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BY THE COMPTROLLER GENERAL

# Report To The Congress

OF THE UNITED STATES

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## A Review Of The Department Of Energy's Energy Tax Policy Analysis

This report addresses the four basic questions:

- Does DOE analyze the energy effects of tax proposals which impact heavily on energy industries?
- Does DOE use this analysis to contribute to the administration's policies?
- Does DOE make the analysis available to the Congress for its use in evaluating the proposals?
- Does DOE analyze the energy effects of major tax law changes after they have been adopted to determine whether future adjustments are required?

The report concludes that with the exception of the National Energy Plan, DOE has (1) made little or no contribution to the administration's tax policies affecting energy, (2) taken no formal position on tax issues, and (3) not analyzed the actual energy effects of major energy tax changes to see if further changes are in order. The report recommends that DOE improve its analysis of energy tax issues; communicate with other executive branch agencies, such as the Treasury and OMB, to ensure that the energy policy view is given consideration; and make the results of its analysis available to the Congress for its use when these issues are under discussion. The report also recommends that a formal mechanism to improve interagency communication be established.

Accounting Office

U.S. General

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To the President of the Senate and the Speaker of the House of Representatives

This report was prepared in response to a request by Senator Frank Church, Chairman, Senate Committee on Foreign Relations. It discusses the failure of the Department of Energy to analyze the energy effects of certain tax measures. The report also points out that the Department of Energy has failed to work with other executive branch agencies to insure that energy concerns are given proper consideration in the formulation of administration tax policies, or to make available to the Congress what analysis has been performed in this area. Chapter 4 contains recommendations to the Secretaries of Energy and Treasury and to the Congress for correcting deficiencies in energy tax policy analysis.

We are sending copies of this report to the Secretaries of Energy and the Treasury, to the Director of the Office of Management and Budget, and to the chairmen of the Senate Committees on Foreign Relations; Finance; and Energy and Natural Resources, and the House Committees on Ways and Means; and Interior and Insular Affairs. Copies are also being sent to the Chairmen of the Subcommittee on Energy, Nuclear Proliferation, and Federal Services of the Senate Committee on Governmental Affairs; the Subcommittee on Environment, Energy, and Natural Resources of the House Committee on Government Operations; the Subcommittee on Energy and the Environment of the House Committee on Interior and Insular Affairs; and the Subcommittee on Energy and Power of the House Committee on Interstate and Foreign Commerce.

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*James A. Steels*  
Comptroller General  
of the United States

COMPTROLLER GENERAL'S  
REPORT TO THE CONGRESS

A REVIEW OF THE  
DEPARTMENT OF ENERGY'S  
ENERGY TAX POLICY ANALYSIS

D I G E S T

Some tax measures are implemented without sufficient consideration given to their impact on national energy policy. Because some tax law changes could be counterproductive to achieving national energy objectives, GAO attempted to determine whether the Department of Energy had considered the potential energy effect of these changes before their enactment. Examples of recently enacted tax changes affecting the energy sector include elimination of the percentage depletion allowance for oil and gas, limitations on the foreign tax credit, and liberalization of the tax treatment for intangible drilling costs.

GAO found that while the Department of Energy did considerable analysis on the energy effect of tax proposals included in the National Energy Plan, and continued this analysis throughout the period of congressional deliberations, it has performed little analysis on tax proposals initiated by other executive branch agencies or the Congress. With the exception of the National Energy Plan, it has (1) made little or no contribution to the administration's tax policies affecting energy, (2) taken no formal position on tax issues, and (3) not analyzed the actual energy effects of major energy tax changes to see if further changes are in order. Hence, many tax changes affecting energy policy have been enacted without any analysis by the Department of Energy of their respective energy effects or impact on national energy objectives.

Since GAO initiated this study and formally advised the Department of Energy thereof, the Department has sent out a request for proposal so it can accomplish the work

GAO has suggested. Although GAO believes that energy tax analysis is important and should be done, GAO questions the means the Department of Energy has chosen to accomplish this work. The effect of the Department's contracting out such basic activities on a massive scale is to dilute its ability to keep essential control over the conduct of its activities, and to assure the Congress that its programs are being carried out in an efficient and economical manner.

#### AGENCY COMMENTS

The Departments of Energy and the Treasury commented on a draft of this report. Their comments are attached as appendices III and IV, respectively. The Department of Energy states that there is a need for analysis of taxes affecting U.S. energy policy and for the Department's coordination with other agencies in formulating energy tax policy. Moreover, the Energy Department states that it is the appropriate agency for performing such analysis and coordinating energy tax policy. The Department of Energy believes that a formal mechanism for coordinating these policies should be established. In order to develop the level of expertise it seeks, the Energy Department believes a large scale consulting contract is necessary. The Department justifies this claim by asserting that it could not provide competitive salaries for such tax experts.

The Department of the Treasury, in its response, states that the Department of Energy should have very limited involvement in "general tax measures." The Treasury defines general tax measures as those with broad application, which extend beyond the energy sector. Such provisions, according to the Treasury, include the Western Hemisphere Trade

Corporation deduction (a special deduction for firms operating primarily within the Western Hemisphere), the "per country" method of computing the foreign tax credit limitation, and the proposed termination of domestic tax deferral of foreign source income.

The Treasury Department response states that "industry-specific" taxes--those tax measures affecting only the energy sector, e.g., percentage depletion, intangible drilling costs, etc.--require close cooperation between the Treasury and the Department of Energy. Consultation between the two agencies should begin in the initial stages of energy tax policy development.

The Treasury Department also distinguishes between the formulation of tax policy through legislation and the administrative implementation of that policy through regulations and rulings. According to the Treasury Department, after the statute has been enacted and regulations published, other agencies have no role to play in further administration of the tax law by the Internal Revenue Service.

