Analysis of Legislative Proposals to Repeal Certain Tax Treatments of Domestic Oil and Gas Exploration and Development

Texas Society of Certified Public Accountants

TSCPA Federal Tax Policy Committee

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Table of Contents

Introduction 4
Financing Oil and Gas Drilling 4
Importance of Oil and Gas Drilling to the Economy 5
Tax Treatment of Oil and Gas Drilling 6
  Intangible Drilling Costs 6
  Percentage Depletion 6
  The Manufacturer's Deduction 7
  Passive Loss Exception for Working Interests in Oil and Gas Properties 7
Conclusion 8

Introduction

The United States is currently experiencing a significant budget deficit with projected expenditures exceeding income of nearly $1.4 trillion dollars for the fiscal year ending September 30, 2011. Both Congress and the Administration are rightfully concerned with the magnitude of this deficit and both have proposed spending cuts and certain decreases in so-called "tax benefits" in an effort to reduce the size of the shortfall. Among the measures suggested by the Obama Administration are four that would have a direct impact on the oil and gas industry. These include repealing the expensing of intangible drilling costs, the percentage depletion allowance, the domestic manufacturing deduction, and the exemption to the passive loss limitation for working interests in oil and gas. The Joint Committee on Taxation estimates that, taken together, over the 10-year measuring period, repealing these provisions would generate an additional $35.6 billion[1] in tax revenue.

While reducing the deficit is a desirable goal, any effort to do so by raising taxes on oil and gas exploration and development should be weighed against its potential to exacerbate our current under-employment issue and our need for a secure source of energy. The following discussion will describe the negative effects upon the domestic oil and gas industry if efforts to repeal these provisions were to be successful. This paper will not attempt to address the longer term issues related to alternative energy development, the preservation of resources, and the environment.

This paper focuses on four provisions that are currently the subject of proposals calling for repeal: deductions for intangible drilling costs, percentage depletion, the manufacturing deduction, and the exception to the passive loss limitation rules for working interests in oil and gas properties.

Financing Oil and Gas Drilling

The U.S. is a mature oil and gas producer; finding scarce new oil and gas sources is more difficult, less certain and can be more costly than in other parts of the world. Forty percent of exploratory drilling in the U.S. results in dry holes.[2] Most new onshore wells in the U.S. are drilled by smaller, independent producers. Credit constraints of financial institutions generally preclude their participation in speculative oil and gas projects, so private investors must often provide the funds. The tax policies permitting percentage depletion and the immediate deduction for intangible drilling costs have been in the Internal Revenue code for more than 50 years, recognizing the inherent risks of the industry, and resulting difficulty in raising funds to finance exploration and production activities. Provisions similar to these oil and gas provisions apply to the mining industry and for all other land-producing minerals.[3]

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[1] Joint Committee on Taxation, "Estimated Budget Effects of the Revenue Provisions Contained in The President's Fiscal Year 2011 Budget Proposal [1]," JCX-7-10R (March 15, 2010), 9, http://www.jct.gov/publications/ (accessed March 10, 2011).

[2] American Petroleum Institute, "Quarterly Well Completion Report" (2010), Fourth Quarter, vol. 26, no. 4, Finance, Accounting and Statistics Department.

[3] However, note that the Obama Administration's 2012 budget also contains similar proposals to repeal certain coal industry tax provisions like the deduction for mine exploration and production expenditures, percentage depletion and manufacturer's deduction qualification.

Importance of Oil and Gas Drilling to the Economy

While all businesses play an important part in the U.S. economy, the oil and gas industry and the independent oil and gas producers, in particular, make a uniquely significant contribution. Energy exploration affects the availability of oil and gas which impacts our trade deficit and the security that derives from having a domestic source of oil and gas. It influences both business and household purchasing power. Any uptick in price affects how businesses, both energy and non-energy, make investment decisions for goods and services. Families' utility and fuel expenses can offset the purchase of other basic necessities. The travel and tourist industry is inherently tied to oil prices. Land values of potential oil and gas reserves along with the security interest of their financial lenders are influenced by the price of these products. An increase or decrease in the cost of oil and gas has a direct effect on inflation with energy costs included in raw materials, such as plastics, production costs and transportation costs. In addition to this indirect effect on the economic well being of the country, independent oil and gas producers directly and indirectly provide a significant percentage of jobs in many communities.

