

**DESCRIPTION OF TAX AND TARIFF  
PROPOSALS FOR DOMESTIC OIL REFINING**

**SCHEDULED FOR A HEARING**

**BEFORE THE**

**SUBCOMMITTEE ON ENERGY AND AGRICULTURAL  
TAXATION**

**OF THE**

**COMMITTEE ON FINANCE**

**ON MARCH 27, 1981**

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**PREPARED FOR THE USE OF THE**

**COMMITTEE ON FINANCE**

**BY THE STAFF OF THE**

**JOINT COMMITTEE ON TAXATION**



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## INTRODUCTION

The proposals described in this pamphlet have been scheduled for a public hearing on March 27, 1981, by the Subcommittee on Energy and Agricultural Taxation of the Committee on Finance.

The hearing is on various proposals for tax incentives and tariffs to aid the domestic crude oil refining industry. Four specific proposals are among those to be addressed by the hearing. As announced in the Subcommittee's press release (81-113) March 11, 1981, these relate to (1) a modification of the foreign tax credit rules, (2) a tariff or fee on the importation of foreign refined petroleum products, (3) tax credits and accelerated depreciation for upgrading or retrofitting domestic refineries, and (4) the creation of tax-exempt crude oil purchasing cooperatives.

The first part of this pamphlet is a summary of the specific proposals listed in the Subcommittee's press release. The second part is an overview of the oil refining industry, and the third part is a summary of the government regulations that have affected the oil refining industry. The fourth part of the pamphlet contains a detailed description of present law and an explanation of each proposal.

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## **I. SUMMARY OF PROPOSALS**

### **1. Tax Incentives for Upgrading or Retrofitting Domestic Refineries**

Under present law, the cost of an asset with a useful life in excess of one year generally must be capitalized and recovered over its useful life. However, the cost of eligible property may be recovered over the appropriate period specified in the asset depreciation range rules (ADR). Equipment used to refine oil can be depreciated over 13 years under present regulations.

Present law generally allows a 10-percent investment tax credit with respect to expenditures for specified tangible property, including equipment used to refine oil. Present law also allows a 10-percent credit with respect to expenditures for the acquisition of certain energy property, but eligible property does not include many energy-saving investments by oil refiners.

The proposal would establish a five-year depreciable life for refinery assets and would allow an additional 10-percent investment credit for the purchase of qualified refinery equipment to modernize or expand the capacity of an existing facility or to improve its energy efficiency.

### **2. Petroleum Product Tariff**

The statutory import duties and license fees applicable to imported petroleum products have been suspended since April 1979.

Section 232(b) of the Trade Expansion Act of 1962 authorizes the President to adjust imports of an item upon a finding that such imports threaten to impair the national security.

Under the proposal, tariffs would be imposed on refined petroleum products at a level high enough to enable some or all small domestic refiners to compete with imported refined petroleum products.

### **3. Modification of Foreign Tax Credit Rules**

Under present law, most U.S. international oil companies have excess foreign tax credits from their foreign extraction operations. This proposal would allow these oil companies to utilize their excess foreign tax credits by selling oil extracted in the U.S. to certain small and independent U.S. oil refineries. The proposal would treat income from the sale of oil extracted in the U.S. and sold to U.S. independent refiners as foreign source income and would thus raise the oil company's foreign tax credit limitation to allow the use of the excess extraction taxes.

### **4. Crude Oil Purchasing Cooperatives**

Cooperative entities utilized for the business or financial benefit of its members generally are subject to Federal income taxation. However, present law exempts from Federal income taxation certain cooperative organizations and associations that meet specified requirements.

The proposal would exempt from Federal income taxation cooperatives formed by small and independent refiners to purchase crude oil from foreign suppliers under long-term contracts.

## II. OVERVIEW OF THE OIL REFINING INDUSTRY

Oil refiners transform crude oil into such usable petroleum products as gasoline, heating oil and jet fuel. As of January 1, 1980, the United States had 303 operating oil refineries with a capacity of 18.8 million barrels per day. Crude oil input to U.S. refineries was 13.5 million barrels per day in 1980, resulting in an average 70-percent utilization rate for all domestic refineries. In 1980, the U.S. imported 1.6 million barrels per day of refined petroleum products, more than half of which was residual fuel oil.

There are many different kinds of oil refiners. Very simple refineries, sometimes called "topping plants," generally are capable only of distilling light and sweet crude oil into certain petroleum products (usually jet fuel, naphtha, and fuel oil). (Light crude oil is oil that is relatively liquid; sweet crude oil is oil with a low sulphur content.) These refineries usually have little or no ability to make gasoline. Because of economics of scale, it is usually uneconomic for simple refineries whose capacity is under about 25,000 barrels per day to install the equipment necessary to produce gasoline.

