

## CHAPTER 11

### TAXATION OF ENERGY AND NATURAL RESOURCES

The tax law has long been used to subsidize the energy and mining industries. These subsidies lead to inefficiencies and misdirect investment capital. They would be eliminated under the Treasury Department proposals.

The business and residential energy credits would be repealed. Percentage depletion would be repealed, and indexed cost depletion made mandatory. Certain exploration and development costs that may be currently expensed would have to be capitalized as part of the cost of the property to which they relate. Preferential tax rates for certain royalty income would be denied, and the special deduction for mining and solid waste reclamation and closing costs would be repealed.

## REPEAL ENERGY TAX CREDITS

### General Explanation

#### Chapter 11.01

#### Current Law

##### A. Business Energy Tax Incentives

Special tax credits are available for business firms to encourage investments in conservation and renewable energy technologies and to encourage production of alternative fuels. These incentives can be grouped into three major categories:

**1. Energy Investment Tax Credits.** Solar, wind, geothermal property and ocean thermal property qualify for a 15 percent energy investment tax credit. Certain hydroelectric generating property qualifies for an 11 percent credit. Qualified intercity buses and biomass property are eligible for a ten percent energy credit. These energy credits terminate on December 31, 1985.

A ten percent energy investment tax credit was available for certain other types of energy property but this credit generally expired on December 31, 1982. However, if such energy property qualifies under "affirmative commitment" rules, the credit continues to be available until December 31, 1990. Under these rules, projects requiring two or more years for completion will continue to be eligible if (a) all engineering studies were completed and all necessary permits filed before January 1, 1983, (b) binding contracts for 50 percent of specially designed equipment are entered into before 1986, and (c) the project is completed and placed in service before 1991. In addition, in the case of hydroelectric generating property, the credit is available through December 31, 1988, if an application has been filed with the Federal Energy Regulatory Commission (FERC) before January 1, 1986.

**2. Production Tax Credits.** A credit of up to \$3 per barrel of oil equivalent is available for certain qualifying fuels. In general, the credit is available for qualifying fuels produced from facilities placed in service after December 31, 1979, and before January 1, 1990, and sold after December 31, 1979, and before January 1, 2001. The credit phases out as the average wellhead price of domestic crude oil rises from \$23.50 to \$29.50 per barrel. The maximum credit and the phaseout range are adjusted for inflation. Qualifying fuels include (a) oil produced from shale and tar sands, (b) gas produced from geopressured brine, Devonian shale, coal seams, a tight formation, or biomass, (c) synthetic fuels produced from coal, (d) fuel from qualified processed wood, and (e) steam from solid agricultural byproducts.

### **3. Alcohol Fuels Credit and Excise Tax Exemptions.**

a) **Alcohol fuels mixtures.** Present law provides a six cents per gallon exemption from the nine cents excise tax on gasoline and a similar six cents per gallon exemption from the 15 cents diesel fuel excise tax if the taxable products are blended in a mixture with at least ten percent alcohol ("gasohol"). The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal (including lignite). The provision terminates after December 31, 1992.

b) **Alcohol fuels.** Present law provides a nine cents per gallon exemption from the excise tax on special motor fuels for a fuel consisting of at least 85 percent alcohol derived from a source other than petroleum or natural gas and a four and one-half cents per gallon exemption if the source is natural gas. The provision terminates after December 31, 1992.

c) **Alcohol production credit.** A 60 cents per gallon income tax credit is provided for alcohol used in gasohol mixtures with gasoline, diesel fuel, and special motor fuels. A like credit is allowed for alcohol used as a fuel other than in a qualified fuels mixture. A lesser credit of 45 cents per gallon is provided for alcohol of at least 150 proof but less than 190 proof. The term alcohol is defined to include only alcohol derived from a source other than petroleum, natural gas, or coal (including lignite). This credit terminates on December 31, 1992, and may be carried forward for 15 years, but not to a tax year beginning after December 31, 1994. If a production credit is claimed with respect to alcohol, the exemption from the gasoline and special fuels excise taxes is not allowed.

d) **Taxicabs refund.** A four cents per gallon exemption from the excise tax on gasoline, diesel fuel and special motor fuels is provided if used in certain taxicabs that are rated at above-average fuel economy. The exemption expires on September 30, 1985.

