

[COMMITTEE PRINT]

ENERGY TAXATION:
ALTERNATIVES FOR THE TAXATION OF
INCREASED DOMESTIC OIL AND GAS
PROFITS

STUDY No. 1

PREPARED FOR THE USE OF THE
COMMITTEE ON WAYS AND MEANS
BY THE STAFF OF THE
JOINT COMMITTEE ON INTERNAL REVENUE
TAXATION



FEBRUARY 19, 1974

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1974

28-627

JCS-2-74

ENERGY TAXATION: ALTERNATIVES FOR THE TAXATION OF INCREASED DOMESTIC OIL AND GAS PROFITS¹

I. INTRODUCTION

Substantial increases in prices for crude oil have produced large increases in earnings for oil producers. To the extent that these price increases are the result of artificial factors, particularly the Arab oil embargo and the high cost of imported oil, producers of domestic oil may be receiving more profit on their operations than can be justified in terms of the prices they expected to receive when their current production was planned. In addition, prices and profits might be considered higher than is necessary to induce oil producers to increase supply. To that extent, these profits may be regarded as "excessive," and the Committee may want to subject them to a tax. It would appear that this could be done without increasing the burden on the U.S. consumer. The taxes discussed below could be designed to raise approximately \$2 to \$4 billion of revenue to be used for various public purposes.

(1) *Present price situation*

At the present time, roughly one-third of United States consumption is imported, and is therefore not subject to price controls. Of the two-thirds which is produced domestically, roughly 75 percent is "old oil" which must be sold at the \$5.25 per barrel controlled price set by the Cost of Living Council. The balance which is produced from new sources or from stripper wells represents an increase in production from existing sources, or is "released oil." "New oil" is the increase in production by a producer over his base period amount (average production during 1972), whether or not from new sources, and was freed from controls in August 1973. Production of "new oil" entitles the producer to sell an equivalent amount of "old oil" at the market price. This practice of releasing oil from price controls provides a bonus to the producer who finds new production. As a result, less than half the oil consumed in the United States is subject to price controls. Much of the new and released oil has been sold at \$9 to \$10, and imported oil costs even more.

Since one-half or more of the oil consumed in the United States is either imported, or is sold at uncontrolled prices, price control for old oil is not likely to be effective in reducing the cost of oil. As a result it can be expected that prices will remain high, and therefore Congress may want to impose taxes to deal with the problem of possible unanticipated and unjustified profits. As costs of production increase, and production attributable to low cost oil diminishes, the situation in

¹ Pamphlet No. 3 will deal with the taxation of foreign profits.

which excessive profits are being realized could well gradually decrease.

The situation with natural gas is different. Natural gas is still subject to regulation by the Federal Power Commission (FPC), although the Commission has allowed interstate sales of gas at prices well in excess of existing contract prices. Most recent sales have occurred at 50-55¢ per thousand cubic feet (mcf), and many intrastate sales have occurred at substantially higher prices. Moreover, projects to import substantial quantities of liquified natural gas (LNG) have been already approved by the Commission at prices ranging from \$1.12 to \$2 per mcf. Since the vast bulk of gas sold in the United States is still regulated, and is priced well below its BTU equivalent for oil,² the pricing situation portends substantial future increases, and may justify including natural gas in any proposal to tax profits of energy companies, as long as the base price is set high enough to shield existing long term contracts set at very low regulated prices.

(2) *General tax alternatives*

Three possible techniques for taxing excessive profits are discussed below: (1) a tax based on the profits of the taxpayer over a base period average (a traditional wartime excess profits tax); (2) a tax based on the price of oil (the Administration's Emergency Windfall Profits Tax proposal); and (3) a restructuring of existing tax benefits provided to the industry (such as relating the percentage depletion deduction to price increases).

In effect, all three of these types of taxes, or tax modifications, would be determined with reference to earnings or prices in excess of corresponding amounts received during a base period. When the tax rates are high, as in the excess profits and windfall taxes, the tax may be justified on the ground that the earnings or prices received during the base period are considered to be "normal." Since the effect of the artificial constraints which produce abnormal earnings or prices in the current year may well diminish to a degree in the near future as regular market forces begin to produce adjustments to new conditions, the "base period" in this case tends to become obsolete. As a result, a large tax which is justified by the "normality" of that base period may be justified only for a temporary period. Thus, if the objective is a continuing source of revenue, an alternate source must be found to supplement the diminishing revenue received from excess and windfall profits taxes as they are phased out.

