INFRASTRUCTURE, ENERGY, AND NATURAL RESOURCES

Senate Finance Committee Staff Tax Reform Options for Discussion

April 25, 2013

This document is the fourth in a series of papers compiling tax reform options that Finance Committee members may wish to consider as they work towards reforming our nation's tax system. This compilation is a joint product of the majority and minority staffs of the Finance Committee with input from Committee members' staffs. The options described below represent a non-exhaustive list of prominent tax reform options suggested by witnesses at the Committee's 30 hearings on tax reform to date, bipartisan commissions, tax policy experts, and members of Congress. For the sake of brevity, the list does not include options that retain current law. The options listed are not necessarily endorsed by either the Chairman or Ranking Member.

Members of the Committee have different views about how much revenue the tax system should raise and how tax burdens should be distributed. In particular, Committee members differ on the question of whether any revenues raised by tax reform should be used to lower tax rates, reduce deficits, or some combination of the two. In an effort to facilitate discussion, this document sets this question aside.

I. INFRASTRUCTURE

A. CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

The federal government collects certain taxes and fees to fund federal and state infrastructure projects. Under current law, there are several trust funds used to fund infrastructure. The most prominent is the Highway Trust Fund. Other trust funds include the Airport and Airway Trust Fund, Harbor Maintenance Trust Fund, and Inland Waterways Trust Fund. The taxes associated with these funds are based on a user-fee model whereby users of the infrastructure system are charged a tax that is related to their use.

1. Under current law, 23 states have infrastructure banks. There is no national infrastructure bank but programs such as the Transportation Infrastructure Finance Innovation Act (TIFIA) provide credit support, loans and loan guarantees for surface transportation programs administered by the Department of Transportation.

e. Reduce taxes on foreign investment in U.S. infrastructure
   i. Relax the Foreign Investment in Real Property Tax Act's (FIRPTA) requirement that certain real estate investment trusts with foreign investors pay tax on gains on the sale of U.S. real estate (S.1616 (112th Congress), Real Estate Investment and Jobs Act of 2011, sponsored by Sens. Menendez and Enzi)
   ii. Exempt foreign pension funds from the FIRPTA tax on gains on the sale of U.S. real estate and infrastructure (FY14 Administration Budget Proposal)

I. ENERGY AND NATURAL RESOURCES

A. CURRENT CHALLENGES AND POTENTIAL GOALS FOR REFORM

The tax code currently contains provisions that play a significant role in the domestic energy market. Certain tax expenditures promote domestic energy production, while others incentivize energy conservation and energy efficiency. There are a variety of energy-related tax expenditures in the form of refundable credits, nonrefundable credits, deductions, and accelerated depreciation schedules. CBO estimates that, in FY2013, energy-related tax expenditures will cost $16 billion in foregone revenue, while federal spending on energy will be $3 billion. Among energy-related tax expenditures, 45% will go to renewable energy, 29% to energy efficiency, 20% to fossil fuels, and 7% to nuclear energy. To the extent that a reformed tax system includes energy tax expenditures, they should be structured to be efficient and effective. Following are some potential broad principles for reform in this area:

- To the extent the tax code includes tax expenditures for energy and conservation, the tax code should:
  - Provide businesses with greater certainty
  - Consolidate and simplify such tax expenditures
  - Make such tax expenditures fairer and more efficient
  - Encourage energy independence through a comprehensive approach
  - Carefully consider whether and how to address any positive or negative externalities

Some specific concerns about tax expenditures related to energy and the environment include the following:

- **Distortion of investment decisions:** Some are concerned that energy tax subsidies distort investment choices, which may hamper economic growth, and believe that the tax code should instead focus on equitably and efficiently collecting revenues.

