A FairTax[SM] White Paper

The 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]

Industry average	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

The oil and gas industry is disadvantaged by current tax law 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 as a preference item the excess of percentage depletion over cost basis[5] and excess intangible drilling costs.[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

[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).

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adverse provisions directly targeted at the oil and gas industry. For example, oil-related income of controlled foreign corporations is specifically targeted for imputation to the parent company and the imputation is taxed currently 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 is advantageous to the oil and gas industry in several respects. First, oil and gas benefits, as do all domestic industries, from sustained growth in the economy. All known economic studies predict growth from replacing the income tax with a consumption tax; indeed, economists typically estimate additional growth to be 10 to 12 percent greater within a decade.[9] Because the economy grows, industrial production, travel, construction (bigger houses), and the like grow, and demand for crude oil and gas increases.

No more corporate income taxes

The oil and gas industry also benefits by never again having to pay U.S. corporate income taxes on either domestic or foreign production. Business-to-business transactions fall out of the taxing net. The retail sale of oil products and gas is subject to sales tax, just like all other retail goods, but 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 increases as well.

More favorable interest rates

The industry is also advantaged by more favorable interest rates. Interest rates are expected to be reduced by between 25 to 30 percent under the FairTax.[10] Although the costs of borrowing are no longer *deductible*, interest expense is paid from pre-tax earnings. Interest is also not taxed to the recipient. As a result, investors 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

Oil and gas enjoys a substantial reduction in cost stemming from transactional and compliance costs. For example, oil and gas companies who engage in international transactions 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 no longer need to be concerned with

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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] Jorgenson, Dale W., "The Economic Impact of the National Retail Sales Tax," unpublished report to Americans for Fair Taxation, November 25, 1996, estimates a 10.5 percent GDP increase; Kotlikoff, Laurence J., "Replacing the U.S. Federal Tax System with a Retail Sales Tax: Macroeconomic and Distributional Impacts," unpublished report to Americans for Fair Taxation, 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 Golob, John E., "How Would Tax Reform Affect Financial Markets?" *Economic Review*, Federal Reserve Bank of Kansas City, Fourth Quarter, 1995. He estimates a 25 to 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.

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disfavorable capital cost recovery or alternative minimum tax rules. They no longer need to spend resources complying with complex employee benefit, pension, and similar tax rules. They 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. The FairTax dramatically reduces the burden on family-owned businesses by repealing the estate and gift tax. This eliminates the need for family-owned small businesses to be sold out of the family to pay the estate tax and eliminates 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).

What is the FairTax Plan?
The FairTax Plan is a comprehensive proposal that replaces all federal income and payroll based taxes with an integrated approach including a progressive national retail sales tax, a prebate to ensure no American pays federal taxes on spending up to the poverty level, dollar-for-dollar federal revenue replacement, and, through companion legislation, the repeal of the 16th Amendment. This nonpartisan legislation (HR 25/S 1025) abolishes all federal personal and corporate income taxes, gift, estate, capital gains, alternative minimum, Social Security, Medicare, and self-employment taxes and replaces them with one simple, visible, federal retail sales tax – administered primarily by existing state sales tax authorities. The IRS is disbanded and defunded. The FairTax taxes us only on what we choose to spend on new goods or services, not on what we earn. The FairTax is a fair, efficient, transparent, and intelligent solution to the frustration and inequity of our current tax system.

What is Americans For Fair Taxation (FairTax.org)?
FairTax.org is a nonprofit, nonpartisan, grassroots organization solely dedicated to replacing the current tax system. The organization has hundreds of thousands of members and volunteers nationwide. Its plan supports sound economic research, education of citizens and community leaders, and grassroots mobilization efforts. For more information visit the Web page: www.FairTax.org or call 1-800-FAIRTAX.

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