April 15, 2015

Senator Orrin Hatch, Chairman
Senator Ron Wyden, Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510-6200

Re: Business Income Tax Working Group

Dear Chairman Hatch and Ranking Member Wyden:

Taxpayers for Common Sense (TCS) is a national non-partisan budget watchdog that has been working on behalf of the nation's taxpayers since 1995.

TCS, like many others, believes federal tax policy should foster economic growth. An improving economy will reduce the rate of growth of our debt – and should ultimately decrease its overall size. We also believe tax policy, like federal spending, should help maximize the benefits of economic growth for all taxpayers.

The attached comments begin with a description of principles for tax reform the Committee should embrace as it endeavors to overhaul the federal tax code. The comments are then divided into three sections: **Business Tax Reform, International Business Tax Reform, and Introduction of Carbon Pricing.** Many of the attached comments refer back to the discussion drafts put forth by then-Chairman Senator Max Baucus and the "Tax Reform Act of 2014" introduced by then-Chairman of the House Ways and Means Committee David Camp last year.

It has been more than a quarter-century since the last overhaul of the tax code, and in that time it has become a confusing thicket littered with narrow carve-outs, parochial preferences, and revenue giveaways. There must be more regular review of the individual and corporate tax codes to ensure that they are providing a return on the taxpayer's forgone revenue investment. The existing lack of oversight and scrutiny rewards political inertia, rather than performance. With that in mind, the Committee and Congress should take this rare opportunity to clear out the undergrowth and create a fair tax system that moves America forward.

Please feel free to contact me or my staff regarding any of these comments.

Sincerely,

Ryan Alexander
President

Tax Reform Principles

1. **Make tax code simpler, flatter, and fairer. Reward hard work and innovation, not creative tax avoidance.**
   What does that mean? It means eliminating special interest breaks, collapsing brackets, and reducing rates in a transparent and accountable way. The nation needs a corporate tax code that rewards the best and most innovative businesses, not the best and most innovative tax attorneys. Policymakers should clean the corporate code completely, eliminating all those narrowly tailored tax breaks, snipping incentives to park profits overseas (without establishing "tax holidays," which just reward those skilled in the art of tax avoidance), and lowering the statutory corporate rate to make us more competitive globally.

2. **Tax things we don't want.**
   Carbon pollution costs taxpayers real money now and down the road in environmental liabilities and health costs. Carbon producers are profitable industries that benefit from an entrenched system of federal handouts. Industry must pay for its costs of doing business, and no single industry should receive special treatment.

3. **Put an end to the current practice of "tax extenders."**
   Under the current system, Congress repeatedly passes packages of "tax extenders," or bills with a laundry list of special interest tax breaks that survive in part because they are sold as temporary. Because they are packaged together, individual breaks never get an up or down vote, making it easier to sneak in wasteful and often absurd tax breaks like the special expensing rules for certain motor sport facilities, better known as NASCAR tracks. The extenders system creates a false sense of flexibility.

4. **Build in oversight.**
   Absence of oversight means we have little data on economic impact of specific policies. Tax expenditures account for more than discretionary spending every year but receive little oversight from Congress.

5. **Don't decrease revenue. Help put government on a sustainable fiscal path.**
   The overarching goal of tax reform should not be revenue neutrality. We spend most of our time at Taxpayers for Common Sense fighting wasteful spending programs, so we know that spending cuts and entitlement reforms must be a major part of any plan to put our fiscal ship on even keel for the long term. But with a $18.2 trillion debt, we clearly need more money coming in the door. Plus, estimating revenue from changes in the tax code is notoriously difficult. The last thing the country needs is to have tax reform that results in less revenue than before.