- **Accounting for externalities:** Measuring externalities is difficult and imprecise. Especially in the area of carbon, estimates of externalities are wide-ranging. Some economists believe that energy tax expenditures enhance economic efficiency to the extent that they address externalities associated with pollution. Specifically, they believe that the lack of a price on pollution, such as emissions of CO_2 and other harmful greenhouse gases, is a market failure because pollution produces costs that are not borne by the polluter (e.g., detrimental effects on human health, agricultural productivity, and coastal infrastructure). Further, some economists find that market-based measures, such as taxes, are a more efficient way to correct for this market failure than regulation. Others are concerned that taxing pollution or carbon could adversely affect U.S. competiveness if other countries are not taking similar measures. They are also concerned about the potential impact of such taxes on economic growth and jobs. However, the revenue raised by such a tax could be used to reduce other taxes or to make public investments.

- **Duplication with spending programs:** Some believe that tax benefits and direct spending programs should be more coordinated. According to GAO, 23 agencies, including 130 sub-agencies, implemented 679 renewable energy initiatives in fiscal year 2010. In some cases, these initiatives involved multiple programs or tax expenditures serving a similar purpose. For example, GAO identified 82 wind-related initiatives of which 83% overlapped to some degree with another initiative. However, GAO also noted such overlapping initiatives did not necessarily result in a duplication of efforts because they sometimes differed in meaningful ways. In addition, under current law, there are limits on the extent to which individual projects can receive support from multiple initiatives. For example, taxpayers must reduce the value of some federal tax credits for energy by amounts they have received in grants, tax-exempt bonds, subsidized energy financing, and other tax expenditures.

- **Neutrality across different technologies:** Current law provides a variety of incentives for specific energy technologies. Some believe that it would be more efficient to structure these incentives, to the extent they are retained, on a technology-neutral basis. They argue that such an approach would be more effective at accommodating and encouraging technological advances and would avoid picking winners and losers among competing technologies. Others believe that the choice of any "technology-neutral" standard itself is subjective. Some are also concerned that a technology-neutral approach could have unintended consequences. For example, when Congress established a tax credit for producing biofuels from alternative fuel technology, the pulp and paper industry was able to claim credits worth billions of dollars for a byproduct of their manufacturing process called "black liquor."

- **Overall complexity:** Multiple provisions for the same purpose create complexity and some would argue diminish their effectiveness. The tax code currently includes about 40 energy-related provisions, including provisions for fossil fuel, alternative electricity generation, alternative fuels and alternative fuel vehicles, and energy efficiency, as well as provisions for nuclear, CO_2 abatement, and other purposes.

- **Temporary nature of certain tax expenditures:** Some are concerned that the temporary nature of expiring tax expenditures creates uncertainty for taxpayers, makes it difficult for businesses to plan and may diminish their effectiveness. On the other hand, some argue that allowing energy tax expenditures to expire ensures that the tax code is not subsidizing industries and technologies once they have become competitive, resulting in a higher bang for the buck, and preventing favored industries from receiving permanent tax expenditures. By CBO's last count, there were 27 energy tax expenditures set to expire between 2011 and 2022. Permanently extending these provisions would cost about $120 billion.

- **Low bang-for-the-buck for tax incentives:** Some argue that energy-related tax incentives could achieve more at a lower cost. For example, some research suggests when consumers are purchasing a car, they are "myopic" in the sense that they focus on sticker prices and do not fully account for the fuel savings over time. This implies that tax expenditures that are delivered earlier in time may be more effective. However, others believe consumers act rationally when making consumption decisions.

- **Limited business effect of tax incentives that defer tax liability:** Some energy tax expenditures allow businesses to pay tax later than it would otherwise be due. Such timing changes do not affect the nominal amount of taxes due, although they can be very valuable due to the time value of money. For example, accelerated depreciation for energy-related investments means that a business pays less tax in the years immediately following the purchase of the asset, but pays correspondingly more tax later in the useful life of the asset. Many, but not all, publicly-traded corporations and certain private businesses plan with a focus on financial statement income. Others rely more on cash flow, which helps finance operations when other financial sources are unavailable. In general, tax deferrals do not impact financial statement income and, as a result, may not affect business behavior in some cases. Therefore, to incentivize business behavior, it may be more effective to replace energy tax incentives that defer tax liability with other types of tax incentives, such as rate reductions or credits.

