

OIL AND TAXES: REFOCUSING THE TAX POLICY QUESTION IN THE AFTERMATH OF THE BP OIL SPILL

*Temí Kolarova**

I. INTRODUCTION

In April 2010, an explosion occurred on the Deepwater Horizon oil rig in the Gulf of Mexico.¹ The accident resulted in oil leaking into the ocean for eighty-seven days, at which point BP p.l.c. (BP), the company which owned the well, installed a cap to contain the flow of oil.² Although the full extent of the oil spill damage may take years to assess, President Obama called the accident “the worst environmental disaster America has ever faced.”³ Shortly after the catastrophe, BP assessed the cost of the clean-up efforts, damages, and claims payments to businesses hurt by the oil spill to be \$32 billion, but warned that the actual cost could easily exceed this number.⁴ In light of the impending elections, both political parties saw the accident as an opportunity to direct public discontent to “local issues and larger ideologies.”⁵ As a result, politicians and the media devoted much of their attention to BP’s tax treatment and, more generally, the tax treat-

* J.D. Candidate, May 2012, Seton Hall University School of Law; B.S., 2008, Fairleigh Dickinson University. I am grateful to Professor Michael Simkovic and Professor Charles Sullivan for their guidance and to Eric Latzer for his comments and assistance. I would like to thank my husband, Anton, for his unwavering support and patience.

¹ Campbell Robertson, *Search Continues After Oil Rig Blast*, N.Y. TIMES, Apr. 22, 2010, at A13.

² Suzanne Goldenberg, *BP Stops Oil Leak in Gulf of Mexico for First Time Since April*, GUARDIAN (London), July 16, 2010, at 1.

³ President Barack Obama, Remarks by the President to the Nation on the BP Oil Spill (June 15, 2010) [hereinafter President’s Remarks], available at <http://www.whitehouse.gov/the-press-office/remarks-president-nation-bp-oil-spill>.

⁴ Neil King Jr., *BP Seeks Tax Cut on Cleanup Costs*, WALL ST. J., July 28, 2010, at A8. Indeed, BP revised the cost estimate upward to \$40.9 billion in its annual report for the fiscal year 2011. BP, p.l.c., Annual Report, (Form 20-F) 34 (Mar. 3, 2011) [hereinafter Form 20-F].

⁵ Damien Cave, *In Campaigns, that Gulf Spill Covers Nation*, N.Y. TIMES, June 30, 2010, at A1.

ment of the oil industry.⁶ BP's financial statements for the second quarter of 2010 indicated that BP took a tax deduction for the \$32 billion in expected remedial spill costs.⁷ Thus, BP's tax liabilities could have decreased by as much as \$10 billion.⁸ For some, the possibility of a reduced tax burden for BP in the aftermath of such an environmental disaster meant that oil companies were not paying their "fair share of taxes."⁹ Although this particular criticism was misguided, it reinvigorated a more fundamental debate—whether the oil industry merits favorable tax treatment.¹⁰

This Comment explores the preferential treatment of the oil industry under the current Internal Revenue Code (the "Code"). Oil companies have enjoyed tax incentives since the beginning of the twentieth century.¹¹ According to some government estimates, the industry saves \$4 billion in taxes per year.¹² Past attempts to repeal oil tax incentives have failed.¹³ The BP oil spill, however, reignited the debate over the tax treatment of oil companies and presented a new opportunity for legislative action. This Comment argues that the preferential tax treatment for oil companies lacks adequate justification and is contrary to important policy goals. Furthermore, repealing these tax provisions may not be sufficient. Decades of excessive oil consumption have created security, environmental, and economic vulnerabilities that need to be addressed through specially-tailored measures, which should complement the repeal of oil tax incentives.

Part II of this Comment provides background information about the BP oil spill and the tax questions that emerged after the accident. Part III then lists and analyzes the numerous provisions in the current

⁶ See, e.g., David Kocieniewski, *As Oil Industry Fights a Tax, It Reaps Subsidies*, N.Y. TIMES, July 3, 2010, at A1.

⁷ BP, p.l.c., Report of Foreign Private Issuer, (Form 6-K) 16 (Jul. 27, 2010) [hereinafter Form 6-K]. BP's estimate of the oil spill costs was later increased to \$ 40.9 billion. See *supra* note 4. Thus, BP's tax liability could decrease even more than initially estimated.

⁸ Form 6-K, *supra* note 7, at 16 n.(a).

⁹ 156 CONG. REC. S4,912 (daily ed. June 15, 2010) (statement of Sen. Bernard Sanders).

¹⁰ See, e.g., 156 CONG. REC. E1,252 (daily ed. June 30, 2010) (statement of Rep. Earl Blumenauer) (arguing that oil companies do not need tax subsidies and that such subsidies are harmful to the future of the American economy).

¹¹ Mona Hymel, *The United States' Experience with Energy-Based Tax Incentives: The Evidence Supporting Tax Incentives for Renewable Energy*, 38 LOY. U. CHI. L.J. 43, 47 (2006).

¹² Kocieniewski, *supra* note 6.

¹³ SALVATORE LAZZARI, CONG. RESEARCH SERV., RL3357, ENERGY TAX POLICY: HISTORY AND CURRENT ISSUES 6 (2008).

Code that afford preferential treatment to the oil industry. In Part IV, the Author explains why these subsidies have no justification today and gives some additional reasons for their repeal. Part IV also evaluates the current legislative actions designed to curb oil tax incentives. Part V identifies some issues that repeal alone may not be able to address and proposes a possible solution.

II. BACKGROUND: THE BP OIL SPILL AND THE TAX CONTROVERSY

BP is an international oil and gas company operating in more than eighty countries.¹⁴ In 2009, it ranked as the fourth largest company in the world by total sales (over \$361 billion).¹⁵ On April 22, 2010, a rig leased by BP off the Gulf Coast sank,¹⁶ and oil leaked into the Gulf for almost three months.¹⁷ The public was outraged. One survey indicated that eighty-one percent of respondents disapproved of BP's response to the spill and that sixty-four percent supported criminal charges against the company.¹⁸ Public criticism had a spillover effect on the industry as a whole.¹⁹

On July 27, 2010, BP released the company's quarterly financial statements and announced that it was taking a deduction for the estimated oil spill costs.²⁰ These costs included the clean-up expenses and the \$20 billion fund that BP established to settle the claims related to the spill.²¹ The public received the news with disapproval. Robert Gibbs, the White House Press Secretary at that time, cautiously expressed his doubt that the public would approve of BP taking the deduction.²² But others outright described BP's deduction as shifting

¹⁴ *BP Plc.*, N.Y. TIMES, http://topics.nytimes.com/top/news/business/companies/bp_plc/index.html (last updated May. 4, 2011).

¹⁵ *The Global 2000*, FORBES (Apr. 8, 2009, 6:00 PM), http://www.forbes.com/lists/2009/18/global-09_The-Global-2000_Rank.html.

¹⁶ Russell Gold et al., *Missing Workers Feared Dead as Gulf Rig Sinks*, WALL ST. J., Apr. 23, 2010, at A5.

¹⁷ See Goldenberg, *supra* note 2.

¹⁸ Gary Langer, *Poll: BP Oil Spill Response Rated Worse than Katrina*, ABCNEWS (June 7, 2010), <http://abcnews.go.com/PollingUnit/Media/poll-bp-oil-spill-rated-worse-katrina-criminal-charges/story?id=10846473>.

¹⁹ During a congressional hearing on the oil spill, the oil industry was castigated for its lack of adequate accident response plans. See Liam Denning, *Backlash Against Oil Could Backfire*, WALL ST. J., June 1, 2010, at C8.

²⁰ See Form 6-K, *supra* note 7, at 16 n. (a).

²¹ *Id.* at 27.

²² See Jia Lynn Yang, *BP to Cut Its U.S. Tax Bill by \$10 Billion*, WASH. POST (July 27, 2010, 11:56 PM), <http://www.washingtonpost.com/wp-dyn/content/article/2010/07/27/AR2010072704437.html>.

oil spill liabilities “to the back of the American taxpayers.”²³ Although the sum is larger than usual, BP relied on standard accounting practices to claim the deduction.²⁴

As a British corporation, BP is subject to U.S. income tax on the income derived from the corporation’s U.S. operations.²⁵ Under the U.S. corporate tax system, taxable income is calculated by subtracting qualified business expenses and other deductions from total business income.²⁶ Tax liability is calculated by multiplying the taxable income by the applicable corporate income tax rate, less any tax credits that the business may be able to claim.²⁷ Section 162(a) of the Code provides for the deduction of trade or business expenses.²⁸ In relevant part, the section states that “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying of any trade or business” are deductible.²⁹ Among others, “ordinary and necessary” include “insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business.”³⁰ The deduction is allowed even if it exceeds the gross income of the applicable period.³¹

In a report on BP’s expense deductibility, the Congressional Research Service explained that, if an oil spill results directly from a company’s operations, the clean-up and claim settlement costs must be treated as “ordinary and necessary” business expenses.³² Other tax professionals agreed that BP was authorized to deduct the \$32 billion costs that the company incurred in relation to the oil spill.³³ The main rationale behind the deduction under §162 is a simple one— income is to be taxed, not revenue.³⁴ The deduction properly reflects

²³ Patrik Jonsson, *If BP Qualifies for \$10 Billion Cleanup Tax Break, Should It Get One?*, CHRISTIAN SCI. MONITOR (Aug. 6, 2010), <http://www.csmonitor.com/USA/Politics/2010/0806/If-BP-qualifies-for-10-billion-cleanup-tax-break-should-it-get-one>.

²⁴ King, *supra* note 4.

²⁵ MOLLY SHERLOCK, CONG. RESEARCH SERV., R41365, TAX DEDUCTIBLE EXPENSES: THE BP CASE 3 (2010).

²⁶ *Id.* at 1.

²⁷ *Id.*

²⁸ 26 U.S.C. § 162(a) (2006).

²⁹ *Id.*

³⁰ Treas. Reg. § 1.162-1(a) (as amended in 1993).

³¹ *Id.*

³² SHERLOCK, *supra* note 25, at 3.

³³ See King, *supra* note 4.

³⁴ Income is a measure of taxpayer’s enrichment and enrichment is considered to be the best indicator of a taxpayer’s ability to pay taxes. See MARVIN A. CHIRELSTEIN, FEDERAL INCOME TAXATION 104 (11th ed. 2009).

the cost of earning the income.³⁵ In other words, refusing BP the deduction would be contrary to one of the fundamental principles of the U.S. income tax system.

