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Revenue-Positive Reform of the Corporate Income Tax

Close Corporate Tax Loopholes — But Don't Give the Revenue Back to Corporations as a Rate Cut

"If there are ideas whereby we can lower corporate tax rates in a way that does not massively add to our deficit, but instead revolves around closing loopholes, ... that is something that we would be very interested in." President Barack Obama at a meeting of his economic recovery advisory board on Monday, October 4, 2010.

The Obama administration has recently been signaling interest in a reform of the corporate income tax that would be revenue-neutral, meaning it would not reduce or increase the deficit. In other words, the administration says it wants to close unwarranted and expensive corporate tax loopholes, but use all the revenue that raises to reduce the corporate tax rate.

Revenue-neutrality is the wrong goal. Corporate tax reform could involve some small reduction in the corporate tax rate, but overall corporate tax reform should be revenue-positive, so that it can reduce the budget deficit.

This report explains several reasons why corporate tax reform should be revenue-positive, rather than revenue-neutral. Despite what corporate CEO's and many politicians claim, U.S. corporate taxes are already lower than the corporate taxes imposed by the countries that we compete with. Surveys show that most Americans want large corporations to pay more, not less, in taxes. The arguments lobbyists make to try to justify reducing U.S. corporate taxes — arguments related to "competitiveness" and alleged "double-taxation" of corporate income — don't add up. **The last major corporate tax reform, which was enacted under President Ronald Reagan at a time when corporate loopholes were out of control, as they are again today, resulted in a 34 percent net corporate tax increase.[1] To do any less today, with our huge long-term deficit problem, simply does not make sense.**

The appendix at the end of this paper describes some of the most significant breaks and loopholes that should be removed from the corporate income tax.

1. U.S. corporations pay a smaller percentage of their profits in taxes than do corporations based in other developed nations. Corporate leaders and anti-tax politicians often point to the top statutory corporate tax rate in the U.S. — 35 percent — which is higher than that of most other countries. But because there are so many deductions, credits and other special breaks in our corporate income tax, the *effective* tax rate for U.S. corporations is actually relatively low.

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[1] Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (May 4, 1987), p. 1357, estimating that the '86 Tax Reform Act would increase corporate income taxes by $120.3 billion over the fiscal 1987-91 period; *Budget of the U.S. Government, Fiscal 2010, Historical Tables* (Feb. 2010), Table 2.1, reporting that corporate income taxes over the fiscal 1987-91 period (excluding 1.9 billion in Superfund taxes) totaled $471.5 billion; and CTJ calculation: 120.3/(471.5-120.3) = 34%.

In 2007, a report from the Bush Treasury found that "the United States takes a below-average share of corporate income in taxes."[2] The report found that, over the 2000-2005 period, U.S. corporations paid 13.4 percent of their profits in corporate income taxes, while the corporations of the other countries in the Organization of Economic Cooperation and Development (OECD) paid 16.1 percent of their profits in corporate income taxes.[3]

2. Increasing taxes paid by corporations is one of the few deficit-reduction measures that garners widespread public support. Americans want corporations to pay more taxes. The Gallup Poll has asked respondents for several years whether corporations pay their "fair share," "too much" or "too little." Between 2004 and 2009 (the only years for which there is any public data) 67 to 73 percent or respondents said corporations pay "too little."[4]

The idea that the corporate tax should be reduced seems to exist only in Washington. In fact, many Democratic and Republican members of Congress seem to assume that the primary goal of corporate tax reform is to sharply lower the 35 percent statutory corporate tax rate. This appears to be one instance in which Washington truly is out of touch with ordinary Americans.

This kind of thinking is particularly bizarre when our government is in dire need of additional revenue to reduce the budget deficit. One would think that politicians would gravitate towards revenue-raising measures that the public approves. But instead, Congress is contemplating all sorts of program cuts that the public will have a hard time digesting. For example, the President's fiscal commission recently proposed cutting discretionary spending by 23 percent by 2020 and cutting Social Security by 10 percent by 2050 and 16 percent by 2070.[5]

3. Low taxes do not make a nation competitive or business-friendly. Are low corporate taxes the key to a growing economy? No. Much more important are a well-educated workforce, a robust infrastructure, economic and legal stability and many other things that can only be provided if the U.S. collects adequate tax revenue from corporations and others who profit the most from these public investments.

