Words of Wisdom for the 110th Congress

By Lawrence B. Gibbs

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As Democrats assume leadership of both the House and Senate, members of the new majority are understandably anxious about advancing their own policy initiatives. After labeling their opponents as the party in control of the ''do-nothing'' Congress, Democrats will face pressure to deliver meaningful legislation. Taxwriters have expressed interest in several priorities, including alternative minimum tax reform, expanding education and healthcare incentives, and permanently extending provisions such as the research tax credit.

Assuming Democrats also reinstate ''pay as you go'' budget procedures, legislators will face considerable pressure to identify offsetting revenue raisers to finance their agenda. Early indications suggest Congress will focus on at least four proposals: (1) increasing taxes on the oil and gas industry, (2) revising the U.S. international tax rules, (3) reducing the amount of uncollected taxes (the tax gap), and (4) curbing the use of tax shelters by codifying the judicial economic substance doctrine. Congress would be wise to proceed thoughtfully, giving all interested parties an opportunity to provide input and fully deliberating the consequences of its proposals on business activity and U.S. competitiveness, economic efficiency, and the overall fairness of the tax code.

Oil and Gas Industry

Our government has wrestled with how to tax oil and gas production for almost a century. In 1916 Congress passed tax subsidies for new oil and gas discoveries to aid the war effort, and the Treasury Department ruled that oil companies could immediately expense intangible drilling costs. Congress gradually cut back on the deduction for intangible drilling costs. Today that benefit largely targets domestic production and small producers. In the 2005 energy legislation, Congress gave oil companies the right to amortize their geological and geophysical costs over two years, only to reduce the benefit for the major oil companies in the 2006 tax reconciliation legislation. A historical major tax preference for the oil and gas industry is percentage depletion, a cost recovery concept that permits taxpayers to continue claiming deductions after recovering all acquisition and development costs. Congress eliminated percentage depletion for major oil companies in 1975, but a partial allowance remains for independent producers.

Assuming Congress determines it is appropriate to increase the tax burden on the oil and gas industry, it would be wise to consider carefully the proposals it pursues. In the 109th Congress, the full Senate and several House Democrats proposed limiting the foreign tax credit that large oil companies receive in some circumstances, in particular if the credited tax is tied to a specific economic benefit from the foreign country. The provision seeks to disallow FTCs for amounts that may substitute for royalties. Congress should exercise oversight to ensure that the FTC regime works as intended to reduce the double taxation of U.S. taxpayers without unnecessarily reducing our own revenue base. Targeting the oil and gas industry's FTCs, however, may create economic distortions while reducing the competitiveness of major U.S. oil firms.

Other proposals aimed at the oil and gas industry would modify inventory accounting rules and deny the recently enacted deduction for domestic production activities. The last-in, first-out accounting method allows oil companies and other taxpayers to match their revenues with the cost of their newest inventory. If inventory costs are rising, LIFO generates lower taxable income by increasing the company's deduction for its cost of goods sold, but only if the company is willing to use LIFO in computing its financial income as well. Although U.S. accounting standards allow use of LIFO, international accounting standards do not. Integration of U.S. and international standards may eventually require the United States to abandon the LIFO method. In 2005 the Senate endorsed changes to LIFO that would limit its use by large oil and gas producers. Others have proposed repeal of LIFO for all taxpayers. Both changes would impose a tax on firms' built-in profits from inventories carried on their books from previous years. Use of LIFO raises important policy questions about how income should be measured, and Congress would be wise to consider those implications carefully before adopting fundamental changes to long-established tax accounting rules. Under current baseline assumptions, repeal of LIFO for oil and gas companies, or all taxpayers, would generate a significant one-time revenue increase.

In 2004 Congress enacted a special deduction in new section 199 for domestic manufacturing activities. Legislation introduced by several Democrats in 2006 would deny the deduction for the domestic production, refining, processing, transportation, or distribution of oil and gas. The proposal to deprive a specific industry of otherwise broadly applicable tax benefits would add further economic distortions to the tax code and violate the general principle that tax policy should not intervene in the allocation of capital.

International Tax Rules

The search for revenue will likely also lead Congress to further examine the U.S. international tax rules. Perceived as lacking political leverage, foreign corporations investing in the United States are, as a group, a popular revenue target. U.S. multinationals also attract scrutiny because of the widely held belief that their overseas activities reduce the number of American jobs. The U.S. international tax system is a complex web of disjointed rules reflecting often-contradictory policy goals. A high corporate tax rate in the United States, relative to that of our major trading partners, increases the incentive to shift income overseas and puts substantial pressure on the U.S. international tax rules. Congress, rather than engaging in a comprehensive review of our international tax system, has adopted a piecemeal approach in recent legislation. Before proposing significant tax increases on international activities, the taxwriting committees would be wise to undertake an honest assessment of how the international tax rules conform with economic objectives and underlying principles of federal tax policy.

Tax Gap

Reducing the tax gap is another popular goal that both parties share. The IRS estimates that more than $345 billion in tax liability goes unpaid annually, or the equivalent of 16 cents for every dollar in tax liability. Contrary to public perception, only a small percentage of the tax gap is attributable to underpayments by corporations. Congress would be wise to view with skepticism proposals to change corporate tax rules as a means to reduce the tax gap. Unfortunately, most of the tax gap is attributable to improper underreporting by small businesses and sole proprietors who often receive income in cash. Administratively, reducing the small-business and sole proprietor tax gap is costly and may necessitate expanding burdensome withholding or information reporting requirements. In the late 1990s a backlash against IRS enforcement techniques drove legislation to create a ''customer friendly'' approach to tax collection. Today the pendulum has swung, and Congress again seeks to improve tax compliance. Congress would be wise to think carefully about the implications of tax gap proposals on the overall effectiveness of the tax administration system and the IRS allocation of scarce budget resources.

Economic Substance Doctrine

Finally, the 110th Congress will consider codifying a judicial doctrine that requires transactions to have independent economic substance to be respected for tax purposes. Many observers question whether codifying the economic substance doctrine will generate the $15 billion suggested by revenue estimators. Relying in part on the economic substance doctrine, the IRS recently has experienced remarkable success combating tax shelters in the courts. The estimators likely assume that codification of the economic substance doctrine, combined with a strict liability penalty for violations of the rule, will deter corporations from participating in transactions they otherwise would pursue. Recent cases, however, have already put a chill on tax shelter transactions, in part because of the imprecision of when and how the courts will apply the doctrine. Many tax specialists worry that codifying the doctrine may reduce judicial discretion and create a bright-line test that creative tax attorneys will learn how to circumvent. Congress would be wise to resist the temptation that the revenue estimate for this codification proposal offers and to consider the competing considerations carefully before acting in that area.

In sum, tax and spending initiatives will generate considerable pressure to find revenue-raising tax provisions. Some of the proposals deserve consideration, but they also deserve careful deliberation because of their implications for tax policy and the economy. Aggressive oversight of the nation's complex, and sometimes unwieldy, tax system is appropriate, but should be driven by substantive and thoughtful debate, not simply by the desire to raise tax revenue.