The fact that the deduction could allow BP to take a refund for taxes paid in previous years raised public concerns.³⁶ This too has a reasonable explanation under the Code. When a corporation's business deductions exceed its income, the corporation has a net operating loss (NOL).³⁷ The Code permits a corporation to spread such losses over a period of time³⁸ to protect businesses with fluctuating income from the negative effects of an accounting system that calculates taxes on a yearly basis.³⁹ Thus, the taxpayer can ease the income and liability changes during different business cycles and reduce financial risk.⁴⁰ In effect, the government works with the taxpayer in sharing both the benefits and losses of revenue.⁴¹ When NOL is carried back, the taxpayer can receive a refund for taxes paid during previous years; when NOL is carried forward, it reduces future tax burdens.⁴² Currently, a taxpayer can carry back losses for up to the two preceding years and forward for up to twenty years.⁴³

When initially reported, BP's tax savings were estimated as of the time when the firm's second-quarter financial statements were filed, which did not allow a conclusive determination as to whether BP would actually be able to realize NOL benefits.⁴⁴ Later, BP reported that it recorded a net loss of \$4.8 billion for the fiscal year 2010 and confirmed that it would pay no U.S. income tax based on this overall loss for the year.⁴⁵ In addition, the net loss could result in additional tax savings⁴⁶ in the form of NOL.

³⁵ *Id.* at 1.

³⁶ See SHERLOCK, *supra* note 25, at 6 (noting suggestions that BP should not take the deduction).

³⁷ See 26 U.S.C. § 172(c) (2006).

³⁸ See § 172(b).

³⁹ Daniel L. Simmons, *Net Operating Losses and Section 382: Searching for a Limitation on Loss Carryovers*, 63 TUL. L. REV. 1045, 1051 (1989).

⁴⁰ SHERLOCK, *supra* note 25, at 4.

⁴¹ *Id.* at 4–5.

⁴² *Id.* at 4.

⁴³ § 172(b).

⁴⁴ See SHERLOCK, *supra* note 25, at 6.

⁴⁵ Jodson Berger, *BP Cut Tax Bill by \$ 13B Due to Losses from Spill*, FOX NEWS (Apr. 22, 2011), <http://www.foxnews.com/politics/2011/04/22/bp-cut-tax-13b-losses-spill/>.

⁴⁶ See *id.* While BP reported part of this information, it must be noted that any conclusions about the taxes actually paid by BP for a given tax year are not completely accurate when based solely on the information from the company's annual report.

The fact that BP's actions were legitimate under tax law principles did not prevent public ire. Senator Bill Nelson called for a congressional inquiry into the deductibility of the settlement fund and the anticipated legal costs that BP could incur defending spill-related lawsuits.⁴⁷ Three days after BP's deduction announcement, Representative Raul Grijaval introduced the Closing Oil Spill Tax Loopholes Act of 2010.⁴⁸ The bill proposes that taxpayers cannot claim deductions for certain damages paid in relation to oil spills.⁴⁹ In a similar effort, Representative Eliot Engel introduced the Denial of Certain Tax Benefits to Offending Oil Polluters Act of 2010.⁵⁰ The bill denies certain tax benefits to oil companies involved in oil discharge incidents.⁵¹ As of publication, the House has not considered either bill. Nothing about the BP expense deduction conflicts with the fundamental principles of the U.S. income tax system. Yet, a lot of political energy was spent on preventing BP from claiming the deduction most likely because of a desire to please the unhappy oil-spill-sensitive voters. Media outlets reported that taxpayers viewed the deduction as wrongful and inappropriate.⁵² While the emotionally charged criticism of the deduction is not well-founded in general tax principles, the debate about tax fairness for oil companies should be refocused on far more significant issue—the tax treatment of the oil industry as a whole.⁵³ The BP oil spill tax controversy highlights the fact that, from a tax policy perspective, it is misguided to distort fundamental tax principles to punish a particular oil company while at the same time leaving untouched numerous tax preferences specifically tailored to provide tax benefits to the oil industry as a whole.

See Susan Crabtree, *BP to Cut Tax Bill by \$13B but Won't Say what It's Paying IRS for 2010*, TPMDC (Apr. 20, 2011, 4:45 PM), <http://tpmdc.talkingpointsmemo.com/2011/04/bp-to-cut-tax-bill-by-13b-isnt-saying-what-it-paid-irs-for-2010.php>.

⁴⁷ *U.S. Senator Calls for Congressional Probe of BP's Tax Deduction Plans*, U.S. SENATOR BILL NELSON (July 29, 2010), <http://billnelson.senate.gov/news/details.cfm?id=326794&>.

⁴⁸ H.R. 5995, 111th Cong. (2010).

⁴⁹ *See id.*

⁵⁰ H.R. 6031, 111th Cong. (2010).

⁵¹ *See id.*

⁵² *See, e.g., Kim Dixon & Jeremy Pelofsky, BP Fund Tax Breaks Could Bite Back*, REUTERS, June 17, 2010, available at <http://www.reuters.com/article/idUSTRE65G4Y320100617?pageNumber=1>.

⁵³ *See Kocieniewski, supra* note 6 (observing that the oil industry is among the most-subsidized industries).

III. OIL INDUSTRY PREFERENCES IN THE INTERNAL REVENUE CODE

The Code is drafted in such a way as to provide multiple tax incentives for the oil industry. Since the 1970s, the tax incentives for the oil industry have decreased,⁵⁴ but they still remain extremely high.⁵⁵ Some of the preferential tax provisions date back almost a century.⁵⁶ Income tax provisions that provide benefit to specific taxpayers at the expense of government revenue are described as tax expenditures.⁵⁷ Tax expenditures include all provisions that lower the tax liability of favored taxpayers.⁵⁸ Such provisions are the functional equivalent to direct spending by the government and are viewed as a mechanism for achieving “budget policy objectives.”⁵⁹ The provisions discussed below are tax expenditures in the sense that they confer special benefits to the oil industry. The provisions are discussed in groups according to their type: (A) deductions, (B) credits, and (C) other provisions.

A. Deductions

As discussed in Part II, the Code allows the subtraction of certain outlays and expenditures from the taxpayer’s income, which are called deductions.⁶⁰

1. Percentage Depletion Deduction

As a general matter, the Code recognizes that long-lived tangible assets used for business or investment purposes wear out after continued use, and it therefore allows taxpayers an annual deduction for depreciation to compensate for this “loss.”⁶¹ The depreciation deduction is limited to the basis of the property (the cost of the property to the taxpayer).⁶² Similarly, the depletion deduction, unique to extraction and timber businesses,⁶³ allows the recovery of investments in

⁵⁴ See LAZZARI, *supra* note 13, at 1–2 (summarizing the major features of U.S. oil tax policy since its inception).

⁵⁵ Kocieniewski, *supra* note 6.

⁵⁶ *Id.*

⁵⁷ STAFF OF THE JOINT COMM. ON TAXATION, ESTIMATES OF FEDERAL TAX EXPENDITURES FOR FISCAL YEARS 2009–2013 3 (2010), available at <http://www.jct.gov/publications.html?func=startdown&id=3642>.

⁵⁸ *Id.*

⁵⁹ *Id.*

⁶⁰ CHIRELSTEIN, *supra* note 34, at 1.

⁶¹ *Id.* at 162; see 26 U.S.C. § 167 (2006).

⁶² CHIRELSTEIN, *supra* note 34, at 163.

⁶³ See 26 U.S.C. § 611(a) (2006).

mineral property.⁶⁴ There are two types of depletion deduction, cost depletion and percentage depletion, which differ in the way they are calculated.⁶⁵

Like the depreciation deduction, depletion deduction can be used only up to the basis of the depletable mineral property.⁶⁶ Thus, a taxpayer's recovery is limited to the investment in the property. By contrast, percentage depletion is calculated as a fixed rate of the gross income derived from the property.⁶⁷ What sets percentage depletion apart from both depreciation and cost depletion is that the percentage depletion deduction is not limited to the basis that the taxpayer has in the property.⁶⁸ Therefore, the sum of all percentage depletion deductions can exceed a taxpayer's investment in the property.⁶⁹ If production is successful, this treatment can reduce the tax rate substantially.⁷⁰ The General Accounting Office estimates that revenue loss from the excess use of percentage depletion over cost depletion for the three decades prior to 2000 exceeds \$82 billion.⁷¹ According to the latest estimates of the Joint Committee on Taxation (JCT), the revenue loss for the period between 2009 and 2013 alone will be \$6.5 billion.⁷² The original purpose of the percentage depletion was to stimulate exploration and production.⁷³ The depletion deduction and other tax incentives led to an increase in oil and gas production from sixteen percent of all energy in 1929 to seventy-one

⁶⁴ Hymel, *supra* note 11, at 48. Some scholars argue that depletion is different in "character and effect" from depreciation because the depletion deduction is applied to an asset which is the product itself, rather than to a product-producing asset. Wendy B. Davis, *Elimination of the Depletion Deduction for Fossil Fuels*, 26 SEATTLE U. L. REV. 197, 200 (2002).

⁶⁵ See OIL & GAS: FEDERAL INCOME TAXATION 215–16 (Patrick Hennessee & Sean Hennessee eds., 2009) (discussing the two types of depletion deductions).

⁶⁶ *Id.* at 215–16. Cost depletion is determined by dividing the basis of the oil interest by the mineral units sold during the tax year and multiplying the result (which is the cost per unit) by the number of units sold during the year. *Id.* at 215.

⁶⁷ *Id.* at 216. The rate is fifteen percent but can increase up to twenty-five percent. *Id.* This increase is triggered when the reference price of oil is below twenty dollars per barrel. *Id.* The depletion rate will increase one percentage point for every dollar the reference price is below twenty dollars. *Id.* The reference price of oil is based on an estimate of the unregulated crude oil prices. *Id.* at 216 n.24.

⁶⁸ *Id.* at 216.

⁶⁹ Hymel, *supra* note 11, at 48.

⁷⁰ *Id.* at 48–49.

⁷¹ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/RCED-00-301R, TAX INCENTIVES FOR PETROLEUM AND ETHANOL FUELS 7 tbl.2 (2000).

⁷² STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 57, at 31 tbl.3.

⁷³ Hymel, *supra* note 11, at 49. The depletion deduction was originally included in the Tariff Act of 1913. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 71, at 6.

percent of all energy in 1970.⁷⁴ These tax provisions generally resulted in more profitable, accelerated oil production and faster depletion of energy resources.⁷⁵

2. Intangible Drilling Costs Deduction

Intangible drilling costs (IDC) include expenditures for “wages, fuel, repairs, hauling, supplies, etc.” associated with the drilling and preparation of wells for oil production.⁷⁶ Ordinarily, taxpayers cannot deduct such expenses and must capitalize them.⁷⁷ The idea behind capitalization is to spread the cost of assets over the period during which the taxpayer will benefit from these assets.⁷⁸ An oil producer, however, is allowed to make a one-time election to deduct IDC instead of capitalizing them.⁷⁹ Thus, the producer can recover IDC immediately rather than spread the recovery over several years.