Large refineries generally are more complex than simple refineries. Because large refineries ordinarily have more sophisticated equipment, they are capable of refining heavy and sour crude oil and producing a wider range of petroleum products (including leaded and unleaded gasoline and petrochemical feedstocks).

Aside from these distinctions among refineries, the Emergency Petroleum Allocation Act of 1973 (EPAA) contains definitions which classify refiners to determine their treatment under price and allocation controls. "Small refiners" are refiners whose total capacity for all refineries owned is less than 175,000 barrels per day. "Independent refiners" are refiners who supplied less than 30 percent of their own crude oil needs in the third quarter of 1973 from their own production and who market substantial volumes of gasoline through independent marketers.

The aggregate capacity of domestic refiners to distill crude oil is large relative to domestic oil consumption, but much of this capacity cannot process heavy and sour crude oil into light petroleum products (such as gasoline) even though these types of crude oil are becoming an increasing fraction of world supply. Thus, new investment is desirable despite apparent excess capacity in the refining industry.

Table 1 lists the companies with over 175,000 barrels/day of total refining capacity. These companies own one-third of operating U.S. refineries but represent over 75 percent of total U.S. refining capacity.

TABLE 1.—COMPANIES WITH OVER 175,000 BBL/D REFINING CAPACITY IN THE UNITED STATES

Name	Number of refineries	Total crude oil capacity (thousand barrels per calendar day)
Exxon.....	5	1, 577
Chevron.....	12	1, 467
Amoco.....	10	1, 238
Shell.....	8	1, 151
Texaco.....	12	1, 059
Gulf.....	7	912
Mobil.....	7	891
Arco.....	4	834
Hess.....	2	728
Marathon.....	4	588
Union Oil.....	4	490
Sun <sup>1</sup> .....	5	484
Ashland.....	7	462
Phillips.....	5	425
Conoco.....	7	361
Coastal States.....	3	298
Cities Service.....	1	291
Sohio <sup>2</sup> .....	2	288
Champlin.....	3	239
Tosco <sup>1</sup> .....	3	222
Getty.....	2	221
Kerr-McGee.....	4	195
Total.....	117	<sup>3</sup> 14, 421

<sup>1</sup> On Sept. 15, 1980, the pending sale of Sun's, Duncan, Okla., 49,000 bbl/d refinery to Tosco was announced. This refinery is still listed as part of Sun's capacity.

<sup>2</sup> British Petroleum owns 53 percent of Sohio. B.P. has 1 U.S. refinery with a capacity of 164,000 bbl/d, which is not contained on list.

<sup>3</sup> 77 percent of total U.S. capacity.

Prior to 1970, small refineries tended to serve relatively small, isolated or specialized product markets. However, small, simple refineries, typically with capacity under 10,000 barrels/day, were constructed at the rate of one a month between 1974 and 1979. Many of these small refineries were constructed to take advantage of certain Federal Government subsidies (described below) available to small refiners. In addition, some large refiners sold their small refineries to new owners who could take advantage of these subsidies because the new owner's total refinery capacity did not exceed the prescribed limits.

The 56 refineries constructed during this period are listed in Table 2. Excluding the 200,000 barrels/day ECOL refinery (now owned by Marathon Oil), all of these refineries are 40,000 barrels/day capacity or under, and 36 have capacity of 10,000 barrels/day or less. Typically, they are simple refineries capable of processing only sweet crude oil and have little, if any, capacity to make gasoline.