I. Business Tax Reform

➢ Repeal Domestic Production Activities Deduction (Section 199)

Although the stated concern of Congress when enacting the provision was retention of U.S. manufacturing jobs and investment, the Domestic Production Activities Deduction (Section 199) applies to many activities that could not realistically be sent abroad. Qualifying activities are loosely defined and complicated. Sec. 199 identifies qualifying income as receipts derived from disposition of property "which was manufactured, produced, grown, or extracted by the taxpayer in whole or in significant part within the United States." However, it does not define the words "manufactured," "produced," "grown," etc. Courts are often left to decide what qualifies as "production."[1]

Roughly one-third of all U.S. corporate activity now qualifies for this deduction, including mining, oil extraction, farming, construction, architecture, engineering and the production of software, recordings and films. Construction of real property in the U.S. that is eligible for the deduction includes the construction of residential or commercial buildings, swimming pools, parking lots, roads, and sidewalks.[2] Electrical, plumbing, heating and air-conditioning contractors qualify. Qualifying production activity does not need to result from or in exports.

Section 199 doesn't require a producer to demonstrate that any new jobs were created by the qualifying activity. Indeed, if a producer is able to increase net income by cutting wages and benefits or replacing workers with machines, the result would be an increased production activity deduction. The jobs associated with qualifying income do not need to be skilled or high-wage jobs. Non-production activities that create substantial economic benefit and high-skilled jobs, such as medical research, do not qualify for the subsidy.

Not surprisingly, the level of domestic manufacturing appears unaffected by the introduction of the production activity deduction. Almost a decade after enactment, the level of domestic manufacturing has continued its steady decline from the 1950s. The Bureau of Labor Statistics reports the manufacturing sector accounted for 13.6 percent of domestic jobs in 1992, 10.7 percent in 2002, only 8.2 in 2012, and will further decline to 7.1 percent by 2022.[3]

➢ Repeal Last-In, First-Out Accounting

LIFO effectively allows a specific group of companies – those with physical inventories – to exaggerate their costs of producing goods, in order to lower the income they report to the

[1] A federal district court ruled that the act of putting wrapped candy bars and wine bottles into gift baskets qualifies for the deduction.1 If a company produces a product and sells it in its own retail outlets, the retail sale can qualify for the deduction, unless the product is further prepared immediately prior to sale, such as food or beverage for consumption (the so-called "Starbucks Footnote"). Thus, roasted and packaged coffee is eligible, but a cup of coffee is not.

[2] Daniel Karnis, "Maximizing the Section 199 Deduction," Journal of Accountancy (September 2010): http://www.journalofaccountancy.com/Issues/2010/Sep/20102727.htm

[3] Bureau of Labor Statistics , Employment Projections, 2.1 Employment by major industry sector at: http://www.bls.gov/emp/#tables

government (not their actual income) in order to pay less in taxes. Congress should repeal LIFO for the following reasons:

LIFO is only about taxes. When Congress passed LIFO, it included a "conformity requirement" that companies use the same inventory accounting method in their financial reporting to shareholders as their reporting to the IRS. This, in theory, would prevent companies from reporting different income to the federal government for tax purposes than they report to shareholders. However, companies that use LIFO circumvent this problem by supplying additional disclosures in their financial statements that report their "LIFO reserve" or "inventory valuation allowance." These measure the difference between the company's net income when using the LIFO method versus the FIFO method. In other words, a company reports this difference in order to provide a more accurate picture of its balance sheet to its shareholders. Companies do not utilize LIFO in other nontax business calculations, such as management compensation. If Congress repeals the tax benefits of LIFO, it will likely disappear completely from general accounting practices.

LIFO creates demonstrably false assumptions about company inventories. Under LIFO, as long as a company's sales do not exceed its purchases (and it maintains a constant or growing inventory), its inventory is considered to *have never been sold*. A company that has used LIFO for many years and maintained its inventory levels will theoretically have goods in its inventory dating back to when it started using LIFO, which could have been more than 30 years ago or more. In practice, few if any of the physical goods that companies added to their inventories in the last century are still in their warehouses, yet these goods rather than more expensive modern ones are still in tax inventory. In fact, most companies use FIFO inventory accounting[4] because it more closely depicts the physical movement of goods, as companies generally use the oldest items in their inventories first.

