Taxing the Environment

Corporate Tax Breaks to Promote Environmental Destruction

by Gawain Kripke and Brian Dunkiel

THE INDUSTRIES MOST RESPONSIBLE FOR POLLUTING the environment and depleting natural resources frequently benefit from special tax treatment in the United States. In stark contrast, tax benefits for clean industries are worth billions less than the tax breaks for polluters.

This coddling of polluters in the tax structure exists alongside a comprehensive set of federal laws that seek to maintain clean air, water, and soil and preserve species of plants and animals. It appears that one hand of government does not know, or has chosen to ignore, what the other hand is doing.

The industries that benefit from special tax breaks for polluting activities are diverse and include:

- Chemicals — Polluters can write off almost all the costs of cleaning up hazardous substances, including lawyer fees. Companies that spill oil and dump toxic wastes receive this tax subsidy even when the actions are intentional or the result of gross negligence.
- Mining — The industry enjoys outright tax subsidies for mining toxic substances such as lead, mercury and asbestos. These subsidies can exceed the value of the owner's investment in the mine.
- Oil & Gas — The oil and gas industry enjoys the best targeted tax treatment available to any industry. For example, investors can write off "passive" losses from oil and gas investments but not from investments in other industries.
- Agribusiness — The tax code provides tax breaks to huge, chemical-intensive agriculture without helping small farmers nor promoting sustainable agricultural practices.
- Timber — Special tax benefits for the industry drive up profits but do nothing to promote sustainable forestry. For example, special rules permit timber companies to deduct capital costs immediately while other businesses cannot deduct such costs.

At a time when there are no guarantees of government support for the poor, the young or the infirm, one might ask whether there should be guarantees of government support for businesses, particularly those that degrade the natural environment and threaten health.

While federal appropriations provide plenty of "pork" for polluters, at least these expenditures are subject to annual review. Typically, they cost millions of dollars. Polluter "pork" in the tax code, on the other hand, is not subject to annual legislative action. Once a tax loophole is in law, it is more likely to become embedded in the tax code than repealed.

GOLD DIGGERS: PERCENTAGE DEPLETION ALLOWANCE

The percentage depletion allowance, first codified early in this century, is based on the idea that as minerals are

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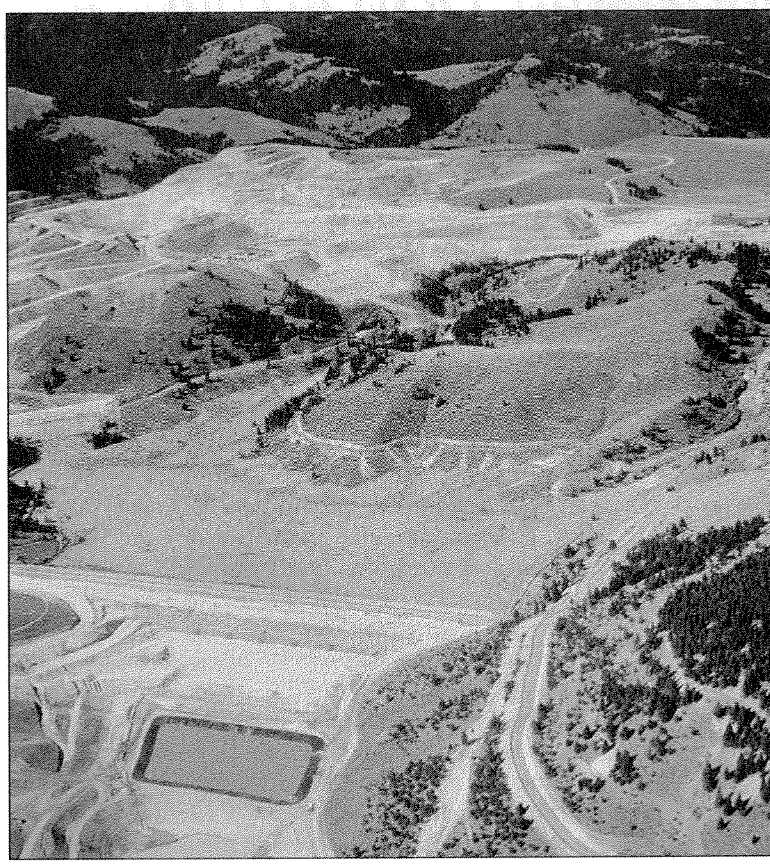
extracted, a mine loses value. The percentage depletion allowance permits mining companies to deduct a certain percentage from their gross income to reflect the mine's reduced value over time.