B. REFORM OPTIONS

1. Eliminate all existing tax expenditures for the energy sector

a. Eliminate some or all existing tax expenditures, including the following (H.R.259, (113th Congress), S.2064 (112th Congress), The Energy Freedom & Economic Prosperity Act, sponsored by Rep. Mike Pompeo and Sens. DeMint and Lee; S.329 (113th Congress), the Sustainable Energy Act, sponsored by Sens. Sanders and Boxer; proposal by Rep. Fred Upton in October 2012)

   i. Permanent tax expenditures

      1. Oil- and gas-specific tax expenditures, such as expensing of intangible drilling costs
      2. Accelerated depreciation for alternative energy assets
      3. Investment tax credit for solar and geothermal electricity

   ii. Temporary tax expenditures

      1. Electricity: Investment tax credit for solar and other resources (expire at the end of 2016) and production and investment tax credits for wind and other resources (expire at the end of 2013)
      2. Biofuels: Tax credits for biodiesel and advanced ethanol (expire at the end of 2013) and for liquefied hydrogen and hydrogen refueling property (expire at the end of 2014)
      3. Vehicles: Tax credits for vehicles utilizing fuel cell technology (expire at the end of 2014) and plug-in electric drive motor vehicles (phase-out after a manufacturer sells 200,000 vehicles)

2. Replace existing energy tax expenditures with technology-neutral tax expenditures

a. Repeal existing energy tax expenditures for targeted industries or technologies and replace them with one or more technology-neutral tax incentives such as the following (Testimonies of Dr. Gilbert Metcalf and Dr. David Greene before the Committee on Finance, April 23, 2009):

i. Establish a new, performance-based tax credit for residential energy efficient retrofits of, for example, $2,000 if the retrofit makes the home 20% more efficient, regardless of what technology is used (S.1914 (112th Congress), Cut Energy Bills at Home Act, sponsored by Sens. Bingaman, Snowe, and Feinstein)

ii. Create a new tax credit for transportation-quality biofuel based on the total carbon reduction of the fuel compared to gasoline or diesel fuel (S.3338 (111th Congress), Advanced Biofuel Investment Act of 2010, sponsored by Sen. Nelson; Union of Concerned Scientists, "The Billion Gallon Challenge," 2010)

iii. Establish a new tax credit for the purchase of energy efficient vehicles based on fuel efficiency alone compared to the corporate average fuel economy (CAFE) for the vehicle's class instead of the existing credits for specific types of fuel efficient technology, such as plug-in hybrid cars or fuel cell vehicles (S.1620 (111th Congress), Efficient Vehicle Leadership Act of 2009, sponsored by Sens. Bingaman, Kerry, Snowe, and Lugar)

iv. Create a new production tax credit for electricity based on the energy content (in British thermal units or BTUs) of the energy source; could be based on the pollution or carbon content instead of BTUs (S.306 (111th Congress), Biogas Production Incentive Act of 2009, sponsored by Sens. Nelson, Brown, Crapo, Hatch, Isakson, Stabenow, Thune, Wyden, and others)

v. Create a program that allocates tax credits on a technology-neutral basis, such as the Section 48C program which provided a 30% investment tax credit for advanced manufacturing facilities (S.1764 (112th Congress), Make it in America Tax Credit Act, proposed by Sen. Stabenow)