GAO continues to believe that the Energy Department's responsibility to analyze the energy impact of tax changes extends beyond taxes which affect only the energy sector. The Department of Energy's tax analysis must include general taxes if it is expected that these taxes would have a significant impact on the energy sector. Over three-fourths of the foreign tax credit, for example, is claimed by oil and gas firms. Over 85 percent of the Western Hemisphere Trade Corporation deduction was claimed by oil and gas firms in 1975. Hence, while the Treasury refers to these as general tax provisions, their impact on U.S. energy policy is most pronounced.

While GAO recognizes that tax policy is the responsibility of the Treasury Department, it is the Department of Energy's responsibility to see to it that the Treasury Department, the Office of Management and Budget, the Congress, and others are aware of any potentially significant energy impacts due to the tax laws. It is also the responsibility of the Department of Energy to ensure that the Congress is aware of the energy effects of tax rulings and procedures which materially affect U.S. energy objectives. GAO believes that the Secretary of the Treasury should, as a normal operating practice, seek out the views of other executive branch agencies at an early stage when changes in the tax law are being considered that have potentially major effects on areas which are a responsibility of another agency--such as energy policy. GAO does not believe, however, that the Treasury Department should seek advice from other agencies on IRS tax rulings, or except to the limited extent already provided for by the Treasury Department, on regulatory pronouncements concerning legal interpretations of the tax laws.

#### RECOMMENDATIONS

GAO recommends that:

- The Secretary of Energy should perform appropriate analysis of the potential energy effects of tax measures or changes having substantive energy effects that are proposed or considered. GAO considers this to be a basic responsibility of the Department in carrying out its duties to develop and implement national energy policy. Such analysis should include not only proposed legislation but also legislation that has been in force which affects the energy sector. This analysis should be

of a continuing nature to determine if and when further adjustments to the tax structure are in order.

- The Secretary of Energy should participate with other executive branch agencies, such as the Treasury and the Office of Management and Budget, on a formal basis to ensure that energy concerns are given proper consideration in the formulation of the administration's legislative tax policies. A formal mechanism for greater inter-agency communication should be established.
- The Secretary of the Treasury should seek out the views of the Department of Energy at an early stage when tax law changes are being considered which have potentially major effects on the energy sector or on energy policy. This includes general tax changes that have a broader application than just energy, but would have a major impact on the energy sector.
- Congressional committees, when considering energy related tax measures, should require the Department of Energy to provide analysis on energy implications to aid in their deliberations.

## C o n t e n t s

		<u>Page</u>
DIGEST		i
CHAPTER		
1	INTRODUCTION	1
	Purpose and scope	1
	Letter of inquiry to DOE	1
	DOE response	2
2	A REVIEW OF DOE'S ENERGY TAX ANALYSIS	4
	DOE's tax analysis	4
	DOE's contribution to administration policies	6
	DOE's support to the Congress	6
	DOE's continuing analysis of existing taxes	7
3	AGENCY COMMENTS	8
4	CONCLUSIONS AND RECOMMENDATIONS	10
	Conclusions	10
	Recommendations	10
APPENDIX		
I	GAO letter of inquiry to DOE	12
II	DOE response to GAO	17
III	Comments by DOE	22
IV	Comments by the Treasury	23

### ABBREVIATIONS

COET	Crude Oil Equalization Tax
DISC	Domestic International Sales Corporation
DOE	Department of Energy
FEA	Federal Energy Administration
FEO	Federal Energy Office
GAO	General Accounting Office
IRS	Internal Revenue Service
NEA	National Energy Act
NEP	National Energy Plan
OMB	Office of Management and Budget
RFP	request for proposal

## CHAPTER 1

### INTRODUCTION

#### PURPOSE AND SCOPE

The General Accounting Office (GAO) has become concerned that certain tax measures affecting energy may have been implemented without sufficient consideration being given to their impact on national energy policy. In recent years, the legislative and executive branches have brought about a number of changes to the tax laws, a significant number of which have had substantive effect on U.S. energy policy.

Through its National Energy Plan (NEP) recommendations, the Department of Energy (DOE) has sought to affect U.S. energy policy through the tax structure. Since tax legislation can have a significant impact on energy demand and supply, and on exploration and development, analysis should be performed to evaluate the energy effects of the proposed measures which directly affect energy industries before final determinations are made. Because some tax changes could be counterproductive to achieving national energy objectives, the Congress should have informed analysis available that indicates how specific tax measures support or conflict with energy policy goals.

The source from which such analysis should originate is DOE, the agency responsible for the formulation and implementation of energy policy.

The purpose of this study is to analyze the impact DOE and its predecessor agencies have had on recent energy taxes. We reviewed DOE's analysis of tax proposals and its support of congressional deliberations in energy tax policy dating from 1975. Our report outlines our efforts to determine (1) which agency is responsible for energy tax analysis, (2) what has been accomplished to date, and (3) the purpose or end result of such work. We hope that this report will serve to increase public, as well as DOE, awareness of the need for additional information and analysis relating to the effect taxes have on our national energy policy.

#### LETTER OF INQUIRY TO DOE

We expressed our concern that adequate consideration may not have been given to the energy impact of tax

policies in a letter written to the Secretary of Energy, dated June 13, 1978. (See app. I.) The letter cited 12 specific tax issues which we feel had significant energy implications. Through this letter of inquiry, subsequent interviews, and documents made available to us by DOE, we attempted to determine (1) the extent, if any, of DOE's and its predecessor agencies' (hereafter referred to as DOE) energy impact analysis of tax changes; (2) if DOE had provided any such analysis to the Congress; (3) if DOE had participated in executive branch decision-making; or (4) if DOE had attempted to analyze the effect of tax laws and regulations once implemented.