For the period between 1968 and 2000, the revenue losses from the IDC deduction were \$42.8 billion.⁸⁰ For the period between 2009 and 2013, the revenue losses are estimated to be \$2.6 billion.⁸¹ Like the depletion deduction, the IDC deduction was introduced in 1918 to stimulate the then-budding oil industry.⁸²

3. Passive Activity Loss Exception

Section 469 of the Code denies taxpayers a deduction for any net loss that results from a passive activity against income from other sources.⁸³ The oil industry benefits from a special exception to this rule. The Code does not consider a working interest in oil property

⁷⁴ LAZZARI, *supra* note 13, at 3.

⁷⁵ *Id.* at 2.

⁷⁶ See Treas. Reg. § 1.612-4(a) (1965).

⁷⁷ Hymel, *supra* note 11, at 49; see 26 U.S.C. § 263(a) (2006). While some expenses can be deducted immediately from income, capitalization mandates a yearly allowance for the exhaustion of capital assets. CHIRELSTEIN, *supra* note 34, at 126. In this way the cost is recovered over a period of time. *Id.*

⁷⁸ CHIRELSTEIN, *supra* note 34, at 126.

⁷⁹ Treas. Reg. § 1.612-4(a) (1965). The producer can even deduct expenses related to nonproductive wells, which represent approximately eighty percent of all wells drilled. Hymel, *supra* note 11, at 49.

⁸⁰ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 71, at 9 tbl.3.

⁸¹ STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 57, at 31 tbl.1. The estimates include revenue losses from oil and gas exploration. *Id.*

⁸² 133 CONG. REC. 6392 (1985) (statement of Rep. Frank Horton).

⁸³ CHIRELSTEIN, *supra* note 34, at 316; see 26 U.S.C. § 469(a) (2006). Passive activities are defined as activities that involve trade or business in which the taxpayer “does not materially participate.” *Id.* § 469(c)(1).

to be a passive activity, regardless of a taxpayer's actual participation.⁸⁴ Thus, while most taxpayers cannot use passive activity losses to offset income from other sources, such as wages, an oil interest owner may be able to do so. The passive activity loss exception was introduced with the Tax Reform Act of 1986.⁸⁵ Until 2000, the exclusion cost roughly \$1.06 billion in lost revenue.⁸⁶

4. Amortization of Geological and Geophysical Expenses

As previously explained, a taxpayer can claim an annual depreciation deduction to compensate for the gradual exhaustion of certain assets⁸⁷ and these allowances are spread over the useful life of the assets.⁸⁸ Costs related to the exploration and development of oil or gas, called geological and geophysical ("G & G") expense,⁸⁹ are considered capital expenses and must be amortized.⁹⁰ Oil producers, however, are entitled to accelerated amortization of G & G expenses, for a period as short as two years for some producers.⁹¹ The Energy Tax Policy Act of 2005 introduced the accelerated amortization provision to stimulate domestic oil production.⁹² The projected revenue loss from the accelerated amortization provision for the period between 2009 and 2013 is \$600 million.⁹³ Repealing the accelerated

⁸⁴ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 71, at 11. A working interest within the meaning of § 469 exists only if the taxpayer holds the interest in a way that does not limit his liability. OIL & GAS: FEDERAL INCOME TAXATION, *supra* note 65, at 483. One example of ownership interest that qualifies for the exception is general partnership interest. *Id.*

⁸⁵ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 71, at 12.

⁸⁶ *Id.* at 12 tbl.5.

⁸⁷ See CHIRELSTEIN, *supra* note 34, at 162.

⁸⁸ Treas. Reg. § 1.167(a)-1(a) (as amended in 1972). Useful life is not the actual time during which the taxpayer uses the asset but a period during which it is expected that the asset will confer a benefit to the owner. Treas. Reg. § 1.167(a)-(1)(b) (as amended in 1972).

⁸⁹ See 26 U.S.C. § 167(h)(1) (2006).

⁹⁰ OIL & GAS: FEDERAL INCOME TAXATION, *supra* note 65, at 145. Such costs include the cost of hiring geologists, conducting various geological surveys, and drilling core holes. *Id.*

⁹¹ See § 167(h); OIL & GAS: FEDERAL INCOME TAXATION, *supra* note 65, at 145. Independent producers and independent oil companies can amortize G & G costs ratably over a two-year period. § 167(h). Major integrated producers can amortize the costs over a seven-year period. *Id.*

⁹² See MARK HOLT & CAROL GLOVER, CONG. RESEARCH SERV., RL 33302, ENERGY POLICY ACT OF 2005: SUMMARY AND ANALYSIS OF ENACTED PROVISIONS 96 (2006). The initial version of the provisions allowed for two-year amortization of G & G expenses for integrated oil producers, but subsequent amendments extended the period to seven years. OIL & GAS: FEDERAL INCOME TAXATION, *supra* note 65, at 145.

⁹³ STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 57, at 31 tbl.1.

amortization provision would result in \$1.1 billion revenue gains over a ten-year period.⁹⁴

5. Tertiary Injectants Deduction

Some oil producers use tertiary recovery methods to increase the oil recovery from certain wells.⁹⁵ Producers inject fluid, gaseous, and other chemical substances into the oil reservoir to recover oil that is too viscous to recover through ordinary methods.⁹⁶ Absent special provisions related to those costs, the taxpayer would have to capitalize such costs.⁹⁷ Section 193 of the Code, however, authorizes a deduction for the cost of tertiary injectants.⁹⁸ In the twenty-year period between 1980 and 2000, the estimated cost of this measure was \$330 million.⁹⁹

B. Credits

Tax credits are tax incentives subtracted directly from the tax liability of the taxpayer.¹⁰⁰ Thus, a credit is a dollar-for-dollar reduction in tax liability, rather than a reduction in gross income.¹⁰¹ There are two major tax credits that benefit the oil industry: the enhanced oil recovery credit and the credit for marginal wells.

1. Enhanced Oil Recovery Credit

Under § 43 of the Code, oil producers are permitted to take a credit for qualified enhanced oil recovery (EOR) expenses.¹⁰² Qualified EOR expenses include tangible property integral to the recovery project, IDC costs, and tertiary injectant expenses.¹⁰³ To the extent that any of these costs are deducted under any other sections of the Code, the deductions must be reduced by the credit amount.¹⁰⁴ Tax-

⁹⁴ OFFICE OF MGMT. & BUDGET, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2011 186 (2010) [hereinafter ANALYTICAL PERSPECTIVES 2011].

⁹⁵ OIL & GAS: FEDERAL INCOME TAXATION, *supra* note 65, at 518.

⁹⁶ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 71, at 14.

⁹⁷ *See id.*

⁹⁸ *See* 26 U.S.C. § 193(a) (2006).

⁹⁹ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 71, at 15 tbl.7.

¹⁰⁰ CHIRELSTEIN, *supra* note 34, at 2.

¹⁰¹ *Id.*

¹⁰² 26 U.S.C. § 43 (2006).

¹⁰³ § 43(c). As discussed earlier, these costs must typically be capitalized. *See supra* notes 77–78 and accompanying text.

¹⁰⁴ *See* § 43(d); OIL & GAS: FEDERAL INCOME TAXATION, *supra* note 65, at 515.

payers can earn credit for up to fifteen percent of the qualified oil recovery costs.¹⁰⁵

For the period between 1990 and 2000, the EOR credit cost over \$1 billion in lost revenue.¹⁰⁶ The credit's purpose is to incentivize domestic oil producers by stimulating the extraction of residual oil from abandoned domestic wells that cannot be extracted through conventional extraction methods.¹⁰⁷

2. Credit for Marginal Wells

The credit for marginal wells¹⁰⁸ allows producers to offset tax liability by three dollars per barrel for oil produced from marginal wells.¹⁰⁹ A qualified well is a well that is both domestic and has an average daily production below a certain limit.¹¹⁰ Like in the case of the EOR credit, when the reference price of crude oil exceeds a certain level, the marginal wells credit phases out gradually.¹¹¹ The American Job Creations Act of 2004 created the tax credit,¹¹² but it has not been used since its inception because crude oil prices have remained high since 2004.¹¹³ The credit was designed to keep domestic supply at a maximum even at times of low oil prices,¹¹⁴ but there is no empirical data about the credit's actual effect because it has never been used.

C. Other Provisions

Some generally applicable Code provisions confer disproportionate benefits to the oil industry as well. These provisions are discussed in some detail in this subsection.

¹⁰⁵ § 43(a). The credit availability depends on the price of crude oil and it is phased out ratably when the price exceeds twenty-eight dollars per barrel. OIL & GAS: FEDERAL INCOME TAXATION, *supra* note 65, at 515. A complete phase-out occurs when the reference price exceeds the statutory limit by six dollars per barrel. *Id.*

¹⁰⁶ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 71, at 13.

¹⁰⁷ ENERGY INFORMATION ADMIN., FEDERAL FINANCIAL INTERVENTIONS AND SUBSIDIES IN ENERGY MARKETS 2007 137 (2007), available at <http://www.eia.doe.gov/oiaf/servicerpt/subsidy2/pdf/subsidy08.pdf>.

¹⁰⁸ See 26 U.S.C. § 45I (2006).

¹⁰⁹ See OIL & GAS: FEDERAL INCOME TAXATION, *supra* note 65, at 522.

¹¹⁰ *Id.* at 522–23.

¹¹¹ See *id.* at 523. The reference price limit is fifteen dollars per barrel. *Id.* After the reference price passes this mark, the credit is reduced proportionately. *Id.* Once the reference price of crude oil reaches eighteen dollars per barrel, the credit is completely phased out. *Id.*

¹¹² *Id.* at 522.

¹¹³ ROBERT PIROG, CONG. RESEARCH SERV., R 41139, OIL INDUSTRY TAX ISSUES IN THE FISCAL YEAR 2011 BUDGET PROPOSAL 3, 4 (2010).

¹¹⁴ *Id.* at 3.