However, instead of allowing deductions that reflect the actual loss of value, the percentage depletion allowance allows mining companies to deduct a fixed percentage of gross income. The percentages range from a 22 percent allowance to a 5 percent allowance, depending on the mineral. For example, clay, sand and gravel receive 10 percent while uranium, sulphur and lead get 22 percent.

This fixed deduction often bears no resemblance to the actual lost value or to the amount of investment. In fact, the money that mining companies recoup through this tax subsidy generally exceeds the total investment in the property.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In other words, the public provides more investment than the owner.

Eliminating the percentage depletion allowance for mining operations, and requiring mining companies to follow standard rules for taking deductions, would save $300 million a year, according to the U.S. Congressional Joint Committee on Taxation.

The subsidy encourages wanton mining — even beyond that warranted by market demand. The result is more tailings piles, scarred earth, toxic byproducts and disturbed habitats. Ironically, the more toxic the mineral, the greater the percentage depletion allowance subsidy is. Mercury, zinc, uranium, cadmium and asbestos are among the minerals that receive the highest percentage depletion allowance while less toxic substances have lower rates.

MONEY FOR MINING: EXPENSING EXPLORATION & DEVELOPMENT

Section 617 of the Internal Revenue Code allows certain costs associated with the exploration and development of mineral resources to be deducted in the year the costs are incurred, rather than over the productive life of the mine. Under normal tax rules that apply to other businesses, such "capital" costs are investments in property like buildings or mines that last more than one year and are written off over time as the property wears out, or is depleted in the case of a mine. Immediate deduction, or expensing, allows companies to write off costs of machinery and equipment faster than they actually wear out. The result is that tax bills early in the life of the property, or mine, are lower and consequently save the mining company money.

Eliminating expensing, or immediate write off, for mining exploration and development costs and special capital gains treatment for coal and iron ore would save about $20 million annually, according to the Congressional Joint Committee on Taxation and the Office of Management and Budget.

Exploration and development costs include site location, determination of quality and amount of mineral resource, and construction of shafts and tunnels. Covered minerals include coal, uranium and hard rock minerals such as lead, gold, copper and asbestos. Congress enacted immediate write off of mine development costs in 1951 and exploration costs in 1966. In 1982, such expensing for corporations was limited to 85 percent of costs.

Another tax break for mining companies is Section 631 of the Internal Revenue Code, which treats the sale of coal and iron ore as a capital gain. Capital gains are profits reflecting increased values of stocks, bonds, investment real estate and other "capital," or lasting assets. Under normal tax rules, the sale of coal and iron ore should be treated as ordinary income (e.g. wages, interest), not capital gains income. It is preferable to have one's income treated as capital gains rather than ordinary income because the tax rate on capital gains is lower than the tax rate on ordinary income for well-to-do taxpayers. This special capital gains treatment for coal was granted in 1951.

PLAY NOW, PAY LATER: RECLAMATION DEDUCTION

Section 486 of the Internal Revenue Code permits mining companies to deduct reclamation and closing costs immediately when beginning mining, even though the eventual closing of the mine and reclamation of the mine site will not occur for some time. Without this special provision, general tax rules would require the companies to wait to deduct those costs until the mine site is closed, restored and the costs associated with these activities paid.

Section 486 costs taxpayers $40 million a year, according to the Congressional Joint Committee on Taxation.

The stated intent of the provision, when adopted as part of the Deficit Reduction Act of 1984, was to encourage companies to set aside monies for reclamation, but there is no requirement that actual payment into a reclamation and mine closing trust fund actually occur. Even companies which never reclaim a mine can claim the tax break. Reclamation of coal mining sites is required by the Surface Mining Control and Reclamation Act (SMCRA) of 1977, but is not well enforced. There is no similar reclamation requirement for hardrock mineral sites.

Since 1977, there have been more than 6,000 coal mines closed but not reclaimed. There are more than 550,000 abandoned hardrock mines. Local governments have the authority to control the nature of the reclamation or closing activity, but enforcement has been lax.