In contrast, relating the depletion deduction to higher prices can be viewed as a structural change in the basic income tax. Such a change could be justified on the ground that increased prices provide the economic incentive necessary for the vitality of the oil industry. As a result a continuing indirect incentive through the tax law can be viewed as unnecessary and may actually distort the economic relationships of the oil market. Modifying the depletion deduction in this way could produce a lasting revenue gain which might obviate the need for an alternate tax to fund federal energy projects.

As discussed below, each type of tax may be used in combination with one or more of the others, and, in addition, may be combined

² The conversion ratio is barrel of oil : mcf of gas :: 6 : 1.

with relief provisions for small operators and incentives to encourage development of United States energy sources.

II. DESCRIPTION OF BASIC ALTERNATIVES

(1) *Excess profits tax*

The Congress has enacted an excess profits tax during three recent wartime emergencies, when scarcity due to diversion of production into wartime material tended to drive prices higher than normal market levels. The most complete version was effective from 1950 until 1954, during the Korean War, and is used below as the model.

(a) *Characteristics of the tax*

Incidence.—An excess profits tax has generally been applied only to corporations because the concepts used in determining the tax are very difficult to apply to individuals and partnerships.

Tax base.—The tax would be imposed on corporate earnings in excess of earnings during a base period, plus an allowance for new investment. (An alternative based on the value of invested capital could be provided.) Earnings would mean taxable income for income tax purposes, computed with adjustments to eliminate the effect of sporadic income or unusual expenses, and to restore amounts deducted from regular corporate income which do not represent actual expenditures, such as percentage depletion. The Korean War tax, for example, excluded capital gains and losses in the computation of income subject to the excess profits tax. Presumably, in this case it would also be necessary to separate the profits and expenses of a company allocable to energy production from those allocable to other operations and impose the special tax only on the funds.

Tax rate.—The Korean War tax rate in effect was 30 percent. Since the income was already subject to normal corporate taxes, the overall tax rate on excess profits was set at 77 percent. Other suggested rates range as high as 90 percent on excess profits, with a limitation that no taxpayer would be subject to a tax in excess of 80 percent on taxable income.

Excess profits credits.—Income subject to the excess profits tax would be reduced by a "credit" equal to a minimum amount (say \$25,000 or a greater amount based on the taxpayer's average earnings (or investment) during a "base period". The base period might be the years 1969 through 1972, the last years before the political and economic developments resulting in the current situation. The "credit" would equal average earnings received by the taxpayer during those years, with the same adjustments as those required in computing current income subject to the excess profits tax. Other adjustments would be necessary to account for abnormally low earnings, or for increases or decreases in production, during the base period.

An alternative means of computing the "credit" could be to allow an arbitrary rate of return on average capital investment during the base period. In the Korean War tax, an invested capital credit was determined either on the basis of the cost of the corporation's assets, or under an historical approach under which value was determined on the basis of the amount paid in. Under either of these approaches,

capital derived from accumulated earnings and borrowings could be taken into account. The Korean War tax allowed a credit for investment due to borrowing equal to 75 percent of the amount of borrowing with adjustments in deductions allowed for interest paid on such borrowing. The amount of the "credit" was 12 percent of invested capital under the assets approach, or 12, 10 or 8 percent under the historical approach graded according to the amount of investment.

The "credit" would be increased by a selected rate of return on new investment. Under the Korean War tax, the amount was 12 percent of new investment. Reductions in investment after the base period similarly reduced the amount of the credit.

Special adjustments.—Other rules would be needed to deal with the special problems posed by deficits, loss carryovers, assets acquired in nontaxable transactions, new taxpayers with no base period experience, etc.

Revenue effect.—The revenue effect of the tax generally outlined above is expected to be about \$2.1 in 1974 and subsequent years while the tax is in effect, assuming the income of the oil companies is about 30 percent over the 1973 estimated levels. Oil company profits will be somewhat higher than this, however, if oil prices are \$7.00 a barrel, or more.

(b) *Arguments against*

An excess profits tax has important disadvantages in the present energy crisis. In the first place, its coverage is limited to corporations, whereas many of the profits flowing from the increased price of crude oil are being received by individuals or partnerships. It may be that the largest profits, relatively speaking, are being received by individual royalty owners who have long since recovered their investment. Furthermore, it would be very difficult to focus the impact of the tax on the energy industry, and more specifically on profits derived from crude oil or natural gas production. So doing would require extremely difficult allocations of costs and income within integrated companies, where different phases of the oil business, or non-oil and gas operations, are closely interrelated.