In other words, even if the effective tax rate for U.S. corporations was higher than the effective tax rate for the corporations of other countries (which it's not), that would tell us very little about how competitive or business-friendly the U.S. is.

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[2] U.S. Department of the Treasury, "Treasury Conference on Business Taxation and Global Competitiveness: Background Paper," July 23, 2007. http://www.treasury.gov/press-center/press-releases/Pages/hp500.aspx

[3] The report attempts to argue that other measures of the corporate tax, like the "effective marginal tax rate" or even the statutory rate, are more relevant to cross-border investment decisions. But those can be reduced through a sensible tax reform, even one that raises revenue overall. It's difficult to believe that our corporate income tax system as a whole cannot collect more revenue when the Bush administration admits to a lower-than-average effective tax rate on U.S. corporations.

[4] Polling Report, http://www.pollingreport.com/budget3.htm.

[5] Citizens for Tax Justice, "Statement on the President's Fiscal Commission Plan," December 2, 2010. http://www.ctj.org/pdf/deficitcommissionplan.pdf Compared to those difficult spending cuts, the tax reform and other revenue proposals in the President's fiscal commission's plan would only increase revenue by 5.8 percent. The tax reform ideas generally call for loophole-closing with most of the resulting revenue to be used for rate reductions in both the personal income tax and the corporate income tax. While the details concerning the corporate income tax are vague, it seems likely that the corporate tax component of the plan would be revenue-neutral. Considering how deeply unpopular many of the spending cuts would be, one would think that the commission members might have attempted to obtain some revenue from corporate tax reform.

Corporate lobbyists claim that corporations, both American and foreign, are less likely to invest in the U.S. because our allegedly higher corporate taxes reduce the amount of dividends that corporations can pay to their shareholders. These same lobbyists have also long argued that states within the U.S. must lower their state corporate income taxes, or provide special tax breaks, in order to lure and keep corporations within their borders. But research shows that state taxes have little impact on where corporations decide to locate. More important are the quality of life in the community, a good supply of highly skilled and educated men and women to fill demanding technical and management positions, good roads and adequate transportation, and the quality of health care.[6] The same is likely true for federal corporate taxes.

Another lobbyist claim is that U.S. corporations who want to produce products abroad will somehow be less able to compete with foreign-based companies unless the U.S. corporate tax rate is reduced. The anti-tax argument goes something like this: Suppose that there is an opportunity for a corporation to profit in country X. A U.S. corporation might seize that opportunity, or a foreign corporation might. All other things being equal, it could be easier for the foreign company to raise capital to support building factories abroad, if allegedly-higher U.S. corporate taxes reduce the dividends that the U.S. company can pay to its shareholders.

There are several responses to this argument:

First, it's not at all clear why the Americans should want U.S.-based corporations to produce their products abroad. Wouldn't it be much better if they made their products here in the United States using American workers? Should we have a tax bias *in favor of* foreign operations? We don't think so.

Second, as things now stand, American corporations generally pay little or no U.S. corporate tax on their foreign earnings. Instead, taxes on foreign profits can be indefinitely "deferred." And if a U.S. corporation does choose to make some of its foreign profits subject to U.S. tax, it can subtract any foreign tax it paid on those profits from it's U.S. tax bill (this is called the "foreign tax credit").

To be sure, we strongly believe that the current system that lets U.S. corporations indefinitely "defer" paying taxes on their foreign profits should be scrapped. But the overriding goal here is to crack down on offshore profit-shifting, that is, to stop companies from shifting, on paper, the profits they earn in the United States into no-tax foreign tax havens. We would retain the "foreign tax credit" just discussed, so that U.S. companies would still get a credit against their U.S. taxes for taxes paid to foreign countries.