1. Foreign Tax Credit

Foreign countries may exercise their tax power to levy taxes on income earned by foreigners within their territory.¹¹⁵ To avoid taxing American taxpayers twice on income earned abroad, the United States allows taxpayers to claim credit for income taxes paid or accrued abroad.¹¹⁶ When a foreign levy is a compulsory payment under a foreign state's taxation power, it is a creditable tax.¹¹⁷ But if the taxpayer receives an economic benefit in exchange for the payment, the levy is not a creditable tax.¹¹⁸ A taxpayer who is both subject to a foreign levy and receives some economic benefit from the foreign country is designated as a dual-capacity taxpayer.¹¹⁹ In some cases the whole levy may not qualify for a credit, but the taxpayer has the option of demonstrating that he can credit at least a part of the levy against domestic tax liability.¹²⁰

Section 907¹²¹ of the Code caps the amount of the credit available for foreign oil and gas income at the tax liability such income would create under the applicable U.S. tax rate.¹²² Although § 907 was enacted to restrict the ability of oil companies to claim foreign tax credit for special payments, it does not prevent them from taking credit for disguised royalties.¹²³ Sometimes it is simply not clear whether a payment that an oil company made was in exchange for an economic benefit (royalty) or not. Thus, oil companies may get im-

¹¹⁵ JOINT COMM. ON TAXATION, PRESENT LAW ENERGY-RELATED TAX PROVISIONS AND PROPOSED MODIFICATIONS CONTAINED IN THE PRESIDENT'S FISCAL YEAR 2011 BUDGET 85 (2010), available at <http://www.jct.gov/publications.html?func=startdown&id=3678>.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ See Treas. Reg. § 1.901-2(a)(ii)(2) (as amended in 2011). An economic benefit is a benefit that is not made available under the general income tax system of the foreign country to other taxpayers. JOINT COMM. ON TAXATION, *supra* note 115, at 85.

¹¹⁹ JOINT COMM. ON TAXATION, *supra* note 115, at 85.

¹²⁰ OIL & GAS: FEDERAL INCOME TAXATION, *supra* note 65, at 580. There are two methods that a taxpayer can use to demonstrate payment of creditable tax. First, a safe harbor authorizes the taxpayer to credit a portion of the levy that is equivalent to the amount that the taxpayer would have paid under the generally applicable income tax of the foreign country. See JOINT COMM. ON TAXATION, *supra* note 115, at 86. The remainder of the levy is not creditable. See *id.* If the foreign country does not impose a generally applicable income tax, the taxpayer can claim a credit for a portion of the levy that the taxpayer would have to pay under the U.S. income tax rate. See *id.* Alternatively, the taxpayer may chose to show that, in light of all facts and circumstances, a certain levy is a tax. See *id.*

¹²¹ See 26 U.S.C. § 907 (2006).

¹²² See JOINT COMM. ON TAXATION, *supra* note 115, at 88.

¹²³ ENVTL. LAW INST., ESTIMATING U.S. GOVERNMENT SUBSIDIES TO ENERGY SOURCES: 2002–2008 10 (2009).

proper tax benefits by relying on the foreign tax credit.¹²⁴ For the period between 2002 and 2008, the estimated revenue losses from such practices were \$15.3 billion.¹²⁵

2. Domestic Manufacturing Deduction

The domestic manufacturing deduction is a generally applicable deduction for manufacturing activities performed within the United States.¹²⁶ The deduction is a statutory percentage of the lesser of the taxpayer's qualified production activity income or the taxpayer's taxable income.¹²⁷ The American Job Creation Act added § 199 to the Code in 2004, and the purpose of the Act was to expand employment in the manufacturing sector of the U.S. economy.¹²⁸

¹²⁴ In the 1950s, certain oil-producing countries reclassified royalties from U.S. oil companies as income taxes based on a suggestion by the State Department. *Id.* Despite the restrictions on this practice that followed in later years, major oil-producing countries continue to impose higher income tax rates on oil businesses than on other taxpayers. *See id.* For example, in Saudi Arabia the income tax rate for oil-producing businesses is eighty-five percent, but the income tax rate for non-oil businesses is twenty percent; in Nigeria, the income tax rate for oil companies is eighty percent, but the general income tax rate is thirty percent. *Id.*

The subsidy that oil companies are entitled to receive under the current rules can be best illustrated through an example. The following example is adapted from ESTIMATING U.S. GOVERNMENTAL SUBSIDIES TO ENERGY SOURCES: 2002–2008 published by the ENVIRONMENTAL LAW INSTITUTE. *See id.* at 11. Country A imposes a general income tax rate of twenty percent but levies fifty percent taxes on oil companies. If a U.S. oil company has taxable income of \$1,000, it pays \$500 in taxes to country A, and can claim tax credit of \$350 against U.S. tax liability (limited to thirty-five percent of taxable income). *See id.* They can carry the \$150 difference forward for up to ten years. *See id.* Thus, the difference between the payment that the company would have made under the twenty-percent tax rate and the special fifty-percent rate is not recognized as a royalty. *See id.* If the difference is treated as a royalty payment, the taxpayer would be considered to have paid only \$200 in income tax to country A (based on the generally applicable twenty-percent tax rate) and would be entitled to foreign tax credit of only \$200. *See id.* The remaining \$300 are deductible by the company but are not counted towards the credit. *See id.* The revenue loss for the Treasury is the difference between the credit available under the first scenario and the second scenario reduced by the effect of the deduction: $(\$350 - \$200) * .65 = \$97.5$. *See id.* at 11.

¹²⁵ *Id.* at 7.

¹²⁶ See 26 U.S.C. § 199(c)(4) (2006). The deduction applies to income derived from qualifying property that has been “manufactured, produced, grown or extracted” in the United States. *See id.*

¹²⁷ OIL & GAS: FEDERAL INCOME TAXATION, *supra* note 65, at 499; JOINT COMM. ON TAXATION, *supra* note 115, at 72. The statutory percentage limit for 2009 was six percent. JOINT COMM. ON TAXATION, *supra* note 115, at 72. The percentage is set at nine percent for 2010. OIL & GAS: FEDERAL INCOME TAXATION, *supra* note 65, at 499.

¹²⁸ *Id.*

Although the oil industry is designated as a manufacturing industry for reporting purposes, it differs significantly from other manufacturing industries.¹²⁹ Unlike manufacturing, the production level is only indirectly related to the level of employment, and a much bigger portion of oil industry investments are capital in nature.¹³⁰ In addition, since the high prices of oil during the last few years have spurred record profits for oil companies, oil prices are more likely to influence capital investment decisions in the industry.¹³¹ Thus, it seems unlikely that the domestic manufacturing credit will play a significant role in oil companies' employment decisions. Repealing the deduction for the oil industry alone would eliminate \$7.3 billion in tax expenditures over four years.¹³²

3. LIFO Method of Accounting for Inventories

The "last-in, first-out" (LIFO) method is a method of accounting for inventories.¹³³ It authorizes companies to record as "sold first" the products that the company acquired last.¹³⁴ The LIFO method closely reflects the current inventory costs,¹³⁵ despite the fact that often the company bought the goods at a lower price.¹³⁶ In a world of rising prices, LIFO permits companies to declare a higher measure of costs of goods sold and thus lower income, as compared to the "first-in, first-out" (FIFO) method of accounting.¹³⁷ Another criticism of LIFO

¹²⁹ *Id.*

¹³⁰ *Id.* Therefore, if the deduction lowers oil companies' production and labor costs, it is unlikely that they will employ more people. *Id.* Any increase in employment would likely be minor. *Id.*

¹³¹ *Id.* at 5.

¹³² *Id.* at 2 tbl.1.

¹³³ See 26 U.S.C. § 467 (2006).

¹³⁴ § 467(b).

¹³⁵ JOINT COMM. ON TAXATION, *supra* note 115, at 78.

¹³⁶ David Reilly, *Outside Audit: Big Oil's Accounting Methods Fuel Criticism—LIFO Leaves the Likes of Exxon with Big Balance-Sheet Reserves as Gas-Pump Prices Slam Drivers*, WALL ST. J., Aug. 8, 2006, at C1.

¹³⁷ JOINT COMM. ON TAXATION, *supra* note 115, at 78; see Reilly, *supra* note 136. Alternatively, if prices are falling, LIFO would produce lower measures of goods sold and higher income. *Cf.* JOINT COMM. ON TAXATION, *supra* note 115, at 78. Some proponents of the LIFO method argue that it shields companies from the effect of inflation by matching current revenue with current costs. Reilly, *supra* note 136. But the method also allows companies to declare higher inventory costs provided that assets were purchased at a lower cost initially. *Id.* The inventory that a company carries from the end of one year to the next under LIFO can relate back to the year when the company adopted the method, which may go back decades. *Id.* Notably, LIFO has been used since the 1930s. *Id.* Thus, LIFO can be over-inclusive because it allows the taxpayer to shield income beyond the mere effects of inflation. *Id.*

is that it provides selective and preferential protection for inflationary gains because only businesses with physical inventories can use it.¹³⁸ Also, LIFO is not generally accepted internationally.¹³⁹

In addition to the oil industry, LIFO is available to many retailers and manufacturers.¹⁴⁰ Empirical evidence shows, however, that the oil industry benefits disproportionately from its use.¹⁴¹ While the average difference between “[the] amount reported under LIFO and [the] market value of inventory” is 15%, for Exxon Mobil, for example, this difference is 200%.¹⁴² In 2006, the JCT predicted that the effect of repealing LIFO for the oil industry would bring \$4.3 billion in tax revenue.¹⁴³

IV. SHOULD CONGRESS REPEAL OIL TAX INCENTIVES?

Reviewing the multiple ways in which oil companies receive disproportionate tax benefits indicates that allowing BP to take a generally applicable deduction is not the real tax policy problem. But proponents of oil industry tax subsidies advance various arguments why these subsidies should be part of the Code. Historically, the proponents have cited various justifications for the tax subsidies, including that the subsidies provide support for the industry in its infancy, develop the industry for national security purposes, benefit consumers, and mitigate the high economic risks associated with the oil industry.¹⁴⁴ As the analysis below demonstrates, though, none of these reasons sufficiently justifies the need for oil tax incentives today. Therefore, Congress should consider repealing the incentives.

One of the oldest justifications for subsidizing the oil industry is the infant industry theory. One of the first proponents of the theory was Alexander Hamilton, who believed that the government is justi-

¹³⁸ Edward D. Kleinbard et al., *Is It Time to Liquidate LIFO?*, 113 TAX NOTES 237, 238 (2006).

¹³⁹ The European Union, for example, does not allow the use of LIFO. Reilly, *supra* note 136.

¹⁴⁰ See Kleinbard et al., *supra* note 138, at 243 (noting that LIFO is used by “many retailers and manufacturers”).