### **B. Residential Energy Tax Credits**

Under current law there are two categories of residential energy tax credits:

1. **Conservation credits.** A 15 percent credit is available to individuals for the first \$2,000 of expenditures for certain energy conservation equipment, such as insulation or storm windows and doors, for a maximum credit of \$300.

2. **Renewable energy credits.** A 40 percent credit is available to individuals for the first \$10,000 of expenditures for solar, wind or geothermal energy property, for a maximum credit of \$4,000.

To be eligible for the residential energy tax credits, expenditures must be with respect to the taxpayer's principal residence. In the case of the residential conservation credits the

residence must have been in use before April 20, 1978. The credits expire on December 31, 1985. Unused credits may be carried over through 1987.

### Reasons for Change

Congress enacted the energy credits because oil and gas price controls understated the replacement cost of energy. Because of price controls, consumers did not have the incentive to invest in energy conservation and alternative fuels. The absence of free-market prices created an economic rationale for energy tax incentives. Since these incentives were enacted, however, crude oil prices have been decontrolled and natural gas prices are being decontrolled. As a result, these tax credits are no longer needed.

### Proposal

The energy tax incentives would be allowed to expire or would be terminated on December 31, 1985.

### Effective Dates

#### A. Business Energy Tax Incentives

1. Renewable Energy Investment Tax Credits. All renewable energy investment tax credits would be allowed to terminate on December 31, 1985. Unused credits may be carried forward or backward. However, for hydroelectric generating property the present law affirmative commitment rules will continue to apply.

2. Energy Investment Tax Credits. All conservation and other alternative source energy investment tax credits would terminate on December 31, 1985. However, present law affirmative commitment rules would continue to apply.

3. Production Tax Credits. All production tax credits would terminate on December 31, 1985. However, eligible fuel produced from a well drilled, or from facilities completed, before January 1, 1986, and sold before January 1, 1990, would continue to be eligible for the credit.

4. Alcohol Fuels Credit and Excise Tax Exemptions. The credit for alcohol fuels would be available for eligible alcohol fuels produced from facilities completed before January 1, 1986, and sold before January 1, 1993. All excise tax exemptions would terminate on December 31, 1985. The qualified taxicab refund that is scheduled to terminate on September 30, 1985, would not be renewed.

#### B. Residential Energy Tax Credits.

The residential energy tax credits would be allowed to expire on December 31, 1985, and would not be renewed. Carryovers of unused credits would continue to be available through 1987 as under current law.

## Analysis

Because these energy incentives apply only to certain targeted activities, they introduce a tax differential among investments. Energy tax incentives distort the allocation of resources, encouraging individuals and firms to undertake investments that are uneconomical at current and expected future market prices. They also encourage users to purchase fuels that have a higher economic cost than alternative fuels because the tax system lowers the cost of the subsidized fuel. As a result, these incentives divert workers, capital and initiative from more productive uses elsewhere in the economy and lower the net productivity of our nation's capital stock.

These energy tax incentives also implement questionable energy policies. Subsidies provided for alternative fuels, for example, are significantly in excess of the price that should be paid for replacement of crude oil. With an alcohol fuel production credit at 60 cents per gallon, the Federal government is paying a subsidy of \$25.20 (in addition to the price paid by the consumer) in order to save a barrel of oil currently valued at under \$30.

The incentives effectively incorporate a Federal government spending program into the tax code. They also thereby add to the complexity of our tax laws and impose additional administrative burdens upon the Internal Revenue Service. A taxpayer compliance study with respect to individual income tax returns for taxable year 1979 disclosed that of \$473 million of taxpayer claims for energy tax credits, \$126 million in claims would have had to be disallowed had the Internal Revenue Service been able to fully audit all returns. Taxpayers failed to claim only \$26 million in credits that they were otherwise entitled to claim. Thus, by Internal Revenue Service estimates, more than one-quarter of the amount of energy credits claimed by taxpayers for 1979 were invalid. The high error rate resulted from confusion over dollar limitations, qualification of equipment for credit, as well as improper carryovers. According to another study, in the case of the geothermal credit, nearly 95 percent of claimed credits were invalid because of an apparent massive misunderstanding of the applicable rules.