Some corporate lobbyists claim that retaining deferral, along with the offshore profit-shifting and the abuses of the foreign tax credit that it engenders, is essential to keeping U.S. corporations competitive with non-U.S. companies in producing products and services outside the United States (e.g., in China). They argue that when U.S. corporations set up facilities abroad, it also leads to investment and job creation here in the United States.

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[6]Institute on Taxation and Economic Policy, "Taxes and Economic Development 101," July 2010. http://www.itepnet.org/policy_briefs/policy_briefs.php

Specifically, the pro-deferral lobbyists claim that foreign investment by U.S. corporations leads to more jobs in corporate headquarters in the United States to support the foreign operations, and that jobs are also created in the U.S. to manufacture components that are assembled abroad. One pro-deferral paper argues that "10 percent greater foreign capital investment triggers 2.6 percent of additional domestic capital investment, and that 10 percent greater foreign employee compensation is associated with 3.7 percent greater domestic employee compensation."[7]

Of course, "associated with" is hardly causation, although the paper seems to think it is. But even if the paper's dubious claim were true, it doesn't explain why we should prefer foreign investment and jobs over jobs and investment in the United States. After all, 10 percent greater U.S. investment and wages by definition gives the full 10 percent to the United States.

More than anything else, companies compete on the basis of the price and quality of the goods and services they provide. What they pay in U.S. income taxes has little or nothing to do with these factors. A U.S. corporation might be able to produce and sell a good in a foreign country because of technical innovations developed in the U.S., or managerial skills developed in the U.S., or component parts manufactured in the U.S. This means that public investments in the U.S. (in education, research, infrastructure) can help U.S. corporations to compete abroad. Slashing corporate income taxes would endanger our ability to make those public investments.

4. The idea that investment income is overly taxed in the U.S., which is often used as a justification for corporate tax reductions, is untrue. One rationale often given for reducing the corporate income tax is the false claim that corporate profits are "double taxed."

Corporations, the argument goes, generate profits that are subject to the corporate income tax. Corporations are not allowed to take deductions for the dividends they pay out to shareholders. When the shareholders receive those dividends, they then have to pay personal income taxes on them. When corporations retain profits, the value of their stock may go up, and shareholders will be taxed on the capital gains if they sell this stock. (This was the argument used to justify the expanded personal income tax break for dividend and capital gains income that was enacted under President Bush in 2003.)

The reality is that personal capital gains and dividends are taxed far less than other types of income, and sometimes are barely taxed at all.

First, about two thirds of personal dividends paid by taxable corporations go to tax-exempt entities such as retirement plans and university endowments.[8] In all likelihood, a similar percentage of capital gains on corporate stock are also tax-exempt.

Second, taxes on capital gains earned outside of tax-exempt plans are not imposed until shareholders sell their corporate stock at a profit. This means that those taxes can be deferred indefinitely. And even if individual shareholders do report taxable capital gains, they often will offset such gains with capital losses (by selling stocks that did poorly at the same time).

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[7]Mihir Desai, C. Fritz Foley, James R. Hines Jr., "Domestic Effects of the Foreign Activities of U.S. Multinationals," May 2008. http://www.people.hbs.edu/ffoley/fdidomestic.pdf

[8]Citizens for Tax Justice, "Allowing the Bush Dividends Tax Cut to Expire for the Richest 2% Will Not Harm Seniors," July 22, 2010. http://ctj.org/pdf/dividends2010.pdf

Third, even personal dividends and capital gains that show up on tax returns are not subject to the Social Security tax of 12.4 percent that applies to the earnings that make up most or all of the income of middle-class taxpayers.[9]

Last and most important, corporate profits are generally not fully taxed (or even taxed at all) at the corporate level because of the various loopholes that riddle the corporate income tax. As a result, the effective tax rate on the U.S. profits of big, publicly-traded corporations is currently half or less of the statutory 35 percent corporate rate. (Some of the most significant loopholes are described in the appendix.)

It's striking that hardly anyone in Washington talks about how the wage income of middle-class Americans is subject to "multiple taxes." For the typical American, all income consists of wages and all of it is subject to the Social Security tax, and much or most of it to the income tax. Then when people spend their income, a great deal of the purchases are subject to sales taxes. Apparently, taxing income multiple times is something that concerns economists and politicians only when it affects the wealthy investor class.