The determination of the tax base depends upon accurate computation of income during the recent past against which to compare current income. There will be large variations in income received during such a base period because of individual circumstances. The tax will have to take into account these different circumstances and allow appropriate adjustments to assure fair application of the tax. The allocation problems and the need for special provisions would result in a complex statute. As experience with the Korean War tax clearly indicates, complexity of that order would generate many disputes, with many appeals for amendments to the basic legislation and with litigation likely to last far beyond the end of the current energy problems.

In the case of the oil and natural gas industry, the tax would be especially difficult to apply because the base period, 1969 through 1972, appears to have been a period during which rates of return, and corresponding investment, were low. In the case of natural gas, that problem is more acute because the price of natural gas was held at an artificially low level. Consequently, a higher rate of return on investment than prevailed during that period would be required to stimulate the additional capital investment which would be needed to

increase diminishing oil and gas supplies. That would require an excess profits "credit" larger than the industry's base period experience would indicate, and that requirement would make definition of "excess profits" more difficult than in the typical wartime tax.

Another difficulty frequently mentioned is the incentive the tax would provide for wasteful expenditures. If a high marginal rate of tax applies to additional income, taxpayers will be encouraged to make expenditures they would not make out of after tax income since most of the expense will be borne by the government in the form of reduced taxes.

(c) Arguments for

The main advantage of an excess profit tax is that it focuses directly on the problem—the excess profits themselves. Thus, assuming that "normal" profits can be accurately defined, the tax would be paid only by taxpayers who actually did have excessive profits, and then in proportion to the amount of profits involved. A producer of high cost oil, such as a producer using secondary and tertiary recovery techniques, for example, would pay less tax, since his higher costs would directly reduce his tax base, than a taxpayer who produced oil under primary, lower cost methods. Furthermore, the tax could be structured to protect increased production by allowing credits or special deductions in the computation of the tax. In that way, incentives to increase production could be built into the tax, and would not necessitate separate computations or refund claims.

(2) Emergency windfall profits tax

The Administration has proposed a tax determined by the price of crude oil. In fact this tax probably is more accurately described as an excise tax rather than an excess profits tax, since cost is not taken into account in determining the amount of tax. Thus, it is quite different from a wartime excess profits tax and can be expected to have different effects.

(a) Characteristics

The Administration's proposed tax would be imposed on the excess of the price per barrel of domestically produced crude oil above a base price. The base price is the controlled price of "old oil" on December 1st as determined by the Cost of Living Council—4.50 per barrel in most cases. The tax is imposed at graduated rates, rising from a minimum of 10 percent to a maximum of 85 percent for prices in excess of \$2.00 over the base price.³

The tax would be withheld from the price paid to the oil producer by the purchaser, and remitted by the purchaser to the Treasury on monthly returns. An integrated producer would owe the tax at the time its oil was transported for refining purposes and at the field price controlling that type and grade of oil in that area.

The windfall profits tax would be phased out by adjusting the rate brackets upward in equal increments over a three year period until the tax would apply only to prices in excess of \$7.00. For the following two years, a further phase-out would occur until the tax completely terminated five years after its effective date.

³ The Administration's proposal formally adopts a base price of \$4.00, but since there is no tax on the first 50 cents, the tax base is really \$4.50.

It is estimated that this alternative would yield about \$2.1 billion in 1974, \$2.5 billion in 1975, \$1.7 billion in 1976 and negligible amounts in the next two years (assuming a long-range price of \$8 per barrel for crude oil; see Table 27 in Study No. 2, *Energy Taxation Statistical Data* for details).

(b) *Arguments against*

Since the proposed tax ignores the cost of producing oil, the tax burden falls most heavily on the producer of high cost oil. Since much new oil is produced through high cost processes, the windfall profits tax could discourage the production of oil from new sources or by new techniques while it is effective. Moreover, since the tax is basically an excise tax on the price of oil, it is similar to a cost of production. To the extent that price controls are retained, it may have to be passed on, in part, to the consumer to allow adequate profit margins to producers, thereby forcing a higher price level than would otherwise be set. Even if there are no price controls, producers may be able to pass on some of the tax to consumers in the somewhat longer run as adjustments in market price provide the opportunity to do so. Therefore, the tax will have to be of even shorter duration than the excess profits tax, which could be retained to tax excessive profits from older, low cost sources of production.