In Texas, the oil and gas industry provides more than 1.7 million jobs and accounts for nearly 25 percent of the state's economy.[4] Nationwide, the industry provides jobs for 9.2 million workers[5], represents 7.5 percent of the overall U.S. economy, has invested more than $2 trillion in domestic capital projects over the last 10 years[6] and paid nearly $100 billion in federal income taxes in 2008 alone (the latest year figures are available).[7] Moreover, it is one of the few industries that has added significant numbers of jobs in the current economy. In 2009, just the development of the Marcellus Shale gas reserves added 57,000 new jobs in Pennsylvania and West Virginia.[8] The *San Antonio Business Journal* in its February 24, 2011 issue cited a study by the Center for Community and Business Research at the University of Texas at San Antonio's Institute for Economic Development: "The Eagle Ford Shale is expected to generate more than $21.5 billion in total annual economic output and support roughly 68,000 full-time jobs in South Texas by 2020."

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If offshore wells are included, approximately 40 percent of oil consumed in the U.S. comes from domestic wells.[9] That represents an important safeguard against being overly dependent on foreign energy sources subject to the political and economic circumstances of other countries. By supporting our independent oil and gas producers, jobs are not being exported overseas and the production created is secure from international conflicts and unrest. Some foreign countries have enormous proven reserves

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[4] PricewaterhouseCoopers LLP, "The Economic Impacts of the Oil and Natural Gas Industry on the U.S. Economy: Employment, Labor Income and Value Added" (September 8, 2009), 2-3, Internet.
[5] Ibid, 9.
[6] "Capital Spending Outlook 2001-2010" (Spring), *Oil and Gas Journal*.
[7] U.S. Energy Information Administration, "Form EIA-28, the Financial Reporting System" (2008).
[8] Timothy J. Considine, Ph.D., "The Economic Impacts of the Marcellus Shale: Implications for New York, Pennsylvania, and West Virginia" (July 14, 2010), 26, Natural Resource Economics, Inc., Internet.
[9] Arthur B. Laffer, "Obama Should Forget About Energy Independence," *The Wall Street Journal* (December 18, 2008).

that prevent the need to incur exploration costs which, in turn, results in a much lower cost per barrel than with domestic reserves. Maintaining tax policies that encourage domestic exploration and development will help protect capital and jobs from shifting to foreign producers. The U.S. has been a leader in developing high-technology drilling techniques, along with energy production, income and jobs.

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Tax Treatment of Oil and Gas Drilling

Intangible Drilling Costs

The advance preparation and the actual drilling of a well are capital intensive and, even if the well is successful, it can take several years of production before the net income is sufficient to cover these costs. Without rapid cost recovery of these drilling expenditures which possess no salvage value, investors would be looking at a high risk venture with, at best, a deferred return of their investment. This financially bleak prospect is somewhat lessened by a longstanding provision in the tax law that permits an elective current deduction for the investors for these preparation and drilling expenses—technically known as intangible drilling costs ("IDCs")—in the year in which these costs are incurred. The costs would be fully deductible even without this provision in the Internal Revenue Code. If the well turns out to be dry, as is frequently the case, these same costs are immediately deductible under general tax law that applies to all business losses. If the well is successful, the tax law clearly permits these business costs to be deducted over the useful life of the well if no election to deduct IDCs was made. Permitting the deduction "up front" has no effect on the long- term revenues of the U.S. government, but it makes a difference to the investors. Depending on their marginal tax rate, they immediately have less at risk, making the investment more tolerable.

There have been proposals in Congress to repeal the election to deduct IDCs. If those proposals were to pass, it could reduce the ability of independent oil and gas producers to attract the capital investment needed to explore and produce new sources of energy. The oil and gas industry is not the only one that benefits from similar tax provisions allowing rapid recovery of high risk expenditures. For example, mine exploration and development expenditures are generally deductible and research and experimentation expenditures are deductible.

Percentage Depletion

If the well is successfully productive, the tax law since 1926 has permitted investors to claim a "percentage depletion" deduction. Percentage depletion is allowed for all natural resource production. This provision was repealed for oil and gas production for all but independent producers and royalty owners in 1975, and only then, with numerous limitations (e.g., limited to a set amount of production per year and 65 percent of taxable income). These limitations ensure that only the smallest of producers and royalty owners receive the full benefit of the deduction. Percentage depletion reduces the investor's cost basis in their investment. Although percentage depletion can exceed the basis of a well in some cases, much of this deduction would be received through cost depletion over a longer period of time. But, like

the “up front” deduction for IDC discussed above, timing is important to the investors. The proposals would repeal percentage depletion for all oil and gas wells while leaving percentage depletion intact for almost all other extractive industry production.