5. President Obama should follow Ronald Reagan's example by raising income taxes on corporations that currently pay little or nothing, and substantially increasing overall corporate income tax payments. The idea of a revenue-neutral tax reform is not entirely absurd. The Tax Reform Act of 1986, which reformed both personal and corporate income taxes, was revenue-neutral overall and was still a great accomplishment. But it's important to note that the 1986 reform act was *not* revenue-neutral for corporations. In fact, despite lowering the statutory corporate tax rate from 46 percent to 34 percent, **the 1986 act closed so many corporate loopholes that, it increased corporate income taxes by more than a third!**[10]

A revenue-neutral corporate tax reform was not appropriate in 1986 because corporate tax avoidance had run rampant, and as President Ronald Reagan pointed out, corporations were not coming close to paying their fair share in taxes.[11]

When President Reagan found out how his former employer, General Electric, and many other giant corporations were thumbing their nose at the tax system, he didn't say, well, let's just let the corporations keep their ill-gotten gains. Instead, Reagan told his Treasury Secretary, "I just didn't realize that things had gotten that far out of line," and issued a mandate to "go full steam ahead" and stop "the inefficiency and selfishness" that had overwhelmed the corporate income tax.[12]

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[9]Social Security payroll taxes apply to the first $106,800 of earnings (indexed for inflation). Technically, half is paid by the employee and half is paid by the employer, but economists agree that ultimately the employer portion is shifted to the employee in the form of reduced wages and benefits.

[10]See footnote 1 on page 1 above.

[11]It's true that the tax reform in 1986 was revenue-neutral overall, meaning that the reforms to the corporate income tax and personal income tax *combined* produced no increase or decrease in the budget deficit. The changes in the personal income tax, taken on their own, reduced revenue, and some of the revenue produced by closing corporate tax loopholes was used to offset that cost. But the long-term budget crisis that we face today is a strong reason why more revenue must be raised from *both* the personal income tax and the corporate income tax.

[12]Donald T. Regan, *For the Record* (1990), p. 195.

Reagan's corporate tax reforms worked, for quite a while. But today, with the help of subsequent Presidents and Congress, corporate tax avoidance has again gone wild and General Electric is again paying no federal income tax. Meanwhile — and not unrelated — long-term budget deficits and lack of revenue are among our nation's greatest problems. In this situation, revenue-neutral corporate tax revenue is even less appropriate than it would have been in 1986.

Just as in 1986, the tax code has too many loopholes and special breaks that reward certain types of investments over others, which leads capital into investments that too often don't make much economic sense. The economy would run more efficiently if corporations simply provided the goods and services that customers want, rather than engaging in whatever tax-sheltering activities lower their taxes the most.

The goal of corporate tax reform should be to restore the corporate tax to a true tax on corporate profits, by getting rid of the loopholes and tax shelters that now allow a large share of those profits to go untaxed — by the United States or any other country.

Reform of our system for taxing multinational corporations should be at the top of the list. Currently, the combination of deferral and the foreign tax credit allows huge amounts of what should be taxable U.S. profits to be artificially shifted (on paper) into tax havens. Repealing deferral, while retaining the foreign tax credit, is the only workable solution to this major defect in our tax laws.

Of course, most American corporations have little or no interest in a loophole-closing reform program by itself. But some corporations that don't enjoy a lot of tax loopholes may be educated to see how they could benefit from a tax reform that levels the business playing field so it's not tilted against them. Indeed, that's exactly what happened in 1986, when there was significant support for *revenue-raising* corporate tax reform among companies that rightfully felt short-changed by a system that vastly favored other, loophole-laden companies.

Today, a small reduction in the corporate tax rate may be necessary to gain the support of those corporations that are now paying their fair share in taxes. But overall, lawmakers contemplating corporate tax reform today should learn a lesson from President Reagan, and make revenue-raising corporate tax reform part of the path to a fiscally sound government and a healthier economy.

