

This document has been prepared as part of the implementation project of Legal Pathways to Deep Decarbonization (Michael B. Gerrard and John C. Dernbach, eds. Environmental Law Institute [2019]) (LPDD). For background information on the project, see <https://lpdd.org>

REMOVAL OF FAVORABLE TAX TREATMENT FOR COAL PRODUCTION, EXTRACTION, AND PROCESSING*

I. Introduction

Pursuant to the Sabin Center's Legal Pathways to Deep Decarbonization project, Allen & Overy (A&O) has drafted model legislation based on recommendations from the book *Legal Pathways to Deep Decarbonization in the United States*.¹ In response to recommendations given in Chapter 4,² A&O drafted a proposal to amend the Internal Revenue Code of 1986 (the **Tax Code**) to remove certain tax expenditures that favor coal (the **Bill**).

II. Background

The world spends \$5.2 trillion a year subsidizing fossil fuels through a mix of tax breaks and budgetary support, as well as (indirectly) externalization of costs relating to the environment and public health.³ Within this grouping, the United States is one of the largest subsidizers,⁴ accounting for approximately \$660 billion in 2020.⁵ This includes significant energy subsidies that exist in the United States Tax Code to promote or subsidize the production of cheap and abundant fossil energy.⁶

Fossil fuel externalities, including societal, health, and environmental costs, are largely overlooked in the process of incentivizing fossil fuel production. Manmade carbon emissions cause climate change and negatively affect society by facilitating disease transmission, decreasing food security, and contributing to increasing coastal vulnerability, among numerous other adverse impacts.⁷ In addition, burning of fossil fuel creates air pollutants that cause 200,000 premature deaths each year.⁸ The Clean Air Task Force estimates that emissions from United States coal plants alone caused 13,200 deaths, 9,700 hospitalizations, and 20,000 heart attacks in 2010.⁹

Furthermore, fossil fuel extraction and refining processes can cause landscape degradation, spills, and other unintentional environmental damage.¹⁰ Coal extraction, for example, involves clearing the vegetation, soil,

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¹ Legal Pathways to Deep Decarbonization in the United States (Michael B. Gerrard & John C. Dernbach, eds., 2019).

² *Id.* at 111.

³ David Coady, Ian Parry, Nghia-Piotr Le, and Baoping Shang. “Global Fossil Fuel Subsidies Remain Large: An Update Based on Country-Level Estimates.” International Monetary Fund. May 2, 2019. Note that inclusion of externalities in the cost of subsidization of coal here increase this figure significantly as compared to fiscal subsidies, only.

⁴ James Ellsmoor. “United States Spend Ten Times More On Fossil Fuel Subsidies Than Education.” *Forbes*. June 15, 2019.

⁵ Ian Parry, Simon Black, Nate Vernon. “IMF Working Paper: Still Not Getting Energy Prices Right: A Global and Country Update of Fossil Fuel Subsidies.” September 2021.

⁶ Amaury Laporte. “Fact Sheet: Fossil Fuel Subsidies: A Closer Look at Tax Breaks and Societal Costs.” Environmental and Energy Study Institute. July 29, 2019.

⁷ *Id.*

⁸ Jennifer Chu. “Study: Air Pollution Causes 200,000 Early Deaths Each Year in the U.S.” MIT News. August 29, 2013.

⁹ Conrad Schneider and Jonathan Banks. “The Toll from Coal.” Clean Air Task Force. September, 2010.

¹⁰ Amaury Laporte. “Fact Sheet: Fossil Fuel Subsidies: A Closer Look at Tax Breaks and Societal Costs.” Environmental and Energy Study Institute. July 29, 2019.

and rock above coal deposits, permanently damaging landscapes and creating massive amounts of mine wastes.¹¹ Moreover, coal leaves behind toxic coal ash after it is burned,¹² and a 2018 analysis of industry data found that 95 percent of coal ash storage sites have contaminated groundwater at levels deemed unsafe by the United States Environmental Protection Agency.¹³ Burning coal also emits large amounts of greenhouse gases. In 2020, coal-fired electricity accounted for approximately 23% of all electricity generated in the United States, and yet emissions from coal combustion accounted for 54% of all greenhouse gas emissions from the American power sector. (The electric power generation sector is responsible for approximately 25% of all American emissions). Coal is about twice as greenhouse gas-intensive as natural gas, the other primary major fossil fuel used for electricity generation in the United States.¹⁴