TABLE 2—NEW U.S. REFINERIES COMPLETED BETWEEN JAN. 1, 1974 AND DEC. 31, 1979

Company, city, and State	Initial barrel per day capacity	On-stream date
Quintana/Howell, Corpus Christi, Tex.....	30, 000	1974
A. Johnson and Co., Newington, N.H.....	14, 000	1974
Toro Petroleum Corp., Port Allen, La.....	36, 000	1974
Northland Oil & Refining Co., Dickinson, N. Dak.....	5, 000	1974
Pioneer Refining Co., Nixon, Tex.....	2, 200	1974
Mid-Tex Refinery, Hearne, Tex.....	7, 500	1974
Crown (Western) Refining Co., Woods Cross, Utah.....	9, 000	1974
Giant Industries, Bloomfield, N. Mex.....	5, 600	1974
Saber, Corpus Christi, Tex.....	9, 000	1974
Famariss, Lovington, N. Mex.....	37, 000	1974
Louisiana Land, Mobile, Ala.....	37, 500	1975
United Independent, Tacoma, Wash.....	750	1975
Inger Oil, Darrow, La.....	470	1975
Glenrock Refining Co., Glen Rock Wyo.....	600	1976
U.S.A. Petrochem, Ventura, Calif.....	15, 000	1976
ECOL, Garyville, La.....	200, 000	1976
Glacier Park, Osage, Wyo.....	2, 000	1976
Sigmor, Three Rivers, Tex.....	10, 000	1976
Arizona Fuels, Asphalt Ridge, Utah.....	3, 000	1976
Basin Petroleum, Long Beach, Calif.....	3, 100	1976
Bi-Petro, Pana, Ill.....	960	1976
ECO Petroleum, Signal Hill, Calif.....	3, 000	1976
DeMenno Resources, Compton, Calif.....	5, 000	1976
M. T. Richards, Crossville, Ill.....	100	1976
Trans-Ocean Petroleum, Wilmington, N. C....	11, 900	1976
Hill Petroleum, Krotz Springs, La.....	3, 000	1976
Dillman Oil Recovery, Oblong, Ill.....	1, 500	1977
Calcasieu Refining, Ltd., Lake Charles, La...	6, 500	1977
Erickson Refinery Corp., Port Neches, Tex...	30, 400	1977
Gulf States Refining Co., Corpus Christi, Tex..	7, 400	1977
Mount Airy Refinery Co. Mount Airy, La.....	11, 600	1977
Mobile Bay Refining Co., Chicasaw, Ala.....	16, 900	1977
Shepherd Oil & Refining Co., Jennings, La....	5, 000	1977
Sentry Refining Co., Corpus Christi, Tex.....	10, 000	1977
Tipperary Refining Co., Ingleside, Tex.....	6, 000	1977

TABLE 2—NEW U.S. REFINERIES COMPLETED BETWEEN JAN. 1, 1974  
AND DEC. 31, 1979—Continued

Company, city, and State	Initial barrel per day capacity	On-stream date
Nevada Refining Co., Tonopah, Nev-----	3, 000	1977
North Pole Refining Co., North Pole, Alaska--	22, 600	1977
Cibro Petroleum Product, Albany, N.Y-----	27, 100	1978
T & S Refining Co., Jennings, La-----	19, 200	1978
Uni Oil, Inc., Ingleside, Tex-----	11, 300	1978
Ergon Refining, Inc., Vicksburg, Miss-----	11, 800	1978
Vicksburg Refining Co., Vicksburg, Miss-----	7, 900	1978
Sierra Anchor, McKittrick, Calif-----	10, 000	1978
Raymal Refining Co., Ingleside, Tex-----	2, 500	1978
Friendswood, Friendswood, Tex-----	10, 500	1978
Port Petroleum, Stonewall, La-----	2, 000	1978
Schulze Processing Co., Talla Bena, La-----	1, 700	1978
Slapco, Mermentau, La-----	10, 000	1978
Quad Refinery Corp., Bakersfield, Calif-----	7, 000	1978
Seaview Petroleum Inc., Paulsboro, N.J-----	37, 500	1979
Gulf Energy Refining, Brownsville, Tex-----	10, 000	1979
Lake Charles Refining Co., Lake Charles, La---	40, 000	1979
Mallard Resources, Inc., Gueydan, La-----	5, 000	1979
Placid Refining Co., Mont Belvieu, Tex-----	12, 000	1979
Sooner Refining, Crowley, La-----	8, 000	1979
Huntway Refining Co., Wilmington, Calif----	5, 000	1979

### III. REGULATORY BACKGROUND

Several of the Federal government's trade and regulatory policies have had a significant impact on the domestic oil refining industry. Often, this impact has been unintentional. These policies include oil import tariffs and quotas, price and allocation controls, and environmental policies.

#### Oil Import Policy

President Eisenhower established mandatory oil import quotas in 1959 under authority granted to him by the "national security" provisions of the Trade Agreement Extension Act of 1958 (now section 232 of the Trade Expansion Act of 1962). These quotas remained in effect until 1973.

At the time the quota system was established, foreign oil was available at very low prices (less than \$2 per barrel), and the Administration was concerned that overdependence on oil imports would impair national security by permanently damaging the domestic crude oil producing industry. The quotas were intended to prevent this overdependence.