Appendix
Some of the Corporate Tax Loopholes and Special Breaks that Should Be Eliminated

Corporations can often pay a very low, or even negative, tax rate on profits of certain investments due to a combination of loopholes and special breaks that clearly influence business decisions. No rational person would structure a corporate tax this way, unless perhaps they ran a corporation that was making use of the loopholes.

Here are some of the most significant loopholes and special breaks that corporations enjoy and that Congress should eliminate.[13]

Deferral of Taxes on Income of U.S.-Controlled Corporations Abroad
2011-2015 cost: $199 billion

U.S. corporations are allowed to defer paying taxes on the profits of their offshore subsidiaries until those profits are brought to the U.S. (repatriated)[14].

Deferral is a huge problem because it allows U.S. corporations to use various accounting gimmicks and transactions that exist only on paper to make their U.S. profits appear "foreign" so that U.S. taxes can be deferred. In some cases, deferral also encourages corporations to move actual operations and jobs to foreign countries.

One of the major problems caused by deferral, which would be greatly reduced if deferral was repealed, is our complicated transfer pricing rules. In general, transfer pricing is the way multinational corporations account for transfers of goods and services between their divisions or subsidiaries. Companies get to deduct the price they pay for goods or services they purchase in the course of business. The same is true when a company pays for a good or service transferred to it from one of its subsidiaries, except that there isn't a true "sale" or "price" because the transfer is internal to the corporate group. The "price" of the transfer is therefore easy to manipulate but it is nonetheless deductible by the company that pays it.

So corporations have a lot of incentives to inflate the price of goods and services "sold" to a U.S. company or subsidiary from a subsidiary in a low-tax jurisdiction. The U.S. companies can thus claim large deductible expenses that reduce their U.S. taxable income. As a result, U.S. profits are effectively shifted to subsidiaries in low-tax (or no-tax) jurisdictions.

Transfer pricing is a particularly thorny issue when intangible assets are involved.

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[13]The revenue estimates are from the Office of Management and Budget, *Analytical Perspectives, Budget of the United States Government, Fiscal Year 2011*, Feb. 2010. http://www.whitehouse.gov/sites/default/files/omb/budget/fy2011/assets/spec.pdf. The revenue estimate for LIFO is not included in the OMB's estimates and is taken from Joint Committee on Taxation, "Estimates Of Federal Tax Expenditures for Fiscal Years 2010-2014," Dec. 21, 2010, with extrapolations to 2015. http://jct.gov/publications.html?func=startdown&id=3717 Most of the loopholes described here are loopholes in both the corporate income tax and the personal income tax and the estimates here include the revenue loss for both. (Congress is unlikely to close a loophole in one and not the other.)

[14]Deferral is not necessary to avoid profits being taxed multiple times because a U.S. corporation (or any U.S. taxpayer for that matter) takes a credit for any taxes paid to a foreign government. (This is the "foreign tax credit.")

Multinational companies often transfer intangible assets, such as a patent, to a subsidiary in a low-tax jurisdiction which then charges its parent company large, tax-deductible royalties for the use of the patent in the U.S. (or other country with a real tax system) thus shifting the income to the lower-tax country.

For example, a U.S. corporation might transfer a patent for some product it produces to its subsidiary in another country, say the Cayman Islands, that does not tax the income generated from this sort of asset. The U.S. parent corporation will then "pay" large fees to its subsidiary in the Cayman Islands for the use of this patent. The U.S. parent corporation deducts these fees from the income it reports to the I.R.S.

The result is that the U.S. corporation avoids U.S. taxes, even though nothing has really changed, except on paper. No real business activity is taking place in the Cayman Islands, and the "subsidiary" there might consist of nothing but a post office box.

Another problem with deferral is that some of the expenses a corporation incurs to earn offshore profits are deductible against their U.S. taxable income right away, even though the offshore profits are not taxed until they are repatriated (which may never happen). Allowing immediate deductions of these expenses is, at best, a tax subsidy for moving operations offshore. Even worse, it makes corporations even more tempted to devise schemes to make it appear that their U.S. income is being earned offshore.