The residential energy credits, particularly the renewable energy credits, tend to favor middle- and upper/middle-income households, and cannot be justified on the ground that they are necessary to help low-income persons adjust to higher energy prices. For example, in 1982, households with adjusted gross income in excess of \$30,000 accounted for about 60 percent of all renewable energy expenditures eligible for tax credits, but accounted for only 51 percent of total adjusted gross income.

Finally, many of the conservation improvements subsidized by the residential energy credits would have been made without the tax credits because of decontrol and the increase in world oil prices in 1979. Thus, in many cases, tax credits have served merely to reduce the encourage additional energy conservation efforts.

## REPEAL PERCENTAGE DEPLETION

### General Explanation

#### Chapter 11.02

#### Current Law

An initial difficulty in designing an appropriate method of capital recovery for the extractive industries arises from the fact that the quantity of reserves and the rate of production may be very different for different deposits. Moreover, production may be prolonged through the application of various enhanced recovery techniques. Thus, unlike depreciation methods which may be used to determine the recovery of investment in plant and equipment, a single economic life cannot be applied to investment in mineral properties.

Cost depletion resolves these difficulties by allowing a deduction each year equal to the product of the unrecovered costs and the ratio of the quantity of minerals sold during the year to the quantity of minerals estimated to be available as of the beginning of the year. By taking into account all the information obtained from the cumulative production record, cost depletion can provide a more appropriate allocation of the costs incurred to individual time periods than methods that rely on a fixed service life.

Percentage depletion, on the other hand, is a deduction in lieu of cost depletion based on a statutory percentage of the gross income from the property. The percentage of gross income that may be claimed is 15 percent for oil and gas, and ranges from 5 to 22 percent for other minerals. The allowance is limited to 50 percent of the net income from the property, and certain additional limitations apply in the case of oil and gas. Unlike all other cost recovery systems, a taxpayer may continue to claim percentage depletion after all the expenditures incurred to acquire or develop the property have been recovered.

Taxpayers with an economic interest in a mineral property must claim the greater of percentage depletion or cost depletion. Percentage depletion generally is not allowed in the case of oil and gas production. However, certain independent producers and royalty owners (i.e., taxpayers that do not refine or market more than specified quantities of product) are allowed to claim percentage depletion on production up to 1,000 barrels of crude oil equivalents per day. This quantity limitation must be allocated between different properties, and, at the taxpayer's election, between oil and gas production. In the case of coal and iron ore, corporate taxpayers must reduce such deductions by 15 percent of the amount in excess of the basis of the property. Taxpayers denied percentage depletion, as in the case of the integrated oil companies, may only use cost depletion.

The excess of percentage depletion over the adjusted basis of the property is a tax preference item for the corporate and minimum tax and the alternative minimum tax.

### Reasons for Change

Since percentage depletion may continue to be claimed after all the taxpayer's costs have been recovered, percentage depletion is best viewed as a production subsidy, rather than as a method of capital recovery. As a production subsidy, however, percentage depletion is inefficient. Because of the relatively lengthy interval between the acquisition of a property and initial production (if, in fact, the property is ever productive) percentage depletion encourages excessive development of existing properties, rather than the exploration for new deposits. Moreover, because the allowance is limited to 50 percent of the net income from the property, tax benefits are cut back for developers of marginal properties. Instead, the greatest benefits are provided to the developers of the most prolific or highly concentrated deposits, which would most likely be developed even in the absence of these benefits.

Even if percentage depletion allowances were limited to capital invested, this method would not be an acceptable capital recovery method. Such a method would still provide faster capital recovery for owners of deposits that can be produced more rapidly (even if such production might represent a smaller fraction of total reserves) than for owners of less productive properties. Percentage depletion also would provide faster capital recovery when mineral prices rise, and less rapid recovery when prices fall. Since the discovery of a particularly prolific deposit or a change in product prices may be entirely fortuitous, a capital recovery allowance based on such factors is both capricious and inequitable. Tax simplification would also be enhanced if taxpayers did not have to determine the percentage depletion allowed and the associated tax preference.