¹⁴¹ According to one estimate, in 2005, Exxon Mobil reported LIFO inventories of \$7.8 billion when the market value of the inventory without the use of LIFO would have been \$15.4 billion more. See *Corporate Tax Issues: Hearing on H.R. 4297 Before the Subcomm. on Finance*, 109th Cong. (2006) (testimony of Prof. George Plesko).

¹⁴² *Id.*

¹⁴³ *Id.*

¹⁴⁴ See *infra* notes 145–71 and accompanying text.

fied in granting monopolies to new and risky trades.¹⁴⁵ Later, the theory incorporated the use of “subsidies, tariffs, and quantitative restrictions” to achieve the same purpose.¹⁴⁶ The infant industry theory seeks to help an industry that is not currently competitive grow through temporary government protection.¹⁴⁷

In the beginning of the twentieth century, the federal government perceived the potential of fossil fuels and directed incentives to help develop the budding industry.¹⁴⁸ Today, however, this justification is inapplicable. Even though the oil industry was in its infancy at the beginning of the twentieth century,¹⁴⁹ currently it is one of the most profitable sectors of the economy,¹⁵⁰ not only domestically but globally. Domestic oil production has increased more than thirty-fold since the early 1900s.¹⁵¹ Today, the oil industry is mature, competitive, and highly profitable, rendering a governmental boost unnecessary. Furthermore, infant industry theory necessarily requires that government protects the industry temporarily.¹⁵² By contrast, some of the oil subsidies have existed for almost a century, and all of them are permanent provisions of the Code.¹⁵³ The oil industry is too developed and has received assistance for too long to fit within the fundamental rationales of infant industry theory.

Another frequently used argument is the national security or defense argument. Proponents suggest that subsidies are necessary for maintaining domestic oil production for national security purposes.¹⁵⁴ This argument focuses on the external non-market costs that can result from oil imports, such as the risk of disproportionate depen-

¹⁴⁵ 2 THE NEW PALGRAVE: A DICTIONARY OF ECONOMICS 828 (John Eatwell et al. eds., 1987) [hereinafter PALGRAVE].

¹⁴⁶ *Id.* at 829.

¹⁴⁷ *See id.*

¹⁴⁸ *See* Hymel, *supra* note 11, at 47.

¹⁴⁹ *Id.*

¹⁵⁰ The two most profitable companies for 2009 on the Fortune 500 list were Exxon Mobil and Chevron. *See Fortune 500*, FORTUNE, <http://money.cnn.com/magazines/fortune/fortune500/2009/performers/companies/profits/> (last visited Sept. 28, 2011).

¹⁵¹ The calculation is based on data from the U.S. Energy Information Administration, which reports production levels at 63,621 thousand barrels per annum in the beginning of the 1900s and 1,998,137 thousand barrels per annum in 2011. *See Petroleum & Other Liquids*, U.S. ENERGY INFO. ADMIN. INDEP. STATISTICS & ANALYSIS (July 28, 2011), <http://www.eia.doe.gov/dnav/pet/hist/LeafHandler.ashx?n=PET&s=MCRFPUS1&f=A>.

¹⁵² *See* 2 PALGRAVE, *supra* note 145, at 829.

¹⁵³ *See* discussion *supra* Part III.

¹⁵⁴ Hymel, *supra* note 11, at 68.

dence on oil imports from hostile or politically unstable countries.¹⁵⁵ This risk is associated with possible disruptions in supply and the costs of ensuring supply levels.¹⁵⁶ A tariff on oil imports could be an effective policy step to address these risks.¹⁵⁷ Nevertheless, such action could be challenged as contrary to the United States' obligations under international trade agreements, and this has lead policy-makers to implement subsidies instead.¹⁵⁸

Oil tax subsidies, however, have failed to immunize the U.S. economy against the risks associated with dependence on foreign oil imports.¹⁵⁹ It is true that domestic production facilitates the creation of a domestic oil reserve that can be diverted for national defense and military purposes without causing a civilian shortage in the case of a supply disruption.¹⁶⁰ But it is also true that U.S. oil consumption continues to exceed production and thus continues to expose the economy to the risks of dependence on oil imports.¹⁶¹ More importantly, some of the subsidies support foreign oil production.¹⁶² Although many of the biggest subsidies to the domestic oil industry have been available for years and even decades,¹⁶³ oil imports have grown steadily throughout the years.¹⁶⁴ Thus, the assertion that tax subsidies reduce oil imports seems doubtful in reality.

¹⁵⁵ See SALVATORE LAZZARI, CONG. RESEARCH SERV. RL 30406, ENERGY TAX POLICY: AN ECONOMIC ANALYSIS 11 (2005).

¹⁵⁶ See *id.*

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* Whether an oil import tariff could be successfully challenged as a violation of United States' obligations under international trade agreements is debatable. For example, the prohibition against quantitative restrictions on trade under the General Agreement on Tariffs and Trade (GATT) is subject to a number of exceptions, including the national security exception under Article XXI. See U.N. CONFERENCE ON TRADE & DEV., TRADE AGREEMENTS, PETROLEUM AND ENERGY POLICIES, at 2, U.N. Doc. UNCTAD/ITCD/TSB/9 (2000), available at <http://www.unctad.org/en/docs/poitcdtsbd9.en.pdf>. In fact, crude oil tariffs are not subject to the World Trade Organization (WTO) system and the United States could impose a higher tariff on crude oil imports than the tariff currently in force without violating its obligations. See *id.* at 117. A more detailed analysis of this issue is beyond the scope of this Comment.

¹⁵⁹ Hymel, *supra* note 11, at 70.

¹⁶⁰ *Id.* at 70–71.

¹⁶¹ *Id.* at 71.

¹⁶² One such example is the foreign tax credit. See *supra* Part III.B.1.

¹⁶³ One example is the percentage depletion deduction which has been available for almost a century. See Hymel, *supra* note 11, at 48.

¹⁶⁴ See U.S. ENERGY INFO. ADMIN., ANNUAL ENERGY REVIEW 2009 129 tbl.5.1 (2009), available at <http://www.eia.gov/emeu/aer/pdf/aer.pdf>.

Another argument for maintaining oil subsidies is that they compensate for the high risk inherent in the industry.¹⁶⁵ The reasoning behind this proposition is that the high volatility of oil prices increases the risk of under-investment in the industry.¹⁶⁶ The oil industry contends that without the current subsidies, the inherent industry risks will lead to domestic job losses.¹⁶⁷ Studies on the effect of oil tax subsidies on risk, though, have not confirmed conclusively that such subsidies are indeed beneficial.¹⁶⁸ Furthermore, to some extent “all prices fluctuate in a free market.”¹⁶⁹ Thus, most subsidies do not seem to be directed toward stabilizing prices.

The risks to the job market are also overstated. The oil industry is capital-intensive and subsidizing it is likely to have limited effect on labor demand.¹⁷⁰ Some estimate that repeal of the subsidies will not lead to a significant reduction in domestic production levels either, resulting in possible reduction in employment levels of no more than 0.5%.¹⁷¹

Not only do tax subsidies lack sufficient justification, but they also seem wasteful in light of the federal budget deficit. The deficit has reached its highest levels since World War II.¹⁷² It is expected to reach eighty percent of gross domestic product (GDP) by 2015.¹⁷³ As Senator Bernard Sanders stated, repealing oil industry tax subsidies “could be an important step forward” to deficit reduction.¹⁷⁴ A repeal of the oil tax subsidies discussed in Part II would result in \$36.5 billion in revenue over a ten-year period.¹⁷⁵ This revenue could either be applied directly towards deficit reduction or provide valuable funds for other programs without burdening the current deficit.

¹⁶⁵ See Hymel, *supra* note 11, at 68.

¹⁶⁶ See LAZZARI, *supra* note 155, at 12.

¹⁶⁷ See Kocieniewski, *supra* note 6.

¹⁶⁸ See Hymel, *supra* note 11, at 69 (“[W]hen risk is evaluated, studies indicate that the benefit of oil and gas tax incentives is not clear.”).

¹⁶⁹ See LAZZARI, *supra* note 155, at 12.

¹⁷⁰ See PIROG, *supra* note 113, at 4.

¹⁷¹ *Oil and Gas Tax Provisions: A Consideration of the President’s FY 2010 Budget Proposal Before the Subcomm. on Energy, Natural Res. and Infrastructure of the Subcomm. on Fin.*, 111th Cong. 5–6 (2010) (statement of Alan Krueger, Assistant Sec’y for Econ. Policy, Dep’t of Treasury).

¹⁷² See INTL. MONETARY FUND, UNITED STATES: SELECTED ISSUES PAPER 37 (2010).

¹⁷³ *Id.*

¹⁷⁴ 156 CONG. REC. S4912 (daily ed., June 15, 2010) (statement of Sen. Bernard Sanders).

¹⁷⁵ See ANALYTICAL PERSPECTIVES 2011, *supra* note 94, at 186.

Supporters of oil subsidies often assume that the subsidies will pass through oil producers and benefit consumers.¹⁷⁶ Lower prices for consumers can be reasonably expected when the industry is price-competitive. Oil prices, however, may not be competitive enough. In the international market, crude oil prices are largely determined by the Organization of Oil Producing Nations (OPEC).¹⁷⁷ In addition, the domestic petroleum industry seems to be highly concentrated, which presents an additional obstacle for competitive pricing.¹⁷⁸ If the industry is sufficiently concentrated and non-competitive, subsidies are likely to benefit producers far more than they benefit consumers.

Perhaps the strongest argument against oil subsidies is the economic vulnerability created by excessive oil dependence. In 2006, President Bush articulated these economic risks when he stated that “America is addicted to oil” and recognized the need to “move beyond a petroleum-based economy.”¹⁷⁹ America’s oil demand has been rising rapidly over the past century and is yet to reach its highest point.¹⁸⁰ At the same time, global oil demand has risen too, largely driven by developing countries such as China and India.¹⁸¹ Failure of oil supply to keep up with the growing demand could cause prices to rise, which could have negative effect on an oil-dependent economy. The robust governmental support for the oil industry throughout the

¹⁷⁶ See, e.g., RONALD J. SUTHERLAND, CATO INST., POLICY ANALYSIS NO. 390, “BIG OIL” AT THE PUBLIC TROUGH? AN EXAMINATION OF PETROLEUM SUBSIDIES 4 (2001), available at <http://www.cato.org/pubs/pas/pa390.pdf> (“Moreover, the benefits bestowed by subsidies are reduced by competition and captured, in part, by others, primarily consumers.”).

¹⁷⁷ See FED. TRADE COMM’N, GASOLINE PRICE CHANGE: THE DYNAMIC OF SUPPLY, DEMAND, AND COMPETITION 14 (2005), available at <http://www.ftc.gov/reports/gasprices05/050705gaspricesrpt.pdf>.