How has the United States justified federal financial support of this industry? In the early twentieth century, American reliance on foreign energy and financial uncertainties inherent in drilling for hydrocarbons at that time prompted the federal government to intervene in the energy market.¹⁵ Its aim was to lower the costs and financial risks associated with fossil fuel production and incentivize new domestic energy sources.¹⁶ Today, however, the coal, oil, and natural gas industries are well-established.¹⁷ More importantly, as other, cleaner sources of electricity are increasingly used throughout the US, coal use is in decline and coal is less critical to US energy sufficiency.¹⁸ Indeed, numerous clean and renewable energy alternatives exist.¹⁹ A 2018 study showed that renewable energy alternatives could, in theory, power up to 80% of the United States without having to look abroad.²⁰ Yet various coal subsidies remain embedded within the Tax Code.

III. Tax Treatment and Coal Emissions

Amending the Tax Code to remove favorable tax treatment for coal production, extraction, and processing could facilitate reduction of the negative consequences of coal combustion. Coal tax subsidies function by providing financial assistance – paid by federal taxpayers – to the coal and power industry through tax benefits such as credits and deductions. This has the effect of distorting the market in favor of coal, at the expense of other forms of energy including renewable energy.²¹ Removing favorable tax treatment for the coal industry would help level the playing field and reduce the incentives for coal mining, thereby effectively reducing US carbon emissions and facilitating a transition towards less carbon-intensive and, ideally, renewable energy sources. Eliminating coal subsidies would also free up resources that could be used to address important social needs, such as public health and education.²²

IV. Overview of the Proposed Bill

¹¹ *Id.*

¹² *Id.*

¹³ “Trump Administration’s New Rule Weakens Toxic Coal Ash Pollution Safeguards.” Environmental Integrity Project. July 18, 2018.

¹⁴ U.S. Energy Information Administration. Energy and the environment explained: where greenhouse gases come from, available at <https://www.eia.gov/energyexplained/energy-and-the-environment/where-greenhouse-gases-come-from.php>. May 21, 2021. Note that complete lifecycle emissions from natural gas may vary, particularly as a result of uncontrolled methane leaks.

¹⁵ See Joseph E. Aldy. “Proposal 5: Eliminating Fossil Fuel Subsidies.” The Hamilton Project.

¹⁶ Amaury Laporte. “Fact Sheet: Fossil Fuel Subsidies: A Closer Look at Tax Breaks and Societal Costs.” Environmental and Energy Study Institute. July 29, 2019.

¹⁷ *Id.*

¹⁸ U.S. Energy Information Administration. Electricity explained: electricity in the United States. Available at <https://www.eia.gov/energyexplained/electricity/electricity-in-the-us.php>. March 18, 2021.

¹⁹ *Id.*

²⁰ Matthew R. Shaner, Steven J. Davis, Nathan S. Lewis, and Ken Caldeira. “Geophysical constraints on the reliability of solar and wind power in the United States.” Energy & Environmental Science. February 27, 2018.

²¹ The Inflation Reduction Act of 2022 offsets this phenomenon to some degree by providing extensive allocation for renewable energy development. However, the distorting effects of coal subsidization remain.

²² Joseph E. Aldy. “Money for Nothing: The Case for Eliminating US Fossil Fuel Subsidies.” Resources Mag. April 11, 2014.

The proposed Bill would amend the Tax Code to remove certain tax expenditures that favor coal production, extraction, and processing. The Bill first seeks to amend 26 U.S.C. § 631(c) (**Section 631(c)**) by removing each mention of “coal,” so the section refers only to domestic iron ore. Section 631(c) states that the difference between the amount realized from disposal (*i.e.*, a sale) of coal (held for more than one year by its owner and mined in the US) and the adjusted depletion basis thereof, plus deductions disallowed for the taxable year, shall be considered as though it were a gain or loss (*i.e.*, rather than ordinary income). In essence, Section 631(c) enables income from the sale of coal under royalty contracts to be classified as capital gains rather than ordinary income, which may be subject to US federal income tax at a lower rate if certain requirements are satisfied. By striking references to coal in Section 631(c), persons recording income from coal royalty contracts will be required to pay ordinary income tax rates thereon, rather than allowing them to pay reduced taxes by classifying such income as a capital gain.