Closed mines can exact a serious environmental toll. In California, wastes from one closed mine delivers an average daily dose of 4,800 pounds of iron, 1,466 pounds of zinc, 423 pounds of copper and 10 pounds of cadmium into the Keswick Reservoir on the Sacramento River, which serves as the source of drinking water for the town of Redding.

PUMPING THE TAX CODE: PERCENTAGE DEPLETION ALLOWANCE

Independent oil companies — those oil companies that are not substantially involved in retailing or refining activities — can use a special "percentage depletion" method to write off oil and gas investments. The percentage depletion allowance allows these oil and gas companies to deduct a flat 15 percent of their sales revenue, to reflect the declining value of the wells as they are drained. This flat deduction bears little resemblance to the actual loss in value over time and the independent oil and gas companies often end up deducting more than the value of the investment.

The annual cost to taxpayers is $480 million, according to the Joint Committee on Taxation.

Percentage depletion allowances were established by Congress early in this century. In recent years, Congress has gradually pared back the subsidy. Nonetheless, the percentage depletion allowance is still an enormous benefit which serves little purpose other than subsidizing production from certain oil and gas companies.

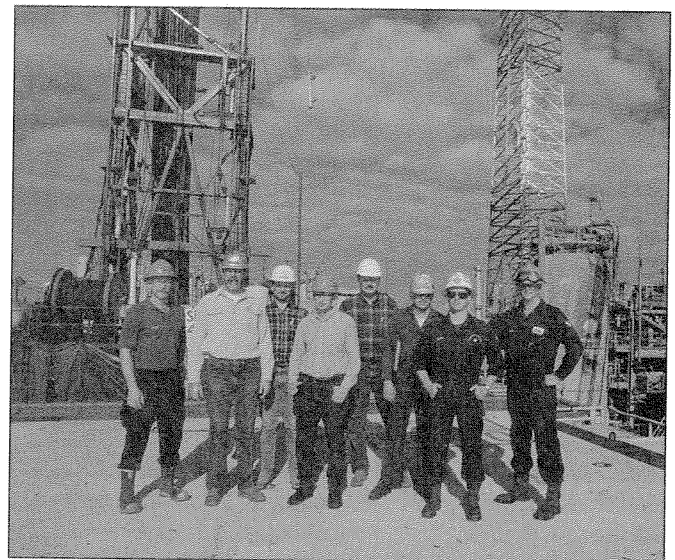
BAD TO THE LAST DROP: ENHANCED OIL RECOVERY

Section 43 of the Internal Revenue Code provides for a 15 percent income tax credit for the costs of recovering domestic oil by a qualified "enhanced-oil-recovery" method. Qualifying methods involve injecting fluids, gases and other chemicals into the oil reservoir, and using heat to extract oil that is too viscous to be extracted by conventional techniques. Costs covered by the tax credit include the costs of equipment, labor, supplies, repairs and injectants. The tax credit was adopted in 1990.

In addition, Section 193 allows for expensing, or immediate write off, of so-called tertiary injectants used in enhanced oil recovery. Again, as with Section 617's immediate write-off for mining, investments in enhanced oil recovery methods are "capital" costs that last more than one year and should be written off over time as the investment is used up. This provision became law in 1980.

Sections 43 and 193 cost taxpayers a combined $60 million annually, according to the Joint Committee on Taxation.

In general, it is environmentally desirable to extract all the oil in a well to avoid waste and seepage. That said, much greater energy savings could be gained by eliminating current waste in the oil and gas industry.



Shell Oil workers.

Today, the oil and gas industry tolerates a degree of energy waste and pollution that is hard to believe: an energy loss — through spills, emissions, evaporative loss, venting and flaring, waste generation, inefficient processing, pipeline and storage tank leaks — that is equivalent to 1,000 Exxon Valdez oil spills every year, according to the Friends of the Earth report "Crude Awakening."

Enhanced oil recovery methods themselves often are bad for the environment. They force oil and sometimes chemical injectants into surrounding surface and groundwater, which can lead to contamination of drinking water, soil, crops and wetlands.

DRILLING FOR DOLLARS: INTANGIBLE DRILLING COSTS

Section 263 of the Internal Revenue Code permits integrated oil companies such as Exxon and Chevron to immediately deduct 70 percent of intangible drilling costs (IDCs). IDCs are the costs of wages, fuel, repairs, hauling, supplies and site preparation. The other 30 percent must be deducted over five years.