The specific method used by the Interior Department to operate the quotas, however, benefited certain segments of the domestic oil refining industry. Because the quotas raised the price at which oil could be sold in the U.S. above the price of imported oil, a license to import oil was worth about one dollar per barrel. Because import licenses could be transferred through oil swaps, moreover, the owner of an import license could realize this gain without actually importing any oil himself. The government distributed the licenses, free of charge, to persons who had been importing oil prior to the quotas and to all domestic oil refiners. This exclusion of foreign refiners from the allocation of import licenses generally gave domestic refiners some protection against foreign competition. Furthermore, small refiners received a proportionately larger share of the import licenses than larger refiners. Thus, the import quotas generally operated to benefit U.S. oil refiners, particularly small refiners and refiners who had been importing oil prior to the imposition of the quotas.<sup>1</sup>

In 1973, President Nixon replaced the quota program with a less cumbersome import fee of 21 cents per barrel on crude oil and 63 cents per barrel on refined petroleum products. The 42-cent differential provided an incentive to import crude oil, rather than refined products; that is, to refine in the United States. Also, because the tariffs initially applied only to imports in excess of prior quota levels (called fee-free allocations), the advantages which small refiners received under the

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<sup>1</sup> One aspect of the quotas, however, did work against domestic refiners. There was a more lenient quota on imports of residual fuel oil than on other imports, which discouraged domestic refining of crude oil into residual oil.

quota system carried over into the tariff. The fee-free allocations, however, were scheduled to be phased out by April 1980. These import fees were suspended by President Carter in April 1979 and have not been reinstated.

### **Price Controls**

In 1971, Phase I of the Nixon Administration's wage and price controls froze petroleum product prices at their August 1971 level. The Cost of Living Council then established comprehensive regulations to govern the pricing of petroleum and petroleum products. President Nixon ordered a second freeze in 1974, which was followed by the Phase IV pricing regulations. For oil, the regulations used May 15, 1973, as the base period for prices charged under price controls. Refiners were permitted to increase their prices above this level on a dollar-for-dollar basis to reflect increases in the cost of petroleum they purchased and to reflect increased nonproduct costs subject to a profit margin limitation. The regulations specified how increased costs were to be allocated by product, and retail price ceilings were established for motor gasoline, home heating oil, and diesel fuel.

These regulations served as a basis for the Emergency Petroleum Allocation Act of 1973 (EPAA). The EPAA allowed the President to allocate and to control the price of crude oil and refined petroleum products even after the expiration of the President's general price control authority. Price and allocation controls were extended further by the Energy Policy and Conservation Act of 1975 (EPCA). Under the EPCA, controls were mandatory through May 1979 and could be extended by the President until September 30, 1981. In April 1979 President Carter announced a program of phased decontrol through September 1981. President Reagan eliminated all price and allocation controls in January 1981.

While most public debate on oil price controls focused on crude oil prices, the controls on refiners also had significant economic impact. The price controls on large oil refiners served to discourage investment in new refining capacity because, while the controls allowed a pass-through of refiners' costs of production, they did not provide for any rate of return on new investment. Hence, any refiner who expected price controls at the refinery level to be binding in the future had little incentive to make investments in new or modernized capacity. This lack of incentive came when new investment was needed to make unleaded gasoline (a new product), to meet environmental requirements, and to adapt to the changing mix of available crude oil. Since the phaseout of price controls was announced in 1979, many large refiners have announced major investment programs to upgrade their refineries.

### **Entitlements**

One result of the original price controls, when combined with substantially increased foreign crude oil prices, was to place domestic refiners who depended on foreign oil at a disadvantage when competing with similar refiners buying price-controlled domestic crude oil. In response, the Federal Energy Administration established the "entitlements program" in 1974. This program, in principle, was intended to

equalize crude oil costs by having all domestic refiners pay the "national average" price for crude oil. Refiners with a greater than average amount of price-controlled oil were required to buy an "entitlement;" refiners with foreign oil or oil exempt from price controls were given entitlements to sell.

This relatively simple concept proved difficult to implement, particularly because the entitlements program was modified to achieve a wide variety of objectives other than price equalization between refiners. These exceptions included the items described below:

*Strategic petroleum reserves.*—Under the Energy Security Act, entitlements were used to reduce the cost of oil acquired for the Strategic Petroleum Reserve.

*East Coast residual fuel oil.*—Importers of residual fuel oil received 50 percent of an entitlement for each barrel of foreign residual fuel oil imported into the State of Michigan or the United States East Coast. Domestic refiners were subject to a penalty for transporting such oil in a foreign tanker.

*Synthetic fuels.*—Shale oil, production of ethyl alcohol for use in making gasohol, and the production of municipal garbage into fuel were automatically eligible for partial entitlements. Other liquid synthetic fuels could have been made eligible on a case-by-case basis.