LIFO distorts business decisions. Studies of LIFO's effect on business decision-making suggest that the opportunity for tax avoidance distorts the inventory choices of firms that use LIFO. In short, LIFO firms are more likely to purchase extra inventory than FIFO firms. One study concludes: "that additional year-end LIFO inventory purchases appear to be made for tax reasons suggests that permitting the LIFO method to be used for tax purposes leads to inventory management inefficiencies."[5] Citing this finding, authors of a critique of LIFO take it one step further, "For firms to purchase additional inventory despite the incremental costs shows how significant the tax benefits can be and further demonstrates the distortion in firm behavior LIFO can cause."[6]

LIFO covers more than just inflation. LIFO allows companies to defer payment on increases in the value of their goods even if those increases have nothing to do with general inflation – the avowed purpose of LIFO. Oil and gas companies use the LIFO accounting method. The price of oil is affected by a variety of factors – such as security issues and global shifts in demand – that

[4] "Roughly 95 percent of firms with inventories use FIFO accounting for tax purposes," according to "Treasury I" inventory analysis for the Reagan Administration during the 1986 tax reform effort.
[5] The Year-End LIFO Inventory Purchasing Decision: An Empirical Test, Micah Frankel and Robert Trezevant, The Accounting Review, Vol. 69, No. 2 (Apr., 1994), pp. 382-398
[6] See #10

have increased the cost of oil far more than the general rate of inflation. From 2005 to 2013, the wellhead price of domestic oil rose nearly 130 percent, compared to a 32 percent rise in the producer price index for all manufacturing and a 21 percent rise in consumer prices.[7] But because oil and gas companies use LIFO, there is no distinction between an increase in inventory values as a result of inflation or other factors.

LIFO is not available to all taxpayers. This kind of accounting method is only relevant to companies that maintain physical inventories. Service industries, for example, are not able to take advantage of this special tax break. Regardless of LIFO's efficacy, it offers preferential tax treatment to a specific group taxpayers relative to other taxpayers based on the arbitrary requirement of maintaining physical inventories.

Both the Baucus discussion draft and Chairman Camp's proposal proposed the repeal of LIFO. However, it is unnecessary to allow the accumulated subsidy that has resulted from LIFO accounting be taken into income over 8 years, as Baucus proposes, rather than 4 years, as would occur under normal accounting rules.

➢ Repeal Master Limited Partnerships

Master Limited Partnerships (MLPs) have all of the characteristics commonly associated with corporations. Unit interests in MLPs are freely transferable on public markets. Investors are shielded from personal liability for the acts or omissions of the MLP; their only risk is the loss of investment. MLPs are subject to the same accounting and reporting rules as public companies and to the securities regulations that apply to publicly-traded companies. MLPs continue in existence for tax purposes even if a majority of the interests in the partnership change hands.

Although similar to corporations in many ways, MLPs that meet specified tax requirements are taxed as partnerships, not as corporations. For an MLP to qualify for the tax-advantaged partnership treatment under the tax code, 90 percent of its income must come from qualified sources. These include interest, dividends, capital gains, real property rents, gains on real estate, and income and gains from specified natural resources activities. The definition of qualified income has resulted in the oil, gas and coal industries dominating the use of tax-advantaged MLPs.

At the end of September 2013, nearly 130 MLPs had a combined market capitalization of $490 billion.[8] Energy and natural resource MLPs accounted for 86 percent of this total. In terms of market capitalization, three-fourths of all MLPs are engaged in mid- and downstream activities, including gathering and processing; refining; compression; transportation by pipeline, ship or truck; storage; marketing and distribution (other than retail).[9]

[7] Calculated from U.S. Bureau of Labor Statistics data
[8] National Association of Publicly Traded Partnerships (NAPTP) data, http://www.naptp.org/documentlinks/Investor_Relations/MLP_101.pdf slide 33
[9] http://www.naptp.org/documentlinks/Investor_Relations/MLP_101.pdf slide35

- **Repeal Exploration and Development Costs Deductions**

Exploration and development costs, also known as intangible drilling costs (IDC), include the costs of designing and fabricating drilling platforms as well as direct "wages, fuel, repairs, hauling, and supplies related to drilling wells and preparing them for production."[10] IDCs can represent 60 to 80 percent of the costs of drilling a well.[11] The IDC deduction allows qualified natural resource developers to deduct all of these costs immediately.[12] Integrated oil and gas producers are required to capitalize 30 percent of their IDCS and recover them over a 60-month period.