Again, under normal tax rules that apply to other businesses, such "capital" costs should be written off over time as the property wears out, or oil is depleted.

Smaller, independent oil and gas producers, which are not involved in retailing or refining activities, can immediately deduct all of their IDCs. In addition, independent producers enjoy special treatment of IDCs under the Alternative Minimum Tax (AMT). The AMT is an alternative tax system that was created to ensure that profitable businesses do not avoid taxation because of extensive write-offs. However, in the case of independent oil and gas producers, the AMT is less effective because write-offs are permitted.

IDCs typically account for 75 to 90 percent of the costs associated with developing an oil and gas well. When combined with other tax subsidies, the ability to deduct IDCs effectively reduces tax rates on oil and gas producers significantly below tax rates on other industries. Unlike the percentage depletion allowance, this tax break is largely claimed by corporate producers rather than smaller, independent producers.

Oregon clearcut.

Immediate IDC write-offs cost taxpayers $200 million annually, according to the Joint Committee on Taxation, and effectively lower income tax rates for oil and gas companies to zero.

LUCKY LOSER: PASSIVE LOSS

The 1986 Tax Reform Act greatly limited the ability of taxpayers to use tax shelters — losses, deductions and credits from so-called "passive" business investments — to offset other income such as salary or portfolio income (e.g. interest, royalties, dividends, annuities and gains from the sale of investment property).

Today, investors have to "materially participate" in a trade or business in order to offset salary and portfolio income with passive losses. IRS rules say that a taxpayer "materially participates" in an activity only if he or she is involved in the operations of the activity on a regular, continuous and substantial basis.

These rules, however, do not apply to oil and gas investments. Passive losses are still allowed to offset other income in the case of investors who have a "working interest" in oil and gas.

"Working interest" is defined by the existence of an unlimited and unprotected financial risk proportionate to the oil and gas investment and is a weaker test than "material participation." Congress decided that the financial risk associated with oil and gas investments outweighed the need to clamp down on tax sheltering.

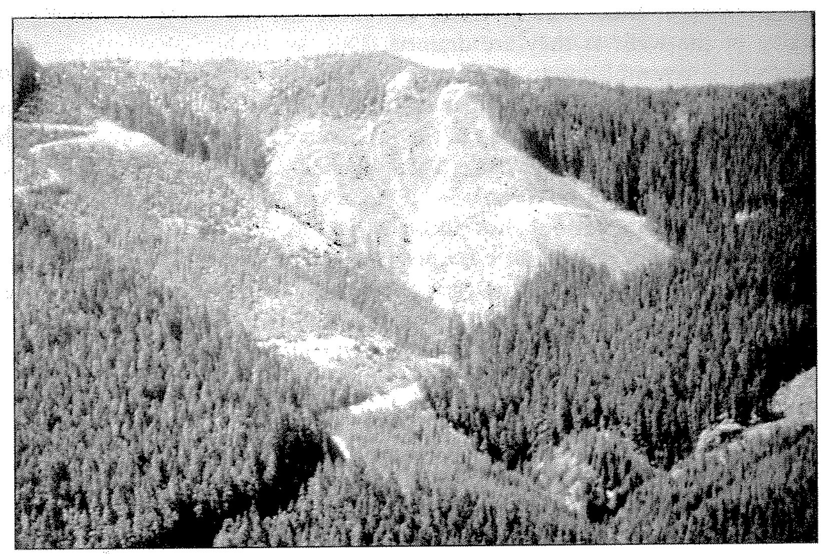
The "passive loss" tax shelter for investors in oil and gas costs the treasury $59 million a year, according to the Office of Management and Budget.

SYN SINS: NONCONVENTIONAL FUEL PRODUCTION CREDIT

A remnant of the $88 billion "synfuel" program under the Carter administration, Section 29 of the Internal Revenue Code provides for a production tax credit of $5.75 per barrel of oil-equivalent for certain types of liquid and gaseous fuels produced from alternative energy sources. These fuels include oil produced from shale or tar sands, synthetic fuels produced from coal, and gas produced from geopressurized brine, Devonian shale, tight formations, biomass and methane from coalbeds.