Most importantly, cost depletion computed by reference to the taxpayer's adjusted basis in the property, indexed for inflation, is the equivalent of economic depreciation. Use of this method by the extractive industries would place them on a recovery allowance system similar to that employed by other industries.

### Proposal

The percentage depletion allowance would be repealed for all minerals. Taxpayers would claim cost depletion on their adjusted basis in the property, if any, indexed for inflation.

### Effective Date

The repeal of percentage depletion would be effective for production on or after January 1, 1986.

## Analysis

Although the exact number of individuals claiming percentage depletion in excess of cost depletion is not known (even if it is assumed that percentage depletion is claimed by all 796,000 individual taxpayers reporting royalty income in 1981), half of the benefits would accrue to only 90,000 taxpayers with adjusted gross incomes of over \$75,000. This amounts to an average benefit of approximately \$6,400 for each of these taxpayers. Terminating this subsidy will increase the fairness of the tax system and permit tax rates for all upper-income individuals to be reduced.

# REPEAL EXPENSING OF INTANGIBLE DRILLING COSTS

## General Explanation

### Chapter 11.03

#### Current Law

Intangible drilling costs (IDCs) are those costs of drilling and preparing oil, gas, and geothermal wells that are not incurred for the purchase of tangible property. These intangible costs include amounts paid for labor, fuel, repairs and site preparation necessary for the actual drilling. The cost of casings, valves, pipelines and other facilities required to control, transport or store the oil and gas produced are not included. Under current law, taxpayers have the right to elect to expense IDCs as incurred or to capitalize them. They may also elect to expense only the IDCs on dry wells and to capitalize the IDCs on productive wells. If capitalized, the costs are recovered through depletion or depreciation. IDCs are subject to recapture upon disposition of the property with respect to which they were deducted. Corporate taxpayers are allowed to expense only 80 percent of their IDCs; the balance must be capitalized and written off over 36 months. IDC deductions are an item of tax preference for the alternative minimum tax and the corporate minimum tax. No investment tax credit is allowed for IDC expenditures. However, non-corporate taxpayers owning other than a limited interest in oil and gas properties may elect to treat the IDCs as if they were investments in five-year ACRS property, and may claim an investment tax credit for such expenditures.

#### Reasons for Change

Intangible drilling costs represent a major portion of the costs necessary to locate and develop oil and gas reserves. Since the benefits obtained from these expenditures are of value throughout the life of the project, a proper matching of revenues and expenses requires that these costs be capitalized and recovered over the period of production.

The expensing of IDCs provides a tax benefit for capital invested in the oil and gas industry. Because investment in oil and gas is tax-favored, capital is diverted from other, more productive, economic activities. Further, even if an incentive for exploration is believed desirable, the expensing of IDCs is an inefficient incentive as it is equally available for developmental as well as exploratory drilling, and does not depend on or vary with the magnitude of the potential oil or gas reserves anticipated or discovered. In addition, since geological and geophysical costs incurred prior to the acquisition of a leasehold must be capitalized, allowing IDCs to be expensed also promotes an excessive reliance upon drilling, and an inadequate utilization of seismic and other more technologically advanced methods of exploration.

## Proposal

The option to expense intangible drilling costs would be repealed, as would the 36-month amortization of 20 percent of IDCs for corporate taxpayers. These costs would be capitalized as depreciable or depletable property, depending upon the nature of the cost incurred. In conformity with the general rules for production cost accounting, as described in Chapter 10.01, depreciation incurred during the pre-production stage would be added to the cost of the depletable property, and these costs would be recovered through cost depletion. The depletable basis would be adjusted for inflation.

## Effective Date

The repeal of the option to expense intangible drilling costs would be effective for costs paid or incurred on or after January 1, 1986.

## Analysis

Based on the 1980 minimum tax data, it is estimated that in 1986, 31,000 individuals with adjusted gross incomes over \$100,000 would receive over one-half of the total IDC tax benefits that go to individual taxpayers. These 31,000 taxpayers thus receive an average benefit of approximately \$28,000.

Termination of these tax subsidies would increase the fairness of the tax system and permit reduction of the tax rates for high-income and other individuals. Repeal would also reduce the necessity of a minimum tax for individuals and corporations.