Non-oil and gas taxpayers who self-construct a plant, equipment or other productive property, by contrast, must capitalize the labor and supplies that are used to create the property. These capital costs can be deducted from their business income over a specified period of time through depreciation allowances, based on class lives (e.g. 5, 7 or 10 years). The book treatment of IDCs for oil and gas companies would be to recover these costs over the life of the well, which can be as long as 20 years or more. Not only is the immediate expensing unique to the natural resource developers who can claim this deduction, this deduction is not subject to any maximum dollar limitation, unlike small business expensing rules, which cap the deductible amount.

The oil industry characterizes the IDC deduction as the equivalent of the "research and experimental" (R&E) cost deduction and other business cost deductions that apply to all industries.[13] Research expenses are defined as reasonable costs incurred: "for activities intended to provide information that would eliminate uncertainty about the development or improvement of a product. Uncertainty exists if the available information does not establish how to develop or improve a product or the appropriate design of a product."[14] IDCs are explicitly excluded from the definition of R&E under both the R&D tax credit (section 41) and the general deduction for R&E expenses (section 174).

The IDC deduction is not the same, or designed with the same purpose, as the R&E deduction available to other industries. In the case of oil and gas wells, the principal uncertainty that exists is only whether oil and gas are present in commercial quantities. Indeed, producers repeatedly use the same or substantially similar equipment and processes on well after well. Little or no new information regarding development, improvement, or design occurs when this happens, but developers can still immediately deduct the costs of designing and fabricating these drilling platforms. At this point in the technological development of the industry, the IDC deduction only serves to subsidize the business generally by allowing certain taxpayers to avoid the capitalization rules that apply to other taxpayers.

[10] Treas. Reg. sec. 1.612-4(a)
[11] The Congressional Research Service reports that "Since 1986, major integrated oil companies have been able to expense 70% of their intangible drilling costs and capitalize the remaining 30% over a 60-month period." "Oil and Natural Gas Industry Tax Issues in the FY2013 Budget Proposal," CRS Report R42374, (March 2, 2012).
[12] 26 U.S.C. 263(c)
[13] American Petroleum Institute fact sheet: "This is a deduction, not a credit or government spending outlay and is no different than the policy behind and treatment of R&D costs vis-à-vis the R&D deduction available for other industries."
[14] Treas. Reg. sec. 1.174-2

The Baucus draft proposed reducing the tax subsidies that allow for immediate write off of intangible drilling costs (IDC), tertiary injectants, and mining exploration and development expenditures, as well as the rapid amortization of geological and geophysical expenditures. Natural resources developers would be allowed a 5-year amortization of these expenditures. Non-US wells have 10-year amortizations under present law. The 5-year amortization also contrasts with the bill's treatment of other forms of capital cost recovery, as it reduces depreciation benefits and lengthens the period for amortization of intangibles to *20 years*. Granting a short 5-year recovery period for oil and gas well investments – the same as the proposed new recovery period for research and development expenditures (R&D) – implicitly accepts the oil industry's fallacious argument that drilling oil wells is like R&D. While the Baucus discussion draft is an improvement to existing law, a 5-year recovery period for oil and gas well investments only lessens the existing tax subsidy. Amortization periods should be tied to economic data.

The Joint Committee on Taxation estimates the repeal of intangible drilling and development (or exploration and development) costs deduction for oil and gas wells will save taxpayers $6 billion over 5 years.[15]

- **Repeal Special Percentage Depletion Allowance**

Depletion deduction is theoretically based on the principle that, as an income-producing asset is depleted, a company should be able to deduct from its income the cost of acquiring the proportion of the asset that has been used. In other words, depletion is similar to the depreciation deduction for the capital cost of plant and equipment; the costs are deducted from income before the net income is taxed. This deduction should allow recovery of the cost of leases for oil and gas wells, as well as the cost of other natural resources and timber. The way the cost depletion formula works, the total deduction will never exceed 100 percent over the life of the well, so it approximates an accurate deduction of capital costs.