¹⁷⁸ There are forty-five oil-refining firms in the United States, of which ten capture seventy-five percent of the refining market. ANTHONY ANDREWS ET AL., CONG. RESEARCH SERV., R 41478, THE U.S. OIL REFINING INDUSTRY: BACKGROUND IN CHANGING MARKETS AND FUEL POLICIES 17–18 fig.9 (2010). See generally U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-04-96, ENERGY MARKETS: EFFECT OF MERGERS AND MARKET CONCENTRATION IN THE U.S. PETROLEUM INDUSTRY (2004) (determining that market concentration has substantially increased).

¹⁷⁹ President George W. Bush, State of the Union Address (Jan. 31, 2006), available at http://www.c-span.org/executive/transcript.asp?cat=current&code=bush_admin&year=2006.

¹⁸⁰ See Hymel, *supra* note 11, at 53.

¹⁸¹ In 2003, “China surpassed Japan to become the world’s second largest consumer of petroleum products,” while between 1987 and 2001 India’s demand doubled. See FED. TRADE COMM’N, *supra* note 177, at 19.

years contributes to the problem.¹⁸² Reducing petroleum dependence has become one of President Obama's central policy goals.¹⁸³ Both the current and the previous administrations ushered in various tax incentives designed to support the development of renewable energy industries to increase energy efficiency and conservation.¹⁸⁴

Tax incentives for alternative energy are just one part of the solution to the oil dependence problem. Despite efforts to stimulate alternative energy, favorable tax provisions for the oil industry still remain firmly in place. Maintaining subsidies for both alternative and traditional energy sources "is clearly inconsistent with the policy goal of moving energy policy in the direction of renewable sources."¹⁸⁵ Not only would cutting oil tax subsidies be "a beneficial undertaking,"¹⁸⁶ but it is also a necessary condition for a permanent solution to the oil dependence problem.

The current Obama Administration considers reduction of dependence on fossil fuels one of its primary domestic goals.¹⁸⁷ Consistent with this commitment, the Administration has taken steps to address the fossil fuel tax subsidies. For example, President Obama's proposed budget for 2011 envisioned the elimination of the preferential tax treatment for fossil fuels.¹⁸⁸ The budget proposed the repeal of the percentage depletion deduction, the IDC deduction, the exception for passive activity loss for oil and gas interests, the tertiary injectants deduction, the EOR credit, the marginal wells credit, and the domestic manufacturing deduction for the oil industry.¹⁸⁹ The budget also recommended the two-year amortization period for D &

¹⁸² Oil dependence could be linked to oil's dominance as a transportation fuel, which can be traced to "a century of favorable government policies and deeply ingrained cultural patterns." DAVID SANDALOW, THE BROOKINGS INST., ENDING OIL DEPENDENCE 2 (2007), available at <http://www.brookings.edu/views/papers/fellows/sandalow20070122.pdf>.

¹⁸³ See, e.g., President's Remarks, *supra* note 3 (declaring determination for transition away from fossil fuels and emphasizing the long-term environmental, economic, and security costs that will result from maintaining the status quo).

¹⁸⁴ For example, President Obama signed into law the American Recovery and Reinvestment Act of 2009, which extended the eligibility dates for the renewable electricity production credit. Pub. L. No. 111-5, div. B, tit. II, § 1101, 123 Stat. 115, 318 (codified as note to 26 USC § 45) .

¹⁸⁵ Roberta Mann, *Back to the Future: Recommendations and Predictions for Greener Tax Policy*, 88 OR. L. REV. 355, 376 (2009).

¹⁸⁶ *Id.*

¹⁸⁷ See Jad Mouawad, *Obama Tries to Draw up an Inclusive Energy Plan*, N.Y. TIMES, Mar. 18, 2009, at B1.

¹⁸⁸ See ANALYTICAL PERSPECTIVES 2011, *supra* note 94, at 177.

¹⁸⁹ *Id.*

D expenses applicable to independent oil companies to be equalized with the seven-year period available to integrated oil producers.¹⁹⁰ The budget proposal also incorporated reforms in the foreign tax credit for dual-capacity tax payers, which would not allow such taxpayers to claim credit for the amount of a foreign levy that exceeded the generally applicable levy in the foreign country.¹⁹¹ In addition, the budget proposed the extension, modification, and enactment of tax incentives for energy conservation and alternative energy.¹⁹² The President's budget for fiscal year 2012 included similar proposals.¹⁹³ Neither proposal was successful.

After the BP spill, legislators were quick to harness the atmosphere of public discontent towards the oil industry and introduced two new repeal bills in the Senate. In May 2010, Senator Robert Menendez introduced a bill entitled the Close Big Oil Tax Loopholes Act, which essentially mimics the 2011 budget proposal.¹⁹⁴ In June 2010, Senator Bernard Sanders followed with an amendment to the Unemployment Compensation Extension Act of 2010 that proposed cutting the percentage depletion deduction, the IDC deduction, and the manufacturing credit for oil and gas activities.¹⁹⁵ The amendment failed to muster even a simple majority in Senate as only thirty-five senators voted in its favor.¹⁹⁶ Notably, the vote occurred right in the midst of the BP oil spill crisis; even this fact did not give momentum to the proposed legislation. A similar effort to repeal tax breaks for the oil industry failed in Senate in May 2011.¹⁹⁷

Judging by these failures, the odds that Congress will repeal oil tax subsidies in the near future are slim. The oil industry's strong lobby in Washington, especially as compared to the alternative energy industry's lobby, could reduce these chances even further.¹⁹⁸ Last but

¹⁹⁰ *Id.*

¹⁹¹ U.S. DEP'T OF TREASURY, GENERAL EXPLANATIONS OF THE ADMINISTRATION'S FISCAL YEAR 2011 REVENUE PROPOSALS 49 (2010) [hereinafter GREEN BOOK].

¹⁹² See generally ANALYTICAL PERSPECTIVES 2011, *supra* note 94. A detailed discussion of these provisions is beyond the scope of this Comment.

¹⁹³ OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, ANALYTICAL PERSPECTIVES, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2012 204 (2011).

¹⁹⁴ See S. 3405, 111th Cong. (2010). There has been no vote on the bill.

¹⁹⁵ 156 CONG. REC. S4753-54 (daily ed. June 15, 2010).

¹⁹⁶ Donna Smith, *Effort to Repeal Oil Tax Breaks Fails in Senate*, REUTERS, June 15, 2010, available at <http://www.reuters.com/article/idUSTRE65F01820100616>.

¹⁹⁷ John Nolen, *Senate Blocks Bill Repealing \$2 billion in Oil Tax Breaks*, CBSNEWS (May 17, 2011), http://www.cbsnews.com/8301-503544_162-20063724-503544.html.

¹⁹⁸ Over the past twelve years, oil and gas interest groups contributed over \$288 million to members of Congress. *Oil & Gas: Long-Term Contribution Trends*, OPEN

not least, oil exporting countries are the fourth largest holder of U.S. treasury securities.¹⁹⁹ This fact may serve as a further incentive to maintain the status quo of generous oil subsidies.

V. FURTHER PROBLEMS AND POSSIBLE SOLUTIONS

A. *The Effect of Repeal*

Repealing oil tax subsidies may not be sufficient to address all problems without additional measures in place. The first problem is directly related to the incentives for oil production and oil consumption. By cutting oil tax subsidies and making the cost of production higher than it currently is, the Obama Administration hopes to discourage overproduction of oil.²⁰⁰ In reality, however, terminating tax incentives is unlikely to cause a decrease in oil production levels. The subsidies are dwarfed by high profits.²⁰¹ A repeal will yield as much as \$36.5 billion in government revenue over a ten-year period.²⁰² But from the perspective of oil companies, the cost of repealing the percentage depletion deduction, the domestic manufacturing credit, and the IDC deduction represents less than one percent of total oil revenues.²⁰³ The market itself, driven by strong demand, would likely provide sufficient incentives for the domestic production of oil even without subsidies.²⁰⁴ Thus, repeal alone would not be sufficient to counteract the strong market incentives for oil production.

Some have also suggested that repealing the subsidies may increase fossil fuel prices, which could lead to both reduced consump-

SECRETS, <http://www.opensecrets.org/industries/totals.php?cycle=2010&ind=E01> (last visited Jan. 06, 2012). During the same time period of time, alternative energy interest groups contributed \$8.4 million. *Alternative Energy Production & Services: Long-Term Contribution Trends*, OPEN SECRETS, <http://www.opensecrets.org/industries/totals.php?cycle=2010&ind=E1500> (last visited Jan. 6, 2012).

¹⁹⁹ See *Major Foreign Holders of Treasury Securities*, TREASURY, <http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt> (last visited Jan. 5, 2012). In October 2011, Ecuador, Venezuela, Indonesia, Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates, Algeria, Gabon, Libya, and Nigeria collectively held more than \$226 billion in treasury securities, surpassed only by China, Japan, and the United Kingdom. See *id.*

²⁰⁰ See GREEN BOOK, *supra* note 191, at 75–90.

²⁰¹ Crude oil production's return on revenues was 19.8% for 2008—the highest among all industries. See *Top Industries: Most Profitable*, FORTUNE (July 20, 2009), <http://money.cnn.com/magazines/fortune/global500/2009/performers/industries/profits/>.

²⁰² See ANALYTICAL PERSPECTIVES 2011, *supra* note 94, at 186.

²⁰³ 156 CONG. REC. S4911 (daily ed. June 15, 2010) (statement of Sen. Bernard Sanders).

²⁰⁴ See PIROG, *supra* note 113, at 6.

tion of oil products and increased consumption of renewable energy resources.²⁰⁵ This argument, however, seems misplaced because subsidies for oil producers are not the major determinant of consumer oil prices. Oil products are refined from crude oil. In the United States gasoline accounts for roughly forty-five percent of all oil use and is the most important oil product.²⁰⁶ The next most widely-used oil-based fuel groups are distillate fuel oil products (diesel, heating oil and other fuels), jet fuel, and residual fuel oil.²⁰⁷ Although different factors affect fuel prices,²⁰⁸ the price of crude oil is the biggest component of consumer price of most of these fuel products,²⁰⁹ and it depends mainly on the supply and demand in the world oil markets.²¹⁰ The growing industrialization of developing countries increases their oil demand.²¹¹ On the supply side, OPEC's policy of setting production ceilings for its members has been an important determinant for oil prices.²¹² Because subsidies are not the key factor

²⁰⁵ STAFF OF THE JOINT COMM. ON TAXATION, *supra* note 57, at 131.