*Puerto Rico naphtha.*—Importers of naphtha for petrochemical manufacture in Puerto Rico were eligible for entitlements.

*California heavy oil.*—Refiners of heavy California oil received entitlements according to the weighted average gravity of the oil.

*Small refiners.*—Refiners with less than 175,000 barrels a day of refining capacity received a greater-than-proportional share of entitlements, determined according to a sliding scale. Refiners with 10,000 barrels or less a day capacity received the greatest number of additional entitlements per barrel. This provision, known as the "small refiner bias," provided small refiners with much larger benefits than they had received under the oil import quotas or tariffs. These preferences for small refiners were structured in such a way that they grew in proportion to the gap between controlled and uncontrolled oil prices and eventually became much larger than was originally intended, at one time exceeding \$500 million per year for about 100 companies.

The entitlements program provided something akin to tariff protection for domestic refiners because importers of crude oil received entitlements and importers of most refined petroleum products did not. This entitlement benefit for domestic refining, instead of foreign refining, varied between one and six dollars per barrel during the period of controls. As a result of price controls on domestic crude oil and the specific structure of the entitlements program, imports of refined petroleum products fell from 3.0 million barrels per day in 1973 to 1.6 million barrels per day in 1980. Also, the domestic refining industry operated at a high level of capacity utilization during most of this period, while foreign refiners had excess capacity. Because the protection against foreign competition provided by the entitlements program was explicitly temporary, however, it did not give large refiners enough of an incentive to make long-term investments to offset the disincentive effect of the price controls.

For small refiners, the preferences built into the entitlements program were large enough to encourage considerable investments despite their temporary nature. As shown in table 2, the period during which the entitlements program was in effect witnessed the birth of a large number of new small domestic refiners.

### Mandatory Controls

Between the enactment of the EPAA and decontrol, the Federal Government has assured access to crude oil for certain refiners through the so-called Buy/Sell Program.

There have been three successive crude oil Buy/Sell programs implemented since early 1974. Each has involved the publication of allocation lists requiring certain refiners to offer to sell specified volumes of crude oil to other qualifying refiners. Eligible buyers may decline to purchase their allocations or may have DOE direct another refiner to sell to them if they have been unable to purchase oil voluntarily from an allocation list.

The first Buy/Sell Program (February-May 1974) required refiners with access to crude oil supplies to share them on a quarterly basis with refiners that lacked crude oil, so that all refiners could run at the same percentage of capacity. Sales were made at each seller's weighted average monthly cost for all crude oil plus 6 percent plus transportation and quality adjustments. Since no entitlements program existed at that time to reduce crude oil price disparities, most Buy/Sell crude oil was priced significantly below market price levels and eligible buyers purchased virtually all their allocations. These allocations amounted to slightly more than 1 million barrels/day. Some analysts have blamed this program for aggravating the oil embargo by discouraging U.S. companies from buying oil abroad.

The second Buy/Sell Program (June 1974-September 1977) was implemented after the Arab oil embargo. Fifteen major refiners, who were presumed to have access to large volumes of imported crude oil, were required by DOE to sell crude oil to all small and independent refiners to allow them to operate their refineries at 1972 levels. The pricing provisions of the program were similar to those of the first program, and Buy/Sell crude oil continued to be priced below the market until the entitlements program was introduced late in 1974. At that time, eligible buyers began to purchase less of their allocations, and program sales dropped to less than 200,000 barrels/day by mid-1977.

The third Buy/Sell Program (October 1977-decontrol) was designed to assure crude oil supplies only for refineries that had to depend on allocated crude oil, either on a continuing or an emergency basis. The fifteen major integrated refiners continued to be required to sell all the oil under the program. Sales were made at each seller's weighted average monthly cost of imported crude oil plus 5 cents per barrel plus transportation and quality adjustments. Large independent refiners (over 175,000 barrels/day aggregate refining capacity) were eliminated from the program because they were considered large enough to be self-sufficient but not to control adequate

production to be sellers. Small refiners could receive allocations: (1) on a regular six-month basis, to maintain historical runs level at land-locked refineries if the refiner purchased oil under the program during the period October 1976–September 1977, or (2) on an emergency basis, on a two- or three-month basis, for refineries that lost 25 percent or more of their crude oil supply and whose owners were unable to replace the lost supply. Small refiners could not receive allocations for new refineries or new refining capacity unless the new refinery or increased capacity was designed and 20 percent of its financing was irrevocably committed prior to August 24, 1977, thereby discouraging the construction of refining capacity that might depend on government allocations for its existence. Sales of crude oil under this program dropped to less than 20,000 barrels/day in 1978 but escalated to as much as 300,000 barrels/day after emergency allocations were granted because of the Iranian revolution. Use of the program fluctuated, depending on the world crude oil market situation.