It was suggested in our letter that the type of analysis required in each instance would include answers to the following questions:

- How and to what extent each segment of the industry would be affected by the tax change.
- The effects of the tax change on production of oil and gas.
- Whether the expected results are beneficial or detrimental to the national energy objectives.
- Who pays the costs of or receives the benefits from the tax changes.
- The expected effects of these changes on investment and employment by U.S. firms at home and abroad.
- The effect on U.S. firms' competitive status.

These questions were intended to provide a reasonable gauge as to the thoroughness of DOE's analysis.

#### DOE RESPONSE

DOE's response, dated September 13, 1978 (see app. II) expressed its concern that "\* \* \* tax changes have been implemented without sufficient attention given to their effects on national energy policy."

The Department, in response to our request, found relevant materials demonstrating previous analysis of tax measures relating to energy which DOE and its predecessors, the Federal Energy Office (FEO) and the Federal Energy Administration (FEA), had performed.

According to DOE, the documents indicate that FEA (1) did analyze and adopt positions on elimination of domestic and foreign percentage depletion, the limitation of the foreign tax credit, and the repeal of the per country limitation of the foreign tax credit; (2) did not make such an analysis of the elimination of the Western Hemisphere Trade Corporation deduction, the United Kingdom Tax Treaty, the termination of the "farm-out" arrangements, 1/ or State/local energy tax policies; and (3) did analyze the impact of the Internal Revenue Service (IRS) ruling on the Indonesian tax system but made no recommendation on this matter. In its response, DOE did not address either the termination of Domestic International Sales Corporation (DISC) benefits for firms claiming percentage depletion nor the limitation on artificial accounting losses imposed on oil and gas.

The letter stated that "since its establishment, the Department has taken an active role in addressing tax policy issues." DOE indicated that it has had a role in analyzing several tax provisions of NEP, and is planning, over the next 12 months, to undertake an "intensive review of how the tax system affects the energy sector."

DOE's letter is not as comprehensive a statement as we requested. We asked 6 specific questions with regard to the 12 tax issues identified. DOE chose not to answer these questions but stated that it had done analysis in these areas and we could review its records on these subjects. We found that the documents failed to support its claims as is demonstrated further in chapter 2.

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1/"Farm-out" arrangements are sharing arrangements.

The essential characteristic of a farm-out is that part of the burden of development and operating rights of a mineral property is transferred to another person who receives an interest in the property, while the grantor retains some interest.

## CHAPTER 2

### REVIEW OF DOE'S ENERGY TAX ANALYSIS

#### DOES DOE ANALYZE THE ENERGY EFFECTS OF TAX PROPOSALS?

To support its claim that some analysis of tax legislation affecting the energy sector had been undertaken, DOE made what it said were all relevant studies and documents available to us. With the enclosures to its letter of September 13, additional documents were provided and made available to us at the Department's Office of Finance and Tax Policy. DOE officials advised us that these documents are all of its records relative to tax policy and, therefore, serve to demonstrate the extent of the analysis and recommendations DOE and its predecessor agencies made concerning the energy effects of all tax measures in recent years.

Notwithstanding DOE claims, we found that DOE has done little analysis of the energy effects of tax proposals other than those associated with NEP. DOE documents addressed only 4 of the 12 tax issues cited in our letter of inquiry, and none of these 4 tax issues were analyzed to the extent we consider adequate. Most of the documents provided us were intra-office memoranda which noted that the Congress or the Treasury was considering changes in taxes which affect energy and discussed what the issues were. We found a lack of analysis of energy effects. In some cases DOE staff advised that DOE conduct analysis and make recommendations on the proposals, but this apparently was never done.

In its initial response, DOE cited examples of its involvement in the formulation and analysis of tax changes affecting the energy sector. Our review of the examples cited revealed much less involvement by DOE than its letter stated. For example, testimony enclosed with DOE's response and cited as an example of DOE's work was not performed by DOE. Data Resources, Inc., the publisher of the document, maintains that this testimony was prepared specifically for the Senate Finance Committee and not for DOE--that DOE had no part in the research, preparation, or any other phase of the work in question. DOE officials we talked with said that it was sent to us in error. The document on the Schroeder-Jones Amendment gives reasons why the amendment should be opposed, but fails to develop analysis explaining how these reasons were formulated. Since the document is undated and unsigned, is not directed to any party, and is not on DOE letterhead,

it is difficult to assess the document's usefulness as an example of DOE's publicly released analysis.

The second enclosure mentioned in DOE's response involves the administration's energy tax analysis of NEP. The NEP document does address the criteria suggested in our letter of inquiry. Furthermore, congressionally recommended changes to NEP elicited further analysis support from DOE. We believe this document best represents the type of analysis DOE should be engaged in relative to energy tax issues.

The third enclosure was not a valid response to our request; moreover, the studies were not performed by DOE nor have they been used to develop policy recommendations. The author advised us that the studies were prepared for foreign governments, members of the oil industry, and others as well as DOE. Each of these sponsors had an opportunity to provide input and direction to the study during the planning phases; however, DOE provided little or no such input. An approach of this nature raises questions about the objectivity of these studies for purposes of U.S. energy policy. We are also concerned about its validity as an example of DOE's energy tax analysis and its usefulness in that it contains (1) no DOE endorsement, (2) no DOE recommendations, and (3) no indication that it was used for any particular purpose by DOE.