Eligible independent oil and gas producers and royalty owners, however, can claim "percentage depletion".[16] While nominally designed to allow the oil and gas industry to deduct the cost of purchasing rights to oil and gas resources, the percentage depletion deduction bears no actual relationship to the cost of acquisition. It has been severed completely from the concept of recovering the capital cost of the resource; it effectively makes a certain portion of gross income tax-free without regard to capital costs. It allows independent producers a flat deduction of a percentage of gross income from each well. At the 2012 average wellhead price of $94.52 a barrel,[17] 1,000 barrels a day would produce an annual deduction of more than $5 million on proceeds of over $34 million.

The percentage depletion deduction was first adopted in the 1926 Revenue Act.[18] At that time, the deduction was set at 27.5 percent for oil and gas wells, and limited to 50 percent of the net

[15] Joint Committee on Taxation, Estimates Of Federal Tax Expenditures For Fiscal Years 2014-2018
[16] 26 U.S.C. 613A
[17] US EIA information at http://www.eia.gov/dnav/pet/pet_pri_dfp1_k_a.htm
[18] 44 Stat. 9 (Feb. 26, 1926)

income from the well. It has undergone a few modifications, with the most significant in 1975.[19] The oil and gas percentage depletion deduction was reduced to 15 percent and the limitation was set at 65 percent of net income and 1,000 bpd.[20] The most notable change was that integrated oil companies – those that operate refineries as well as producing oil and gas from drilling – were restricted from using the percentage depletion deduction. In 1990, the limitation was revised again to allow percentage depletion deductions up to 100 percent of net income from marginal wells.[21]

Setting the limit at 100 percent means that the deduction may offset the entire net income – a producer may pay zero tax on the income from a marginal well. Even this limit was suspended for 1998 through 2007 and 2009 through 2011, meaning that a producer could deduct more than 100 percent of the net income from a marginal well.[22] The special percentage depletion allowance enables producers to claim tax deductions *in excess* of their investment. No other taxpayer has such a benefit.

The Baucus discussion draft proposed repeal of the percentage depletion allowance. For new wells and mines, taxpayers will no longer be able to deduct more than the amount they have invested. However, the effective date for the repeal of percentage depletion (properties placed in production after 2014) allows owners of *existing* mines and wells to continue to deduct amounts in excess of their actual costs. This is poor tax policy, and it contrasts with the changes proposed for depreciation and amortization of intangibles, which would slow down the recovery of costs incurred *before* the bill's effective date. A better policy would repeal percentage depletion for all properties and allow any remaining basis in existing wells or mines to be recovered through cost depletion.

The Joint Committee on Taxation has estimated the repeal of percentage depletion allowance for oil and gas companies would save taxpayers in excess of $7.4 billion over 5 years.[23]

- **<u>Repeal Deduction for Tertiary Injectants</u>**

"Tertiary recovery," sometimes called "enhanced oil recovery," includes a variety of methods to increase the productivity of an oil and gas reservoir. Tertiary injectants increase the amount of oil or gas that is recovered and extend the life of a well. As oil and gas is withdrawn from a geological formation, the pressure inside the reservoir declines, making it more difficult to remove the hydrocarbons inside, requiring tertiary recovery. The principal means of tertiary recovery involve injecting materials into the formation to increase the reservoir pressure, increase the mobility of the remaining hydrocarbons within the formation, or to increase separation between injected fluids (used for secondary recovery) and the remaining hydrocarbons.

[19] Tax Reduction Act of 1975, Pub. Law 94-12 sec. 501, 89 Stat. 47 (Mar. 29, 1975).
[20] 26 U.S.C. 611, 613, 613A.
[21] Omnibus Budget Reconciliation Act of 1990, Pub. Law 101–508 sec. 11522, 104 Stat. 1388 (Nov. 5, 1990). (Marginal wells are defined as those that produce very little oil or only heavy oil.)
[22] 26 U.S.C. 613A(c)(6)(H).
[23] Joint Committee on Taxation, Estimates Of Federal Tax Expenditures For Fiscal Years 2014-2018