Crude oil allocations also were implemented with respect to Canadian oil. Under the Canadian crude oil allocation program, first priority refiners were those whose crude oil runs during the base period (November 1974 through October 1975) were made up of at least 25 percent Canadian oil and who possessed no current capability to replace Canadian suppliers. Refiners who could not meet the 25 percent level could request priority from the Department of Energy if they can demonstrate dependence upon imports.

### **Pollution Control Rules**

The domestic refinery industry is subject to a variety of Federal, State, and local pollution control laws that contribute to the cost of refining petroleum in the United States. Because some foreign countries do not have comparable pollution control laws, it has been argued that American refiners may be at a cost disadvantage relative to foreign competitors.

Although expenditures for pollution controls required to be used in conjunction with crude oil refining may increase the cost of refining domestically relative to refining petroleum outside of the United States, preferential tax incentives are available with respect to expenditures for such equipment. In addition, small refiners may be exempted from certain pollution control rules by the Environmental Protection Agency.

## IV. DESCRIPTION OF PROPOSALS

### 1. Tax Incentives for Upgrading or Retrofitting Domestic Refineries

#### *Present law*

##### *Depreciation*

Under present law, the cost of an asset with a useful life in excess of one year generally must be capitalized and recovered over its useful life. Alternatively, an election may be made to use the asset depreciation range (ADR) rules for eligible property. Under these rules, the cost of eligible property may be recovered over a period within a range of 20 percent above or below an established useful life for property within its guideline class. The guideline life for refinery equipment generally is 16 years so that this equipment may be depreciated over a 13-year life.

##### *Investment tax credit*

Present law provides a 10-percent investment tax credit for investments in tangible property with a useful life of 7 years or more. Oil refineries are eligible for the credit.

##### *Energy investment credit*

Qualified investments in "energy property" generally are eligible for a 10-percent energy investment tax credit if placed in service after September 30, 1978, and before 1983. A special effective date rule extends the expiration date of the credit when certain "affirmative commitments have been undertaken prior to the expiration date.

"Energy property" includes "alternative energy property," and "specially defined energy property."

The term "alternative energy property" includes boilers and burners, as well as related pollution control, handling, and storage equipment, which use an "alternate substance" as a primary fuel. "Alternate substances" include all substances other than oil and natural gas, or a product of oil and natural gas. "Alternative energy property" also includes equipment to convert an alternate substance into a synthetic liquid, gaseous, or solid fuel, equipment to modify existing oil or gas equipment to use an alternate substance (or not less than 25 percent of an alternate substance), and equipment that uses coal or its products as a feedstock.

The term "specially defined energy property" includes specific items of equipment, such as heat wheels and heat exchangers, used to improve the energy efficiency of industrial and commercial facilities and processes in existence on October 1, 1978. The Secretary of the Treasury has the authority to add new items to the list of those eligible as specially defined energy property.

### ***Explanation of proposal***

The proposal consists of two amendments to the Internal Revenue Code to encourage investments in domestic refinery assets.

#### ***Depreciation***

The proposal would establish a 5-year useful life for new refinery assets that are tangible property.

The proposed 5-year capital cost recovery period for refinery assets is essentially the same as that proposed in S. 683, the Administration's tax reduction proposals. The tax reduction bill reported by the Finance Committee in the 96th Congress, H.R. 5829, would have established 7 years as the cost recovery period for refinery assets.

#### ***Investment credit***

Under the proposal, an additional 10-percent investment credit would be allowed for the purchase of qualified refining equipment. Qualified refining equipment would include new refining equipment that upgrades or retrofits an existing refinery facility. Qualified refining equipment would also include equipment that improves the energy efficiency of an existing domestic refining facility.

## **2. Petroleum Product Tariff**

### ***Present law***

Section 232(b) of the Trade Expansion Act of 1962 (19 U.S.C. sec. 1982) grants the President authority to "take such action, and for such time, as he deems necessary to adjust the imports of [an] article and its derivatives so that such imports will not threaten to impair the national security. . . ." This adjustment authority includes both the imposition of quantity restrictions, such as quotas, and import fees. The President's authority, however is eliminated whenever Congress enacts a joint disapproval resolution.

Currently, existing statutory import duties and license fees on imported petroleum products have been suspended. These tariff rates generally are expressed as specific rates (i.e.,  $x$  cents per gallon). The existing rates, which have been in effect since at least 1963, are equal to about one percent or less of the current value of the products. For example, the rate for fuel oil is 0.125 to 0.25 cents a gallon, and that gasoline and jet fuel is 1.25 cents a gallon.

