



# FISCAL FACT

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## Oil Today, Fatty Foods and Sugary Drinks Tomorrow: The Administration's Assault on the Manufacturing Deduction for Oil Companies

*By Scott A. Hodge*

The oil industry is the favorite political tax target of Congress and the Administration right now, thanks to the BP spill. But if there's any such thing as a sure bet in Washington, it's that when the next big story puts a different industry in a bad light – probably another industry that allegedly makes us unhealthy – the picadors in Congress and the Administration will stick the offending industry with a raft of new corporate tax hikes.

But oil is the target right now, and one of the so-called corporate loophole closers that the Administration is promoting is the repeal for oil companies of the Domestic Manufacturing Activities Deduction, which tax professionals simply refer to by its tax code number, the “Section 199 deduction.” So, what is the 199 deduction, how does it benefit manufacturers, and why is it wrong for the administration to want to repeal it for a specific industry?

The 199 deduction was enacted in 2004 to replace another tax deduction meant solely for U.S. exporters called the “Extraterritorial Income Exclusion (ETI).” The World Trade Organization had ruled this tax break in violation of international trade laws for unfairly subsidizing U.S. exporters and demanded that Washington either repeal ETI outright or replace it with something that did not violate international trade rules.

But rather than cut the 35 percent U.S. corporate income tax rate in order to benefit all American companies, Congress instead chose to create a new tax credit available only to domestic manufacturers – even those that do not export. Lawmakers believed that this approach would avoid further WTO challenges. The credit allows companies to deduct up to 9 percent of their net income from domestic manufacturing activities. This has the effect of reducing their tax on these activities from 35 percent to 32 percent.

While the credit, in our mind, unfairly excludes companies engaged in other economically worthwhile activities such as services, finance, and information technology, it is available to a broad swath of “manufacturing” activities and taxpayers, be they individuals, C corporations, farmers, estates, or owners of S corporations.

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Some activities identified as “qualified” production activities by the U.S. Treasury,<sup>1</sup> include:

- The manufacture, production, growth, or extraction of clothing, goods, food, software development, music recordings or films;
- Production of electricity, natural gas, or water in the United States;
- Construction or substantial renovation of real property in the United States including residential and commercial buildings and infrastructure such as roads, power lines, water systems, and communications facilities; or
- Engineering and architectural services performed in the United States and relating to construction of real property.

However, firms cannot deduct the income from production activities for retail consumption, only from those for wholesale distribution. So grinding hamburger meat for wholesale distribution is a qualified activity, but if a fast-food restaurant grinds hamburger meat for take-out sales it is not a qualified activity.

So why has the administration determined that companies that produce t-shirts, hamburgers, toys, software, or rap music are qualified to receive the credit but oil companies are not? Or that companies that design and build roads or those that manufacture automobiles are qualified for the tax break but the companies that produce the gasoline that powers cars down those roads are not?

It appears that it all comes down to environmental politics, not sound tax policy or even sound economics. According to the explanation in Treasury’s Greenbook,<sup>2</sup> which outlines the administration’s tax policies each year, this proposal is justified by the president’s promise during the G-20 Summit in Pittsburgh, to “phase out subsidies for fossil fuels so that the United States can transition to a 21<sup>st</sup> century energy economy.”

Treasury argues that “the lower rate of tax, like other oil and gas preferences the Administration proposes to repeal, distorts markets by encouraging more investments in the oil and gas industry than would occur under a neutral system. To the extent the lower tax rate encourages overproduction of oil and gas, it is detrimental to long-term energy security...”

To follow Treasury’s line of reasoning, the Section 199 deduction should be repealed for every industry because the lower rate of tax distorts markets by encouraging more investment in all manufacturing production activities and, since most production activities use energy to produce goods, it leads to the overuse of fossil fuels and nonrenewable energy.

So if the administration believes that denying oil companies the manufacturing deduction will reduce oil production, then it makes just as much sense to deny the tax break for automakers, asphalt layers, smelters, tire companies, rubber toy companies, and manufacturers of synthetic clothing. After all, Section 199 contributes to the overproduction – and, ultimately, the overconsumption – of these petro-chemical based goods.

The Section 199 manufacturing activities deduction is by no means perfect tax law. The principles of sound tax policy dictate that tax laws should not give preference to one economic activity over another – like manufacturers over services. But nor should tax law be used to punish one type of

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<sup>1</sup> Department of the Treasury, Office of Public Affairs, Fact Sheet: Guidance on Section 199 – Income Attributable to Manufacturing Activities, January 19, 2005. <http://www.ustreas.gov/press/releases/reports/199factsheetjs2200.pdf>

<sup>2</sup> <http://www.treas.gov/offices/tax-policy/library/greenbk10.pdf>

economic activity over another. Using the tax code in this fashion is arbitrary and has led to the byzantine tax system we have today.

The reason U.S. companies were disadvantaged before 2005 is the same reason they are struggling today – the U.S. corporate tax rate of 35 percent is out of step with the rest of the global economy. Rather than create a new tax credit for “manufacturing activities” in 2005 as a response to the WTO, lawmakers should have responded by slashing the U.S. corporate tax rate down to a competitive level. But, since they chose to cut taxes for every type of manufacturing imaginable, it would be wrong and punitive to start carving up Section 199 just to score political points against the oil and gas companies.

If such a move can be justified under environmental politics today, there is no reason the same tactics can't be justified tomorrow to exclude the makers of sugary drinks, fatty foods, alcoholic beverages, or any other manufacturer that becomes the political target of the day.

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