The Bill then seeks to amend 26 U.S.C. § 617(f) (**Section 617(f)**), which sets forth and defines the key terms referenced throughout Section 617. Generally, Section 617 permits certain expenditures relating to mining exploration to be treated as deductible against taxable income rather than capitalized (in which case the taxpayer would generally claim depreciation deductions in respect of such expenditures over a longer period of time). The Bill seeks to add a new subsection providing that coal-related expenses should not be eligible for the deduction under Section 617, as well as to make conforming changes to other existing definitions.²³ It should be noted that, whereas the Section 631(c) amendment described above seeks to place coal on a level playing field with other energy sources not subject to this special treatment by removing such treatment under the Tax Code, the amendment to Section 617(f) would subject coal to uniquely (relative to other mined minerals) disfavored treatment. This is arguably an appropriate position for the United States to take given coal’s uniquely disproportionate impact on climate change, but may subject this change to greater political scrutiny or resistance versus a measure that merely removes coal’s privileged status and subjects it to equal treatment.

The Bill then seeks to amend 26 U.S.C. § 616 (**Section 616**), which allows certain expenditures relating to the development of mines or other natural deposits with commercially marketable quantities of ores or minerals to be treated as deductible against taxable income. The Bill seeks to include coal in the list of excluded mines or other natural deposits in subsection (a) for the purposes of Section 616. The Bill also seeks to add a new subsection (f) excluding coal from “ore or other minerals” and from the meaning of “mine or deposit” in Section 616.

The Bill also proposes an amendment to Section 613 of the Tax Code (**Section 613**) that removes the word “coal” from Section 613(b)(4), and strikes Section 613(c)(4)(A) from the Tax Code in its entirety. Section 613(b)(4) lists coal as eligible for an allowance for a 10 percent depletion deduction and Section 613(c)(4)(A) describes processes exclusive to coal that are considered as mining for the purposes of the Section. The Bill also seeks to add a new paragraph to Section 613(b)(7) which adds coal to the list of items not included in the term “all other minerals.”²⁴

The Bill then proposes the complete removal of Section 48A of the Tax Code (**Section 48A**). Section 48A introduces a “qualifying advanced coal project credit” for some projects using “advanced coal-based general technology” in which the fuel input for the project is at least 75 percent coal. The Bill also

²³ The amendment to Section 617(f) discontinues favorable tax treatment of coal under Section 616 of the Tax Code (**Section 616**). Section 616 allows a taxpayer to deduct from “taxable income all expenditures paid or incurred during the taxable year for the development of a mine or other natural deposit” in some instances.

²⁴ An alternative to full elimination of coal entirely would be to drop the allowable level (the levels for various minerals have changed regularly over the course of this provision’s history). As the allowable percentage drops, the probability of % depletion yielding a higher deduction than standard cost depletion may drop sharply as well, so in terms of impacts on production costs at some point a reduced rate may have the same effect as full elimination.

proposes an amendment to Section 48B of the Tax Code (**Section 48B**) that removes the word “coal” from Section 48B(c)(2) and appends the products listed in the subsection with “(other than coal)” so that processes involving coal are not included in the definition of “gasification technologies” that are eligible for the “qualifying gasification project credit.”

In addition, the Bill proposes several amendments to Section 45 of the Tax Code (**Section 45**). Section 45 introduces the renewable electricity production tax credit (**PTC**), a per-kilowatt-hour tax credit for electricity produced using qualified renewable energy resources. As currently defined, the renewable electricity PTC is available for taxpayers that produce electricity subject to certain conditions, including, without limitation, that it be generated at a “qualified facility”. Under Section 45(d)(2), “qualified facilities” include closed-loop biomass facilities which meet certain criteria, including those which use closed-loop biomass to co-fire with coal. The Bill seeks to amend Section 45(d)(2)(A)(ii) to strike references to coal in this criterion, thus eliminating a tax benefit for facilities that use coal in addition to biomass, as opposed to those facilities using only biomass.

Pursuant to Section 45(d)(8) and (10), “qualified facilities” also currently include both refined coal production facilities and Indian coal production facilities²⁵, respectively. The Bill seeks to amend Section 45(d) to strike paragraphs (8) and (10) so that refined and Indian coal production facilities will not be subject to the same credit allocation as the rest of the “qualified facilities.” Paragraphs 8 and 10 of subsection (e) provide the mechanisms for tax credit allocations for refined coal and Indian coal, respectively, subject to certain pricing and criteria. Thus, in addition, the Bill seeks to strike these paragraphs so that the allocation of the tax credits for these coal production activities is removed. Lastly, the Bill seeks to strike paragraphs 7 and 9 of subsection (c), which currently introduce the terms, “Refined coal” and “Indian coal,” in order to avoid the potential confusion that would arise from introducing these terms without any further reference to them to explain their relevance.