(c) *Arguments for*

The most important advantage of the Windfall Profits Tax is its simplicity. The tax is based on the increased price of crude oil and is, therefore, completely independent of cost. Moreover, since it applies directly to the price of the commodity in short supply, allocation is unnecessary. The tax is also precisely focused on the source of the "windfall" profits, the increase in the price of crude oil. It therefore avoids practically all of the complexity of the excess profits tax, and can be imposed as easily on individuals as on corporations.

The proposed withholding system of collection greatly simplifies collection problems, and assures that the tax will be paid at the time that the profit is realized, and not later. Because the tax is mechanical, there would be few disputes, and less litigation, extending past the period of energy shortages. Finally, the tax will not encourage wasteful expenditures, as would the excess profits tax.

The Windfall Profits Tax may also be applied to natural gas. A base price could be chosen, say 65¢ per mcf (roughly the energy equivalent of \$4.00 per barrel for oil), and the tax applied at graduated rates to prices in excess of the base, in the same manner as for oil. In addition, the tax on natural gas could be phased out as the tax on crude oil is phased out.

(3) *Relating percentage depletion to price increases*

An alternative source of revenue would be to restructure the existing percentage depletion deduction (i.e., the excess of percentage over cost depletion) so that it may not be used to offset income from increased prices of oil or natural gas. If the deduction is reduced as prices increase, the resulting tax increase would reduce the "excess profit" in the short run, much as an excess profits tax or the Emergency Windfall Profits Tax would. Adopting this alternative would avoid the incongruity of enacting a tax on the profits of oil

companies at the same time as existing law provides special tax benefits.

(a) *Characteristics*

The excess of percentage depletion over cost depletion for oil would be reduced as the price per barrel of crude oil rose above a base price. The base price could be selected at a level reflecting a "normal" price before the recent price surges, say \$3.50 (approximately the average price of a barrel of crude oil during 1973); or the base price could be set to protect producer expectations such as at \$4.00 (the formal base price suggested by the Administration for its Windfall Profits Tax). Depletion at the existing rate (22 percent) would be allowed on the base price, reduced by the excess of the actual price above the base price. If the price of oil were \$5.50, for example, percentage depletion could be allowed on \$4.00 less \$1.50 (\$5.50 - \$4.00). Thus, depletable income in this example would be \$2.50 per barrel. A similar reduction could apply to natural gas, with the base price for natural gas corresponding to the oil price in BTU terms (or roughly, 65¢ per mcf).

It is estimated that this alternative would yield about \$1.7 billion in 1974, \$2.4 billion in 1975, \$3.0 billion in 1976, \$3.2 billion in 1977, and \$3.4 billion in 1978.

(b) *Arguments against*

Reducing the percentage depletion deduction as the price of oil rises would diminish tax incentives for additional production (or more accurately would lessen the non-tax incentive effect of the price increase). The percentage depletion deduction does lower the effective tax rate on income from oil and gas production, and reducing it might cause some producers to discontinue plans for additional and probably higher cost production because of lower profit margins. The lower return would also discourage needed new capital from flowing into the industry. On the other hand, however, the rise in market prices for oil and gas could be expected to offset this effect.

The increase in general revenues would not result from a separately identifiable tax. Therefore, if the revenue from increased energy taxes is to be kept separate from general revenues, as for example, in a trust fund, some mechanism would have to be devised for transferring into the designated fund on the basis of the estimated revenue gained as a result of restructuring percentage depletion.

(c) *Arguments for*

Of the three alternatives discussed in this paper, relating the percentage depletion to price increases is the simplest. It would involve an adjustment on existing income tax returns, with no additional returns or special collection mechanisms required.

This alternative would provide a permanent source of revenue to support energy related activities.

Furthermore, relating the percentage depletion deduction to price increases would serve tax reform and revenue raising objectives simultaneously. It has long been recognized that the depletion deduction substantially reduces the tax burden on the oil industry or consumers and thus is thought to provide a special tax benefit either to the industry or to the consumers.

Reducing depletion as the price increases would not damage the industry financially, whether or not price controls are continued, since the increased profits would more than compensate for the loss of the tax benefit.

III. MODIFICATIONS IN BASIC TAX ALTERNATIVES

Each of these suggested taxes may be modified to take account of special problems.

(1) *Plowback*

If a portion of profits derived from the increased prices for oil were to be siphoned off in additional taxes, the funds available for new exploration and development would be reduced. The rate of return on investment would also be reduced, thereby possibly discouraging the influx of needed new capital. To mitigate the effects of new taxes on oil profits, any of the three alternatives discussed above could be modified to allow reductions in the tax to taxpayers who undertake preferred exploration and development.