In addition to the statutory tariffs, imported petroleum products have been subject to various other trade restrictions. As noted above, from 1955 to 1959, a voluntary quota system was in place. This voluntary system was followed by the mandatory quotas which were in effect from 1959-1973. The mandatory quotas were replaced in May 1973 by import license fees of 21 cents a barrel for crude oil and 63 cents a barrel for refined petroleum products, with supplemental fees in 1975. The import fees were suspended by Presidential Proclamation in April 1979.

The statutory tariff rates on refined petroleum products are "bound" in the General Agreement on Trade and Tariffs (GATT) against increase. As "bound" rates, tariff increases could imply an obligation to pay compensation to foreign countries which are substantial suppliers of the relevant items. Similarly, imposition of such non-tariff measures as quotas or licenses, for reasons other than national security or balance-of-payments, could lead to requests for compensation or retaliation by other GATT countries.

### ***Explanation of proposal***

Under the proposal, tariffs would be imposed on refined petroleum products at a level high enough to enable some or all small domestic refiners to compete with imported refined petroleum products. It is not clear what level of tariff would be necessary to accomplish this because each refinery's costs and economics vary.

### 3. Modification of Foreign Tax Credit Rules

#### *Present law*

##### *General*

The foreign tax credit was enacted to prevent U.S. taxpayers from being taxed twice on their foreign income—once by the foreign country where the income is earned and again by the United States as part of the taxpayer's worldwide income. The foreign tax credit is intended to allow U.S. taxpayers to offset the U.S. tax on their foreign income by the income taxes paid to a foreign country.

This foreign tax credit system embodies the principle that the country in which a business activity is conducted (or in which any income is earned) has the first right to tax the income arising from activities in that country, even though the activities are conducted by corporations or individuals resident in other countries. Under this principle, the home country of the individual or corporation has a residual right to tax income arising from these activities, but recognizes the obligation to insure that double taxation does not result.

A fundamental premise of the foreign tax credit is that it should not offset the U.S. tax on U.S. source income. Accordingly, the computation of the foreign tax credit contains a limitation to insure that the credit only offsets the U.S. tax on the taxpayer's foreign income. The limitation operates by prorating the taxpayer's total U.S. tax liability before other tax credits ("pre-credit U.S. tax") between his U.S. and foreign source taxable income. Therefore, the limitation is determined by using a simple ratio of foreign source taxable income divided by total taxable income. The resulting fraction is multiplied by the total pre-credit U.S. tax to establish the amount of U.S. taxes paid on the foreign income and, thus, the upper limit on the foreign tax credit.

Historically, the foreign tax credit limitation has been determined based upon either the taxpayer's total foreign income or his foreign income from each separate country, or both. These are known as the overall limitation and the per-country limitation, respectively. Currently, the foreign tax credit limitation can only be computed under the overall method.

Under the overall method, the taxpayer combines the income and losses from all his foreign operations and allocates the pre-credit U.S. tax based upon this amount. Thus, if a taxpayer has \$100 of income from Country A which bears a \$60 tax, and \$100 of income from Country B which bears a \$40 tax, under the overall limitation the taxpayer is treated as having \$200 of foreign source income on which \$100 of foreign taxes were paid. The taxpayer's overall foreign tax credit limitation is \$92 (i.e., assumed U.S. tax rate of 46 percent times \$200 of foreign source income). The taxpayer can thus fully

offset the \$92 of pre-credit U.S. taxes attributable to its foreign operations and is left with \$8 of excess foreign tax credits.

The overall limitation is generally advantageous to the taxpayer when he has income subject to a high tax (as compared to the U.S. rate) in one foreign country and income subject to a low or zero tax in another country. The use of the overall method allows the taxpayer to use the foreign taxes imposed by the high-tax country to offset the U.S. tax imposed on the foreign income in the low or zero tax country. Thus, in the above example \$6 of the tax paid to Country A is allowed as a foreign tax credit against the income of Country B.

In the case of the international oil companies, the overall foreign tax credit limitation allows them to credit high taxes (up to a 95 percent tax rate) on extraction income against low-taxed income from oil-related activities (e.g., oil trading, shipping, and refining) carried on in other foreign countries. Because of the U.S. source rules, this use of excess foreign extraction tax credits against income from oil-related activities undertaken in other foreign countries occurs even though the ultimate destination of the oil being traded, shipped, or refined is the U.S.; that is, the source of the income from the extraction, shipping, and refining of the oil (for purposes of determining the limitation of the foreign tax credit) is the place where these activities are carried on, not the place where the oil is ultimately used. Thus, if an oil company has available excess credits arising out of its foreign extraction activities, it may use them to offset its U.S. tax liability attributable to its foreign refining operations, even where the oil being refined is destined for the U.S. market.