V. Political Challenges

Although phasing out coal tax expenditures can mitigate climate change and provide other environmental benefits including reduction of localized air and groundwater pollution, the political context of fossil fuel subsidies means that such reform is not straightforward. Governments can face opposition from coalitions active in decision-making that will reject policies that violate their core beliefs, as well as from stakeholders with vested interests in maintaining the subsidies. That is why it is unsurprising that—despite President Obama’s commitment in the 2009 Group of 20 summit to “phase out and rationalize over the medium term inefficient fossil fuel subsidies”—efforts to remove favorable tax treatment for fossil fuels in the United States have been largely stifled.²⁶

In April 2015, Senator Bernie Sanders of Vermont introduced the End Polluter Welfare Act (**S. 1041**) in the Senate. S. 1041 would amend the Tax Code to close tax loopholes and eliminate other federal subsidies for the oil, gas, and coal industries.²⁷ The bill was designed to fight the climate crisis and raise revenue for essential social programs. Unfortunately, S. 1041 did not receive a vote after its introduction in the 114th Congress and was subsequently cleared from the books.

In September 2017, Representative Tulsi Gabbard of Hawaii introduced the Off Fossil Fuels for a Better Future Act (**H.R. 3671**) in the House of Representatives. Similar to S. 1041, H.R. 3671 sought to amend

²⁵ An “indian coal production facility” means a production facility that produces “indian coal”. “Indian Coal” is defined under 26 U.S.C. 45(c)(9) as coal “produced from coal reserves which, on June 14, 2005 — (i) were owned by an Indian tribe, or (ii) were held in trust by the United States for the benefit of an Indian tribe or its members.” For purposes of section 45(c)(9), the term “Indian tribe” has the meaning given such term by section 7871(c)(3)(E)(ii).

²⁶ Jakob Skovgaard and Harro van Asselt. “The Politics of Fossil Fuel Subsidies and their Reform.” Cambridge University Press. August 2018.

²⁷ S. 1041 — 114th Congress (2015-2016). End Polluter [Welfare Act of 2015](#). April 22, 2015.

several sections of the Tax Code to eliminate subsidies aimed specifically at the fossil fuel industry.²⁸ Nevertheless, like S. 1041, H.R. 3671 died in the 115th Congress. Unlike S. 1041 and H.R. 3671, the proposed Bill specifically targets the coal industry and is thus significantly more limited and targeted in scope.

While the fates of S. 1041 and H.R. 3671 demonstrate the potential difficulties that the Bill would face, changing societal attitudes toward the existence and effects of climate change, as well as recent changes in federal legislative power, make presentation and passage of the Bill more hopeful and pressing than ever. Recent data show that, for example, more than three-quarters of Republican voters now favor government action to reduce greenhouse gas emissions.²⁹ Further, a repeal of certain fossil fuel subsidies was considered as part of the “Build Back Better” legislation that was under consideration in Congress in 2021, prior to passage of the less ambitious Inflation Reduction Act. The fact that the (politically viable) Inflation Reduction Act allocated funds to renewable energy deployment but did not focus on elimination of fossil fuel subsidies may be telling. Nonetheless, there is increased political focus on this issue and the decreasing economic viability of coal may accelerate political shifts in this regard.

VI. Conclusion

Removing expenditures from the Tax Code that favor coal production, extraction, and processing should be a priority for policymakers aiming to mitigate the negative consequences of coal combustion with respect to global climate change and localized pollution. As detailed above, incentivizing and subsidizing the coal industry can result in major societal, health, and environmental costs that are no longer justified by the uncertainties that characterized drilling for hydrocarbons in the early twentieth century. Thus, the proposed Bill should be considered for passage into law.

²⁸ H.R. 3671 — 115th Congress (2017-2018). Off Fossil Fuels for a Better Future Act. September 1, 2017.

²⁹ Samantha Gross. “Republicans in Congress Are Out of Step With the American Public on Climate.” The Brookings Institution. May 10, 2021.