The Section 29 production credit applies to facilities "placed in service" between 1979 and 1993 and may be claimed through 2002. The credit is available for gas produced from biomass and synthetic fuels produced from coal or lignite until 2007 if the facility was placed in service by 1996. Although set to expire, Congress has extended the "placed-in-service" rule three times since it first enacted the provision.

This provision costs the treasury roughly $1.36 billion a year, according to the Congressional Joint Committee on Taxation.


Timber clearcut in the U.S. Pacific Northwest.

In theory, the credit was supposed to lower the costs of producing nonconventional substitutes for imported petroleum. Instead, the credit has distorted fuel markets without displacing imports. With oil prices low and costs of nonconventional fuel production high, the credit has proven ineffective.

Total production of nonconventional fuels has not increased since the credit was enacted, according to the Joint Committee on Taxation. So, in effect, the credit has been a windfall for a few producers and a waste of taxpayers' money. The generosity of the credit has spurred coalbed methane production, which has boomed the expense of conventional natural gas production.

The Section 29 credit has had unintended environmental consequences. Coalbed methane developers in states such as Colorado, New Mexico, Wyoming and Alabama have placed a new grid of wells on top of older fields of abandoned oil and gas wells that have not been properly plugged.

When new methane wells are drilled, the gas moves up the new wells and can move into underground aquifers and escape through older oil and gas wells and even water wells. The result of this gas migration has been polluted drinking water supplies, contaminated irrigation systems and even explosions.

Maintenance of the credit may be justified in some limited circumstances. One is for coal beds that are emitting methane into the atmosphere. When coal beds are opened for mining, methane escapes. Methane is a powerful greenhouse gas that contributes to climate change. A "Section 29" well can trap the methane so that it does not escape into the atmosphere. A similar situation exists at landfills that emit methane as the rubbish decomposes.

LOGGING LOOPHOLES: SPECIAL TAX TREATMENT OF TIMBER

Timberland owners and the forest products industry enjoy special tax benefits, including capital gains treatment of timber income and expensing, or immediate write off, of capital costs.

Timber income has been treated as capital gains since 1944, with the benefits mentioned above, of a lower tax rate.

While timber sales are artificially treated as capital gains, real capital investments — including silvicultural practices after seedling establishment, disease and pest control, fire protection, insurance, property taxes, and management — are permitted immediate deduction. and thus has been taxed less than other kinds of income. Again, immediate deduction, or expensing, allows companies to write off costs of machinery and equipment faster than they actually wear out, or before the timber is harvested.

Unlike other businesses, timber producers are able to deduct costs before the product, in this case, timber, is sold. This gives timber producers an interest-free loan from the government and can effectively reduce their tax rate on investments to zero. When combined with capital gains treatment, timber receives a negative tax rate or a net benefit.

These two provisions cost the treasury about $220 million annually, according to the Joint Committee on Taxation.

These tax benefits are not conditioned on use of sustainable forestry practices, including replanting a diversity of native species after harvest, allowing natural reforestation or selective cutting.

LOOPHOLE IN THE SKY: TAX OZONE-KILLING CHEMICALS

In 1989, Congress enacted a tax on ozone-depleting chemicals to provide an economic incentive to reduce production and use of these destructive substances.

The tax complements international and domestic measures to reduce and phase out these chemicals.

Ozone-depleting chemicals include chloroflourocarbons (CFCs), methyl chloroform, carbon tetrachloride, halons, methyl bromide, and HCFCs (CFC substitutes). These chemicals are found in various consumer products and are used in agricultural and industrial processes.

Release of these chemicals into the atmosphere causes damage to the stratospheric ozone layer which shields the Earth and its inhabitants from the sun's damaging ultraviolet radiation. Ozone layer destruction causes increased ultraviolet radiation which can lead to higher rates of skin cancer and eye diseases such as cataracts. Radiation may also decrease crop yields, stunt animal reproduction and cause fast degradation of materials such as plastics, wood and rubber.

In 1987, more than 120 countries negotiated and agreed to the Montreal Protocol on Substances that Deplete the Ozone Layer. While the Protocol called for the phase-out of many ozone-depleting chemicals, some chemicals such as HCFCs and methyl bromide were not included in the original agreement.

In 1992, however, parties to the Protocol amended the original agreement to include HCFCs and methyl bromide. The Protocol requires industrialized countries to cap methyl bromide production at 1991 levels and to phase out all HCFC production by 2030.