Three months after DOE received our letter of inquiry, it issued a request for proposal (RFP) for technical support services for energy tax policy. Interviews with DOE officials reveal that this RFP is to cover the intensive energy tax study referred to in DOE's response. DOE has set aside over \$1 million for 3 years to accomplish this work. We agree that this work is useful and necessary to a successful national energy plan which relies upon taxes and other levies for its implementation; however, we question the means being employed by DOE. The effect of an agency's contracting out basic activities on a massive scale is to dilute the agency's ability to keep essential control over the conduct of its activities, and to assure the Congress that its programs are being carried out in an efficient and economical manner. With the small staff DOE has for tax policy analysis, a contract of this size will only reduce staff output because of the need for monitoring the various aspects of the contract. Additionally, private studies acquired by DOE to date have not produced any policy recommendations or analysis by DOE. DOE has not even endorsed these studies. On the basis of past performance, we question whether further

contracted studies by DOE will be successful in furthering DOE's energy tax policy analysis and subsequent recommendations.

DOES DOE USE THIS ANALYSIS TO  
CONTRIBUTE TO THE ADMINISTRATION'S  
POLICIES?

We found no examples of written communication between DOE, the Office of Management and Budget, the Treasury, or any other governmental agency on matters of energy tax policy. Although interviews with DOE and Treasury officials indicate some informal communication between these two organizations, they are unable to identify any tax proposals which were changed due to these conversations.

DOE supplied a document which indicated that DOE officials have become concerned with the lack of adequate consultation with the Treasury on energy-related tax measures, and expresses a need for greater cooperation between the two agencies under the NEA tax provisions.

Treasury officials have overriding concerns other than energy policy. In an October 1977 memorandum from the Assistant Secretary of the Treasury for Tax Policy, and the Commissioner of Internal Revenue to the Secretary of the Treasury, it was stated that "Foreign policy, oil prices, etc., are irrelevant to evenhanded administration of the tax law." In a broader sense, as conflicting objectives between energy and tax policy present themselves, it seems the Treasury Department's primary responsibility is to a fair tax structure. The Treasury is not the only agency that DOE should be communicating with relative to energy tax policies. One former DOE official involved in this area felt that more effective communication within the administration was necessary for DOE to influence administration energy tax policies.

DOES DOE PROVIDE THE RESULTS OF  
ITS ANALYSIS ON TAX ISSUES TO  
THE CONGRESS THROUGH TESTIMONY  
OR OTHER MEANS?

Although DOE's letter stated that it took positions on some of these issues, little evidence indicates that this is a regular practice. Enclosure I of DOE's letter was cited as an example of DOE's testimony on tax issues. We previously pointed out that this is an erroneous statement relative to the testimony by Hudson and Jorgensen

of Data Resources, Inc. DOE officials were unable to tell us when the Schroeder-Jones Amendment article was written, or by whom or to whom it was addressed. For that matter they were unable to assure us that it had been provided to anyone outside DOE. As already mentioned, the NEP document represents the only example we found where the administration took a formal position on energy tax policy based on its analysis. The TAXPROBE reports are not DOE policy analysis, and do not commit DOE to any particular position since they were not prepared by or exclusively for DOE.

The remaining documents we reviewed were of an internal nature. They do not represent formal positions taken on energy tax issues.

Since our letter of inquiry to DOE, the Congress has passed the Revenue Act of 1978. It repealed the non-business tax deduction for State and local taxes on gasoline and other motor fuels, provided for tax exempt bonds on the local furnishing of electricity by local governments, and changed the treatment of intangible drilling costs relative to the minimum tax. Since DOE indicated in its letter that it was becoming more active in the tax policy area, we asked for copies of any analysis, public statements, or testimony it had provided the Congress on these issues. DOE said it had not analyzed these provisions and had no such documents.

DOES DOE ANALYZE THE ACTUAL ENERGY  
EFFECTS OF MAJOR TAX CHANGES AFTER  
THEY HAVE BEEN ADOPTED TO SEE WHETHER  
FURTHER CHANGES ARE IN ORDER?

Based on the interviews we conducted and the documents we reviewed, DOE has not analyzed the energy effects of major tax changes after they have been adopted. None of the documents we reviewed provided any insight into the energy effects of existing tax provisions or recently enacted tax changes. The interviews we conducted with DOE officials indicated no specific plans for this type of analysis other than the work outlined in the RFP.

## CHAPTER 3

### AGENCY COMMENTS

Department of Energy and Treasury comments on a draft of this report are attached as appendices III and IV, respectively. DOE states that there is a need for analysis of taxes affecting U.S. energy policy and for DOE coordination with other agencies in formulating energy tax policy. Moreover, DOE states that it is the appropriate agency for performing such analysis and coordinating energy tax policy. DOE believes a large scale consulting contract is necessary. DOE justifies this claim by asserting that it could not provide competitive salaries for such tax experts.

The Department of Treasury, in its response, states that the Department of Energy should have very limited involvement in "general tax measures." Treasury defines general tax measures as those with broad application which extend beyond the energy sector. Such provisions, according to Treasury, include the Western Hemisphere Trade Corporation deduction (a special deduction for firms operating primarily within the Western Hemisphere), the "per country" method of computing the foreign tax credit limitation and the proposed termination of domestic tax deferral of foreign source income.

The Treasury Department response states that "industry-specific" taxes, those tax measures affecting only the energy sector, e.g., percentage depletion, intangible drilling costs, etc., require close cooperation between Treasury and the Department of Energy. Consultation between the two agencies should begin in the initial stages of energy tax policy development.

The Treasury Department also distinguishes between the formulation of tax policy through legislation and the administrative implementation of that policy through regulations and rulings. After the statute has been enacted and regulations published, other agencies have no role to play in further administration of the tax law by the Internal Revenue Service according to the Treasury Department response.

We continue to believe that the Energy Department's responsibility to analyze the energy impact of tax changes extends beyond taxes which affect only the energy sector. DOE's tax analysis must include general taxes if it is expected that these taxes

would have a significant impact on the energy sector. Over three-fourths of the foreign tax credit, for example, is claimed by oil and gas firms. Over 85 percent of the Western Hemisphere Trade Corporation deduction was claimed by oil and gas firms in 1975. Hence while Treasury refers to these as general tax provisions, their impact on U.S. energy policy is most pronounced.