The Manufacturer’s Deduction

More recently, the “manufacturer’s deduction” was enacted to reduce the rate of tax on domestic manufacturing. Congress enacted the Section 199 manufacturing deduction in the American Jobs Creation Act of 2004 to assist U.S. companies competing in the world economy, and to stimulate investment and jobs formation. The U.S. has one of the highest corporate marginal rates of tax among developed countries (second only to Japan which is about to pass a rate reduction). Currently, most domestic manufacturers are permitted a deduction that is generally equal to nine percent of their net manufacturing income. That deduction has been reduced to six percent for the production, refining, processing, transportation or distribution of oil and gas and its primary products. The legislative proposals would eliminate it altogether for the oil and gas industry.

Beyond keeping jobs in America, if the manufacturing deduction were to be repealed for the oil and gas industry, it would further tilt an unlevel playing field when the domestic oil and gas industry competes for investment dollars with other, less risky, manufacturers.

What could we expect if the IDC deduction and the manufacturer's deduction were to be selectively repealed for the oil and gas industry? Wood MacKenzie completed a study in August 2010, for the American Petroleum Institute.[10] Based on a sample of 230 wells[11], it concluded that without these incentives, the number of prospective wells economically viable for investors would fall from 88 under current law to 55. That represents an increase in the economic failure rate from 24 percent to 38 percent. The study projects this would result in a loss of production of as much as three billion cubic feet per day of natural gas, 60,000 barrels per day of oil, and a reduction in investment of $15 billion in 2011 alone.[12] And that translates into 58,000 jobs at risk in 2011, rising to 165,000 by 2020.[13] The Wood Mackenzie report expects the U.S. would need higher oil and gas prices to incite drilling or almost all growth potential in the U.S. would be eliminated.[14]

Passive Loss Exception for Working Interests in Oil and Gas Properties

By way of background, the passive loss rules generally limit deductions from trade or business activities in which the taxpayer does not materially participate to the extent of income from other passive trade or business activities. Any unused losses are carried forward indefinitely or until the investor makes a tax disposition of their investment.

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[10] Study by Wood MacKenzie analyzed 230 fields and plays (onshore drilling targets) with future development potential for purposes of estimating an overall production and investment impact, “Evaluation of Proposed Tax Changes on the US Oil & Gas Industry” (August 2010), Internet.
[11] Ibid, 7.
[12] Ibid, 10.
[13] Bill Bush, “Poll: By two-to-one Americans oppose new oil, natural gas industry taxes – most cite job loss fears,” *API Energy Newsroom* (September 15, 2010), survey by Harris Interactive, Internet.
[14] Wood Mackenzie, 13.

For the last 25 years since the inception of these rules, the tax law has provided an exception to the passive loss rules where an investor directly owns (or owns through a partnership or other entity that does not limit his or her liability) a working interest in an oil or gas property. As stated above, typically drilling activities produce losses in the early years, therefore, without this exception, the current benefits of the deduction for intangible drilling costs and percentage depletion would be deferred until the well became profitable (or until the investors sold their interest). Investors look to the current tax benefits of these deductions as a mitigating factor to the inherent risk of oil and gas exploration. Moreover, there are safeguards against overuse of this tax provision: in order to take advantage of the exception, the taxpayer must be willing to structure the investment to assume the risk of financial ruin from accidents or environmental damage as a result of drilling.

Again, it is important to note this is a temporary benefit in the sense that, over the life of the well, the tax revenue will be the same. It's the timing of this deduction that is crucial to attracting the necessary capital.

Conclusion

Long-standing tax policies and tax accounting treatments are appropriate and necessary to attract investors to energy exploration and development projects. Oil and gas exploration and production is important to the economies of Texas and other energy producing areas of the U. S. Without these tax treatments, capital may not be available for many oil and gas projects, resulting in loss of jobs; a slower economic recovery and more dependence on less reliable foreign energy sources.

Changes to the tax benefits that have helped build a strong energy industry affect Texas and American businesses and households. Congress should carefully consider the far-reaching effects of any proposed changes.