Unleashing a Green Stampede Within America's Energy Industry

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While on the campaign trail, Barack Obama made greening America's infrastructure a priority for his administration. As noted in the *Los Angeles Times*, Obama planned

> to spend $150 billion over the next decade to promote energy from the sun, wind and other renewable sources as well as energy conservation. Plans include raising vehicle fuel-economy standards and subsidizing consumer purchases of plug-in hybrids. Obama wants to weatherize 1 million homes annually and upgrade the nation's creaky electrical grid. His team has talked of providing tax credits and loan guarantees to clean-energy companies.

His goals: create 5 million new jobs repowering America over 10 years; assert U.S. leadership on global climate change; and wean the U.S. from its dependence on imported petroleum.

He's currently battling Congress for the appropriations required to turn his vision into reality, and the resistance from Capitol Hill raises once again a question that's been bouncing around the office here for the last six months: ***why not revise the tax code to make wind, hydroelectric, solar and other renewable technologies "like-kind" with traditional fossil technologies?*** This would allow companies wanting to transition into green energy to employ Section 1031 Like-Kind Exchanges (LKEs), thereby speeding the switch-over considerably.

Some quick background. At present 1031 Exchanges can only be performed on assets that are either "like-kind" or "like-class." Whether assets are "like-class" is determined by the General Asset Class (GAC) or North American Industry Classification System (NAICS) codes. If the assets do not fall within the same class, they can still be considered like-kind by the IRS and exchanged. However, the exchange will be outside the like-class safe harbor and the determination of whether the assets are like-kind will need to focus on the nature or character of the property.

The NAICS codes relevant for this discussion are found in sections 31-33. Code 333132 defines Oil and Gas Field Machinery and Equipment Manufacturing while code 3336 covers Engine, Turbine, and Power Transmission Equipment Manufacturing. As such, the Internal Revenue Code would not allow an LKE between the two, even though both are used for the same purpose.

The ABC Energy Case

America's energy companies understand the need to green their operations. According to the American Petroleum Institute, US oil and natural gas industry companies are investing more than all of private industry and the federal government combined in new energy technologies to meet future energy needs.

- Oil and Gas Companies – $121.3B
- Other Private – $58.2B
- Federal Government – $8.2B

On carbon mitigation alone, oil and gas companies outspend the federal government by nearly three-to-one.

- Oil and Gas Companies – $42B
- Federal Govt – $15B

With this in mind, let's illustrate the case of ABC Energy. Imagine that ABC is a large firm (market cap of $175 billion) that currently focuses on oil and natural gas exploration, development, production and distribution. Like every other energy company in America, they can see the writing on the wall and realize that if they're to be successful in the long term that they must evolve from an *oil* company into a full-spectrum *energy* company. As a result, they're already investing significantly in renewables.

They believe this evolution will happen over X years at a cost of $Y. But what are the values for X and Y? There's going to be tremendous political (and consumer) pressure to shorten X, but these are balanced against the obvious business pressures to mitigate Y. Part of the transition will be accomplished organically, as old assets are retired, and tax credits can also ease the burden some. Of course, in the current political climate, most legislators will be eager to steer clear of "tax breaks for Big Oil" stories.

The upshot is that Y will remain too high to spur a quick transition.

Now, let's consider what might happen if the tax reform proposed here were enacted. (In a good-faith attempt to make the scenario as plausible as possible we're going to use what we believe to be very conservative numbers.)

At the end of 2008 ABC reported $60B in Property, Plant and Equipment assets. Let's say that half of this number would potentially be eligible for 1031 exchange treatment. Senior leadership at ABC now has a new path toward sustainable production that didn't exist before, and since it's already investing in renewables and green tech research, it makes good business sense to begin using Like-Kind Exchanges to accelerate its transition. Over the span of 10 years (let's use something close to the timeframe imagined by President Obama and Al Gore's We Initiative, although there's every reason to think the pace can be sped up) ABC aggressively begins exchanging fossil assets. When you combine federal and state rates the total tax bill on the sale of existing assets would be approximately 40%, which means they're able to defer around $12B, which they immediately reinvest in their new sustainable energy production assets – wind, solar, etc.

ABC is one company, and while they're big they're hardly the largest (they're roughly half the size of ExxonMobil). On a revenue basis, ABC represents a little over 2% of the US oil and gas sector's revenues for 2008, so if we assume that its profile is more or less average by industry standards, ***this proposal could potentially unleash more than $600 billion for green energy development***.

At this point, let's remember two things. First, we're aiming low. Second, at this point we're still only talking about the oil and gas sector – to get the full impact of this proposal you'd also have to factor in a similar transition by coal companies.

We're still trying to nail down the math on the scenario presented above, but we feel comfortable that we're in the right ballpark, and are continuing to work on firming up the actual industry numbers. Thanks for tolerating the fuzzy math, and if you're able to help us tighten up the scenario, please let us know.

What Are the Potential Objections?

In imagining how we might get an idea implemented, we have to consider what barriers would stand in the way. A few objections have occurred to us, but so far there are very good answers to each. Let's take them one at a time.

1: Such a change would be very difficult to implement. Not necessarily. The standard route for amending the tax code runs through Congress, obviously, and that's always a complex process. However, the IRS has tools at its disposal that could potentially expedite fossil-to-green exchanges, at least in the short term. One is called a Private Letter Ruling (PLR). As the page linked here notes, "the IRS private letter ruling is applicable to that tax situation and that taxpayer only." However, PLRs are often treated as precedent, and there's no reason to think that one couldn't be used to signal to energy firms that the agency is ready to accept fossil-to-green exchanges as eligible for 1031 by virtue of "same use" status. The second (and more powerful) approach could involve the use of a Revenue Ruling.

2: What is proposed can be done already. This is true in principle. ABC could, if its CPAs and attorneys agreed that it was a defensible move, go ahead and execute such an exchange and then make their case before the IRS on audit. However, this is risky – they could potentially be exposed to the full tax bill plus penalties if they failed to convince the IRS. If companies have done this in the past (or are doing it currently) we're not aware of it, and it's likely that the risk would serve as a significant barrier for any energy company.

3: There will be major public and political resistance to "tax breaks for oil companies." While there certainly might be such a response, this program is very explicitly *not* a tax break for oil companies. Three reasons:

- They can perform 1031 exchanges within NAICS class now. This means that if there is a "tax break" involved, it exists already. Moreso, it's an incentive to *continue reliance on fossil fuel resources*, which is the opposite of the government's stated goal.
- Existing tax incentive proposals do come with direct budget implications – federal monies are being shifted to energy enterprises. But this proposal has no such impact. There are no new tax revenues that would be realized in the absence of the proposal – that is, no proposal, business as usual.
- We're not talking about a permanent revenue transfer. If the proposal were adopted these taxes would be *deferred*, not forgiven.

To this equation add the tax revenue implications associated with the creation of green collar jobs and the ripple that a half-trillion dollar development spree would set off in support and peripheral markets.

As a result, amending the tax code to allow LKEs across current asset classes would be a win for both major parties (and even the Libertarians and Greens). Objections might be voiced, but at this point it seems like there are solid answers to them.