The oil and gas industry has suggested that the deduction for tertiary injectants is simply a standard cost recovery provision.[24] If tertiary injectants were useful only in the year when they were injected, they could be deducted as an expense under other ordinary business provisions of the tax code. But the industry's argument ignores the fact that tertiary injectants may support production from a well for a period of time, and not simply in the year that they are used. Section 193 allows oil and gas companies to deduct the cost immediately, and avoid capitalizing and depreciating the cost over the life of the injectants' usefulness. Producers may also deduct the cost of tertiary injectants without limitation.[25]

- **Repeal Amortization Period for Geological and Geophysical Costs**

Geological and geophysical assessments (G&G) are activities that oil and gas companies engage in to determine where oil and gas may be located on their properties, and in what amounts, and also to determine where drilling may be most appropriate. The activities may include seismic surveys, electromagnetic surveys, other types of remote sensing, shallow test drilling, and bottom sampling.[26] While G&G does not directly yield income, the investment in G&G contributes to the income an oil and gas company may receive from the property assessed, throughout the life of the company's use of the property. As such, the results of G&G investment are a capital asset whose cost should be recognized over the period of the usefulness of the data.

G&G expenditures include the costs incurred for geologists and geologic surveys that are used as the basis for decisions to acquire and retention of mineral properties. The Energy Policy Act of 2005 specified that the tax deduction for geological and geophysical assessments by smaller oil and gas companies should be recognized over an amortization period of just 24 months.[27] For major integrated oil companies, the amortization period is seven years. Even this longer period is not tied to the actual usefulness of the information generated from G&G assessments.

Seven years is not an unreasonable estimate of the period that such information may be most useful, though in fact some information from the assessments may be used for decades. The size of the company conducting the G&G assessment is not itself relevant to determining the period that G&G data may be useful, so the current provision simply provides a tax subsidy to smaller companies.

The Joint Committee on Taxation has estimated that changing this amortization period to uniform 7 years would save taxpayers $700 million over 5 years.[28]

- **Repeal Carbon Capture and Sequestration Credits**

Current carbon capture technology would need to be scaled-up as much as 100 times in order to be workable in commercial power plant. Not only would it take massive investments in infrastructure and subsidies to test the commercial viability of CCS, but any consequent clean-

[24] "API Key Tax Issues," American Petroleum Institute.
[25] 26 U.S.C. 193
[26] "Atlantic OCS Proposed Geological and Geophysical Activities Mid-Atlantic and South Atlantic Planning Areas Draft Programmatic Environmental Impact Statement," BOEM 2012-005 p. 3-3 (March 2012).
[27] 26 U.S.C. 167(h), Energy Policy Act of 2005, Pub. Law 109-56 sec. 1329, 119 Stat. 1020 (Aug. 8. 2005).
[28] "Estimates Of Federal Tax Expenditures For Fiscal Years 2014-2018," JCX-97-14 (Aug. 5, 2014).

up, should leaks or unforeseen accidents occur, would likely be paid for by taxpayers. The Camp proposal includes the repeal of the carbon dioxide sequestration credit, effective for credits determined for tax years beginning after 2014. The Baucus draft proposes the option of claiming a 20 percent investment tax credit after 2016 for existing facilities that undertake a carbon capture and sequestration (CCS) retrofit that captures at least 50 percent of carbon dioxide emissions.

- **Biofuels and Alternative Fuels**

Production tax credits and investment tax credits (ITC) by their nature and design distort investment decisions and subsidize otherwise non-economic investment. Biofuel, biomass, and alternative fuel tax preferences – including the cellulosic, biodiesel, open-loop biomass, alternative fuel, and alternative fuel property tax credits – should be allowed to expire permanently, and they should not be replaced with other tax credits.

The Baucus energy discussion draft proposed simplifying current energy tax incentives by consolidating over 40 separate provisions into two production tax credits and two alternative ITCs. However, these new credits would still create unnecessary subsidies and distort the market. The transportation fuel credit proposed in the Baucus plan would allow corn ethanol facilities powered by biomass sources to once again become eligible for federal tax breaks, even though the Volumetric Ethanol Excise Tax Credit (VEETC) was so unpopular that it was ended in 2011. For the first time, corn butanol, another corn-based biofuel, would become eligible for the new tax credit even though the use of corn-based biofuels has failed to reduce greenhouse gas emissions. This proposed credit also fails to take into account full life-cycle carbon emissions since it would exclude carbon emitted during the production of feedstocks used in ethanol or biodiesel production, such as corn or soybeans. It would also create unintended consequences as a result of increased biomass and biofuel production, such as higher food prices and indirect land use changes which cause deforestation and production on previously uncultivated land.