Due to the delay in listing methyl bromide and HCFCs under the Montreal Protocol, however, these chemicals were not included when Congress passed the tax on ozone-depleting chemicals. Political pressure on Congress has worked to ensure that methyl bromide and HCFCs are kept off the tax list.

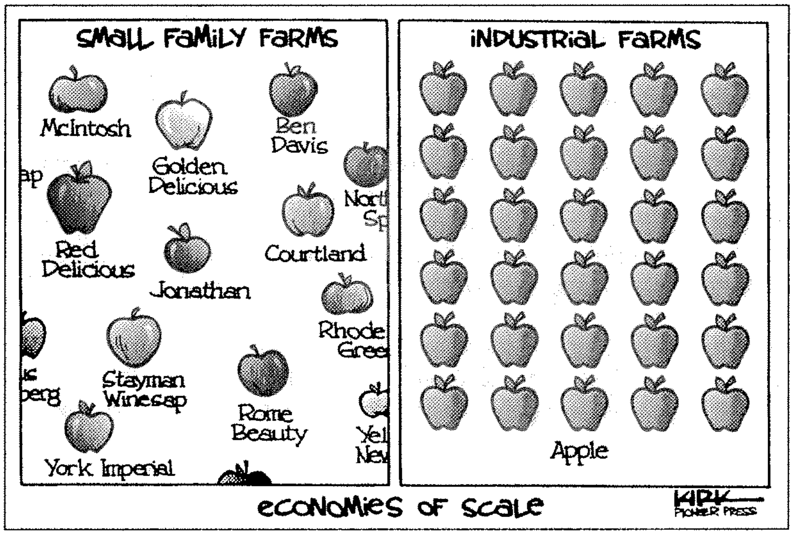
Taxing methyl bromide and HCFCs makes good economic sense. The existing tax has very successfully accelerated the phase-out of harmful chemicals while at the same time spurred development of ozone-safe alternatives.

COOKING THE BOOKS: CASH ACCOUNTING

The cash accounting method does not require a farmer to accurately match expenses to income when paying income taxes. The rules date back to the early part of this century when the IRS determined that many farmers were not sophisticated enough to use more complex bookkeeping procedures that are required of most businesses.

Since 1919, however, farms have become much larger and most farms are run more like businesses. Today, large agricultural operations are able to take advantage of cash accounting under current law, and they are able to significantly reduce their taxes by manipulating expenses, inventory and income.

Cash accounting is one of a number of special tax breaks and loopholes that once lured nonfarmer investors into agricultural tax shelters and speculation. This speculation drove up land prices and caused havoc in the farm economy. According to a 1982 U.S. Department of Agriculture report, "The Effects of Tax Policy on American Agriculture," "the tax preference may overstimulate production and lead to lower product prices, or may cause the values of limited inputs, such as land, to be bid up." In general, these tax breaks, and the game-playing they invite, make it difficult for smaller-scale farming to compete and survive.



In the tax reform of 1986 and subsequently, many of the worst tax shelters in agriculture were eliminated. However, some, like cash accounting, survived.

Since, as the 1982 USDA study found, cash accounting tends to benefit richer farmers, who are able to manipulate the tax system, it plays a role in the increased concentration of farmland ownership with high-income farmers and businesses.

PIGS IN A POKE: DAIRY AND LIVESTOCK EXPENSING

Under current law, livestock breeders and dairy producers enjoy special rules which provide favorable tax treatment for their business.

When their livestock and cattle are sold, the profits are counted as capital gains income which is taxed at the rate of 28 percent, even if the taxpayer is in a higher tax bracket.

However, the costs of purchasing, breeding and raising the livestock are not treated as capital investments, but rather as ordinary expenses. This is the best of both worlds for livestock and dairy producers. Costs are deducted immediately and income is taxed at a relatively low capital gains rate rather than as regular income.

This inconsistency is highly favorable for dairy livestock producers and has helped to make cattle and other livestock operations profitable tax shelter ventures.

Eliminating immediate deduction for costs related to raising livestock and dairy would raise about $180 million a year, according to the Joint Committee on Taxation.