If deferral was repealed, U.S. corporations would simply pay taxes on their profits no matter where those profits are earned.[15] This would not result in corporate profits being taxed by multiple governments because the foreign tax credit is available to prevent that. The need for complicated transfer pricing rules would be greatly reduced, as would the incentive to move operations offshore.[16]

Accelerated Depreciation on Equipment
2011-2015 cost: $141 billion

Businesses are allowed to deduct from their taxable income the expenses of running the business, so that what's taxed is profit. Businesses can also deduct the costs of capital purchases, but since capital investments don't lose value right away, these deductions are taken over time. The basic idea behind depreciation is that when a company makes a capital purchase of a piece of equipment, they can deduct the cost of that equipment over the period of time in which the equipment is thought to wear out.

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[15]Congress could repeal deferral and make our corporate tax system a "pure worldwide" system, meaning all profits are taxed no matter where in the world they are generated. This is the opposite of a "territorial" system, which many countries have and which many corporate leaders want Congress to enact. Under a territorial system, a government only taxes the profits generated within its borders. Our current system is a sort of hybrid of a territorial system and a worldwide system since offshore profits of U.S. corporations are not taxed until they are repatriated, which may never happen. The problems associated with transfer pricing and the incentives to shift profits and operations offshore would only increase if the U.S. shifted to a territorial system.

[16]Another way to repeal deferral would be to enact a system based on formulary apportionment. Under such a system, the U.S. government would use one or more factors (preferably sales, property, and payroll) to determine the fraction of a corporation's worldwide profits that should be subject to U.S. taxes. (This system is used in some U.S. states' corporate income tax systems.) A corporation's worldwide profits would be multiplied by a fraction that would be a composite of the portion of sales, property and payroll that are in the U.S. The result is the portion of profits that are taxed as U.S. income.

Accelerated depreciation allows a company to take these deductions more quickly — sometimes far more quickly — than the equipment actually wears out. The deductions for the cost of the capital purchase are thus taken earlier, which makes them more valuable. Accelerated depreciation was introduced during the 1970s and was so generous that many large corporations were able to avoid taxes entirely. This resulted in a public outcry that led to the Tax Reform Act of 1986, which curtailed, but did not eliminate, accelerated depreciation.[17]

Combined with rules allowing corporations to deduct interest expenses, accelerated depreciation can result in a very low, or even negative, tax rate on profits from a particular investment. A corporation could borrow money to purchase equipment or a building, deduct the interest expenses on the debt and quickly deduct the cost of the equipment or building thanks to accelerated depreciation. The total deductions can then be more than the profits generated by the investment.

Deduction for Domestic Manufacturing
2011-2015 cost: $76.7 billion

In 2002, the World Trade Organization (WTO) found that a particular tax break meant to support exports violated U.S. trade treaties with other countries. In the wake of this ruling, the European Union began imposing retaliatory sanctions against the United States in March of 2004. Congressional tax writers immediately sought to comply with the WTO ruling by repealing the illegal tax break. But lawmakers were wary of being seen as hiking taxes on manufacturers—even when the "tax hike" in question resulted from repealing an illegal tax break — and sought to enact new tax cuts that would offset the lost illegal subsidy for manufacturers. However, as the tax bill took shape, this provision was hijacked by legislators seeking to use the tax bill to provide new tax breaks for other favored corporations.

As finally enacted, the "manufacturing deduction" ballooned to apply to a wide variety of corporate activities that no ordinary person would recognize as "manufacturing," the most egregious of which is oil drilling. The President has proposed to prohibit oil and gas companies from using the break, but Congress should go much farther and repeal the manufacturing deduction altogether. It provides no identifiable benefit to the economy and repealing

[17]While companies paid more in taxes after 1986, however, business investment flourished. To the chagrin of the supply-side advocates of corporate tax loopholes, real business investment grew by 2.7% a year from 1986 to 1989. That was 43 percent faster than the paltry 1.9% growth rate from 1981 to 1986. Even more significant, while construction of unneeded office buildings tapered off after tax reform, business investment in industrial machinery and plants boomed. As money flowed out of wasteful tax shelters, industrial investment jumped by 5.1% a year from 1986 to 1989, after actually falling at a 2% annual rate from 1981 to 1986. As former Reagan Treasury official, J. Gregory Ballentine, told Business Week: "It's very difficult to find much relationship between [corporate tax breaks] and investment. In 1981 manufacturing had its largest tax cut ever and immediately went down the tubes. In 1986 they had their largest tax increase and went gangbusters [on investment]."

it altogether could raise around $100 billion over a decade.[18] (President Obama's proposal to bar oil and gas companies from using it would raise only $17 billion over a decade.)

