxed at high, host country rates.

Tax reform efforts might consider a number of changes to the taxation of international operations; but, should the current worldwide system remain, it is imperative to maintain the robust foreign tax credit mechanism of section 901. Foreign tax credits are not included on the list of "tax expenditures" as they are recognized as a necessary part of a worldwide income tax regime to avoid double tax. However, certain proposals attempt to undermine these rules by modifying the existing dual capacity taxpayer rules outlined in the section 1.901-2A of the Treasury regulations. These proposals are unnecessary based on the stringent requirements of the existing regulations and would significantly compromise the goals of tax fairness and economic growth.[8]

Currently, the dual capacity rules require taxpayers to assume that a portion of a tax paid by a dual capacity taxpayer is non-creditable, unless that taxpayer can prove all or some portion of that payment is, in fact, a tax and not some other type of payment. The requirements are in addition to those applicable to all taxpayers, where it must be demonstrated that the amount paid

[8] Economic and Foreign Policy Implications of the Administration's "Dual Capacity Taxpayer" Proposals

is an income tax. The facts and circumstances approach, like all positions that rely upon a taxpayer proving their return position, is meant to overcome preexisting presumptions though audit and even litigation. Elimination of this approach would, therefore, run counter to the objective of treating taxpayers fairly. Modifying the foreign tax credit to ensure the denial of a credit for actual foreign income taxes would lead to, as stated by the Joint Committee on Taxation, "the potential for double taxation" and "arguably does not constitute sound tax policy."[9] As a result, we do not see any policy basis for modifying these rules should the current worldwide system be retained or in any system that will continue to subject foreign active income to US taxation.

The discussion of taxing international operations may also consider the adoption of an exemption system that excludes a portion of income from a US taxpayer's overseas operations from US taxation. Because of the many broad policy issues, some of which are still to be discussed, it is difficult to comment specifically at this point in the process. However, if discussions advance, any such exemption system should be consistent with the exemption systems employed by other nations and eliminate existing provisions that would be unnecessary.[10]

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[9] Description of Revenue Provisions Contained in the President's Fiscal Year 2013 Budget Proposal, Joint Committee on Taxation, page 408.

[10] For additional information on potential impacts and concerns associated with instituting a foreign income exemption system see, API Submission to Ways and Means International Tax Reform Working Group, March 26, 2013.