### *Special oil and gas rules*

Special rules (sec. 907) have been enacted in recent years which apply to foreign tax credits claimed by oil companies. These special oil tax credit rules were adopted largely because of the difficulty in determining whether payments made to foreign governments on oil income are, in substance as well as in form, creditable income taxes or whether they are, instead, noncreditable payments such as royalties or severance taxes. Generally, these special rules limit the credit which may be claimed for foreign taxes on oil and gas extraction income to 46 percent of the company's overall foreign extraction income. However, a foreign tax credit carryover is allowed for excess extraction taxes paid to the extent of 2 percent of foreign oil extraction income.

The taxpayer's extraction income is generally the sum total of the company's income and loss from foreign extraction operations. However, if the extraction activities and sales of the extraction assets in any country result in a net loss for any year (as ordinarily is the case during the exploration and development stage), the loss from the country is not taken into account in the computation of the foreign oil extraction income for the year (the special "per-country extraction loss rule"). This benefits the taxpayer because its oil and gas extraction tax limitation exceeds its pre-credit U.S. tax attributable to its foreign extraction activities (including the loss activities) by 46 percent of the nonincluded loss. Consequently, notwithstanding the 46-percent limitation of section 907(a), the company may have substantial excess

credits attributable to its foreign extraction operations available for use against its low-tax oil-related income.

Present law also provides that a taxpayer is to compute the foreign tax credit limitation (sec. 904 and sec. 907(b)) separately for its foreign oil-related income. (Thus, foreign taxes paid on the taxpayer's foreign oil-related income may not offset its U.S. tax on its other income and vice versa.) Foreign oil-related income includes foreign oil and gas extraction income as well as foreign income from refining, transporting, distributing and selling such foreign production. Importantly, foreign extraction losses are included in computing the foreign oil-related income limitation. In most cases, the combination of these extraction losses with losses from other foreign oil-related activities (notably shipping) has resulted in a limitation that is lower than the amount of the creditable foreign taxes on extraction income and on the other foreign oil-related income. Thus, in computing their foreign tax credit for foreign oil-related income, most oil companies have had excess foreign tax credits.

For a fuller explanation of the U.S. foreign tax credit rules, particularly as they apply to foreign oil taxes, see the Joint Committee staff pamphlet, "Explanation of Foreign Tax Credit Rules Applicable to Petroleum Income and Description of Administration Proposal" (JCS-26-79).

### ***Explanation of proposal***

The proposal would allow oil companies to treat income from oil that was extracted in the United States and was sold to certain unrelated domestic small and independent refiners as foreign oil extraction income or foreign oil-related income. This is intended to induce U.S. international oil companies with otherwise unusable excess foreign extraction tax credits to sell U.S. oil to independent U.S. refiners. It would allow these oil companies to utilize their excess extraction foreign tax credits to offset the U.S. tax on the income from the sale to independent oil refiners of oil and gas extracted in the United States.

## 4. Crude Oil Purchasing Cooperatives

### *Present law*

Cooperative entities utilized for the business or financial benefit of its members generally are subject to Federal income tax. However, present law exempts from Federal income taxation certain cooperative organizations and associations that meet specified requirements. Among those organizations that may be exempt from taxation are certain cooperative insurance associations, mutual ditch or irrigation companies, and telephone companies (sec. 501(c)(12)), crop financing corporations (sec. 501(c)(16)), cooperative hospital service organizations (sec. 501(e)), cooperative educational service organizations (sec. 501(f)), farmers' cooperatives (sec. 521), and homeowners associations (sec. 528). These tax-exempt mutual and cooperative organizations generally are operated to provide goods or services to their members at cost. As such, gross membership revenues in excess of costs ordinarily are viewed as being "overcharges," rather than as income, if refunded promptly to its members. Revenue from non-membership sources, e.g., investments and non-membership dealings, may be taxable.

Under present law, antitrust statutes generally prohibit cooperative business arrangements which may reduce competition. However, Congress has granted U.S. oil companies a limited antitrust defense for participation in the International Energy Agency (IEA). In the absence of such a defense, U.S. oil companies could not share information and, in the event of an emergency, allocate supplies with the IEA's membership.

### *Explanation of proposal*

The proposal would allow small and independent refiners to establish privately owned tax-exempt cooperatives to purchase crude oil from foreign suppliers under long-term contracts.