Last-In, First-Out Accounting (LIFO)
2011-2015 cost: $24.2 billion[19]

The "last-in, first-out" or LIFO, inventory rule allows companies to manipulate their inventory accounting to make their profits appear smaller than they actually are. LIFO allows companies to deduct the higher cost of recently acquired or produced inventory, rather than the lower cost of older inventory.

For example, we normally think of profit this way: You buy something for $30 and sell it for $50 and your profit is $20 (ignoring any other expenses). But corporations, notably oil companies, use an accounting method that doesn't fit this picture. They might buy oil for $30 a barrel, and when the price rises they might buy some more for $45 a barrel. But when they sell a barrel of oil for $50, they get to assume that they sold the very last barrel they bought, the one that cost $45. That means the profit they report to the IRS is $5 instead of $20.

This "last-in, first-out" rule (LIFO) has been in place for decades, and critics have long called for its repeal. In 2005, the then-Republican-led Senate tried to repeal it for oil and gas companies. (The provision was dropped from the tax bill in conference, so oil companies still get to use LIFO.) The Obama administration has, reasonably, proposed repeal of LIFO.

Fossil Fuel Production Breaks
2011-2015 cost of largest three: $10 billion

A number of special tax breaks are targeted towards the oil and gas industry and, to a lesser extent, the coal industry. Given the threat of global warming and the need to shift towards renewable energy sources, it seems reasonable that we, at very least, stop subsidizing dirty fuels through the tax code. Here are the three largest tax breaks for fossil fuels, which President Obama has proposed to eliminate.

The deduction for "intangible" costs of exploring and developing oil and gas sources. The "intangible" costs of exploration and development generally include wages, costs of using machinery for drilling and the costs of materials that get used up during the process of building wells. Most businesses must write off such expenses over the useful life of the property and some get to write them off more quickly because of accelerated depreciation. But oil companies, thanks to their lobbying clout, get to write these expenses off immediately.

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[18]Repeal of the manufacturing deduction would also greatly help several state governments (many of which are facing dire budget crises). This is because many states have corporate income taxes that are linked to the federal corporate income tax, so a deduction on the federal level applies on the state level as well. State lawmakers can enact legislation to "decouple" from the federal rules related to this deduction. But political and constitutional constraints in some states make it difficult to enact any sort of "tax increase," even when it only consists of decoupling from federal rules allowing a deduction. See Institute on Taxation and Economic Policy, "The QPAI Corporate Tax Break: How It Works and How States Can Respond," October 2008. http://www.itepnet.org/pb33qpai.pdf

[19]The revenue estimate for LIFO comes from the Joint Committee on Taxation (JCT) because it is not included in OMB's tax expenditure estimates. The final year of the five-year period is projected by CTJ because the JCT report does not cover 2015.

"Percentage depletion" for oil and gas properties. Most businesses must write off the actual costs of the property over its useful life (until it wears out). If oil companies had to do the same, they would write off the cost of oil fields until the oil was depleted. Instead, some oil companies get to simply deduct a flat percentage of gross revenues. The percentage depletion deductions can actually exceed costs and can zero out all federal taxes for oil and gas companies. The Energy Policy Act of 2005 actually expanded this provision to allow more companies to enjoy it.

The break for amortization of geological and geophysical expenditures. As already explained, most businesses write off the actual cost of property over its useful life (until it wears out). If a business can amortize (write off the costs) more quickly, that means it receives tax deductions earlier, making them much more valuable. The amortization over a two-year period of the costs of searching for oil was introduced in the Energy Policy Act of 2005 and is available even when oil and gas is discovered. The President has proposed to change the rule to allow seven-year amortization.