While we recognize that tax policy is the responsibility of the Treasury Department, it is the Department of Energy's responsibility to see to it that the Treasury Department, the Office of Management and Budget, the Congress, and others are aware of any potentially significant energy impacts due to the tax laws. It is also the responsibility of the Department of Energy to ensure that the Congress is aware of the energy effects of tax rulings and procedures which materially affect U.S. energy objectives. We believe that the Secretary of the Treasury should, as a normal operating practice, seek out the views of other executive branch agencies at an early stage when changes in tax laws are being considered that have a potentially major effect on areas which are a responsibility of another agency--such as energy policy. GAO does not believe, however, that the Treasury Department should seek advice from other agencies on IRS tax rulings, or except to the limited extent already provided for by the Treasury Department on regulatory pronouncements concerning legal interpretations of the tax laws.

We also continue to question the appropriateness of the Energy Department's large scale consulting contract. The Department of Energy has noted salary restrictions as its justification; however, the Treasury Department is constrained by the same salary restrictions as the Energy Department and it maintains a high level of tax expertise.

## CHAPTER 4

### CONCLUSIONS AND RECOMMENDATIONS

#### CONCLUSIONS

Tax changes with potentially significant effects on U.S. energy policy have taken place in recent years other than those contained in NEP. Based on our review, we conclude that:

- DOE has not adequately analyzed the energy effects of these changes.
- The little work that DOE has done relative to energy tax issues has been primarily of an internal nature, i.e., the only contacts outside the agency have been of an informal nature. According to one DOE document, these contacts have not been effective.
- DOE has failed to provide the Congress with analysis or recommendations regarding these energy-related tax measures nor has it taken a formal position on them.
- DOE has not analyzed the energy effects of major tax changes after they have been adopted in order to determine whether further changes are required or advisable.

#### RECOMMENDATIONS

We recommend that:

- The Secretary of Energy should perform appropriate analysis of the potential energy effects of tax measures or changes having substantive energy effects that are proposed or considered. We consider this to be a basic responsibility of the Department in carrying out its duties to develop and implement national energy policy. Such analysis should include not only proposed legislation but also legislation that has been in force which affects the energy sector. This analysis should be of a continuing nature to determine if and when further adjustments to the tax structure are in order.

- The Secretary of Energy should participate with other executive branch agencies such as the Treasury and OMB, on a formal basis to insure that energy concerns are given proper consideration in the formulation of the administration's legislative tax policies. A formal mechanism for greater inter-agency communication should be established.
- The Secretary of the Treasury should seek out the views of the Department of Energy at an early stage when changes to tax laws are being considered which have potentially major effects on the energy sector or on energy policy. This includes general tax changes that have a broader application than just energy, but would have a major impact on the energy sector.
- Congressional committees, when considering energy related tax measures, should require the Department of Energy to provide analysis on energy implications to aid in their deliberations.



UNITED STATES GENERAL ACCOUNTING OFFICE  
WASHINGTON, D.C. 20548

ENERGY AND MINERALS  
DIVISION

JUN 13 1978

The Honorable  
The Secretary of Energy

Dear Mr. Secretary:

In the course of our on-going review of the effects of the foreign tax credit on crude oil imports, we have found that a number of recent changes made to the tax laws and regulations affect the oil and gas industries. In reviewing these changes, we have become concerned that some of these tax changes may have been implemented without sufficient attention given to their effect on national energy policy.

We feel it is important that to the extent practicable tax changes having a potentially significant effect on National Energy Policy be analyzed by your Department prior to a determination on whether to implement the change. We have had discussions with Treasury Department officials who inform us that the Treasury Department does not concern itself with the effect of tax laws on the energy sector and the resulting energy effects. We believe that there is a potential that some of these tax changes could be counter-productive to achieving national energy objectives.

The magnitude of the estimated Treasury revenues resulting from these tax changes is, by itself, sufficient to cause concern. We find it hard to believe that virtually billions of dollars annually in additional tax liabilities imposed since the Tax Reduction Act of 1975 could not have significant effect on energy supply and demand and on exploration activities. Moreover, we feel that the Congress should be kept informed on how tax policy supports or conflicts with energy policy. We want to emphasize the fact that GAO is not addressing whether or not these tax changes are beneficial but rather the extent to which they have been analyzed in relationship to their effect on national energy policy.

The purpose of this request is to inquire what the Department of Energy has done in analyzing the effect of past changes in tax laws, regulations, and rulings on energy exploration, development, production, and consumption, and what plans the Department has to analyze the energy effect of proposed changes in the future. We would like to know what resources are committed to these efforts and how they relate to the efforts of the Treasury Department and the tax writing committees.

We have compiled a list of some of the more significant tax changes affecting primarily the oil and gas industry and some of the questions which we feel the Congress needs answers to and which should be addressed in your response. We realize that absolute answers to these questions may be difficult, if not impossible, to determine. Nevertheless, the additional information and analysis which only DOE can provide relating to these questions is important in raising the level of national debate and thereby supporting Congress in its deliberations. These tax changes include:

- Elimination of percentage depletion estimated to result in about \$1.7 billion in additional tax revenues annually.
- Phasing out of the Western Hemisphere Trade Corporation Deduction by 1980. This amounted to a 29% deduction from taxable income. It was used extensively (approximately \$1.3 billion of a total \$1.5 billion in 1975) by oil firms.
- A limitation on how much foreign tax credit could be claimed for oil and gas extraction income. The new limitation of 48% of taxable income applies to only oil and gas extraction.
- A limitation on the amount of foreign tax credit that could be applied to oil- and gas-related income. This prevents foreign tax credits for oil extraction, processing, transportation, distribution, etc., from being used to offset taxation on other business endeavors.
- The U.K. tax treaty now pending will permit a non-income type tax (e.g., a severance tax) paid by U.S. firms operating in the North Sea to qualify for the foreign tax credit. This is preferential tax treatment in the sense that no other similar foreign taxes (i.e., non-income type taxes) qualify for the credit. The treaty will also limit the

ability of States within this country to levy income taxes on income received from worldwide sources.