(a) *Determination of qualified expenditures*

Federal energy policy, as expressed by the President and set out in testimony by Secretary Shultz before this Committee, is to encourage private investment to increase domestic oil and gas supplies. To qualify for the plowback, therefore, all qualified expenses would have to be incurred in developing new energy sources in the United States, including the continental shelf. The range of investments and activities which might serve United States energy policy would include not only exploration and development of oil and gas wells, but also research and development in alternative energy sources. One way of handling this might be to provide that the Federal Energy Administrator could prescribe qualified projects by their general characteristics and the Secretary of the Treasury could then prescribe what types of expenditures for those projects would qualify. Guidelines as to the types of projects and expenditures could be provided by the statute.

(b) *Amount of plowback*

The purpose of giving incentives, in the form of relief from special energy taxes, for new energy expenses is to increase exploration and development activity. To the extent that such activity was already planned, and would have occurred even without the stimulus of a plowback provision, no incentive is necessary. Moreover, preexisting exploration and development activity—let alone the increases planned in response to the rise in the price of oil—are sufficiently great to reduce the impact of any energy tax to low levels, should a plowback benefit be provided. Thus, a plowback could be limited to the expenses for which it is intended—increases over exploration and development expenses incurred during a base period, say 1972. That would focus the plowback where it is most needed.

To be sure that a plowback provision does not absorb all of the new taxes raised, the benefit resulting from a plowback provision might be limited to 50 percent of the new taxes raised.

(c) *Relating plowback to specific taxes*

Excess profits tax.—If income for excess profits tax purposes were reduced by deductions for intangible drilling costs, research and development expenses, and rapid depreciation or amortization of new processing plants, that activity would naturally be encouraged as a means of reducing the tax burden. Those expenditures might be further encouraged by restricting deductions for normal business expenses to the same proportion of income as they were in the base period, thereby channeling expenditures into the preferred activity and discouraging additional, and possibly wasteful, business expenses.

As an alternative to the deduction, a "credit" could be allowed against excess profits income for an assumed rate of return on new investment. If the assumed rate were high enough to slightly exceed the actual rate of return on new investment, excess profits income would be reduced more by the credit than it would be increased by the income actually earned on the new investment. That effect could be further enhanced by including borrowing in new investment.

If the revenue raising objective is important, the plowback could be limited to a percentage, say 50 percent, of additional energy expenses.

Windfall profits tax.—A direct rebate in the form of a refund or a credit against the oil producer's income tax liability could be provided to a producer who made qualified investments during some reasonably short period of time after paying the tax. The rebate could be limited to a percentage of the additional energy expenses, say 50 percent. To prevent the revenue gain from being entirely consumed by the plowback, a limit could be set on the rebatable portion, say 50 percent, as is now done with credits against income tax. Carrybacks and carryovers of excess expenses could be allowed to prevent loss of rebates for qualifying expenditures made in years to which the tax applied.

Relating percentage depletion to price increases.—It has been suggested that the allowance for percentage depletion, under existing law, should be limited to the extent that actual expenditures are made by the taxpayer for new energy sources. In connection with the depletion phase-out, that suggestion can apply in reverse by allowing the percentage depletion deduction if investment in new energy sources is made. This could be done by increasing depletable income by a portion, say 50 percent of the qualifying expenses. The amount of the increase could not exceed the difference between gross income from mining computed on the base price of \$4.00 per barrel and depletable income determined on the basis of the price charged for the oil. The plowback provision referred to above would be in addition to immediate write-offs for intangible drilling expenses.

(2) *Relief for small producers*

These tax suggestions are basically intended to absorb excess profits realized by large oil producers which can spread costs of production over a large base. Smaller producers may not have a similar ability to protect themselves from the impact of these new taxes. The very small operators, who might own and operate oil wells on their own properties, may find it uneconomical, with the added cost of new

energy taxes, to continue production at the low levels involved. Since these marginal operations are a significant portion of current production, some relief from the impact of new energy taxes might be helpful.

Therefore, the Committee may want to consider some form of relief provision for the marginal producer.

(a) *Scope*

Royalty owners rarely have operating expenses and would not therefore be affected by rising costs. Simultaneously, however, they receive the benefit of rising prices. There is, therefore, a substantial "wind-fall" element in their increased earnings which could more properly be subjected to new energy taxes than the more volatile earnings of small operators. Hence, one alternative would be to limit relief to operators.

