

POLITICAL PULSE

A Whiff of Windfall Profits Taxes

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Extending the 2003 tax cuts is now complicated by an accounting penalty on big oil.

The **House Ways and Means Committee** and the **Senate Finance Committee** have now each passed their own **revenue reconciliation** bills. Hope is still alive -- barely -- for extension this year of the **2003 tax cuts on dividends and capital gains**. If extension can be achieved, we think it would be an important **positive catalyst** for **stocks**. We think expectations are almost nil at this point for passage of this important **pro-growth policy**, so passage would be an **upside surprise**. Extension of the tax cuts would not only significantly lower the **certainty-equivalent after-tax cost of capital** -- it would also send an important **confidence**-building signal that the **pro-growth consensus** within the **Republican majority** is still alive and still capable of getting something right. That signal would have special salience now because, at the moment, the Senate is heading very much in the wrong direction -- its revenue reconciliation bill not only doesn't extend the 2003 tax cuts, but includes a provision that amounts to a one-time **windfall profit tax** on the **oil industry**.

Here's the state of play.

- The House and Senate versions, approved in committee, now have to go to full floor votes in their respective chambers. The risk here is the House, which so far hasn't been able to bring its **spending reconciliation** bill to a vote. That bill was pulled at the last moment last Thursday for lack of support, with **Democrats** rejecting it *en bloc* and Republicans divided on whether it's too aggressive or not aggressive enough (no one seems to think it's just right). Technically, the spending reconciliation and revenue reconciliation bills are entirely separate, and revenue could be voted without a vote on spending. But the mindset in the House is that spending has to be voted first -- and if spending fails, there is the general sense that the whole reconciliation process could fall apart.
- Assuming that the revenue reconciliation bills are approved, they would go to House-Senate **conference** for negotiation into a single bill. Right now the two bills are very different, and therein lies both a challenge and an opportunity. The House version includes the two-year extension of the 2003 tax cuts on dividends and capital gains -- the Senate version does not. The Senate version includes the one-year extension of the **Alternative Minimum Tax "patch"** -- the House version does not. Most Republicans favor extensions of both forms of **tax relief**, but Democrats favor only the AMT extension (though it's a tax on "the rich," AMT affects primarily "**blue states**" where **state and local taxes** tend to be high). From an apolitical economic standpoint, both are powerfully pro-growth through their positive effects on **incentives** to put **marginal labor** and **capital** to work. So the best case would be for *both* extensions to be enacted, with Republican threatening to block AMT extension as a negotiating club to use against Democrats. But that's a dangerous game of **mutual assured destruction**, in which the

worst-case scenario would be that *neither* extension is enacted. That would probably be a **negative surprise** for stocks, as bipartisan support has always made AMT extension seem like the one type of tax relief that can be taken for granted.

- This process will extend well into December. Markets will have no choice but to watch and wait.

A nasty wild-card in the conference negotiation is Monday's last-minute inclusion in the Senate's revenue reconciliation bill of a complicated provision that has the effect of raising taxes on the oil industry. Technically, it's not a windfall profits tax -- the provision does not deal directly with profits, windfall or otherwise. Instead, it imposes an accounting change in which **integrated oil companies** with **revenues** in excess of \$1 billion would have to undergo a one-time **inventory revaluation** using a partial mark-to-market formula based on current oil prices. The oil industry uses **LIFO** inventory accounting, so this would have a dramatic effect on the valuation of aged inventory layers valued today at very low prices. According to estimates by the **Joint Committee on Taxation**, the resulting inventory gains would increase **reported profits** -- though not *economic* profits -- and consequently drive a one-time industry-wide tax increase of \$3.96 billion in 2006 and \$0.96 billion in 2007.

When **Hurricane Katrina** struck, our worst fear was that it would lead to 1970s-style **re-regulation** and **taxation of energy** (see ["Blamestorm"](#) September 6, 2005). This provision in the Senate's revenue reconciliation bill is the closest we've come so far, and it's a warning that our present **Congress** seems not to have learned from history, and is at risk of dooming us to repeat it. That said, unlike a true windfall profits tax, the Senate's provision is only a one-time penalty -- it's neither an implicit **price-control** nor an ongoing **marginal disincentive** to earn profits. And it is even theoretically possible for this penalty to be partially recouped in future years, if both oil prices fall dramatically *and* inventories from the aged layers are liquidated, thus generating **accounting losses**. More important, at this point we don't see this provision as the engine of a legislative runaway train. We believe it has no real support from either **majority leadership** or from the **White House**, and it's likely to get thrown out in conference. But be careful what you wish for. Given the way tax bills are "**scored**," if this \$5 billion in revenues is thrown out, that's \$5 billion in tax cuts (or tax cut extensions) that are no longer "paid for" -- so it makes extending the 2003 cuts and the AMT "patch" \$5 billion harder.

Bottom line: We continue to be impressed at how steady stocks have been during a time of increasing political and policy uncertainty. We have to continue to conclude that deeply **undervalued** stocks have already discounted the most likely negative outcome -- that the 2003 tax cuts on dividends and capital gains will not be extended this year (see ["Beyond Disappointment"](#) November 11, 2005). The corollary of that is that stocks have not discounted the least likely negative outcome (that the AMT "patch" won't get extended, either), nor the positive outcome (that the 2003 tax cuts *and* the AMT "patch" *will* be extended). Abstracting from a runaway train toward energy re-regulation, we see the pattern of outcomes as asymmetrically positive for stocks. Thus stocks remain the king of the **carry trades** (see ["The King of Carry Trades"](#) June 14, 2005). 