- The Internal Revenue Service recently ruled against the most popular "farm out" arrangement used by domestic firms for exploration of oil and gas. The effect of the ruling, to render certain non-monetary transactions subject to taxation prior to the realization of income, is to kill this farm out arrangement according to industry sources.
- The "per country" foreign tax credit method of calculation was eliminated thereby forcing firms to average their worldwide tax rates but simultaneously preventing individual country losses abroad from offsetting domestic profits. Since 75% of the total foreign tax credit (\$20 billion in 1975) is claimed by oil firms, we assume there may be considerable effect on oil exploration and production.
- Many states have changed or modified their tax laws to take advantage of the energy resource development within their boundaries. Alaska has, for example, changed its corporate tax or oil taxes almost a dozen times since oil was first discovered on the North Slope causing oil firms to question the feasibility of continued exploration and development in Alaska. Montana's severance tax on some of its coal is over 30% of gross receipts. Is DOE monitoring and advising the U.S. Congress and the States as to the effect of specific State taxes on national energy policy?
- The IRS ruled against a financial arrangement worked out by the Indonesian government and certain U.S. firms for the production of oil and gas. The IRS effectively killed the arrangement by denying the foreign tax credit to the U.S. firms involved. Recently, the IRS also ruled against the OPEC tax arrangement by denying the foreign tax credit based on the posted price of oil. In both cases, contracts were restructured and different arrangements worked out so that firms could qualify for the foreign tax credit.
- Of a more recent and pressing nature, the Administration submitted to the House Ways and Means Committee in January a proposal (see Revenue Bill of 1978, H.R. 12078) to terminate the deferral of domestic taxation on foreign source income to foreign subsidiaries of U.S. corporations. This

proposal has far-reaching effects. Proponents maintain it will result in significant revenue increases to the U.S. Treasury as well as a disincentive to invest overseas solely for the tax benefits. Opponents argue that due to foreign withholding taxes on dividends leaving that host country there will be a decrease in revenues to the Treasury. Opponents also maintain the elimination of deferral will, over the long run, result in a disincentive to invest in overseas operations for whatever reasons. It is not clear what effect such a change would have on our energy objectives.

The following questions are representative of the kind of information we feel should be developed in evaluating tax changes that affect the energy industry. We would like copies of any testimony and/or analysis developed by DOE (or its predecessor agencies) relating to these subject areas:

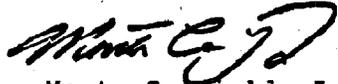
- How and to what extent is each segment of the industry affected by the tax change (e.g, domestic vs. foreign; oil vs. gas; large firms vs. small firms, etc.)?
- How much more or less oil or gas is expected to be produced as a result of the tax change?
- Are the expected results beneficial or counter-productive to National Energy Policy? How?
- Who is expected to pay the additional costs incurred or receive the benefits as a result of these tax changes?
- Are these changes expected to affect investment or employment by U.S. firms at home or abroad?
- How will the competitive status of U.S. firms vis-a-vis foreign firms be affected?

While there have been other tax changes affecting the energy industry (such as the termination of DISC benefits for firms claiming percentage depletion, the limitation on artificial accounting losses imposed on oil and gas, etc.), these salient issues noted above require the Department of Energy's attention if they have not already been addressed. We are not expecting that you perform additional analysis at this time, however, this is an inquiry to determine what information is

available concerning past tax changes and what the plans are with regard to analyzing future proposals.

We look forward to receiving your answers to the questions noted and would appreciate receiving your response by August 1, 1978. We have had contact with Senator Church's staff and the Senate Foreign Relations Subcommittee on Foreign Economic Policy which have also expressed concern about these issues. They have indicated that they will be interested in your response and wish us to keep them advised. If there are any questions relating to this request, please feel free to contact Mr. Donald Z. Forcier, Assistant Director; or Robert Andros at 275-3563.

Sincerely yours,



Monte Canfield, Jr.  
Director



Department of Energy  
Washington, D.C. 20585

SEP 13 1978

Dear Mr. Canfield:

Thank you for your letter of June 13, 1978 to Secretary Schlesinger, concerning your review of energy tax policy issues. We share your concern that, in the past, tax changes have been implemented without sufficient attention given to their effect on national energy policy. For this reason, with the establishment of the Department of Energy (DOE), responsibility for energy tax issues within DOE was assigned to the Assistant Secretary for Policy and Evaluation. My Office is now undertaking a comprehensive review of various tax provisions at the Federal, state, and local levels which affect the energy sector.

In your letter, you ask for copies of any DOE testimony and/or analysis developed concerning tax changes relating to the energy sector. Our review of the files of the Department's predecessor agencies reveals some involvement by them in the formulation and analysis of tax changes affecting the energy sector. Enclosure 1 shows some of the publicly released analysis and testimony prepared by these agencies. We are continuing to search our files for additional material and will forward it to you as it is found. Other internal working documents will be made available to your staff for review in our offices in accordance with our telephone conversation of September 7, 1978.

As these documents indicate, the Federal Energy Administration (FEA) did adopt positions on: the elimination of percentage depletion; elimination of foreign percentage depletion; limitation of foreign tax credits; and repeal of the per country limitation on foreign tax credits. These analyses also indicate that the FEA reviewed various Congressional and Administration tax proposals and analyzed their energy impact. FEA did not analyze the energy impact of the phase-out of the Western Hemisphere Trade Corporation, the U.K. Tax Treaty, farm-out arrangements, or state and local energy tax policies.