²⁰⁶ See *Demand*, U.S. ENERGY INFO. ADMIN. INDEP. STATISTICS & ANALYSIS, http://www.eia.doe.gov/pub/oil_gas/petroleum/analysis_publications/oil_market_basics/demand_text.htm#U.S.%20Consumption%20by%20Product (last visited Jan. 6, 2012).

²⁰⁷ *Id.*

²⁰⁸ See, e.g., *Factors Affecting Gasoline Prices*, U.S. ENERGY INFO. ADMIN. INDEP. STATISTICS & ANALYSIS, http://tonto.eia.doe.gov/energyexplained/index.cfm?page=gasoline_factors_affecting_prices (last updated May 19, 2011); see also *Factors Affecting Diesel Prices*, U.S. ENERGY INFO. ADMIN. INDEP. STATISTICS & ANALYSIS, http://tonto.eia.doe.gov/energyexplained/index.cfm?page=diesel_factors_affecting_prices (last updated July 19, 2011); *Factors Affecting Heating Oil Prices*, U.S. ENERGY INFO. ADMIN. INDEP. STATISTICS & ANALYSIS, http://www.eia.gov/energyexplained/index.cfm?page=heating_oil_factors_affecting_prices (last updated July 19, 2011).

²⁰⁹ See *Factors Affecting Gasoline Prices*, U.S. ENERGY INFO. ADMIN. INDEP. STATISTICS & ANALYSIS, http://tonto.eia.doe.gov/energyexplained/index.cfm?page=gasoline_factors_affecting_prices (last updated June 29, 2011) (fifty-three percent average); *Diesel Prices & Outlook*, U.S. ENERGY INFO. ADMIN. INDEP. STATISTICS & ANALYSIS, http://tonto.eia.doe.gov/energyexplained/index.cfm?page=diesel_prices (last updated July 1, 2011) (sixty-two percent); *Heating Oil Prices & Outlook*, U.S. ENERGY INFO. ADMIN. INDEP. STATISTICS & ANALYSIS, http://tonto.eia.doe.gov/energyexplained/index.cfm?page=heating_oil_prices (last updated August 18, 2011) (sixty-eight percent).

²¹⁰ U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-283, CRUDE OIL: UNCERTAINTY ABOUT FUTURE OIL SUPPLY MAKES IT IMPORTANT TO DEVELOP A STRATEGY FOR ADDRESSING A PEAK AND DECLINE OF OIL PRODUCTION 10 (2007).

²¹¹ FED. TRADE COMM'N, *supra* note 177, at 18.

²¹² Although OPEC has used its market leverage with varied success, studies indicate that OPEC has generally "been successful in exercising a significant degree of market power in obtaining prices above competitive levels." *Id.* at 23. OPEC's crude oil production accounts for a lesser percentage of global production than in the

determining oil prices, their repeal will likely affect prices minimally. Consequently, consumption would not decrease either.

Failure to deal with oil dependence comes at a cost. Defense spending is largely affected by the need to secure continuous supply of oil.²¹³ OPEC countries, the largest numbers of which are located in the Middle East, hold eighty percent of world oil reserves.²¹⁴ Iraq and Iran, for example, face significant political risks such as civil war, coup, or general strike.²¹⁵ Most recently, unrest in Libya, as well as across other countries in the Middle East, caused oil prices to soar because of fears that supplies could be disrupted.²¹⁶ Although it may be difficult to allocate military spending in the Middle East to securing American energy needs, it is plausible to infer that a significant portion of defense spending is for energy security purposes.²¹⁷ In 1996, it was estimated that securing oil supplies in the region cost anywhere between \$6 billion and \$60 billion a year.²¹⁸ Thus, ensuring oil security is an expensive endeavor. There is overwhelming agreement in the scholarly community that the road to better energy security is reduction in the overall oil consumption, rather than increase in domestic production at the expense of oil imports.²¹⁹

1970s, but OPEC still produces a large enough share of crude oil to influence strongly oil prices. *See id.* at 14.

²¹³ *See generally* Roger J. Stern, *United States Cost of Military Force Projection in the Persian Gulf, 1976–2007*, 38 ENERGY POL'Y 2816 (2010).

²¹⁴ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 210, at 15. "OPEC controls most of the estimated world oil reserves" and OPEC's decisions may affect "future oil exploration and production." *Id.* at 4, 25. The current OPEC members are Algeria, Angola, Ecuador, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, United Arab Emirates, and Venezuela. *Member Countries*, ORG. PETROLEUM EXP. COUNTRIES, http://www.opec.org/opec_web/en/about_us/25.htm (last visited Jan. 6, 2012).

²¹⁵ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 210, at 21. Together with Venezuela and Nigeria, which face the same high degree of political risk, these countries account for more than one third of world oil reserves. *Id.* at 21–22.

²¹⁶ Grant Smith & Lananh Nguyen, *Oil-Price Swings Double as Unrest Spreads Before Saudi Talks*, BLOOMBERG (Feb 21, 2011, 12:11 PM), <http://www.bloomberg.com/news/2011-02-21/oil-price-swings-double-on-middle-east-unrest-as-producers-meet-in-riyadh.html>.

²¹⁷ U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 210, at 21–22.

²¹⁸ *Id.*

²¹⁹ *See* Roberta Mann, *On The Road Again: How Tax Policy Drives Transportation Choices*, 24 VA. TAX REV. 587, 599 (2005); Heather Ross, *Producing Oil or Reducing Oil: Which is Better for U.S. Energy Security?*, 148 RESOURCES 18, 19 (2002), available at <http://www.rff.org/rff/Documents/RFF-Resources-148-oil.pdf> ("[D]emand reductions will continue to offer the best hope for a secure energy future."); Michael A. Toman, *International Oil Security: Problems & Policies*, 20 BROOKINGS REV. 20, 23 (2002) ("The key to increasing U.S. energy security, from a macroeconomic perspective, is reducing the petroleum intensity of economic activity.").

Another cost of excessive oil use is the detrimental effect it has on the environment. Damage includes air and water pollution, land deterioration, and dangers to human health.²²⁰ The BP oil spill is a prime example of the environmental risks that the quest for securing oil supplies carries. Similarly, motor vehicles, which use oil-based fuel products, are responsible for large quantities of the toxic emissions in the air, including “[c]arbon monoxide, hydrocarbons, nitrogen oxides, and particulate matter . . . produced by fossil fuel combustion.”²²¹ Combustion of fossil fuels, including oil, also emits carbon dioxide, which has been linked to global warming.²²² These detrimental effects impose costs on society that the market fails to take into account.²²³ Therefore, corrective measures are necessary to account for these costs.²²⁴ Although repealing tax subsidies for oil production is sound policy in other regards, it cannot compensate for the external costs of pollution and other environmental damage.²²⁵ Usually, negative externalities call for a separate tax.²²⁶

The third—and perhaps most serious—cost related to American oil dependence is the risk it poses to economic stability. Empirical research has established a relationship between oil price shocks and subsequent periods of economic decline.²²⁷ The oil shock of 2007–2008, when the price per barrel reached new records, primarily resulted from two factors: the low elasticity of demand for oil and the failure of oil production to increase along with demand.²²⁸ Price elasticity of demand represents the relationship between the percentage change in demand that results from a percentage change in a product’s price.²²⁹ Low price elasticity demonstrates that the demand for a product is less sensitive to the increase of the product’s price.²³⁰ In other words, consumption fails to decrease significantly in response to relatively small increases in the price of oil.²³¹

²²⁰ LAZZARI, *supra* note 155, at 8.

²²¹ Mann, *supra* note 219, at 599.

²²² LAZZARI, *supra* note 155, at 8 n.9; *see* Mann, *supra* note 219, at 603–05.

²²³ *See* LAZZARI, *supra* note 155, at 8.

²²⁴ *Id.*

²²⁵ JOINT COMM. ON TAXATION, *supra* note 115, at 131.

²²⁶ LAZZARI, *supra* note 155, at 8.

²²⁷ *See* James Hamilton, *Causes and Consequences of the Oil Shock of 2007–08* (Nat’l Bureau of Econ. Research, Working Paper No. 15002, 2009).

²²⁸ *Id.* at 23.

²²⁹ *See* 1 PALGRAVE, *supra* note 145, at 126–27.

²³⁰ *Id.*

²³¹ Some scholars have also suggested that short-term demand for gasoline today is less elastic than it was two to three decades ago. *See* Jonathan Hughes et al., *Evi-*

There is persuasive evidence that, had it not been for the recent oil price shock, the United States would not have entered a period of recession in 2007.²³² The global demand for oil grew rapidly from 2005 to 2007, while at the same time production stagnated.²³³ Although energy prices increased as a result of growing demand, consumers continued to buy gasoline at the same levels as before simply because they “could afford to do just that.”²³⁴ With the growing disparity between supply and demand and the unwillingness of consumers to reduce consumption accordingly, the prices needed to rise “by whatever it took to persuade [consumers] to do so.”²³⁵ Thus, gasoline needed to reach the record price of four dollars per gallon to finally affect consumption in a meaningful way.²³⁶ The shock led to significant decline in the automobile industry, as well as declines in overall consumer spending and consumer sentiment.²³⁷

The recent recession demonstrates the troubling vulnerability of the U.S. economy created by its dependence on oil. Policy measures are urgently needed to address this challenge.²³⁸ Because a repeal of oil subsidies is not likely to decrease oil production or to increase the price of oil products, additional measures are necessary to address America’s overconsumption of oil.

B. A Proposed Solution—Production Tax

As this Comment demonstrated earlier, oil subsidies are unnecessary and contradict important policy goals. While repeal is a necessary step in the creation of effective tax oil policy, it must achieve at least two important policy goals. First, it needs to address the costs of oil dependence. Second, it should foster United States’ competitiveness in the global market for clean energy technologies. The driving force of oil dependence is America’s appetite for oil. As noted

dence of a Shift in the Short-Run Price Elasticity of Gasoline Demand, 29 THE ENERGY J. 93 (2006).

²³² See Hamilton, *supra* note 227, at 32.

²³³ *Oil and the Economy: The Impact of Rising Global Demand on the U.S. Recovery: Hearing Before the J. Econ. Comm.*, 111th Cong. (2009) (statement of James Hamilton, Professor, University of California San Diego).

²³⁴ *Id.*

²³⁵ *Id.*

²³⁶ See *id.* By contrast, European economies seem to be less vulnerable to increases in oil prices despite, or maybe because of, the fact that oil prices are much higher in Europe. See Mark Landler, *With Its Gas Prices Already High, Europe Is Less Rattled by Jump*, N.Y. TIMES, June 1, 2004, at C1.