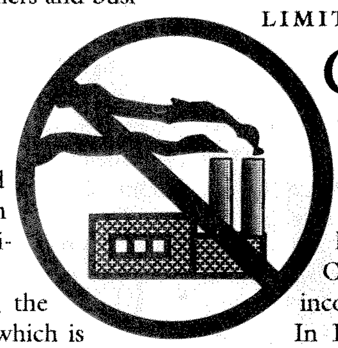
UP IN SMOKE: TAX EXEMPT BONDS FOR INCINERATORS

Current law provides a tax exemption for interest income on state and local bonds used to finance construction of certain energy facilities. These bonds are classified as "private activity bonds," instead of government bonds, because individuals or businesses, rather than the general public, reap a substantial portion of their benefits. Most private-activity bonds, including hydroelectric facility bonds, are subject to certain limits set by each state. However, bonds issued for government-owned solid waste disposal facilities are not subject to these limits. In general, the 1986 Tax Reform Act repealed the tax-exempt status of most bonds used to finance projects with substantial private involvement due to the fact that they served as tax shelters for wealthy investors and oftentimes subsidized projects with little overriding public benefit, such as golf courses. Tax-exempt bonds for incinerators and a few other private-activity bonds escaped reform.

Subjecting tax-exempt bonds sold to finance incinerators (solid waste facilities that produce electric energy) to the private-activity bond annual volume cap would raise about $240 million a year, according to the Office of Management and Budget.

Incinerators emit harmful levels of highly toxic substances into the air such as cadmium, mercury and lead. They are the leading source of dioxin creation in the United States.

CLOAKING PROFITS: PUBLICLY TRADED LIMITED PARTNERSHIPS



Certain "publicly traded limited partnerships" enjoy tax benefits not available to many other similar business entities. On the one hand, these partnerships enjoy the advantages of being treated like corporations in that investors can trade their interests in public markets and investors have limited financial liability. On the other hand, they do not pay corporate income tax, essentially skipping a level of taxation.

In 1987, the Congress changed the law to treat publicly traded partnerships like corporations for tax purposes.

However, major loopholes remained, including an exemption for partnerships that are primarily involved in natural resource development. Thus, publicly traded partnerships involved in mining, geothermal energy, fertilizer and timber enterprises can continue to avoid a corporate-level tax while retaining the advantages of being traded like a corporation.

According to a 1994 report of the House Natural Resources Committee, this tax loophole can radically reduce tax revenues from companies.

For instance, one timber company was reportedly able to reduce its tax liability from about 59 percent to about 3 percent.

Some companies engaged in natural resource development have restructured as partnerships to avoid corporate-level tax.

SPOILS OF SPILLS: POLLUTION DEDUCTION

Under current law, polluters who cause environmental harm can fully deduct all the costs related to illegally released pollution, including cleanup costs, legal costs, court settlements and even the cost of the polluting substance itself.

For instance, when Exxon's Valdez oil tanker spilled 11 million gallons of oil into Prince William Sound, nearly all the costs related to the disaster were deductible. This included all the costs of litigation, legal settlements, cleanup, studies and public relations. Exxon settled a criminal case in court with the United States and the State of Alaska for about $1 billion. However, except for a paltry $25 million criminal fine, the entire settlement was tax deductible for Exxon. The value of this deduction is approximately one-third of the settlement, or $300 million.

This situation arises because under tax law, a business may deduct nearly all the expenses incurred as a matter of conducting business. The law allows deduction of "ordinary and necessary" business expenses, and the IRS has been liberal in its interpretation of this clause. While the vast majority of business expenses are deductible, Congress has disallowed a deduction for some egregious or ethically complicated activities. For instance, illegal bribes, kickbacks, fines, lobbying expenses and political campaign contributions are not deductible.

Friends of the Earth estimates that disallowing corporate income tax deductions for future costs associated with illegally released pollution could save taxpayers at least $300 million a year.

Eliminating the business deduction for illegally released pollution would reduce the incentive to cut corners or to knowingly risk dangerous accidents. Currently, the tax code allows costs such as cleanup for negligent oil spills, intentional dumping of toxic pollutants and litigation on the illegal filling of wetlands to be immediately deducted. Ironically, investments in pollution prevention are not immediately deductible. If, for example, a company wanted to double-wall a pipeline or make other improvements to prevent leaks, those costs would likely have to be deducted over many years. If the pipeline burst and spilled oil into a river, the company could immediately deduct costs of repair and cleanup.■

The Exxon Valdez: Taxpayers unwittingly contributed to the cleanup through tax subsidies.