The International Affairs Office of the FEA analyzed the impact of the Internal Revenue Service (IRS) ruling on the Indonesian tax system but made no recommendation to Treasury.

As you are aware, energy tax issues were taken into account in the development of the National Energy Plan. Besides legislation for a crude oil equalization tax, an oil and gas users tax, the gas guzzler tax, and a number of tax credits, the Administration also submitted legislation that would treat intangible drilling costs (IDC's) for independent oil and gas producers as a tax preference item only to the extent IDC's exceed oil and gas production income (Section 2071 of H.R. 5263). These proposals are discussed in Enclosure 2.

Since its establishment, the Department has taken an active role in addressing tax policy issues. In assigning responsibility for tax policy to the Assistant Secretary for Policy and Evaluation, the Department has sought to ensure the coordination of these issues at the senior levels of the Department. In order to accomplish this task, the Division of Finance and Tax Policy has been established within the Office of Policy and Evaluation. One of the functions of this Division is to conduct analyses of Government tax policies as they affect the energy sector. The Division is staffed with six professionals with expertise in finance and tax issues. In addition, the Division of International and Security Policy will provide assistance on foreign tax issues.

The Department has addressed a number of tax issues since its formation last year. For example, DOE reviewed the question of foreign tax credits available to U.S. oil producing companies and the testimony presented at the hearings on foreign tax credits by the Subcommittee on Commerce, Consumer, and Monetary Affairs in October of 1977.

The DOE has also reviewed the tax systems of Japan and the United Kingdom. The Japanese system was reviewed to determine if it gave Japanese petroleum companies an advantage over petroleum companies based in other tax domiciles. The U.K. tax system was reviewed to determine how companies from different countries are affected by the U.K. system of taxation. These studies are included as Enclosure 3.

The Department has also worked closely with the Treasury Department staff in the Office of Tax Policy. The Department commented on a number of energy related proposals contained in the tax reform legislation dealing with energy, including a proposed change of the depletion allowance for coal.

When the IRS proposed to limit the availability of the investment tax credit to investor owned utilities participating in projects with tax exempt entities, the Department conducted an analysis of the basis for the ruling and the possible impact on the utility industry. These findings were discussed with the Tax Policy staff at Treasury.

Over the next 12 months, the DOE plans to undertake an intensive review of how the tax system affects the energy sector. Taxation of the producing sector of the oil and gas industry will be reviewed to determine the cost effectiveness of the tax benefits that sector now receives. The implications of current tax policies with regard to the regulated utility industries, the appropriateness of tax credits for these industries, and accelerated depreciation and the rapid write-off of oil and gas-fired equipment will be analyzed. In addition, the analysis will compare whether the current system is biased in favor of some industries and against others, particularly against the renewable resource industries. Finally, DOE will be examining, on a continuing basis, the effectiveness of the tax provisions of the National Energy Act.

The resources of the Office of Policy and Evaluation will be used for this review. In addition, other offices within the Department will contribute technical and other information

as required. It will be necessary for the Department to obtain timely information from the IRS concerning aggregated tax return data on energy sector companies. Finally, our analysis will be coordinated with the Congressional tax committees and the Office of Tax Policy at Treasury.

If justified by the analysis, the Department will recommend that the Administration propose changes to the tax provisions affecting the energy sector.

We appreciate your bringing these issues to our attention and hope that you will feel free to contact us with any additional questions you may have concerning energy tax policy.

Sincerely,



Alvin L. Alm  
Assistant Secretary  
Policy and Evaluation

Mr. Monte Canfield, Jr.  
Director, Energy and Minerals  
Division  
United States General Accounting  
Office  
Washington, D. C. 20548

Enclosures

Enclosures

1. a. Tax Policy and Energy Use, Edward A. Hudson and Dale W. Jorgenson, January 29, 1974.  
b. The Schroeder-Jones "Plowback" Amendment, ND.
2. National Energy Plan; Oil and Gas Supplies, July 15, 1977.
3. "Tax Probe" Reports No. 1 and No. 2; September 1977, April 1978.



Department of Energy  
Washington, D.C. 20545

February 1, 1979

Mr. J. Dexter Peach, Director  
Energy and Minerals Division  
General Accounting Office  
Washington, D.C. 20548

Dear Mr. Peach:

We appreciate the opportunity to review and comment on the GAO draft report entitled "A Review Of The Department Of Energy's Tax Policy Analysis."

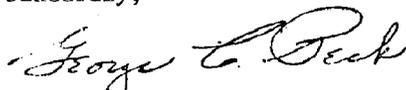
We agree that there is a need for analysis of taxes affecting U. S. energy policy and for DOE coordination with other agencies to insure that energy concerns are articulated in the process of formulating such tax policies. We also support the finding that such analysis and coordination should most appropriately originate in the Department of Energy.

We believe that your criticism of DOE's proposal to let a major consulting contract rather than an in-house analysis reflects insufficient appreciation of the complexity of the tax issue. Tax analyses of the sort recommended can only be most adequately addressed by highly specialized tax experts. It is unlikely that DOE could provide competitive salaries for such tax experts. The only way to obtain their services is through a consulting contract.

We do agree that a formal mechanism for communications with the Executive Branch agencies more directly involved in the development of tax policies and programs could help to assure more meaningful consideration of energy interests and tax impacts, and, therefore, support your proposal that we institute a formal mechanism to coordinate energy analysis of tax policies.

We will be pleased to provide any additional information you may require.

Sincerely,

  
Donald C. Gestiehr  
Acting Director  
GAO Liaison



ASSISTANT SECRETARY

## DEPARTMENT OF THE TREASURY

WASHINGTON, D.C. 20220

FEB 01 1979

Dear Mr. Voss:

We appreciate your affording the Treasury Department an opportunity to comment on the draft report, "A Review of the Department of Energy's Energy Tax Policy Analysis."