By allowing investors in oil and gas ventures to base their decisions on intrinsic economics, rather than on the tax benefits generated from their investments, the productivity of all investments would increase, even if a somewhat reduced percentage of investment capital is allocated to oil and gas production and more to other industries. The adverse effect which this proposal might otherwise have on the level of drilling activity would be partially offset by the reduction in corporate tax rates, the repeal of the windfall profit tax, and indexation of the depletable basis.

# REPEAL EXPENSING OF HARD MINERAL EXPLORATION AND DEVELOPMENT COSTS

## General Explanation

### Chapter 11.04

#### Current Law

A taxpayer may elect to expense the exploration costs incurred to locate and delineate hard mineral deposits. After the existence of commercially marketable ores has been established, the development costs associated with the preparation of the mine for production also may be expensed. The exploration costs expensed (but not the development costs) must be recaptured, generally by claiming a reduced level of depletion deductions once the mine reaches the production stage. Corporate taxpayers can expense only 80 percent of the exploration and development costs. The remaining 20 percent of these costs must be capitalized and depreciated as five-year ACRS property, which qualifies for the investment tax credit. Mining exploration and development expenses are also items of tax preference under the alternative minimum tax.

#### Reasons for Change

The exploration and development costs incurred in locating and readying a mine for the production of hard minerals are similar to capitalized costs incurred in other industries. Since the benefits obtained are of value throughout the life of the mine, a proper matching of revenues and expenses requires that these costs be capitalized and recovered over the period of production.

#### Proposal

The option to expense hard mineral exploration and development costs would be repealed. These costs would be required to be capitalized, and the capitalized costs recovered through cost depletion deductions. The depletable basis of the mineral property would be adjusted for inflation. In determining the costs to be capitalized, the general rules for production cost accounting, which are described in Chapter 10.01, would apply.

#### Effective Date

Exploration costs paid or incurred on or after January 1, 1986 would be required to be capitalized.

## Analysis

Because of the excess capacity which currently exists in the hard mineral industry, this proposal would have minimal impact on the level of mineral exploration and development for the next several years. The reduction in corporate tax rates will serve to offset any longer term impact of this proposal and the proposed repeal of percentage depletion on the extractive industries.

# REPEAL DEDUCTION FOR QUALIFIED TERTIARY INJECTANT EXPENSES

## General Explanation

### Chapter 11.05

#### Current Law

Qualified tertiary injectant expenses may be deducted in the year paid or incurred. Qualified tertiary injectant expenses are the amounts paid for any tertiary injectant, other than a recoverable hydrocarbon injectant, that is used as part of an enhanced recovery process. The expenses are subject to the generally applicable recapture rules upon disposition of the property.

#### Reasons for Change

Tertiary injectant expenditures which yield enhanced production beyond the current year are similar to investments in other industries. Since the benefits obtained from these investments are of value throughout the life of the project, a proper matching of costs and expenses requires that these costs be capitalized and recovered over the life of the project. The allowance of an immediate deduction for these costs was intended to parallel the treatment given to intangible drilling costs. Since it is proposed that IDCs be capitalized, consistency (as well as fundamental tax accounting) requires capitalization of these costs as well.

#### Proposal

The deduction for qualified tertiary injectant costs would be repealed. Such costs would be required to be capitalized and recovered through cost depletion deductions. The depletable basis would be adjusted for inflation. The general rules for production cost accounting, which are described in Chapter 10.01, would apply. Waterflooding and similar pressure maintenance techniques, which enhance production for a period of less than one year, would continue to be expensed.

#### Effective Date

Qualified tertiary injectant expenses paid or incurred with respect to projects initiated on or after January 1, 1986 would be required to be capitalized. Prepaid costs would be deemed paid when economic performance occurs. Expansion of an existing tertiary recovery project would be regarded as the initiation of a new project.

## Analysis

The proposal would make the choice of oil recovery processes depend upon sound engineering practices and economics, unaffected by Federal tax subsidies. The reduction in personal and corporate tax rates and repeal of the windfall profit tax would reduce the impact of this proposal on enhanced recovery projects.