3. Modify and consolidate some incentives while eliminating others

a. Modify existing energy tax expenditures to reduce the total number and cost of tax expenditures while making them permanent
   i. Make refundable and permanently extend the alternative electricity production tax credit (section 45) and the deduction for energy efficient commercial buildings (section 179D) (FY14 Administration Budget Proposal)
   ii. Make permanent the individual tax credit for energy efficient home retrofits (H.R.6398 (112th Congress), Home Energy Savings Act of 2012, sponsored by Reps. Gerlach and Neal)
   iii. Repeal certain tax credits, such as the wind production tax credit or solar investment tax credit, and replace them with expensing or accelerated depreciation (H.R.2652 (110th Congress), Generating Renewable Energy and Encouraging Novel Technologies Act of 2007, sponsored by Rep. English)

b. Replace all energy tax expenditures that defer tax (through accelerated depreciation or other enhanced deductions) with provisions that provide an immediate tax benefit (through a credit or rate reduction)
   i. For example, replace the section 179D deduction for energy-efficient commercial building property with a tax credit of up to $1.80 per square foot (FY13 Administration Budget Proposal, estimated in 2012 to cost $1 billion over 10 years)

c. Modify the carbon dioxide sequestration credit allocation rules to provide more certainty for taxpayers (S.3581 (112th Congress), sponsored by Sens. Conrad, Enzi, and Rockefeller)

4. Equalize tax treatment of master limited partnerships (MLPs) in the energy sector

a. Extend the ability of certain MLPs to pay tax on a pass-through basis to MLPs in the renewable energy sector (S.3275 (112th Congress), Master Limited Partnership Parity Act, sponsored by Sen. Coons)
   i. Current law allows certain publicly-traded businesses in the oil, gas, mineral and real estate sectors to pay tax on a pass-through basis; most publicly-traded businesses must pay the corporate income tax

b. Alternatively, deny pass-through tax treatment to all MLPs in the energy sector, thereby treating fossil fuel and renewable energy producers equally in this regard (S.3080 (112th Congress), End Polluter Welfare Act of 2012, sponsored by Sen. Sanders)

5. Establish a carbon tax or cap and dividend approach while eliminating most or all other existing energy tax expenditures

a. Eliminate most or all existing tax expenditures for the energy sector and create a new federal excise tax on the sale or importation of fossil fuels (H.R.3242, (112th Congress), Save Our Climate Act of 2011, sponsored by Rep. Stark; S.332 (113th Congress), Climate Protection Act of 2013, sponsored by Sens. Sanders and Boxer; National Surface Transportation Infrastructure Financing Commission, "Paying Our Way, A New Framework for Transportation Finance," 2009; Mankiw, "One Answer to Global Warming: A New Tax," 2007; Shultz and Becker, "Why We Support a Revenue-Neutral Carbon Tax," 2013)
   i. Design issues to consider include: Whether to impose the tax upstream or downstream, how to set the price, whether and how to phase-in the tax, how to deal with cross-border issues, and whether to include an adjustment mechanism for taxpayers that invest in CO_2 capture and sequestration or energy efficiency
   ii. If policymakers decide to maintain the current level of progressivity, a challenge with this option would be how to do so

b. Alternatively, follow a cap and dividend approach (S.2877 (111th Congress), Carbon Limits and Energy for America's Renewal Act, sponsored by Sen. Cantwell)

6. Modify conservation easements

a. Make permanent the expansion of the charitable deduction for contributions of conservation easements (S.526 (113th Congress), The Rural Heritage Conservation Extension Act of 2013, sponsored by Sens. Baucus, Hatch, Collins, Heinrich, Heller, Shaheen, Stabenow, Tester, Udall and Whitehouse)

b. Increase the limitation on the estate tax exclusion for land subject to a qualified conservation easement (S.1901 (112th Congress), American Family Farm and Ranchland Protection Act of 2011, sponsored by Sens. Udall and Crapo)

c. Repeal the deduction for contributions of conservation easements and replace with a refundable tax credit capped at a limited dollar amount (Halperin, "A Better Way to Encourage Gifts of Conservation Easements," Tax Notes 307, 2012)