In our view, the draft report would provide better guidance for Department of Energy involvement in tax issues if two basic types of distinctions were drawn:

(1) A distinction should be made between tax measures with broad application, designed generally to finance activities of government, and measures intended to intervene in particular markets.

(2) A distinction should be made between the formulation of tax policy through legislation and the administrative implementation of that policy through regulations and rulings.

(1) Distinction Between Tax Measures With Broad Application and Measures Intended to Intervene in Particular Markets.

The Department of Energy should have very limited involvement in general tax measures. On the basis of its assigned responsibilities, DOE has little to contribute to a consideration of fundamental tax issues: the appropriate level of aggregate tax revenues, the rates of personal and corporate taxes, the taxation of capital gains, the degree of progressivity of the tax system, the manner of taxing foreign source income, and other matters affecting the basic structure of the tax system. These issues involve policy considerations that transcend effects on particular sectors of the economy.

In developing or responding to general tax proposals, the Treasury Department must examine such factors as the effect on revenues, the fairness of tax burden distribution, the short-run impact on aggregate demand, the long-run impact on the rate of economic growth, the effect on allocation of economic resources, and the ease of taxpayer compliance and IRS administration. Treasury does consider the

special concerns of other government agencies (including DOE) and private organizations as it explores these basic tax policy issues. But the weight to be accorded industry-specific effects is necessarily limited; the potential impact on a particular industry is only one minor factor that must be weighed in the balance. Therefore, we question whether DOE should be criticized for limited tax analysis efforts in connection with the phase-out of the Western Hemisphere Trade Corporation deduction, elimination of the "per country" method of computing the foreign tax credit limitation, and the proposed termination of domestic tax deferral of foreign source income.

In contrast to this set of general tax policy issues are industry-specific interventions managed through exercise of the taxing power. Such interventions include the imposition of excises to adjust market prices as well as the use of tax preferences to subsidize specific economic activities. With respect to this set of focused tax matters, agencies with substantive program responsibilities have an obvious and important obligation of involvement.

The objectives of focused tax measures are often indistinguishable from objectives which might be achieved by regulatory and expenditure programs administered by an executive agency. Accordingly, the agency should be partly responsible for effective involvement in the process by which the tax system is selected as the vehicle for intervening in markets. In this connection, we suggest the following additions to the elements of an energy tax measure analysis listed in the June 13, 1978 letter to Mr. Schlesinger: (i) whether the agency has considered nontax options to accomplish the same objectives as existing or proposed energy-specific tax measures; and (ii) why nontax options have been rejected. These additional elements are essential to rational tax analysis; there ought to be persuasive reasons why administration of subsidies and other market intervention programs is delegated to the IRS rather than being lodged with the Executive agencies otherwise having responsibility in the substantive area.

If specific tax proposals are being considered as a means to intervene in energy markets, close cooperation between Treasury and the Department of Energy is critical. Consultation between the two agencies should begin in the initial stages of energy tax policy development. DOE has expertise to gauge the impact of a proposal on energy policy. Treasury should consider the impact of that proposal on the progressivity of the tax system, the possibility

for unintended tax sheltering effects, problems of taxpayer compliance and IRS administration, and interaction with other tax provisions. To the extent the report recommends close cooperation in this limited area of tax law, we are wholeheartedly in agreement.

(2) Distinction Between Formulation of Tax Policy Through Legislation and Administrative Implementation of that Policy Through Regulations and Rulings.

Within the limited area of tax analysis responsibility of executive agencies, further restrictions develop from the distinction between formulating tax policy through legislation and administering that policy. The Internal Revenue Code imposes on the Secretary of the Treasury (or his delegate) the legal responsibility to write regulations implementing the provisions of the Code, to issue rulings that interpret the application of the tax laws to particular circumstances, and to prescribe procedures by which taxpayers may discharge their obligations under the tax laws. Unless Congress provides express authority for other agencies to perform certain administrative functions under the Code, Treasury cannot share this responsibility.

We have noted the implicit obligation of executive agencies to participate in the development of tax legislation proposals specific to their regularly assigned program responsibilities. Limited participation in the promulgation of regulations to interpret such tax legislation is also commonly sought by the Treasury; in any event, proposed regulations are generally published for public comment, and hearings scheduled to elicit views from all interested parties. Although ultimate responsibility must rest with Treasury, we take these comments into account in issuing the final regulations.

After the statute has been enacted and regulations published, other agencies have no role to play in further administration of the tax law. Application of the law to particular taxpayers is a matter to be resolved between the IRS and those taxpayers; it is improper for other agencies to intervene with comments about substantive policy or political implications.

One of the consequences of using the tax system to intervene in private markets is the relinquishment of administrative control by the agency with normal responsibility in the substantive area. This consideration is insufficiently weighed by many executive agencies eager to promote programs executed through tax excises or subsidies. While agencies are grateful to be relieved of budgetary responsibility, they may be discomfited by the concomitant loss of administrative control.

The distinction between industry-specific tax legislation and its subsequent administration suggests that "farm-out" and Indonesian "production sharing" rulings are inappropriately included among the items selected for review in the draft report. These rulings involved the application of the whole body of tax law to taxpayers having certain property rights and contractual arrangements; if IRS administration is to be even handed, it cannot base its rulings on considerations of current energy policy. Once measures are incorporated in the tax laws, their application and interpretation are constrained by the legal and traditional institutions of tax administration.

We trust you will find these comments helpful in the preparation of a final draft of the report.

Sincerely,



Donald C. Lubick  
Assistant Secretary for Tax Policy

Allen R. Voss, Director  
General Government Division  
United States General Accounting Office  
Washington, D.C. 20548

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