## REVISE ROYALTY TAXATION

### General Explanation

#### Chapter 11.06

##### Current Law

Royalty income received by the owner of a royalty interest in coal or iron ore production qualifies for treatment as long-term capital gain. No percentage depletion allowance may be claimed with respect to such income. In order to receive capital gain treatment, the taxpayer must have been an owner of an interest in the coal or iron ore in place for at least six months, and must dispose of the ore under a contract by which he retains only a passive economic interest. In order to prevent operating owners from benefiting from these provisions, related party rules limit the availability of capital gain treatment.

Royalty income received by the owner of a royalty interest in timber qualifies for long-term capital gain treatment under rules similar to those applicable to coal and iron ore royalties. In addition, an owner of timber or a contract right to cut timber may elect to treat the cutting of timber (for sale or for use in the taxpayer's trade or business) as a sale or exchange of timber eligible for long-term capital gain treatment.

##### Reasons for Change

The special tax treatment of income from certain interests in timber, coal and iron ore is unjustified. Income from these natural resources should be subject to tax on the same basis as income from other investments.

##### Proposal

The provisions establishing special tax treatment for timber, coal and iron ore royalty income would be repealed, along with the provisions permitting elective sale or exchange treatment for owners of timber or contract rights to cut timber.

##### Effective Date

The repeal of capital gain treatment of timber, coal and iron ore royalty income would apply to all royalty income received on or after January 1, 1986. The repeal of the elective sale or exchange treatment for owners of timber or of contract rights to cut timber would apply to timber cut on or after January 1, 1986.

## Analysis

The Treasury Department proposals would end preferential treatment for capital gains generally following a three-year transitional period for assets held prior to January 1, 1986. See Chapter 9.01. Owners of interests in timber, coal and iron ore would be eligible for capital gain treatment during the transition period only to the extent such treatment would be available without regard to the repeal of section 631.

**REPEAL MINING AND SOLID WASTE RECLAMATION  
AND CLOSING COST DEDUCTION**

**General Explanation**

**Chapter 11.07**

**Current Law**

Expenses that will be incurred in the future cannot generally be deducted currently, even if the existence of the liability can be established with certainty. As a general rule, taxpayers using the cash method of accounting may deduct future expenses only when payment is made. Taxpayers using the accrual method of accounting generally may deduct future expenses only when the economic performance or activity giving rise to the expense has occurred. However, pursuant to a statutory exception to the economic performance requirement, taxpayers may take current deductions associated with certain mining and solid waste disposal site reclamation and closing costs. The amount that may be deducted in any year generally is the estimated future reclamation or closing costs attributable to production or mining activity during the taxable year. The estimate must be made on the basis of reclamation and closing cost prices prevailing in the taxable year. To obtain the deduction, no amount need be placed into a fund, but deducted amounts are added to a bookkeeping reserve maintained for tax purposes. In addition, interest on the additions to the reserve must be added to the reserve each year at a rate specified in the statute. When reclamation or closing occurs, the balance in the reserve is compared to the actual cost of closing or reclamation. If the total amount in the reserve, including interest, exceeds the reclamation or closing costs, further deductions are not allowed and the excess must be included in income. Amounts spent on reclamation or closing costs are charged against the reserve, and only if the reserve is exhausted are the amounts deductible.

Expenses subject to the above rules include generally any expenses for land reclamation or closing activity pursuant to a reclamation plan under the Surface Mining Control and Reclamation Act of 1977 or similar law. Also included are expenses incurred for any land reclamation or closing activity in connection with any solid waste disposal site conducted in accordance with the Solid Waste Disposal Act or other similar law. Expenses attributable to property which is disturbed after being listed in the national contingency plan established under the Comprehensive Environmental, Compensation, and Liability Act of 1980 are not, however, included.

**Reasons for Change**

The special rules for strip mining and waste disposal closing and reclamation costs allow a current deduction for future costs without recognition of the fact that economic performance will occur, and the

cost will be paid, in the future. The requirements to increase the reserve by an interest charge and to recapture reserves limit the extent to which the present value of the reserve is overstated. Nevertheless, the deduction generally is overstated in real terms and results in a reduced effective tax rate for those companies that find the special tax treatment to be advantageous for them.