(b) *Determination of size*

The easiest method of determining who would qualify for relief would be to base the determination on the producer's volume. Since prices vary with market conditions and price controls, relief would be more consistent with respect to those it affected than if the determination depended upon the amount of sales involved.⁴

(c) *Interaction with specific tax structure*

Since the taxes described in this pamphlet have different characteristics, the exemption would have to be tailored to fit the requirements of each type of tax.

Excess profits tax.—The excess profits tax would apply only to corporations, and then only to income above the excess profits credit. Small operators could be protected by providing a minimum credit of sufficient size to prevent the tax from applying to many small or marginal oil producers. Alternatively, since the credit is determined with respect to a base period, the credit could be increased by a small business exemption.

The Korean War tax provided a minimum credit of \$25,000. Because of the generally higher cost of oil operations, a larger minimum credit would appear to be justified, say \$100,000. If the additional small business exemption appears to be more appropriate, a somewhat smaller exemption could be selected.

Under the minimum credit idea, small operators would have to compute both the credit and the tax base to determine the effect of the exemption on them. In the alternative, a corporation which handled a relatively small volume of oil production each year would be excused from filing a regular excess profits tax return. A relatively low level of production would be sufficient to protect the small operator, say 10,000 barrels per month. In light of today's prices, the gross receipts of such a "small producer" could be expected to exceed \$700,000 per year.

An equivalent production figure could be established for natural gas.

Windfall profits tax.—A taxpayer below the minimum production level referred to above would be entitled to recover his entire tax. If production exceeds the minimum level, he could reduce his tax liability in the proportion that the minimum exemption (in terms of numbers

⁴If royalty owners were to be included, volume could be determined by the amount of production with respect to which his royalty was computed.

of barrels) bore to his total production. That would average out the different prices (and therefore tax burden) for each barrel and would avoid onerous tracing problems. Since much of the tax would be collected by withholding from the sales proceeds of the oil involved, a refund system would be instituted to allow producers to recover the withheld tax. An estimating system could be provided for integrated producers required to file monthly returns.

Relating percentage depletion to price increases.—The effect of restructuring percentage depletion deduction could be mitigated in relation to the volume on which percentage depletion was computed. Percentage depletion would not be allowed on increases in price above the base price. Hence, the small producer exemption would be structured in terms of the base price times the minimum volume of production. (That is, depletion would be allowed on up to \$40,000 per month.)

An operator would be allowed a minimum deduction for percentage depletion determined with respect to the base price times the minimum volume, or his actual volume, if less. As in the Windfall Profits Tax, this would be allowed for all taxpayers. Since the computation would relate to the basic percentage depletion deduction which must be computed under existing law, it would not impose an additional reporting burden.

(3) *Combination of Windfall Profits Tax and restructured depletion*

Important features of the Windfall Profits Tax and restructured depletion systems may be combined to incorporate desirable characteristics of each into a single tax package.

The Windfall Profits Tax would have two basic purposes: to absorb excessive oil company profits, and to provide revenue for Federal energy projects. As explained earlier, the Windfall Profits Tax would be designed to be temporary, and would be phased out over a relatively short period of time. Moreover, its major impact would be on the higher prices where excessive profits would be realized. In contrast, a restructured depletion deduction would have substantially different objectives: to improve the accuracy and fairness of the taxation of oil income in relation to other incomes, and to provide a lasting revenue gain. These two taxes may be combined to achieve all the purposes listed above without doubling the tax impact.

The combination is made possible by the fact that both tax systems depend upon a base price as their reference point. The impact of each tax would increase as the price charged for a barrel of oil increases above the base price. If the Windfall Profits tax is phased out over a five year period as proposed by the Treasury Department, the restructured depletion deduction may be phased in over the same time period. That could be achieved by limiting the effect of the restructured depletion deduction to 20 percent in the first year, and to 20 additional percentage points for each successive year until the full reduction was effective.

Under the Windfall Profits tax, gross "income from mining" (the amount with respect to which percentage depletion is computed) would be reduced by the windfall profits tax paid by the producer,

so that he would take depletion only on the amount he actually received from the sale of oil. The same reference point, of course, would be used in this suggested combination of tax systems, so that the portion of the price which would be taxed away would not cause any reduction in the producer's depletion deduction.

Other features of these tax systems could be adapted to the combination idea. Thus, the relief for small operators, which could be allowed on a volume basis, could apply by allocating a portion of the minimum exemption to each tax system. A similar allocation technique could be used to allocate any plowback benefits.