The Camp proposal would have repealed tax credits for biofuels and electricity produced from certain renewable resources, including closed-loop biomass, open-loop biomass, and municipal solid waste.

II. International Business Tax Reform

New rules for international taxation need to be grounded in today's economic environment of global taxpayers, characterized by the increasing importance and mobility of intellectual property and constant developments in information and communication technologies. Unless the corporate code recognizes and anticipates avoidance opportunities like inversions in a globalized economy, the U.S. corporate tax base will continue to erode. Several high-profile corporate inversions last year focused more attention on the shortcomings of the current international tax system. Members of both parties in Congress recognize gaps in the existing tax code provide opportunities for companies to eliminate or significantly reduce taxation on both domestic and foreign income in ways that are inconsistent with the intent of existing tax policy.

Congress should follow through on the international provisions in the Baucus and Camp proposals that sought to narrow the U.S. worldwide taxation regime and eliminate the disincentive under current law to repatriate foreign earnings; and enact base erosion protections to increase taxation of foreign income earned with respect to the U.S. market.

The Baucus draft, for example, proposed ending the present deferral of tax on pre-reform foreign income of Controlled Foreign Corporations (CFCs). Amounts earned by CFCs in years starting in 2014 will be deemed repatriated at the end of the tax year. A domestic corporation that is a U.S. shareholder of a CFC must include in gross income its share of the CFC's accumulated undistributed foreign income (both current income and previously accumulated amounts), regardless of whether any distributions are made to the domestic corporation. The draft proposed a special deduction that results in a 20 percent effective tax rate on this income before foreign tax credits are included. A foreign tax credit would be allowed for taxes paid with respect to the taxable portion of the included income.

However, in the Baucus proposal, a U.S. shareholder could elect to pay the net tax liability that results from the mandatory inclusion of pre-effective-date undistributed CFC earnings in up to eight equal installments. While the draft denies taxpayers who took advantage of tax havens and aggressive tax planning the opportunity to reap another windfall in the taxation of deemed distributions, the option to spread payments over 8 years seems like a budgetary gimmick. Many of the affected companies file audited financial statements. For these companies, the additional tax required by the deemed repatriation will have to be accrued immediately upon enactment – in advance of even the first cash payment required by the change. The eight-year spreading of payments is a cash-flow windfall. Some installment payment may be appropriate to allow taxpayers to manage their cash effectively, but eight years is too long a period of continued deferral.

III. Introduction of Carbon Pricing

Overview

A carbon tax is an excise, or consumption, tax imposed on specified sources of carbon emissions. It may be imposed either "upstream" on products the consumption of which will result in the release of carbon into the atmosphere, or "downstream" on actual emissions.

A carbon tax would have important points in common with any federal tax. First, the proceeds of a carbon tax could be used to reduce other taxes, to reduce the deficit, to fund specific programs, or to achieve a combination of those goals. Second, in designing any particular carbon tax system, tradeoffs will be necessary between the desire to encourage certain behaviors through exemptions or credits and the competing desires either to impose as low a rate as possible on taxable substances or to achieve targeted reductions in emissions. Third, the administrative structures currently in place for a number of taxes, such as the motor fuels and the black lung excise taxes, could support administration of an upstream carbon tax.

Consumption tax as a policy choice

The federal government does not currently have a broad-based consumption tax; however, such taxes frequently are suggested either as a replacement for one or more existing taxes[29] or as sources of additional revenue for deficit reduction.[30] Prior to enactment of the income tax, consumption taxes in the form of tariffs and excise taxes were the principal source of federal revenue.