The preferential tax treatment reduces the production costs of companies engaged in surface mining and companies generating solid waste. By reducing the costs of the products of these companies, the tax system encourages production processes that cause environmental damage. Regulations already in place require the environmental damage to be corrected. The tax system should not, however, subsidize the costs of compliance. Such costs generally should be borne (through higher product prices) by the users of the products whose production damages the environment, rather than by all taxpayers. If it is determined that certain of these costs are of such societal importance as to justify a Federal subsidy, that subsidy should be provided through the appropriations process, not the tax system.

The current reserve system is substantially more complicated than simply deducting the future expenses when they occur. Future expenses must be estimated; records must be kept of previously deducted amounts; interest must be imputed on this amount on a cumulative basis; and excess amounts in the account must be recaptured, requiring a re-estimate of future costs each year. Further, as reclamation or closing costs are incurred, the costs must be allocated to particular properties, since reclamation and closing can be taking place on several sites at the same time.

### Proposal

The special rules for mining and solid waste disposal reclamation and closing costs would be repealed. Accordingly, such costs would generally be deductible only as the sites were closed or the land reclaimed.

### Effective Date

The proposal would be effective for mining and solid waste disposal reclamation and closing costs incurred on or after January 1, 1986.

## Analysis

The proposal would eliminate the indirect Federal subsidy for mining and solid waste reclamation and disposal costs. Under existing law, companies are allowed to accelerate deductions for future expenses, thus reducing their effective tax rates through tax deferral. This preferential tax treatment reduces the costs of companies incurring such expenses. The elimination of the tax preference can be expected to raise by a small amount the price of the affected products, which for the most part involve production processes that cause environmental damage. A small shift in consumption away from such products would result.

## REPEAL WINDFALL PROFIT TAX

### General Explanation

#### Chapter 11.08

##### Current Law

Under current law, an excise tax is imposed on crude oil produced domestically. Taxable crude oil is classified in three tiers. Generally, oil in tier one is oil that had been subject to price controls; oil in tier two consists of stripper well oil; and oil in tier three is newly discovered oil, tertiary oil and heavy oil. The base for the tax is the difference between a statutory base price (lower for tier one oil and progressively higher for tiers two and three), adjusted for inflation, and the amount for which the oil is sold, less a severance tax adjustment. The tax rate is 70 percent for tier one oil and descends to 60 percent for tier two oil and 30 percent for tertiary oil and heavy oil. The tax rate for newly discovered oil is 22-1/2 percent through 1987, 20 percent for 1988 and 15 percent for 1989 and thereafter. Independent oil producers are taxed at a 50 percent rate for tier one oil with respect to 1,000 barrels per day of production and are exempt from tax on stripper well oil. The tax is deductible for the purpose of the Federal income tax.

The windfall profit tax is scheduled to phase out over a 33-month period beginning in January 1991, or the first month after December 1987 in which cumulative net receipts exceed \$227.3 billion, whichever occurs first.

##### Reasons for Change

The windfall profit tax was enacted in 1980 at a time when crude oil prices were greatly accelerating. The enactment of the tax was associated with the decontrol of crude oil prices. Since that time oil prices have significantly declined from their record high levels. Consequently, the perceived "windfall" for producers has generally dissipated. While windfall profit tax receipts have also declined significantly from projected levels, the windfall profit tax nevertheless reduces producer profits that might otherwise be reinvested in oil production or other productive activities.

In general, the Treasury Department proposals are designed to produce consistent rates of taxation on economic income and to eliminate tax-induced distortions in investment activity. Together with repeal of percentage depletion and expensing of intangible drilling costs, it is appropriate that the windfall profit tax be terminated.

##### Proposal

The windfall profit tax would be repealed.

### Effective Date

The windfall profit tax would phase out over a 33-month period beginning with the month of January 1988.

### Analysis

Gross receipts from the windfall profit tax for fiscal year 1983 were \$12.2 billion while net receipts totaled \$5.7 billion. It is anticipated that from the inception of the tax through fiscal year 1990, \$53 billion in net tax receipts will have been collected. Since the price of oil is determined in the world market, producers are generally unable to pass the cost of the tax along to consumers.

Repeal of the windfall profit tax, together with the reduction in corporate and individual tax rates, would serve to offset the effects of the repeal of expensing of intangible drilling costs and of percentage depletion.