²³⁷ Hamilton, *supra* note 227, at 35.

²³⁸ *Id.* at 43.

earlier, scholars suggest that the only viable alternative to address oil security is through reduction of overall reliance on oil.²³⁹ The environmental damages and the economic vulnerabilities that oil creates can also be alleviated by general reduction in demand.

When certain industries impose external costs on society (in this case security, environmental, and economic costs), a common policy choice is to tax them to compensate for these costs.²⁴⁰ Taxes that serve to correct the market for such costs are called Pigovian taxes.²⁴¹ One of the most frequently mentioned Pigovian taxes today is a tax on carbon emissions.²⁴² The objective of carbon tax is to reduce carbon emissions to fight global climate change.²⁴³ While reducing carbon emissions may correlate somewhat with a decrease in oil consumption, reduction in the one variable does not necessarily lead to decrease in the other. For example, recent legislative proposals aimed at curbing carbon emissions targeted electric utilities and would affect oil consumption relatively little.²⁴⁴ Effectively addressing oil externalities requires a more direct approach.

Taxing oil production targets production directly by making investments in oil projects less attractive and affects consumption by making it more expensive. Thus, this Comment proposes that an oil production tax could be a sensible way to address the problems that oil dependence creates. One of the first questions that emerge is who should pay the tax. It would be difficult and expensive to impose the tax on a broad tax base, such as oil consumers, because consumption is spread among many individuals and entities.²⁴⁵ Therefore, it is sensible to impose the tax upstream, at the earliest point of produc-

²³⁹ See sources cited *supra* note 219.

²⁴⁰ LAZZARI, *supra* note 155, at 8.

²⁴¹ Gilbert E. Metcalf & David Weisbach, *The Design of a Carbon Tax*, 33 HARV. ENVTL. L. REV. 499, 500 (2009).

²⁴² See generally Reuven S. Avi-Yunah & David M. Uhlmann, *Combating Global Climate Change: Why a Carbon Tax Is Better Response to Global Warming than Cap and Trade System*, 28 STAN. ENVTL. L.J. 3 (2009).

²⁴³ See *id.* at 50.

²⁴⁴ Anne C. Mulkern, *Would a Push to Curb Carbon Really Reduce U.S. Dependence on Oil*, N.Y. TIMES (June 22, 2010), <http://www.nytimes.com/gwire/2010/06/22/22greenwire-would-a-push-to-curb-carbon-really-reduce-us-d-19627.html>. This Comment is not arguing against a carbon tax. A carbon tax can achieve important environmental policy goals and can be used in conjunction with other measures that address the oil dependence problem in a more direct way.

²⁴⁵ See Metcalf & Weisbach, *supra* note 241, at 501 (“As the [carbon tax] base gets broader, collection costs increase . . .”). Although Professors Metcalf and Weisbach discuss the optimal tax design in terms of costs and basis of a carbon tax, the same concerns exist in the design of oil production tax.

tion.²⁴⁶ Such design is more efficient because there are fewer upstream producers, which results in lower collection and monitoring costs.²⁴⁷ In substance, taxing oil production could raise the marginal cost of production and consequently discourage investments in oil.²⁴⁸ At the same time, such disincentives could have the opposite effect with respect to alternative energy sources and make them more attractive investment choices. The relative attractiveness of alternative energy sources as compared to oil could be further augmented by the myriad of renewable energy subsidies that the government currently provides.²⁴⁹

Of course, it is also possible that oil companies pass at least part of the tax on to consumers. Thus, the oil production tax could turn into a consumption tax because consumers will bear it. As the consumer prices of oil products rise, they could discourage consumption of oil products and encourage energy consumption from alternative sources.²⁵⁰ One common criticism with this respect to oil taxes is that they are regressive.²⁵¹ Regressivity, however, is not an immutable characteristic. The extent of regressivity largely depends on the way the tax revenues are returned back into the economy.²⁵² One way of reducing the regressive effect of an oil tax is to pair it with a reduction in another tax.²⁵³ Such a design achieves both the main objective of the tax and alleviates its economic burden on the taxpayers.

²⁴⁶ See *id.* at 523. A commensurate tax on oil imports may be necessary in order to prevent consumers from switching to cheaper oil imports.

²⁴⁷ See *id.*

²⁴⁸ See Mitch Kunce & William E. Morgan, *Taxation of Oil and Gas in the United States 1970–1997*, 45 NAT. RESOURCES J. 77, 79, 81 (2005) (observing that oil and gas production taxes raise the marginal cost of production and reduce investment in the development of oil and gas).

²⁴⁹ One example of such an incentive is the credit for investment in manufacturing facilities for clean energy. See, e.g., 26 U.S.C. § 48C (2006). The credit equals thirty percent of the investment in such a facility and is distributed on a competitive basis. See § 48C(d).

²⁵⁰ Cf. Antonio Bento et al., *Distributional and Efficiency Impacts of Gasoline Taxes: An Econometrically Based Multi-Market Study*, 95 AM. ECON. REV. 282, 285–86 (2005) (linking an increase in gasoline taxes to decline in gasoline consumption, mainly from decrease in vehicle-miles traveled).

²⁵¹ See, e.g., LAZZARI, *supra* note 155. (noting that energy taxes tend to be regressive and could have dire macroeconomic effects).

²⁵² Cf. Bento, *supra* note 250, at 283.

²⁵³ See, e.g., Robert Stavins, *A Tale of Two Taxes, An Economic View on the Environment*, BELFER CENTER (Mar. 19, 2009, 8:08 AM), <http://belfercenter.ksg.harvard.edu/analysis/stavins/?p=73> (proposing a gas tax increase combined with a decrease in Social Security tax on wages).

While an oil production tax is at the core of a program to curb oil consumption, there are other factors that could affect its success. Meaningful reduction in oil consumption can only be achieved if there are viable transportation alternatives for consumers. Federal policies have supported automobile-dependent transportation modes for decades.²⁵⁴ Intense highway construction, spurred by federal support, occurred at the same time that suburban living expanded as a result of local regulation favorable to single-family homes and housing subsidies for sparsely populated areas.²⁵⁵ New policies need to make alternative transportation modes accessible to consumers. For example, imposing congestion fees and tolls, providing policy incentives for telecommuting, using intelligent traffic management systems, increasing the flexibility of land development rules, and providing financial help to low-income individuals for mass transit use could achieve this goal.²⁵⁶

Another critical factor for the success of the proposed tax policy is the development of a robust, green energy industry, which can both secure abundance of oil alternatives and create new jobs to absorb any job losses from traditional energy sectors.²⁵⁷ In this regard, China's growing competitiveness in renewable energy manufacturing is a cause for concern. While the U.S. government has dedicated substantial resources for the development of the green economy, these resources are slow to trickle down to manufacturers.²⁵⁸ There are various bureaucratic reasons behind these delays, such as pay requirements for contractors and understaffed administrative bodies.²⁵⁹ Meanwhile, China is emerging as the world leader for green energy manufacturing.²⁶⁰ China is on its way of becoming the world's largest

²⁵⁴ See Mann, *supra* note 219, at 589 ("For years, the government has subsidized a low density, petroleum-intensive lifestyle . . .").

²⁵⁵ See ANNE KORIN & DERON LOVAAS, TAKING THE WHEEL: ACHIEVING A COMPETITIVE TRANSPORTATION SECTOR THROUGH MOBILITY CHOICES 4-5 (2010), available at <http://www.mobilitychoice.org/takingthewheel.pdf>.

²⁵⁶ See *id.* at 10-17.

²⁵⁷ Cf. BRUCE ARNOLD, CONG. BUDGET OFFICE, HOW POLICIES TO REDUCE GREENHOUSE GAS EMISSIONS COULD AFFECT EMPLOYMENT 10 (2010), available at http://www.cbo.gov/ftpdocs/105xx/doc10564/05-05-CapAndTrade_Brief.pdf (concluding that, in the case of job losses in the traditional energy sectors as a result of green-house-gas reduction policies, "most laid-off workers would find work" in industries with lower emissions and in industries specializing in cleaner energy).

²⁵⁸ See Kate Galbraith, *Stimulus Aid is Slow to Reach Energy Savers*, N.Y. TIMES, Apr. 22, 2010, at F7.

²⁵⁹ *Id.*

²⁶⁰ Keith Bradsher, *China Leading Global Race to Make Clean Energy*, N.Y. TIMES, Jan. 30, 2010, at A1.

manufacturer of wind turbines and solar panels.²⁶¹ Government policies give China a competitive edge. The Chinese government transfers free land and subsidizes loans for green energy initiatives on a regular basis.²⁶² Despite criticism that such practices are in violation of international trade rules, many businesses are unwilling to protest due to fears that China will retaliate against foreign business ventures in the country.²⁶³ But China's success teaches one thing—the United States' green energy industry can flourish only with robust government subsidies. While the United States should adhere to its obligations under international trade agreements, the current Administration should devise innovative ways to support the green industry and ensure that the resources are distributed quickly and efficiently, without undue delay.

VI. CONCLUSION

In the aftermath of the BP oil spill, important policy questions about the tax treatment of the oil industry have emerged. These issues have spurred debate and legislative actions. Some of the questions were myopic. For one, in spite of the criticism, BP's oil-spill related deduction reflects long-accepted tax principles and was perfectly legitimate. But, the oil spill also helped refocus the discussion on a more fundamental problem. Critics have aptly noted that the oil industry has enjoyed unprecedented favorable tax treatment for decades. Today, these benefits are unjustified, wasteful, and contradict important policies that are designed to steer the U.S. economy away from oil dependence into a clean energy future. Repealing oil tax subsidies is an important step towards achieving these policy goals, but it may be insufficient. Excessive oil consumption results in security, environmental, and economic costs that require separate actions. The linchpin of a plan designed to address these problems is a tax on oil production. Another important feature of such a plan is the implementation of policies that allow for auto-independent existence and adequate response to world competition in the clean energy industry. Ultimately, Congress must create a comprehensive, long-

²⁶¹ Keith Bradsher, *On Clean Energy, China Skirts Rules*, N.Y. TIMES, Sept. 9, 2010, at A1.

²⁶² *Id.*

²⁶³ *Id.* On December 22, 2010, the United States brought dispute settlement proceedings with the WTO against China's subsidy program for wind turbine manufacturers. See Sewell Chan, *U.S. Says China Fund Breaks Rules*, N.Y. TIMES, Dec. 22, 2010, at B1.

term policy plan to address the challenges of oil consumption, in which taxes and tax incentives, together, should play a major role.