The policy considerations surrounding consumption taxation are well documented.[31] Advocates of consumption taxes typically identify four advantages of this form of taxation. First, they argue that it corrects a current law bias that rewards consumption over savings and investment and is therefore, more economically efficient. That is, individuals can avoid a broad-based consumption tax by choosing to save rather than to consume. Second, they argue that a consumption tax, assuming some protection for very low income workers, would improve tax fairness by creating a flatter tax system. Third, they argue that consumption taxes, through border adjustments, would exempt U.S. exports making them more competitive and impose taxes on imports. Fourth, to the extent that consumption taxes are imposed before the last retail sale, they believe the tax would improve overall tax compliance.

Opponents of consumption taxes dispute the assertions of proponents and argue that such taxes are inherently regressive and that a federal consumption tax would interfere with the ability of states to impose sales taxes, a traditional source of state and local revenue.

Design of a Carbon Tax

As noted, a carbon tax could be imposed either upstream on products the consumption of which will release carbon, or downstream on actual emissions. A downstream tax must also include an upstream or mid-stream component that imposes tax on the carbon released by business and residential consumption of fuels.

The imposition of an upstream tax would have two principal advantages.[32] First, imposition of an upstream carbon tax would not require the creation of a large new bureaucracy to measure actual emissions and collect the tax. The Internal Revenue Service already collects a variety of excise taxes under well established procedures. In some cases, it might even be possible to eliminate one or more existing excise taxes such as the motor fuels excise, oil spill liability, black lung, and leaking underground storage taxes. This could be done through appropriate adjustment to carbon tax rates on various products to approximate the present law tax burdens.

[29] For early examples see, H.R. 2060, 104th Congress, July 1995 (The Flat Tax introduced by Rep. Armey [R-TX]); H.R. 2525 106th Congress, July 1999 (The Fair Tax introduced by Rep. Linder [R-GA]). Similar tax proposals have been reintroduced repeatedly.

[30] The National Commission on Fiscal Responsibility and Reform (Simpson-Bowles) recommended a 15-cent a gallon increase in the gas tax in addition to additional revenues from tax reform.
The Bipartisan Policy Center debt reduction report (Domenici-Rivlin) recommended a 6.5 percent VAT described as a "national debt reduction sales tax."

[31] See, *A VAT Reader*, Tax Analysts 2011.

[32] See CBO, *Policy Options for Reducing CO_2 Emissions*, February 2008 at xii – xiii; Metcalf, Gilbert E., A Proposal for a U.S. Carbon Tax Swap, (The Hamilton Project October 2007) at 13 – 14.

Alternatively, the reporting and collection of existing taxes could be combined with reporting and collection of a carbon tax.

Second, the number of firms required to file tax returns for an upstream tax would be limited. Most of the tax would be paid by the operators of approximately 150 refineries, 500 gas processing plants and 1300 coal mines.[33] In contrast, an emissions tax could require filings by, for example, every business consuming coal or petroleum products and by firms selling transportation fuels and fuels for residential use.

An upstream carbon tax would apply to the principle sources of CO_2 emissions: coal, natural gas and petroleum products. The tax would impose differing rates on each taxable substance so that each is taxed equivalently in terms of tons of potential CO_2 emissions. The CO_2 equivalence rate could be set and adjusted to achieve any desired combination of revenue collections and CO2 emissions reductions.

As with any tax, credits and exemptions could be provided to encourage specific activity. The most frequently suggested carbon tax credit, one for carbon offset activities, would require new regulatory processes for the certification of offsets and new IRS expertise and audit resources to evaluate carbon offsets claims.

Carbon versus Value-Added Tax

The most commonly discussed consumption tax option is a Value-Added Tax (VAT) imposed on most goods and services. Such a tax would require extensive collection and reporting activities across the private sector as well as the creation of entire new systems within the IRS to administer and enforce the tax. The tax would be avoided by saving rather than consuming. For households with limited ability to save, the tax would be largely unavoidable although its impact could be mitigated through rebates to low-income households or other measures.

A carbon tax would be more targeted than a VAT; nonetheless, the tax would have a broad impact because carbon contributes to the value of many goods and services through its presence in raw material, transportation and energy. In contrast to a VAT, a limited number of entities, many of which already file federal excise tax returns, would have compliance responsibilities for an upstream carbon tax. Households could reduce the impact of the tax on them by taking energy savings measures.

[33] U.S. Energy Information Administration data